



Reports of the Death of Equities: Greatly Exaggerated

March 9, 2009

Dear Investor:

The Dow is at 6,547, down 54% from its high of 14,164 back in October, 2007. This terrible bear market now exceeds the market losses of 2000-2002.

It may seem counterintuitive to make the case for stock investment against such a backdrop, but so much value now resides in so many stocks that there's never been a better time to remain in stocks—or to buy more with bonds or cash. I realize that my words must seem ridiculous, even insulting at this point, given that I said the same thing six months ago when the Dow was down only half as much as it is now. I also realize that the more undervalued stocks get, the less people like investing in them. Call it the investor's paradox. But the case for the value in stocks can only be understood by understanding what a stock really is—a claim on the future cash flows of a business.

Value vs. Momentum

The current time reminds me of two periods when it was similarly lonely to advocate attention to value: 1) 1999, when Internet stocks fueled a mega-mania and no one wanted to invest in any real companies, and 2) 2005, when the real estate bubble was at its furious peak and all dollars flowed to housing. Neither of these periods was economically similar to the present—nor was either psychologically similar. In fact, they were psychological inverses of the present. Neither was a time of abject fear. They were times of mania, not panic. But they were the same in one respect: attention to value was declared dead.

In 1999, it was humbling to advocate value investing. I remember it well. Each day a new dot-com or tech story was the darling, and at 90 times earnings they all looked frighteningly overpriced. There were: Pets.com, JDS Uniphase, Akamai, Priceline, and DrKoop.com. The expensive heroes were Cisco and AOL. I had a very hard time keeping my clients from owning 100% dot-coms. Many days someone would call and recommend a particular high-flier. I would proclaim it dangerous and overvalued, to watch as it went up another 20% the next day. I denounced Internet stocks for two years in my client newsletters, only to see them do nothing but rise. I even re-examined my own strategy of sticking with value, in the context of people claiming it was a "new paradigm," that brick and mortar stores were the buggy whip factories of the day—or that nothing would "ever be the same." Or that my strategy was outdated, old-fashioned, or just plain dumb. The grand exemplar of value investing, Warren Buffett, was widely mocked at the time for not buying tech stocks because he said they were too expensive and hard to understand. We all know how the story ended: The Nasdaq collapsed 78% and most Internet stocks disappeared from the map.

In 2005, I was at a cocktail party. Someone told me they had taken all their cash and put it into real estate investment properties. I told him I thought that real estate was overvalued and that

funneling money in at current prices was dangerous. He asked me a very good question: Would I have said the same thing a year ago. I said that I would have. “Then you would have missed out on the huge gains since then,” he replied. Of course, he was right. The real estate market had skyrocketed over the past year and my Cassandra-like prediction of collapse looked silly. But the reality was that all real estate, whether valued at cap rates, or cash flow multiples, was overvalued. It wouldn’t have mattered if it became *more* overvalued before it collapsed—unless you could expertly dart in and out of your holdings and time it perfectly—because all prices revert to fair value eventually. And they did.

In both these bubbles, value was forsaken in favor of recent patterns, or what’s commonly referred to as *momentum*: the wrong-headed assumption that what goes up will continue to go up—regardless of intrinsic value—simply because it’s gone up in the past.

Today is the psychological inverse, but momentum—this time downward—once again rules the day. People assume that stocks will keep falling because they’ve been falling, regardless of intrinsic value. The very idea of stocks rising seems absurd, since stocks seem to do nothing but go down, day after day, week after week, month after month. The trend is down, the momentum is down, the pattern is down. It all seems like a foregone conclusion that all stocks will go to zero. And once again, I’m too early in advocating value over momentum. My pitch for equities may seem either stubborn or overly optimistic.

But I know that stocks were not expensive a year ago when they were trading at 16 times earnings (their long-term average price to earnings ratio, p/e), and they are downright bargains trading at 13 times trough (lowest) earnings today. Even accounting for further depressed earnings levels, stocks are as cheap as any time since 1982, especially after adjusting for current interest rates: The p/e ratio is really just an earnings yield expressed in reverse. In other words, a p/e ratio of 13 is the same as an earnings yield of 7.7% (1 divided by 13), which is very attractive compared to current Treasury bond yields of 3%.

