

Q1 2008 Commentary: Traversing a Gauntlet

*By Bob Marshalla
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The title of last quarter's commentary, "A Stormy Year – More to Come?", ended with a question. Three months later, the answer to that question is clear: "you betcha"! This past quarter we saw \$110 oil and the failure of Bear Stearns, one of the five top investment banking franchises in the nation. The stock market declined in each of the months of the quarter, and has now fallen for five consecutive months for the first time since 1990.

There are signs that the worst may be over. The market has been shrugging off continued huge write-offs and other bad news, and has actually perked up a bit since mid March as it begins to look forward to a recovery, perhaps late this year.

But to quote myself in last quarter's commentary, the operation of the credit markets is still far from returning to normal. This is the most uncertain and scariest factor in this slowdown. The collapse of the housing markets and associated mortgage woes are rightly cited most often as the major causes of the current slowdown / recession. But we can pretty much count on how that cycle will unfold – things will gradually get better, even if we do not know how long it will take or exactly how bad the situation may get before they do.

On the other hand, the credit market problems are unprecedented and far less well understood. Many commentators say we have not experienced anything like this since the 1930's. On the plus side, we learned a great deal about liquidity problems from that experience. It is now well understood that the Fed took the exact opposite policy that it should have at the time by tightening credit rather than flooding the market with liquidity. This greatly contributed to pushing the economy over the precipice into full scale depression. In his earlier professional life, Ben Bernanke has done significant scholarly research about that era, and in the present crisis he has proven to be aggressive and creative in finding ways to enhance the market's liquidity and confidence. No one knows yet how well these actions will work out, nor what other remedies may be on the way, but so far I'd have to say he has done an impressive job. I believe the odds are pretty good that we will get through this crisis in months, not years. Still, given the unprecedented nature of the problems, you never know. We are indeed traversing a financial and economic gauntlet.

The remainder of this commentary has two distinct sections, first a specific review of recent market performance, and second a discussion about market timing as it relates to the stock market. "Market timing" is the practice of attempting to increase or decrease exposure to a given asset class in hopes of exploiting the periodic ups and downs of that asset class's performance. I decided to discuss the topic now because during the market turmoil of the past few months I have received about an equal number of queries about whether I thought it might now be a good time to decrease or to increase equity exposure.

Review of Market Performance

Market Returns – The S&P 500 lost 9.5% in the first quarter, and as of quarter's end it had fallen by 15% from its recent peak on October 9. The performance amongst sub-market classes was much more uniform in the first quarter than it had been last year. Large, mid and small caps all turned in about the same results, as you can see in Table 1, as did domestic and international stocks. This is significant mainly inasmuch as it may signal the stalling if not reversal of last year's trend of notable under-performance by small cap stocks. Growth and value stocks also performed about same, with value winning out by a small margin. Again, this is significant mainly inasmuch as it may signal the stalling if not reversal of last year's trend of substantially better performance by growth than value stocks.

Table 1 - First Quarter and Last Year's Returns

	Representative Index or Fund (blue font)	1st Quarter 2008	Year 2007
U.S. Equities			
Full U.S. Market (98% of Mkt Cap)	Russell 3000	(9.5)	5.1
By Market Cap			
Large Cap	S&P 500	(9.5)	5.5
Mid Cap	Russell Mid Cap	(10.0)	5.6
Small Cap	Russell 2000	(9.9)	(1.6)
Micro Cap	Russell Microcap	(12.4)	(8.0)
Value & Growth			
Value Stocks	Russell 3000 Value	(8.6)	(1.0)
Growth Stocks	Russell 3000 Growth	(10.4)	11.4
Economic Sectors			
Best	Consumer Staples	(2.8)	
Worst	Information Technology	(15.4)	
International Equities			
Large Cap	MSCI - EAFE	(8.9)	11.2
Small Cap	MSCI - EAFE Small Cap	(6.2)	1.5
Emerging Markets	MSCI - Emerging Markets	(11.0)	39.4
MAM Equity Benchmark	.8* Russell 3000+.2* EAFE	(9.4)	6.3
Real Estate			
Equity REIT's - Domestic	NAREIT Equity Index	1.4	(15.7)
	Morgan Stanley US Real Estate	3.2	(16.6)
Equity REIT's - Foreign	EPRA Global ex US Index	(9.3)	(0.9)
	Eur. Investors Int'l Property	(6.9)	(7.1)
Commodities			
Commodity Futures	Dow Jones AIG Com Index	9.6	16.2
	PIMCO Commodity Real Ret	14.4	23.8
Fixed Income			
Investment Grade Bonds	Lehman Aggregate Bond Idx	2.2	7.0
Inflation Protected (TIPS)	PIMCO Real Return Fund	5.5	11.6
Int'l Bonds, Developed Mkts	PIMCO Foreign Bonds	10.8	10.5
Emerging Mkts Currencies	PIMCO Developing Local Mkts	3.4	13.2
Floating Rate Bank Loans	Eaton Vance Floating Rate	(6.2)	2.0
Ultra Short Bonds	Schwab Yield Plus	(19.8)	(1.0)
Short Term Money	3 Month T- Bills	0.6	4.8

