Meritäge Portfolio Management

October 1, 2010

Investment Update

A Glass Half Full

As quarters go, this was a good one. Good enough to pull most stock indices into positive territory for the year and good enough to give some pause to the doom and gloom crowd. The pattern of big swings in investor sentiment did continue in the third quarter, the difference being this quarter ended on a high note.

For most of the year, stocks have tracked the roller-coaster expectations of the economic recovery. These expectations hit bottom coming into this quarter as the year-old recovery lost momentum. Fears of a double-dip recession, sovereign debt risk and deflation concerns overshadowed relatively good performance from corporate America.

The pessimism seemed to be overdone. Bearish indicators were at levels not seen since the market bottomed in March of 2009. The third quarter included some positive developments, but most of the reported data was simply not as bad as feared. Sometimes that's all it takes to trigger a turn-around, but broad-based uncertainty remains high as does the likelihood that the pattern of sentiment swings will continue.

At the core of this uncertainty is slower economic growth, which means a trend line closer to no growth. As such, there is very little cushion for any below-trend news. If there is certainty anywhere, it has more to do with continued anemic job growth and a non-existent housing recovery. Even more revealing is that 15 months after the official end of the recession, world central banks are unable to wind down many of the extraordinary measures they established to deal with the financial crisis.

We did say that there were some positive developments in the quarter and those are worth noting. The BP disaster has abated as did the political circus surrounding the Goldman Sachs indictment and financial reform. There is a greater likelihood that the Bush tax cuts will be extended and mid-term elections suggest a more pro-business tone coming out of Washington. Consumers continue to consume and de-lever, the Fed looks for ways to provide more stimulus, and corporations are refinancing their debt at historically low interest rates.

Is It Really Different This Time?

Three years ago we wrote a piece in the Worth Mentioning series titled It's Different This Time. In that note, we questioned the popular notion that strong global growth would support commodity prices (energy, metals, agriculture, etc.) through a normal business cycle and give commodity investors protection in down markets. When stocks weakened in early 2008, commodity prices initially held up fine, but by mid-2008, they collapsed along with stocks as the global growth story became a global recession story. What was believed to be different turned out to be anything but.

The idea that entrenched historical patterns and cycles no longer have relevance has generally been costly to investors over time. Not surprisingly, the chorus of "It's different this time" becomes loudest at times of market extremes, when it's easiest to rationalize current levels and get comfortable with predictions of more of the same.

Today is no exception. The financial collapse of 2008-09 and the current recovery-challenged environment have produced a variety of assertions that history will again be a lousy guide for the future. One of the more widely accepted views along this line is the "New Normal" description of the economy – an extended period of slow growth, high unemployment, increased government intervention, corporate malaise, nominal bond yields and below-average return opportunities for stocks.

This certainly describes current conditions. History, though, tells us the deeper the recession, the stronger the recovery, but few are able to defend that argument today, including us. Is this another case of believing it's different this time? Maybe, but we think not, primarily because we are emerging from a different kind of recession – one triggered by an atypical debt crisis rather than a normal business cycle. Among other things, this means the corrective tools to stimulate the economy, like lower interest rates, are less effective, because high interest rates were not part of the root problem.

In the face of this new paradigm outlook, other familiar, long-held beliefs about the markets are also said to now be different. These include:

- "Stocks will outperform bonds over the long-term."
- "It's a stock pickers market."
- "Excessive monetary stimulus will result in uncontrolled inflation."
- "The dollar is the reserve currency of the world."
- "You can't time the market."

We appreciate that the experience of the past few years teaches investors to take nothing for granted, but we also see the "It's different this time" net being cast too wide. We can argue that none of the generalizations above will prove different over time, but we take particular issue with the cavalier dismissal of the first two.

Statistics highlighting the retreat from stocks by individual investors are of interest, but we find implications that this represents a long-term secular shift somewhat curious. One headline from a large equity research department proclaiming the "Death of the Equity Cult" does seem a little over the top. While we do understand why investors' long-term faith in stocks has been shaken, it is rash in our view to call for the descent in equities at a time when stocks have already underperformed bonds for the longest period in 70 years. The timing of such bold statements at this point in the cycle is classic. We also question this logic when the outlook for bonds and other asset classes seem equally, if not more, challenged.

In a similar vein, our contrarian instincts take comfort from claims that the recent dominance of macro (big picture) factors on market moves and increased use of trading baskets of stocks (ETF's) will render the selection of individual securities as largely ineffectual. In our view, in a market where overall performance opportunities are expected to be sub-par for some time, security selection may, in fact, turn out to be the best opportunity to generate distinguished returns. We welcome this popular chatter - it makes us all the more confident that our focus on individual companies is where we need to be.

At the heart of our investment philosophy is the belief that our focus on company fundamentals will drive portfolio performance. While most of the attention in this current environment has been on daily economic and political headlines, we are encouraged to see investors once again seek out companies that possess the characteristics that are emphasized in our models. In particular, we are seeing positive attribution coming from factors like historical growth, profitability, free cash flow and price momentum. Companies with excess cash and strong balance sheets are benefiting from increased merger and acquisition activity, as are companies showing top line growth since the benefits of cost cutting may be largely behind us.

Much of what is overhanging the market today seems unprecedented – an inconceivable budget deficit, terminally low interest rates, and a regulatory tsunami. The tools to combat these obstacles, at least for now, seem overmatched. All true, but also helpful to remember that markets have experienced other challenging economic periods that were equally unsettling at the time. Mark Twain once said "History doesn't repeat itself, but it does rhyme." Something to keep in mind when it gets too easy to accept that this time, it really is different.

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