In fact, the last time stocks were truly *expensive* was in 1999, when the S&P was at 30 times earnings and the Nasdaq north of 80 times earnings. That was the last time that it made sense to sell stocks on valuation—so I recommended decreasing equity exposure at the time. Yet, by definition, that was when people poured more dollars than ever into stocks. Today, at 13 times trough earnings and 11 times ten-year average earnings, stocks are being tossed to the curb by people who are selling when they should be buying.

Numerous research studies show that the average stock investor: (1) buys when things look rosy (e.g. 1999), then (2) rides stocks all the way down to a panicked low, (3) capitulates and sells when things look most bleak (4) buys back when things look safe again (by which time stocks are already up sharply and bargains are gone), then (5) repeats the pattern back down, compounding losses. This type of buying high and selling low, though a recipe for repeated wealth destruction, is wholly understandable in terms of human nature. That’s why the necessary motto is to buy low and sell high, or as Buffett likes to say: “be greedy when others are fearful and fearful when others are greedy.”

Why Intrinsic Value Matters

To understand why intrinsic value matters, we need to step away from the panic and the bleak macro picture to understand that stocks are valued on earnings or cash flows. The latter is preferable because it strips out the accounting fictions of depreciation, amortization, goodwill write-downs and other non-cash charges. I teach my NYU students to follow the cash flows, not the earnings, because cash is what a business actually runs on.

Let's take the example of Automatic Data Processing, or ADP (which is a core holding in both the Turray Fund, which we own for clients in separate accounts, and in the JBGlobal Fund). ADP is the largest payroll processor, the leader in a tremendously stable and unglamorous business. Due to rising unemployment, its stock has been hit hard, despite the fact that ADP has virtually no debt, an enormous cash position, healthy cash flows (even in this severe recession), and virtually no chance of going bust. I chose ADP but I could have chosen so many of the stocks now trading on the Dow, given how undervalued stocks are on a global basis.

ADP is currently trading at \$32 per share, or 9 times its operating cash flows of \$3.50 per share. In 1999 it was around four times as expensive, trading at 37 times cash flows. In effect, it is selling at a 76% discount to its 1999 price. People get excited when a pair of shoes, a car or a house sell at a 76% discount—but not stocks. As Benjamin Graham (the father of value investing and Warren Buffett's mentor) liked to say, you should buy your stocks like you do your groceries, not as you do your jewelry: you should be happy to buy a stock when it's on sale, even if a bleak environment is responsible for the sales price. As value investors often preach, you pay a dear price for a cheery consensus.

Intrinsic Value Understood Through a Real Estate Analogy

To understand intrinsic value, let's analyze the case behind owning ADP in terms of real estate. Imagine you own a house outright in Miami that you rent out for income. The house was appraised at \$500,000 at the peak and would now sell for \$250,000. You rent the house for \$36,000/yr. After property taxes and maintenance expenses, you net \$25,000/yr. Your cash flow yield on the house was thus 5% at the peak (\$25,000/\$500,000) and is now 10% at the bottom (\$25,000/\$250,000). Said differently, the price was 20 times cash flows at the peak and is now only 10 times. Let's assume that, given the dire economy in Florida, you'll only be able to rent the house next year for a net \$20,000 (this is similar to decreasing earnings estimates for a stock to a conservative level to account for a prolonged and severe recession). This will still provide an earnings yield of 8%. If the house goes down further in value, the earnings yield will only *increase*.

Similarly, at 9 times cash flows, ADP offers a cash flow yield of 11% (the inverse of 9/1 equals 1/9 or 11%). To the extent any of this cash flow is not paid out to the shareholder in the form of dividends, it will be used to buy back stock or to invest in the business, either of which should boost cash flow over time.