In other asset classes, domestic real estate pulled out of last year's tailspin (down 15.7% last year) and eked out a 1.4% gain in the first quarter (while our domestic real estate fund did better at 3.2%). Meanwhile international real estate performed worse than last year, and seems to be marching to its own beat as we might expect for a diversifying portfolio element. The market index lost 9.3%, although the fund we use did better with only a 6.9% loss.

Commodity futures was the runaway winner among the asset classes in which we invest, as the Dow Jones AIG Commodity Index increased by 9.6%. Meanwhile the PIMCO commodities fund that many of us use, and which combines commodity futures with TIPS investments, had a spectacular quarter with a 14.4% gain. As you may recall, the most important reason we added commodity futures to our portfolio allocations was its historical lack of correlation with common equities, and that is showing up now in a big way now¹.

Like last year, the various fixed income categories had wildly different performances. Continuing on last year's performance, foreign fixed income and TIPS (inflation indexed bonds) excelled. At the other extreme, the troubles with floating rate bank loans and ultra-short bonds not only continued, but got much worse. The perverseness continues, as these categories are supposed to be the next safest after money markets.

One particular ultra-short bond fund that we have favored, Schwab Yield Plus, has turned out to be a disaster. Its exposure to mortgage backed securities was apparently higher than previously admitted. Now its investors have essentially made a run on the fund, which has exacerbated their problems as they have been forced into distress selling. At least two class action lawsuits are being planned against the fund, and we are looking into joining one of them. Last month (March 27) we sold all remaining MAM clients' shares of this fund. The fund value has continued to drop and has fallen another 7% since the last MAM shares were sold two weeks ago.

Volatility – If the stock market has seemed to be especially volatile recently, it's because it has been. In the first quarter (plus April 1) the S&P 500 experienced:

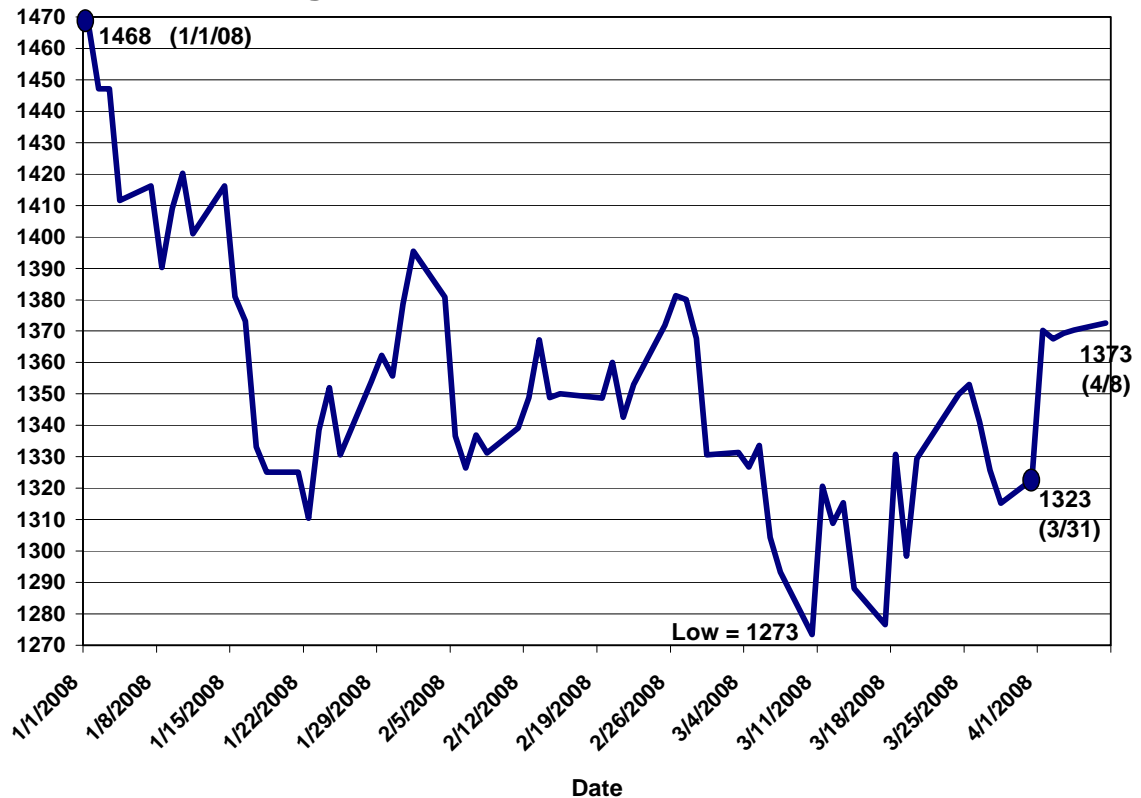
- 11 sessions with one day losses² greater than 1.5%, and
- 8 sessions with one day gains greater than 1.5%.

