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JANUARY 2010

Quarterly Newsletter

Market Commentary

A Miserable Decade for Stocks

The 26.5% return for the S&P 500 in 2009 brought a small ray of light to investors, closing what was a miserable decade. From January 1, 2000, through year end 2009, an investor in the S&P 500 had 9% less total dollars than he or she started with. The picture is bleaker as a dollar in 2009 is worth about 23 cents less than it was in 2000 due to inflation. Net of this inflation, only small cap stocks (both US and foreign) and emerging market stocks had positive returns for the decade. Furthermore, emerging market stocks were the only major area of the equity markets to significantly outperform bonds for the decade.

Along with the global credit bubble, the valuation of the equity markets at the start of the decade was a primary contributor to the poor performance of stocks. Price earnings ratios on the large cap multinational companies that comprise both the S&P 500 and foreign developed indexes were between 30 and 100. Popular investment stories at the end of the 1990s breathlessly predicted another decade of 20% stock returns driven by the limitless potential for information technology and the Internet. Of course we know now that the reality was different. The record growth in technology sector earnings in the late 1990s was a short-term cyclical phenomenon driven by a combination of preparation for Y2K (remember how that was going to cause the end of the world?) and the explosion of venture capital-backed dot.com companies. In 2000 the Y2K spending stopped. Internet companies began failing and most corporations realized they had overinvested in IT and stopped spending.

Consensus Wisdom can be Dangerous

While decades are arbitrary boundaries, they do provide a useful way to generalize longer term financial history. Each of the past four decades has unique characteristics that defined the market – inflation in the 1970s, recovery in the 1980s, a boom in the 1990s and the dismal performance of the 2000s. In hindsight, the consensus investment wisdom at the end of the last four decades usually turned out to be completely wrong for the ensuing ten years. A quick scan of Google News, for example, reveals headlines written in December 1979 entitled "The 1980s, Decade of the Farmer" or "Think Gas Prices Are High? You Ain't Seen Nothing Yet." A pundit in 1989 predicts the 1990s will be a "golden age for Japanese stocks" while another points to the similarities between 1989 and 1929 and suggests the US adopt a Japanese model of state led industrial policies to prevent disaster.

In 1969 the wisdom was to buy "nifty fifty" growth stocks like Polaroid or Xerox at 70 times earnings because they could grow at high rates forever. In 1979 oil was on the path to $100 and gold to $2000. Japan was taking over the world in 1989 and the 2000s were going to see Dow 36,000. Is the 2009 equivalent position to be down on the dollar, long gold and long emerging markets?

What does this Decade Hold?

These examples illustrate what should be obvious to all: The future is unknowable. Popular ideas become crowded trades that offer only downside once there are no marginal investors to take the position. With this in mind, the most meaningful investment trends we are anticipating are:

A) A "New Normal" period of lower economic growth for developed economies as overhang from the credit bubble and high government debt results in higher taxes and continued deleveraging in the private sector. The tension between the current deflationary reality and inflationary fears will likely continue, causing greater volatility in global bond markets. Note that this environment is not limited to the US. Europe and Japan face equal or greater economic problems as a result of the credit bubble. Wild card events include dissolution of the Euro as the fiscally restrained North separates from the heavily indebted and profligate South or a bankruptcy of Japan as its demographic problems come to the fore later in the decade.

B) Continued economic growth in the developing world. The challenge is that much of that growth is already reflected in securities prices. This growth will lead to a greater range of investment opportunities and differentiation of investment styles. Beyond broadly diversified equity and fixed income strategies, managers will increasingly develop narrower mandates. Large companies such as Petrobras in Brazil and Posco in South Korea tend to dominate their local markets and indexes. Below them is a second tier of more consumer oriented names that will benefit most directly from a growth in local consumption. These stocks are difficult to access using ETFs or most active emerging markets managers. It is likely that a few surprise shocks will provide unpleasant reminders that political risk still remains in these markets. Risks include looming natural resource supply constraints (particularly water), the potential for a Chinese equity and real estate bubble reminiscent of 1980s Japan or war between India and Pakistan.

C) Growth in natural gas consumption. Widespread development of shale gas projects has increased US proven natural gas reserves by over 40% since 2005. Volatility of natural gas prices continues to decline and moderate prices and favorable environmental attributes relative to other fossil fuels encourage more consumption. Continuing build-out of infrastructure to support the new fields, including pipelines, storage and gathering and processing facilities, provides growth opportunities for MLPs. Risks include potential for restrictive environmental regulation due to concerns about groundwater contamination on the hydraulic fracturing drilling process used in extracting shale gas or prohibitions on offshore drilling. No legislation for either is currently being contemplated by congress; although, there is a bill to require drillers to disclose the chemicals used in hydraulic fracturing and put this activity under the jurisdiction of the Clean Water Act, from which it has been exempted.

D) Materials Science will cement its position as the "Next Big Thing." A plethora of emerging technologies involving nanotech and applications of biology to creating advanced materials provides the ingredients for disruptive new technologies in energy, medicine, agriculture and water resource management. Outside of early-stage venture capital, there are few current investment opportunities, and "story stocks" almost always prove disappointing. Given the financial landscape, large companies will likely be the biggest beneficiary for marketable technologies over the first half of the decade, particularly as many of them are already very active in R&D and venture investing in this space.

While these trends appear relatively certain, their individual magnitudes and interaction with each other creates a wide range of possible outcomes. Inflation, deflation or sustained economic growth are all possible outcomes. Portfolios need to be balanced to handle a wide variety of risks, as what seems obvious today may turn out to be completely wrong in the future. Within equity portfolios, the key factor will be attention to business quality and financial strength. Easy credit and private equity are unlikely to rescue weak companies like they did during the past two decades. Within developed markets, larger companies that operate globally generally have the expertise and financial strength to adapt to a multitude of potential economic and currency scenarios. In addition, their current valuations tend to be more attractive than those of smaller cap stocks.

These long term potential trends are not new. Client portfolios have been positioned for this environment for some time and in fact, they were positioned early and missed out on the low quality rally in 2006 and 2007. Therefore the changes proposed in the oncoming year will be incremental and evolutionary rather than a dramatic departure from current positions. We are optimistic that our investment strategy, which has always focused on quality, valuation and "knowing what you own" will come to the fore this decade as the only sensible way to invest.

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