If I told you that your Miami house could continue to decline in value and you should sell it, you might say I was crazy. You would point out that you're getting 8% net of expenses on your house, money you could reinvest in the property to increase its value over time. You would point out that there's nowhere else you could get 8% on your money. If you put the \$250,000 into a savings account or T-Bill, you would earn close to zero. You would point out that inflation will diminish bond and cash income over time and will, therefore, lead to losses in real terms. You would explain that there's no way your house can be anything but undervalued based on that current cash flow yield (in terms of prevailing interest rates) and, thus, you would never sell it unless it was trading way above intrinsic value, at a cash flow yield under 2%. If I told you that everything looks scary and that the price could go down another 30% or 40%, you would say that the cash flow yield makes holding onto the house worthwhile and rational. You would again assert that the property is clearly undervalued, even if it goes down further in price before going up again. And you would be right.

There are also times when an asset is overvalued according to a cash flow analysis. A few years ago, real estate cash flow yields were pitiful and we wrote about it in our newsletter of August, 2005:

A comparison of this ratio for the average NYC-area apartment shows massive overvaluation. Even the outer areas look--to use Greenspan's new term--"frothy." Our own recent analysis of random properties bears this out. An average New Jersey home, for example, can be purchased today for a monthly carrying cost of \$4,298 (including mortgage payments, property taxes, maintenance, net of tax deductions) while a comparable home can be rented for \$3,100. This shows an overvaluation of 38.6% based on the historical norm that rental costs should roughly equal purchase costs. This disconnect proves that some distortion is going on in the sales market, namely interest rates. If the normal pistons of home prices-population and wage growth-were driving gains, rental prices would be higher. The Monopoly money of artificially low interest rates is what's propping up home prices.

The house in Miami is easy to hold onto, but if I told you the same thing about ADP, you would have less conviction. Stocks are abstract and harder to touch and feel. They are marked to their market price every second during the trading day, and such price action can be terrifying. They also seem riskier, but much of that risk is no greater, since a company, like real estate is ultimately underpinned by its assets and cash flow.

If your Miami house were valued by the second on your laptop, it might be hard to watch. If you saw the price going down 10%, 20%...or 50%, as any Florida house *has* during the past three years, you might get scared enough to call a real estate broker and ask if you should sell. If you could sell the house with the click of a mouse, without any paperwork, lawyers or closing documents, it could all be hard to resist.

Stocks get sold in panicked ways because they are: (1) abstract (2) easy to sell (3) difficult to understand and (4) hard to value.

Clearly, the real estate investor gets to touch the cash himself, which provides a tangible feeling of ownership. And the business must be well-run in order for the cash-flow yield to accrue to the shareholder. But the economic case for owning any asset is the same. Whether it's a house, a private business or a stock, it should be valued relative to its underlying cash flows and to the expectation of future ones. This is the logic behind a discounted cash flow valuation, a technique that tries to discount all expected future cash flows of a business back to the present (to adjust for the time value of money). On a discounted cash flow basis, the market is now 40%-50% undervalued, according to Morningstar. It was 20-25% undervalued a year ago. The value was there then, the value is greater now. Follow the value, not the momentum. Just as I never advocated jumping on the bandwagon of Internet stocks in 1999 or real estate in 2005, I would not recommend jumping on the bandwagon of panicked selling of stocks when the value increases daily. Even if stocks get cheaper, value will show itself eventually.

A concern that people often have is that stocks will go to zero. As you can see from the cash flow analysis, that's nearly impossible unless a company files for bankruptcy, since the value of the cash flows puts a floor on the stock price. If a stock gets too cheap relative to healthy cash flows, it will become an acquisition target and value will be realized eventually. Of course, a company must be well-capitalized and have strong cash flows in order for value to be unlocked. Only companies that survive will provide investment returns. The solution is to focus on corporations that have invincible balance sheets and unassailable cash flows, of which there are many, even in this deep recession. The other answer is to diversify across at least 10-20 companies, and often many more, so that the inevitable blowup or two does not derail the investment plan.

Warren Buffett and the Intrinsic Value Approach

Warren Buffett readily admits that his secret in acquiring enormous wealth was not vastly superior intelligence, prescience, or any trading strategy—but in always looking at stocks for what they really were: claims on the underlying cash flows of a business. Instead of trying to time the market, trade in and out, predict macroeconomic trends or divine the next stimulus package, he simply tried to buy businesses selling at reasonable prices relative to their cash flow and hold them for long periods of time—as they increased in value—often “forever.”

