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Be Like Lance

Investment managers traditionally report investment performance on annual basis. In recent times, the trend has been toward shorter and shorter reporting periods – quarterly, monthly, even weekly. We believe that focusing on the big picture of a market cycle is more important than focusing on fixed time periods.

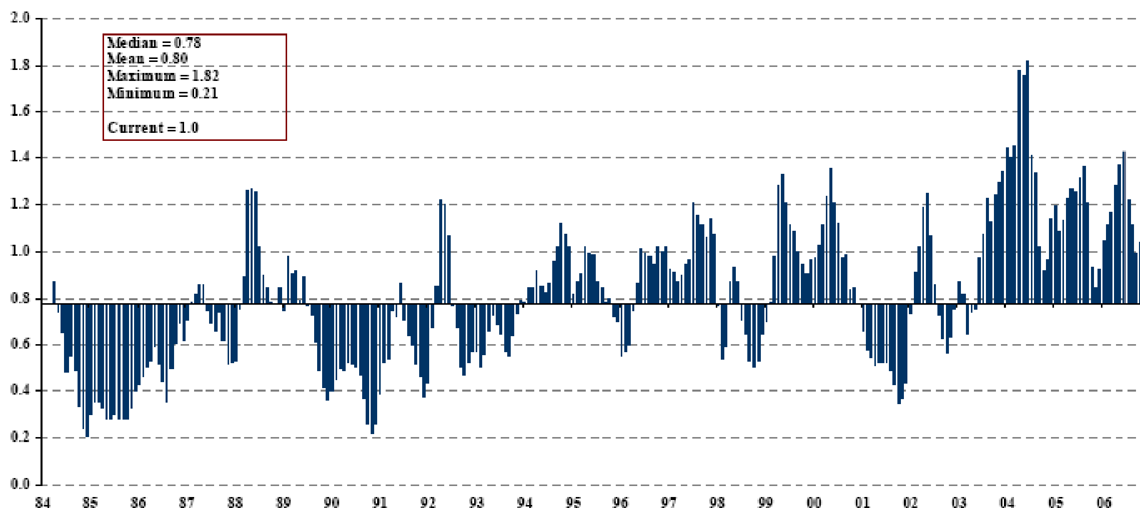
In this regard, the stock market is like cycling's Tour de France. Each year, the Tour has twenty-one stages including prologue covering flatlands, mountains, hills and time trials. The differing terrain of the various segments favors different types of riders. During his seven-year reign as champion, Lance Armstrong won only 23 of 147 individual segments.

The stock market has its own ups and downs, hills and valleys. Investors must manage through recessions and recoveries, rising and falling interest rates, accelerating and decelerating inflation, etc. Investment styles that produce fabulous returns in a particular time period or phase of the market – like the 1999 Internet bubble, to take an extreme example – may nonetheless produce poor overall results.

Like Lance Armstrong, our goal is to produce superior results over the entirety of a cycle.

Accentuate the Positive

The stock market advance over the past four years has been driven by one primary characteristic – positive earnings surprises. The chart below shows the ratio of upward-to-downward earnings revisions by Merrill Lynch analysts from 1984 through November 2006. Over the entire period, Merrill's analysts have tended to be overly optimistic resulting in ten downward revisions for every eight upward revisions.



Since early 2003, however, upward revisions have been running at an unprecedented rate in both magnitude and duration. Returning to our Tour de France analogy, the last four years have been one smooth, monotonous, earnings-driven ride. Earnings-surprise strategies look like world-beaters due to this prolonged period of favorable conditions.

Because we focus on stocks with relatively predictable earnings, our holdings are less likely to benefit from positive surprises. Our best comparative years have been 1984, 1988, 1990-1991, 1996 and 2000-2002. In most of these years, downward revisions predominated.

We believe that earnings revisions will eventually return to historical patterns. Upward revisions are already well below the 2004 peak. Earnings risks are to the downside due to tighter monetary policy, deflating home prices and a likely cooling off or reversal of the unprecedented improvement in corporate profit margins. The "Tour de Wall Street" is ready to move on. We have tracked the averages during a stage that does not play to our strength. A change to a less predictable, more problematic earnings climate should allow the benefits of our all-terrain investing to shine.

