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Quarterly Newsletter

Market Commentary

By Stephen C. Browne, CFA, CIO

While the equity markets performed well over the first quarter, indications that the rally is running out of steam began to emerge. With the global equity markets returning over 50% for the past twelve months and very few obviously cheap stocks available, it stands to reason that the initial stage of the recovery is over. The crisis in the financial markets has passed – companies can issue affordable debt and equity, and liquidity is available to investors at acceptable prices. However, the world is left with a host of economic issues that will likely take several years to resolve. Looking forward, the equity markets appear to be priced to deliver returns in line with historical averages of 5-6% net of inflation.

Any beliefs that the Euro could challenge the dollar as the leading global currency were shattered by the insolvency of the Greek government. This is a complex situation that will not be resolved in the short term, and many leading analysts believe that a default is inevitable. On top of this looms the poor financial condition of the rest of what has been termed the PIIGS (Portugal, Italy, Ireland, Greece and Spain). Europe lacks the labor flexibility to respond to local changes in employment. It is not only the US that faces unsustainable budget deficits and high unemployment. The UK, Continental Europe and Japan all face similar problems.

Low quality stocks led the March rally, with companies with "BB" or "B" credit ratings returning over 11% for the quarter while stocks of companies with "A" or AA credit ratings returned under 8%. Given the rally spurred a massive rotation last year from defensive sectors such as healthcare and consumer staples into more cyclical and leveraged companies, lower quality stocks are at risk for a serious correction should the direction of flow reverse itself. Credit spreads continued to tighten with the average yield on a ten year junk bond dropping to under 9%. The dollar strengthened in the wake of the Greek debt crisis leading the US equity market to outperform most indexes of non-US stocks. Emerging market economies continue to outperform the developed world, which should translate into higher earnings growth for companies operating there. MLPs continued to perform on both a fundamental and market price basis. Yields on the Alerian MLP Index declined below 7% and companies continued to raise distributions. We believe the compression in MLP yields is about finished, but relative to stocks they still offer an attractive value proposition.

Does Anyone Still Believe Markets Are Efficient?

Given the recent financial crisis one might wonder if any but the most dogmatic financial economist still believes markets are efficient. If the Internet bubble was not proof enough that markets can be irrational, certainly subprime mortgage backed securities and CDOs must surely demonstrate the fallacy of the proposition. I was recently invited to participate in a Research Affiliates Advisory Panel meeting where such luminaries of academic finance as Harry Markowitz, Burton Malkiel, Jack Treynor, John Cochrane and Richard Roll shared their opinions on various market matters. It was a valuable experience to interact with some of the founders of financial theory in an informal and personal setting. Perhaps the highlight of the weekend was a debate between Burton Malkiel, author of the famous *A Random Walk down Wall Street* (the one investment book everyone should own a copy of) and James Montier of Grantham Mayo & Otterloo, author of a recent piece in the *Financial Times* that compared the Efficient Market Hypothesis to the dead parrot in the Monty Python Sketch (the sketch involves a man who returns a dead parrot to the pet store he bought it from and the store owner who keeps denying the parrot is dead, saying that it is "just resting"). Rather than the dogmatic pronunciations of theory one might expect, what followed was a thoughtful discussion from both sides which stumbled more over semantics than actual data.

To most investors, the question of market efficiency is a simple yes/no proposition, the answer to which determines whether one should hire active managers or use index funds. While this is a simple and practical interpretation, it misses several nuances the understanding of which is beneficial. What does it really mean to say that a particular market is efficient? The answer from the conference all the participants agreed upon is simply that they are hard to consistently beat. This should be no surprise, after all the whole fact that market economies create wealth is due to the fact that the prices of any traded item, be it a General Electric stock, a bar of soap or a barrel of oil, are the result of the coordinated and collective actions of millions of individuals all working independently. If markets could not efficiently collect and process information that is dispersed among individual participants across the economy then capitalism would simply not work. The US economy contains about ten billion different things to buy (SKUs in retail parlance). Each item contains multiple inputs – commodities, labor, energy, etc. whose prices have to be reflected in the final finished good. The chains of priced items that go into even the most basic goods are staggering in their complexity. If markets were not efficient in the sense that they could not tie together the prices of inputs with end products then the economy would collapse. This was the basis of economist Frederich Hayek's key insight into why attempts at socialism are doomed to failure. His key insight was that no central planning authority could ever hope to collect and process the information contained in prices in a free market.

The efficiency of markets is perhaps better viewed along a continuum that changes over time, rather than a yes/no proposition. Analogous to a dynamical physical system maximizing entropy, over time and with a lack of new information markets move toward a maximum state of efficiency. For financial markets, the amount of new relevant information, demands for liquidity and changes in risk aversion can at times overwhelm the price discovery process. Hence, the appearance of blatant mispricing of some securities during times of panic selling. For example, one hedge fund manager we know was shorting the shares of companies trading on foreign exchanges against their US-listed ADRs and making 3-4% per day during a brief period in October 2008. This mispricing of course disappeared quickly. However longer term and more difficult to exploit inefficiencies, such as the outperformance of unpopular stocks, persist.

Some Basic Facts About The Financial Markets

■ As markets represent the sum of all investors, the average invested dollar must receive the market return before fees, making active management a zero-sum game. For every dollar invested in an outperforming portfolio another dollar must hold an underperforming portfolio.