His secret was in understanding that when the price of a valuable business goes down, it’s time to buy, not sell. This understanding allowed him to hold stocks during the paralyzing market of the Seventies. At that time, the world seemed like it was coming to an end with Watergate, war in the Middle East, Vietnam, horrible inflation, recession, price controls, gas shortages, double digit unemployment and riots in the streets. But he held and bought more stocks (as he is now) because he understood the value at such prices.

Market Timing Just Doesn’t Work

Everyone harbors the fantasy that they can dart in and out of the market, picking bottoms, fleeing tops and trading the channels in between. One of the most common questions we get is: “Why don’t you sell, sit in cash for awhile until everything looks better, and then buy back in at the bottom?” There’s a simple answer: *It just doesn’t work*. It’s exactly as effective as reading your future with coffee grinds, tea leaves or entrails.

Short-term market moves are absolutely unknowable and completely indiscernible. Everyone has a story of the person who timed this or that entry or exit perfectly. That person, if they’re honest, will admit they were lucky, not prescient. The person who claims to sell at the top was fortunate, not “skilled” in the same way someone who correctly calls a coin toss “heads” is lucky, not “right.”

Hindsight is 20/20 and patterns that look knowable after the fact are not knowable ahead of time, but neither the gambler, nor the market-timer, ever will admit it. There’s an old expression about traders: “A person who times the market perfectly is called a liar.”

I can assure you that if there was any convincing evidence that a sustainable strategy of moving in and out of the market showed any signs of working, we would use it. Every study (including our own detailed work examining the returns of 8,000 mutual fund returns, of every imaginable strategy, over the past two decades) shows it just doesn’t work. If it worked, everyone would be rich, since it’s the most intuitive, most common approach. But it’s exactly the common, intuitive nature of the approach that prevents it from working. The dynamic of markets—that they price in human emotion and available information instantaneously—prevents any one participant from profiting on a sustainable basis from timing moves in and out of the market. We don’t know of any market timers in the Forbes 400, but we do know of many, great, long-term investors.

On the other hand, rebalancing from overvalued sectors to undervalued sectors, or from overvalued stocks to undervalued ones, is what we specialize in doing. This is not market timing. It’s a process that aims to capitalize on *what* will happen (reversion to fair value) while remaining agnostic as to *when* it will happen (which is unknowable).

In the wake of the past “lost” decade, where stock returns were negative (even with dividends reinvested), many will draw the conclusion that long-term investing is dead. This will be the wrong conclusion to draw at precisely the wrong time. Given that the twenty-year annualized

return on stocks (with dividends reinvested) is usually 10% (and almost never less than 6%), the next decade should easily provide double-digit returns. Pure reversion to the mean tells us so. Many forget the power of dividends on stock market returns. Even if the market were to end at 6,500 in 2020, the current 3% dividend yield would provide a compound return of more than 40% over the next decade, far more than cash will yield.

Over the past century, across many different countries, through pestilence, plague, wars, and dictatorships, stocks have somehow managed to return 10% a year on average. This remarkable result, profiled in the book [Triumph of the Optimists](#) (Dimson, Marsh & Staunton), analyzes how the equity risk premium holds stable over time, and the return equities provide relative to bonds does as well.

To look at the power of long-term investment (over a longer term than even the youngest of us can admittedly consider) watch how \$1 grows in different investments. \$1 invested 100 years ago is now approximately the following amount in various asset classes:

Stocks: \$10,000
Real Estate: \$400
Bonds: \$100
Gold: \$20
Savings Account: \$15

The point is not that any of us has a 100 year investment time horizon, but that long-term investment works. Even over any 20 year trailing period of time, stocks win—and win big. That’s why the world’s second richest man is a long-term stock investor, not an economist, bondholder or gold bug (the richest is a software entrepreneur).