Play It Again

Last January, we offered the opinion that the S&P 500 at 16.6 times Goldman Sachs' estimated 2006 earnings of $75 was slightly undervalued and would likely increase in line with the 6% estimated earnings growth. The Value Line Composite appeared fully valued at 18.3 times earnings with estimated 3-5 year appreciation potential of 40%. It now appears that S&P earnings for 2006 will approach $81 with Value Line's earnings overshooting by a similar percentage. These "extra" earnings are entirely responsible for the better than expected performance of both indices in 2006.

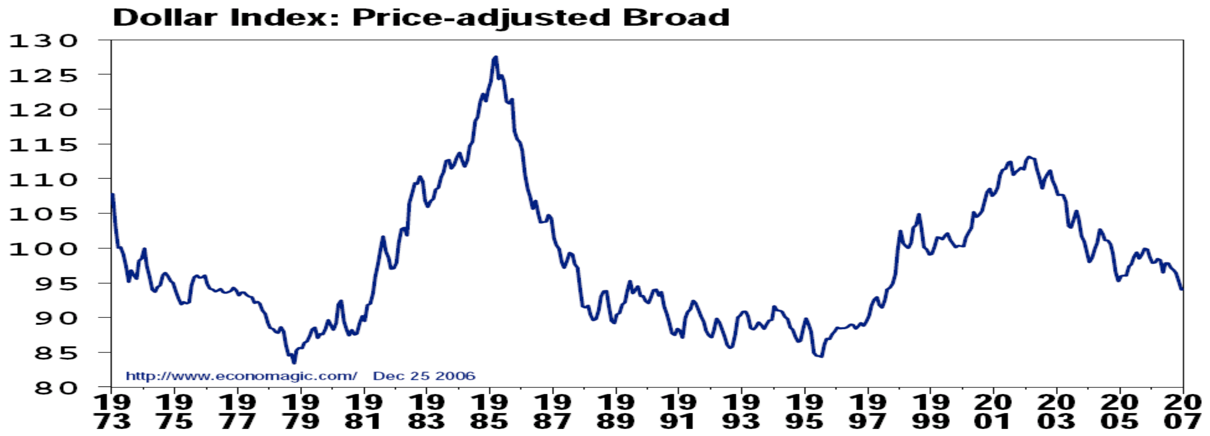
As 2007 opens, valuations are little changed from last year. The S&P is trading at 15.4 times estimated earnings of $92. The Value Line Composite trades at 18.4 times estimated earnings with estimated 3-5 year appreciation potential of 35%. The S&P has single-digit upside to its historical average of 17.7 times earnings if inflation is between 2.5% and 3.5% and double-digit upside to 18.6 times earnings if inflation is below 2.5%. The Value Line Composite is near its peak valuation in either instance. Additional opportunity consists of higher than expected earnings and/or valuations exceeding historical norms. Downside risks include earnings shortfalls, valuations below historical norms and/or inflation rising above 4.5%.

We continue to find the greatest value in high quality stocks with consistent patterns of earnings growth. In many cases, the prices of these stocks are lower than they were in 1999-2000 even though earnings per share may have doubled or tripled. Many of our current holdings fall into this category. As we have noted in our past few letters, our holdings have historically sold at a collective premium to the market average but now sell at a collective discount. As positive earnings surprises elsewhere dissipate, we believe the virtues of predictability will be rediscovered and predictability premiums will be restored.

The Dollar

The U.S. dollar has declined recently. Alarming headlines have appeared over stories attributing the fall to our perennial trade deficit, lack of domestic savings, federal budget deficit, lack of international confidence in U.S. leadership, etc. etc. etc.

The chart below follows the rambling course of the inflation-adjusted, trade-weighted U.S. dollar since 1973. Looking at the chart, one is hard-pressed to find any meaningful correlation with the factors above. The dollar was strong during the 1980's when U.S. interest rates were high and deficits were large. It was strong in the 1990's when deficits were small and interest rates were low. Over the course of 24 years, the trade-weighted value of the dollar has changed very little.



For U.S. investors, we believe the primary benefit of international investing arises from exposure to foreign economies, not exposure to foreign currencies. Foreign economies in general may experience different business cycles than the U.S. Developing economies in particular have the potential to grow faster than the U.S.

Exposure to foreign economies may be obtained through investment in companies headquartered overseas or through multi-national companies headquartered in the U.S. Our portfolios have considerable exposure to foreign economies through both of these sources.

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President