■ For capital markets to function, someone has to buy and sell securities based upon perceptions of value. If everyone bought index funds, the financial markets would not work and financial resources could not be allocated across the economy. The economic incentive of profitably buying or selling mispriced securities has to exist for people to make markets more efficient.

■ Numerous studies of US mutual funds find very little evidence of sustained outperformance. Funds that outperform during one period are no more likely to outperform in subsequent periods than funds chosen at random. Studies of manager terminations by endowments, foundations and pension plans show that the terminated managers on average outperforms their replacement for the three year period following their firing.

■ Documented evidence exists for classes of investors who, over long periods of time, underperform the equity markets. These are primarily retail in-

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Smart Investing Monthly Conference Calls

Download available now for The Comstock Perspective on the First Quarter, recorded April 6, 2010.

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News

Grants Conference

James Engelbrecht, Senior Research Analyst, attended the Grants Conference in New York City in March.

For over 25 years, James Grant has focused on bringing a "value-oriented and contrary minded" voice to the investment world. Renowned financial writer and commentator, Mr. Grant founded *Grant's Interest Rate Observer* in 1983. As the semi-monthly publication holds itself as "the financial information medium that least resembles CNBC," the semi-annual conferences seek to bring sharp, highly esteemed and independent thinkers in finance together for a day of stimulating discussion regarding financial markets and the prevailing economy. Presentations were wide ranging and certainly not short of independent ideas. At this year's spring conference, presenters ranged from Brazilian portfolio managers to internationally renowned economists.

With such an abundance of contrarian thought and independent ideas, filtering the mass of information down to useful snippets is essential. Adrift in this ocean of information, a few themes inevitably surface. Significantly, even amongst some of the smartest and most seasoned luminaries in finance, one gets a strong sense of professionals coming to grips with a new paradigm. There is still a grappling to understand the implications of the dislocation and the effect on markets going forward. However, the resounding sentiment is that the landscape has changed on multiple levels and in intricate and nuanced ways. From the vast corporate deleveraging to unprecedented government intervention, things have changed. With this change, the struggle remains for investors to determine appropriate courses of action.

Also, contrary to some public media sources, the sky is not falling. As the investment world continues to process the repercussions of the new environment, ideas for investing continue to emerge. With the level of uncertainty that abounds, some of these investment ideas will fail but others will undoubtedly surface as winners. Mr. Grant brought in Bruno Rocha and Cristiano Souza from Dynamo Capital (Brazil) as a nod to the excitement that exists in Emerging Market opportunities. While investments like Emerging Markets are a very exciting space, we still lack the omnipotence to know what tomorrow will bring. What we do know is that in times with this level of ambiguity, sound investment processes always make the most sense. At the core of these processes for managing risk and returns is diversification.

Diversification is one of the most basic tools to limit risk in a portfolio. Will there be another bubble in different asset classes over the next few years? Almost certainly. Where or which asset class? Equities? Bonds? Commodities? If we knew the answer to those questions, only our imagination could limit our ability to profit. The cold hard truth is that we can do the difficult work of identifying the best investments with the information available today, but the "black swan" is ever hiding in the places you least expect. So to counteract this doubt, we do not conjecture as to the one bet which will win, we invest in a diversified portfolio based on the best information available.

To bring the conference to a close, David Rosenberg of Gluskin & Sheff pointed out rule number 9 from *Bob Farrell's 10 Market Rules to Remember*, "When all experts and forecasts agree, something else is going to happen." It is safe to say that Mr. Grant put on a conference that was far from running that risk. Considering the lack of agreement, one must be best prepared for anything else to happen.

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vestors who chase the performance of equity mutual funds, buying them after they have performed well and selling them when they subsequently fail to outperform.

■ Over 60% of the US stock market is held by professional investors and the average holding period for individual stocks is six months, down from over five years in the 1950s.

■ Risk has become synonymous with volatility. Many hedge fund investors are willing to pay managers four percentage points or more in fees simply to avoid short term fluctuations in value. Taxable investors are particularly disadvantaged by this structure.

What Does This Mean In Structuring Your Portfolio?

If stock picking is a zero-sum competition between professional money managers then investing like the average money manager or their average client is almost certain to result in underperformance. Over-diversification, rigid adherence to style and/or market capitalization criteria, unwillingness to accept more than a couple of years of underperformance and chasing popular stocks all should be avoided. If the average stock is held for six months it follows that there is very little ability to obtain better than market performance at that time horizon. However, it also follows that there are opportunities for patient investors willing to hold stocks for longer time periods. Perhaps the reason so many mutual funds do not outperform is because they do not even try. A significant incentive exists for management firms to hug benchmarks in order to not risk losing clients from short term underperformance. Finally, volatility should be harnessed, not avoided. Investment managers should focus on long-term fundamental values and cash flows rather than short term price fluctuations. Since its inception, Paul Comstock Partners' investment process has been based on these realities and has resulted in superior results for clients. The winning investment formula for this uncertain environment is simple: Know what you own and why you own it and do not let the panic or fad of the moment sway your actions. Maintain a good sense of future liquidity needs and plan accordingly. After 27 years of advising clients, following these guidelines is the only way we know of to successfully invest over the long term.

If you have any questions, please feel free to give us a call. A recording of the quarter end conference call is also available on our website: www.paulcomstockpartners.com.

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