Even during the Great Depression, stocks turned eventually. The Dow reached a low of 41 in July of 1932. Then the Dow began a remarkable reversal. The index climbed a stupendous 377%, from 41 to 194, over the next five years. This climb took place against a backdrop of Hoovervilles, soup kitchens and breadlines. In the way that markets do, the Dow started pricing in recovery long before it actually occurred. Those who sold at the bottom, when things looked most bleak, never knew when to get back in. By the time things looked “safe” enough to invest, it was far too late. This is the paradoxical way markets work, confounding the market timers and those who trade based on gut or instinct.

Long-term investing is painful because it involves riding the highs and lows—and then the highs again. But there is no better, sustainable system. It’s like losing weight. There are pills, fads, and potions galore. But the only things that really work—diet and exercise—are the hardest to do and the least popular. It reminds me of the description often used of Democracy: long-term investing is a terrible system, but it’s still the best one.

When to Sell Stocks

A logical question we’ve been getting a lot lately is “When would you sell stocks?” The first answer is: not when things look bleak and thus prices are panicked, when you guarantee yourself a poor return. The logic of this approach looks questionable when prices go still lower, but remember the real estate investor at the cocktail party. Prices can go still lower, or still higher, but the best time to sell stocks is *never* when they’re undervalued. Whether or not they were undervalued a year ago at a moderate multiple to cash flows, they are definitely undervalued now by any logical measure of value, even accounting for a terrible recession and decline in the underlying cash flows. Keep your focus on the present and the future, not the recent past. The

human obsession with the recent past is a phenomenon well-noted by behavioral finance. It's called "recency" and it's the way people extrapolate past events (or returns) into the future, even as those past returns become less likely to repeat.

I am not a stock market "cheerleader" or perma-bull (see 1999). I do not receive any commissions or excess compensation for advocating stocks. Our firm takes a fee on the percentage of assets under management (and performance fees in the JBGlobal Fund L.P. on profits) and since those fees rise and fall along with those asset levels, I would never recommend stocks unless I thought that recommendation would make those asset levels rise over time. My belief in stocks is predicated only on their value.

There *are* four situations when we recommend selling stocks:

- 1) *When stocks are grossly overvalued, the atmosphere is giddy, and everyone is optimistic.* At times like these, stock prices are often at bubble valuations. Think of 1999, not 2009. Wherever you think we're headed, today is clearly *not* one of those times.
- 2) *If you need a certain amount of cash within a 3-5 year time period, it cannot be in stocks.* The vagaries of stock prices on a five year basis are unknowable, but history tells us that prices usually revert to fair value over five year periods. For example, if you need money for a down payment on a home, tuition payment, or emergency, that money cannot be in stocks. It must be in cash or bonds. If you are in retirement and drawing from your portfolio for living expenses, you must have a certain allocation in bonds or cash to fund current needs.
- 3) *If you just can't take it anymore.* If worrying about the market is keeping you up at night or ruining your health, you might consider cutting your allocation to equities. In today's environment, it's understandable to do this, but I still don't recommend it. A better approach is tuning out the market and dissociating yourself from the day-to-day panics in the market. Let us do your worrying for you. If you sell stocks just to make yourself psychologically comfortable, you're selling for the most popular, and the worst, reason. It's the very reason most people don't get rich. You will pay a heavy price by coming back in once it feels "safe." By then, prices will have already recovered dramatically. If you sell out of fear, it's best to just say stocks are not for you and never buy a stock again. But you will then be leaving yourself open to the ravages of inflation, as you keep your money wholly in cash or bonds.
- 4) *If you think we're entering another "Great Depression"* If you think we're entering another Great Depression, as defined by 30% GDP contraction and 25% unemployment, then stocks are overvalued even now. Selling stocks today would be logical. We don't believe this is so, but more on that later. Keep in mind that it would have to be a *Great Depression* to make selling stocks here and now worthwhile. Even a "regular" Depression of 10-12% aggregate GDP contraction and 15% unemployment would not make selling stocks today a logical choice, because stocks have probably already priced in that expectation.

Economists as Investment Advisors

Economic columnists and finance theorists, not investors, seem to be influencing the public investment psyche more than ever before. Whether via Krugman, Roubini or Schiller, people are deriving their investment strategies from the wrong source. These voices deserve their large

followings because they know the macro situation; however, some of them—like the broken clock twice a day—are right only by dint of saying the same thing for 20 years and then having their moment finally arrive.