And remember, the S&P 500 tracks only the largest of stocks. All told, almost 30% of the market days in Q1 had changes greater than 1.5% in magnitude (up or down). In fact, there were three sessions just within the last two weeks of the quarter in which the market gained more than 3.5% in one day. Those are enormous moves for one day!

¹ I made the case for including commodity futures in our portfolios as a top level asset class in a paper dated September 30, 2005, entitled "The Case for Diversifying with Commodity Futures". The paper is posted on the MAM website.

² Cited losses and gains are measured from daily market close to market close, and do not consider sometimes even greater intra-day movements.

Figure 1 - S&P 500 in Q1 2008



Market Timing

The stock market has been a real headache since last summer – extremely volatile from day to day, but generally headed downward. Should we get defensive for awhile by decreasing equity exposure and wait for signs that the worst is over before getting back in? Or has most of the bad stuff already happened so that we should consider more aggressively buying stocks, especially in the hardest hit sectors, so that we can enjoy the benefits of buying in at amazingly low prices? Or should we take the boring route and pretty much stick with our current equity targets?

In the earlier discussion on market volatility I mentioned that the market gained more than 3.5% in one day three times last quarter. But interestingly, there were no days in which the market was down more than 3.5%. So despite the market's performance for the whole period being an awful -9.5%, there were more really big up days than down days. For a period this short this is likely just a matter of chance. Nevertheless, it is somewhat indicative of how the market bounces around. The market goes up over time not so much because there are so many more good days (or other short periods) than bad as because it goes up more on the good days than it goes down on the bad days.

This is one of the things that makes market timing so hard. In recoveries the market tends to come back in short explosive rallies, and the timers who were out of the market often have a hard time getting back in time to catch them.

Several studies have shown that for a market timer to beat a buy-and-hold strategy he needs to be even more accurate than you might expect in calling the turns of the market. A couple of finance professors did a simulation study in which each quarter the simulation considered a decision to

either be entirely in stocks or entirely in T-Bills³. Obviously in quarters in which stocks outperform T-Bills, the correct timing decision would have been to be in stocks, and vice versa when stocks underperform. The decision was modeled to occur randomly every quarter. The question it then addressed was, what percentage of correct calls - i.e., being in stocks when they do well or out of them when they do poorly – would one need to have made in order to just equal a static buy-and-hold strategy. You might think this accuracy threshold would be somewhere just above 50%. But the surprising result they obtained is that the timer needs to be right over 70% of the time just to break even with buy-and-hold. The study covered a 50 year period from 1926-1983. While results will differ depending on time periods selected, other similar studies have yielded similar results.

An aspect of market timing that is sometimes ignored is that to be fully successful over a market cycle, the timer needs to make two correct calls – when to get out and then when to get back in again. Even if she could call both of these events with 70% accuracy, she would tend to get both right only about half the time (assuming, perhaps incorrectly, independence between the two decisions).

Some other information on the difficulty of market timing comes from the world of investment newsletters. There are actually a few hundred investment newsletters published by organizations from Morningstar to Bob Brinker to your local huckster that offer investment advice for a fee. Many of these practice market timing and many do not. Mark Hulbert is an analyst of sorts who has published his own newsletter for 28 years now, the Hulbert Financial Digest (HFD). Its purpose is to track and compare the performance of all the other investment newsletters using a consistent and objective methodology. I have subscribed to his newsletter at times, have seen him speak a couple of times, and I think he has good credibility.

Occasionally he looks at how well market timing has been working amongst those newsletters that practice it. The most recent was about a year ago⁴ when he reported on the percentage of market timing strategies tracked by the HFD that would have beaten a buy-and-hold strategy over the five years ended January 31, 2007. The results for market timers were, in a word, abominable. Only 8% of the market timing strategies outperformed buy-and-hold. He further massaged the data to compare what he calls “risk-adjusted returns”, and this improved the results to 24%. But the risk adjustment process is somewhat dubious,⁵ and the adjusted results, while better, are still very poor indeed.

