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Bailing Out

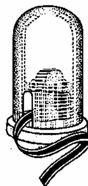
We believe the disease underlying the distress in the financial markets and the economy can be stated in a sentence: Americans borrow too freely and spend too much. Consumer spending topped 71% of GDP in 2007 compared to 68% in 2000 and 65% in 1980. Individual, business and government debt rose to 320% of GDP compared to 165% in 1981 and 130% in 1952. The only cure is to save more and spend less. A return to a 65% consumption ratio would take about $900 billion per year out of the consumer economy. This multi-year trend has investment implications which are discussed below.

While action by Congress, the Treasury and/or the Federal Reserve can lengthen or shorten the adjustment time and ameliorate or worsen the collateral effects of the adjustment, government action cannot stop the process. The Swedes opted to take their medicine quickly under similar circumstance in 1992 and the pain lasted 2-3 years. The Japanese tried to avoid taking their medicine after 1989 and their economy suffered through a lost decade. So far, U.S. policy appears to be between the two extremes.

As for investors who are understandably concerned about apocalyptic news coverage and schizophrenic market action, it may be helpful to review the basic case for equity investing. First, stocks are not just pieces of paper. They are fractional interests in businesses which have real value based on their current assets and future earnings. The economic value of these interests often differs greatly from market value. We try to exploit these differences by purchasing issues where we believe business value exceeds market value by at least 30-40%. At the market low last week, 150 stocks passed our basic statistical screen for 40% plus potential appreciation between now and the end of 2009.

Second, stocks have historically produced much higher returns than bonds or cash. According to figures compiled by Ibbotson Associates, $1 invested in S&P equivalent stocks in 1926 would now be worth about $2567 compared to $90 if invested in 20-year Treasury bonds or $20 if invested in Treasury bills. These returns span the Great Depression, World War II, the oil embargo of 1973-74, the Hunt Brothers/Bache bankruptcies of 1980, the stock market crash of 1987, the S&L crisis of 1990, the Russian default/Asian currency panic of 1997-98, 9/11 and this year's shock related to the housing bubble. As is the case today, the "D" word was often heard during financial earthquakes and the wheels could have come off the economy. But we believe the economy will muddle through. The primary goal of U.S. economic policy is to avoid repeating the 1930's. We guarantee bank deposits; we have automatic stabilizers such as unemployment insurance, Social Security, welfare, food stamps and farm payments; and we are willing, as we have already seen this year, to drop $150 billion into the system to bolster consumer spending. While one can never say never, the excess returns accruing to stock investors over the past 83 years have been ample reward for persevering in the face of uncertainty and risk.

Third, valuations are very attractive. Spreads between at-risk and non-risk assets are widest at the bottom. The gap between the earnings yield on stocks – that is, the earnings/price ratio – which we highlighted in our last two letters grew wider at the end of the third quarter. If XYZ Corp. has an estimated 2009 p/e of 14, it has an earnings yield of 7%. Investors can effectively earn 7% on XYZ with the overwhelming probability that - assuming it has a solid business model - earnings will go up over the next 30 years. Or investors can earn a sure 4.2% per year on a 30-year Treasury bond. As a long-term proposition, choosing XYZ appears to be an easy decision. However, easily said is not easily done. The urge to sell seemingly undervalued stocks in 2008 is the flip side of the urge to buy overvalued Internet stocks in 2000.



Fourth, high quality stocks with predictable earnings are on sale. Unlike the bond market, which is in a full-fledged flight-to-quality panic with investors eschewing municipal bonds, commercial paper and money-market funds in favor of Treasury-backed instruments, stock investors can buy quality companies at large discounts to historical norms. Despite expected 2009 earnings growth of 10% based on Value Line estimates and 90th percentile earnings predictability (100 is best), our stocks have lower valuations than the Value Line Universe as a whole.

Having said all of the above, we agree with J.P. Morgan's dictum that investors should not own stocks beyond their "sleeping point." Investors who cannot sleep are prone to making emotional rather than reasoned decisions. Investors must develop an allocation that is both financially sensible and psychologically sustainable.

Charting a Course

While predicting the short-term direction of the financial markets is a fool's errand, we believe there are four clear investable trends that we are using as compass points to plot our course.

1. Deemphasize U.S. consumers – As noted above, we believe consumer spending as a percentage of the U.S. economy will trend downward for the foreseeable future. This bodes ill for domestic housing, autos, retailers and others
2. Go global – the world's developing economies are likely to grow faster than developed economies. More than 40% of the revenue from our portfolios comes from abroad. Recent purchases of Nestle and Emerson Electric fit this theme.
3. Debt is dangerous – Business models that are highly leveraged and dependent on easy access to cheap credit are vulnerable in today's economic landscape.
4. Maintain exposure to oil – The long-term trend in oil prices is higher. Global oil production may be peaking while demand from developing countries is nearly certain to increase.

In summary, our goal is to find situations where the probability of gain is much greater than the probability of loss and the magnitude of the potential gain is greater than the magnitude of the potential loss. While risk is always present, we believe today's probabilities are greatly in our favor.

Jeffrey R. Scharf
President
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