However informative these voices may be on the macro picture, they have little to do with the investment strategy of the average person. Economists are not professional investors, nor are professional investors economists. They are two separate fields with separate skill sets. An economist is trained to measure the tide of the economy, but not whether the levels of the economy ***have already been priced into the stock market.*** This is a crucial point. Economists do not spend their time looking at the case for individual companies and fair value. They usually approach things from a macro level, not the practical investment level.

Taking investment advice from an economist is a little like getting your annual physical from a biochemist: she may be trained from the same textbooks as your doctor, but you wouldn't let her take out your appendix. The biochemist might know more about the mechanisms of the circulatory system than your cardiologist. But would she know the right dose of Lipitor to prescribe?

It's often noted that economists shine at times of pessimism because they only see how things can fail, never how they can succeed. Perhaps that's why economics is called the "dismal science." In any case, there are far more investors in the Forbes 400 than economists. As far as I know, Roubini, Krugman, and Schiller are not billionaires. But Buffett, Munger, Davis, and Brandes *are*. From whom would you rather take your investment advice? Choose your oracle wisely.

Another Great Depression?

The question still looming large is whether another "Great Depression" will occur again. The gap between a severe recession (or even a "regular" depression) and a "Great Depression" is vast. An error in the measure of that gap can lead to major mistakes in a long-term investment plan. We continually check the current facts against history, and history shows that a "Great Depression" is an aberration, not a normal cyclical collapse.

The Great Depression involved 30% aggregate GDP contraction and 25% unemployment. We are currently at a 2% aggregate GDP contraction and 8.1% unemployment. Despite the best attempts of journalists to conjure images of the Great Depression by showing picture after picture of people waiting in line at job fairs and the like, the reality is that the scale is all wrong.

People were terrified when the media reported the 6.8% contraction in GDP in the fourth quarter, not realizing that this was on an annualized basis. In other words, it only was a 1.7% or so aggregate contraction. The contraction would have to stay at that level for four quarters to add up to a 6.8% *aggregate* decline. It could. It may even be likely at this point. But even that wouldn't reach the level of the lowest threshold of the 10% aggregate decline seen in a "regular" depression.

Could we go to 30% and 25% respectively? It's possible but unlikely. All the differences between 1930 and today make this type of systemic and unrestrained complete collapse a very remote possibility. To reiterate the distinctions we compiled in an earlier letter:

- 1) FDIC insurance, which did not exist at that time, is preventing deposits from leaving the banking system and seeking haven in a mattress. Instead deposits are shifting from weakly capitalized banks to well-capitalized banks such as J.P. Morgan Chase. In

addition, strong depository institutions are acquiring weaker ones, protecting these deposit bases and sparing the FDIC costly payouts.

- 2) The entire social safety net of social security, disability, unemployment insurance, etc. did not exist during the Great Depression. Most of these important innovations were signed into law by President Franklin D. Roosevelt in 1935. The existence of these government programs will cushion the contraction in the economy caused by job losses.
- 3) The Fed is heavily biased toward promoting liquidity. Though credit markets remain stunted, low interest rates and the Fed's purchases of securities will maintain a bias toward money supply expansion. In the Great Depression, the gold exchange standard prevented this flexibility. The Fed's actions will promote liquidity but with some unwanted consequences: an expansion of the Fed's balance sheet which will eventually lead to much higher interest rates and a debasement of the dollar. But that's another problem for another day.
- 4) Global trade is still intact. Though the credit crunch is contracting global trade to very low levels, it's not halting it as did Smoot-Hawley protectionism during the Great Depression.
- 5) There are many well-capitalized institutions expanding lending, even in this constrained credit environment. J.P. Morgan Chase, Wells Fargo, and Hudson City are just a few of the banks committed to seizing market share through aggressive expansion of their loan books.
- 6) The amount of cash on the sidelines is staggering. There's an estimated \$4 trillion in money market funds. This is an enormous pile of money available for spending, investment, and debt repayment. Though it may remain where it is until some measures of confidence return to the financial system, it is an unprecedented reserve of funds that sits dormant and waiting for deployment.

On the other hand, the facts that would incline toward another Great Depression are as follows:

- 1) Policy mistakes are the key ingredients of a major depression. It takes a cascade of very poor policy decisions to create one. Washington's bungling of the bank stress test is an example of poor policy begetting more problems. The longer the stress test looms incomplete, the longer confidence takes to return.
- 2) The credit crunch is very severe. If a revised bailout or Fed intervention fails to unfreeze the credit markets, a severe recession could turn into a Great Depression. However, the history of most credit crises (1907, 1982, 1990, and many others) is that reasonably priced lending does resume once intervention stabilizes the system. The Thirties was the outlier in this series, not the norm.
- 3) Fear and panic snowball. The media compound this problem.

I believe it's important to invest for probabilities, not limited possibilities; that is, for the more probable outcome that the bulk of our country and institutions will survive, not the limited possibility that none will. This is because history is littered with predictions of ends that never came. Thus, logic, as opposed to panic, dictates no other approach. As we've said before, panic

and nihilism are not investment plans. A recent op-ed in the *Wall Street Journal* put the odds of a depression (the regular type as measured by 10% GDP contraction) at 20%. Many people will latch onto the 20% figure and sell everything. But this can't be the logical choice. If you saw a roulette wheel with 80% of its wheel shaded green and the remaining 20% red, would you bet on red? Of course not. Any rational approach would dictate otherwise. But the red looms so much larger than the green, and the possibility of the red is so scary, that it distorts logical decision-making.

Returning to the medical analogy, a biochemist might tell you that you have a 20% chance of getting prostate or breast cancer based on your genetic profile. If you went to a doctor and asked for a prophylactic prostatectomy or mastectomy on that basis alone, any rational doctor would decline. Is it possible you might end up with prostate or breast cancer in two months? Of course, but it's unlikely, and it doesn't render the doctor's original decision misguided. Doctors can only make decisions on what's observable and probable, not what's remotely possible and invisible. Investment advisors must work the same way.

Our personal view is that we might come close to "depression" levels but will not hit "Great Depression" levels. Again, the distinction may sound technical, but it's crucial. In other words, we *will* probably hit 12-14% (not 25%) unemployment and 7-8% (not 30%) aggregate GDP contraction. This will all be painful, but none of it comes close to a "Great Depression" and none of it justifies selling stocks here, since stocks have already priced in this bleak expectation.

Remember that the cultural memory of the Great Depression makes another less likely in that policy makers will try everything to prevent it. This type of reaction is more likely to lead to new, different mistakes and new, different problems (i.e. inflation) than to the same old deflationary spiral that caused the Great Depression.

Only Exponential Gains Lead to Exponential Declines

One issue I haven't seen covered by the press is the sense of proportionality that should exist between rises and declines in index price levels. For example, a giddy, euphoric increase in stock prices has *always* preceded a collapse that falls beyond the 60% level.

Our research shows that every major market collapse that exceeded 60% peak-to-trough had been caused by an exponential, parabolic rise in the preceding 5-7 years. The following shows all the mega-collapses (as defined by greater than 60%) of the past 100 years and their preceding stock rise:

Market Collapse	Peak-to-Trough Decline	Increase in Preceding Period
Dow 1929-32	89%	546%
Nikkei 1989-95	63%	292%
Nasdaq 2000-02	78%	615%
Dow 2007-09???	54%???	94%

As you can see, if laws of proportionality should hold, we are nearly done with our declines, whatever the economy. There has never been a time in the past 100 years where a major index has fallen more than 60% without first experiencing a parabolic increase of more than 250% in the preceding years. Given that we already had a bear market in the Dow from 2000-02, many of the excesses of stocks had already been wrung out. When the market recovered from 2002-07, the recovery was a near doubling—not the parabolic, exponential rise that precedes an 80% collapse. In fact, whatever comparisons are made to the Great Depression, one thing that's quite different today is the scale of the preceding stock boom.

Perspective

The one thing everyone needs to keep in mind is perspective. No good investment decision ever came from panic, despair or single-minded pessimism. In 1999, no good investment decision grew out of wild-eyed optimism. There are many positive aspects brewing now, just as in 1999 there were many negatives people ignored. This type of tunnel vision, where people view the future as only good or bad, tends to occur at market inflection points, when it's about to change its direction.

At such inflection points, fashions and shams hold sway. In 1999, the popular books were *Dow 36,000* (that one was right on the money, wasn't it?) and *The New New Thing*. Today they are the *The Black Swan* and the *The Great Depression Ahead*.

At a similar inflection point, in 1979—the year that marked the end of that other “lost decade” in stocks, the cover of *Business Week* proclaimed: “*The Death of Equities*.” It should have read the “*Birth of Equities*,” since the greatest 20 year bull market in history had just begun—and no one even knew it yet. That infamous magazine cover is the biggest example of recency that journalism has ever known. All fashions become less fashionable with time. But long-term investing is not a fad or a fashion. It's a classic.

Much rationale/rationalization is now propagated to explain why stocks will never go up again: (1) growth will never return (2) the economy will never rebound (3) globalization is dead (4) China's growth has been permanently derailed. Some of these are 10% true. None is completely correct. These grand sweeping statements—that transform grey into white and black—are never as valid as they sound. They are oratorical triumphs, because their sound bites cause panicked selling. But they are merely the inverted analogs to the 1999 sound bites that caused panicked buying, such as: (1) the market will never go down again (2) the Internet justifies unlimited growth (3) dot-coms will rule the world (4) brick and mortar is doomed.

The common incantation “*This time it's different*” is growing very popular, just as it did in 1999. As Sir John Templeton reportedly said, these are the four most dangerous words in investing, because nothing is ever that different. Everything that's happening now has actually happened before. It satisfies the ego of humans to believe their time on earth is unique, but it never quite is. To the extent it doesn't match exactly, it's just set against a different backdrop. As Mark Twain said, “History doesn't repeat, but it rhymes.”

At the Allen & Company conference in 1999, the “new economy” was in full triumph and the phrase “new paradigm” was all over the 'net. According to Alice Schroeder in her book *The Snowball*, Buffett gave his controversial speech predicting the end of the Internet bubble on a valuation basis. Herbert Allen agreed, saying: “*New Paradigm? There's No Such Thing. It's Like New Sex. It just doesn't exist.*”

Looking Forward

Among the factors that will help turn the economy (and markets) around—as they always have before—are the following:

(1) Cash in money markets is at \$4 trillion. This is enough to buy half the entire U.S. stock market capitalization. Once a hint of optimism returns, this money will start to find a home in the stock market. Just a small portion can cause massive price rises from this low base.

(2) China's stimulus appears to be gaining traction. Shipping rates are up, as are some commodity prices, hinting at a bottoming of the Chinese economy.

(3) The world is engaged in the greatest coordinated monetary and fiscal stimulus in history. By some estimates, total stimulus approaches \$10 trillion, 20% of worldwide GDP, a percentage that approaches the stimulative impact of WWII, the war that finally got us out of the Great Depression. Policy makers will make different mistakes by debasing the currency and reflation the world. This will lead to high inflation, but the chances of a deflationary spiral are reduced.

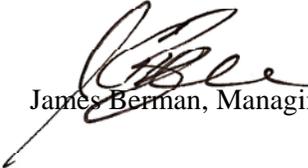
(4) Recent inflation numbers bear this out. We appear to be in a period of flat or slightly rising aggregate price levels (disinflation), not deflation. This indicates that monetary stimulus is having some effect.

As to our client's personal situations, the important thing is a correct asset allocation. A heavy equity allocation is still the best approach for those who won't tap money for three to five years, since there are very few periods in financial history where large-scale market recovery wouldn't occur by then. Those who need money within a few years should have enough in bonds to cover that need.

This is a bleak period looking backwards at recent losses, but may well be a once-in-a-lifetime opportunity looking forward and focusing on value. The successful investors will be the ones who wait out this period and reap the rewards once the tide turns, which it will. Soon we hope.

With best wishes,

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James Berman, Managing Member