A couple of points to keep in mind when considering these results. For one, they are quite sensitive to the time period analyzed, particularly for periods as short as five years. Hulbert has found better results for market timing strategies in other time periods, particularly when stocks were performing poorly. This is probably because market timers tend to be out of the market more than buy-and-hold investors. But over long periods the data simply do not support the value of market timing strategies over the newsletter universe.

A second point is that Hulbert carefully distinguishes the effects on performance due to timing versus that due to security selection. Timing results have to do with the editors’ advice on increasing or decreasing equity exposure, not on which particular stocks they are recommending. That aspect of performance is separately attributed to security selection, and is considered to be independent of timing.

³ Gains from Stock-Market Timing (Monograph series in finance and economics, 1986-2) (Paperback) by Jess H Chua & Richard S. Woodward (previously available on Amazon.com)

⁴ The Hulbert Financial Digest, February 2007, p.1

⁵ The risk adjustment process gives the timers credit for being less volatile than stocks when they were out of the market, even though the stocks were generally trending upwards during those periods.

Another perspective on the relative success or failure of market timing advice comes from a comprehensive study by two business school professors from Duke⁶. This study examined 237 newsletters during the period 1980 through 1992. The authors compiled statistics concerning stock market performance in the month following each newsletter's buy or sell recommendations. What they found was that when newsletters recommended an increase in equity weights, the subsequent one-month equity market return was in fact positive 70.4% of the time. This doesn't sound too bad – until you consider that in the months succeeding a recommended *decrease* in equity weightings, the market proceeded to go up 69.4% of the time, essentially the same percentage as when they recommended increases in equity. The percentage of newsletters that recommended changes in equity weights in the correct direction for the subsequent month was 50.1%, really no different from a coin flip.

We may worry that one month is too short a period to test the efficacy of timing recommendations. But when the same authors looked out six months, the results were even worse. The mean annualized return of the stock market in the six months following recommendations to increase equity was 12.7%. Again, this sounds pretty good, until you consider that the mean annualized return six months out after recommending *decreases* in equity exposure was 16.2%, significantly *better* than the returns following increase equity recommendations.

So the evidence is pretty clear: market timing is really hard, so hard that it is probably not worth attempting except perhaps in the most extreme of circumstances. I think there are two major reasons that market timing is so hard:

1. Imperfect correlation of the stock market to macro-economic performance – There is no doubt that the economy's performance affects stock market performance. After all, when you buy a stock what you are buying is a future stream of corporate earnings. And macro-economic performance is essentially the aggregate of all companies' earnings streams. So in the end, they are one and the same. But it should take no convincing to say that accurately predicting macro-economic trends is exceedingly difficult, if not impossible. And making it so much worse is the fact that stock market performance does not track economic performance contemporaneously. The market is a forward looking pricing mechanism, so the prices of stocks are based on what market participants think will happen in the future, not what has happened to date. So even if we knew the future path of GDP and inflation for certain for the coming year or two, we would not be able to reliably predict when the stock market might turn up or down.⁷ We would *still* have to understand what all the other market participants thought was going to happen and how that was affecting their investment behavior.
2. Razor's edge in the valuation of stocks – If we could estimate the true economic "fair values" of stocks with reasonable accuracy, then one might think we could effectively employ a valuation-based form of market timing -- buying more equities when market prices are below our estimates of fair value and pruning equity exposures when market prices are above fair value. The theory of what constitutes a stock's fair value is neither mysterious nor controversial. Any student of financial economics could recite the formulas. The problem is that the forward looking assumptions that go into these

⁶ Graham, J.R. & Harvey, C.R., "Market Timing Ability and Volatility Implied in Investment Newsletters Asset Allocation Recommendations," Journal of Financial Economics, 42 (1996)

⁷ Unless of course everybody knew it. But the assumption here is that only we have access to the wizard. Market prices continue to be set based on all the other participants estimates, so to use our information effectively we would still have to understand how the other participants are processing the information they have.

formulas are quite uncertain, and even miniscule changes in them can alter one's conclusion of fair value by substantial amounts. They sit, effectively, on a "razor's edge". For example, the formulas for fair value are based on finding the present value of all future cash flows generated by a company. The items in this calculation include discount rates and earnings growth rates, both of which must be projected into the future essentially forever. Anyone who has ever computed the present value of a very long (if not infinite) series of future cash flows can appreciate that even a tiny change in discount rate or cash flow growth rate can lead to a very large change in present value. So to get to the point, it's not that hard to compute an estimate of a stock's or even the overall market's fair value, but the range of uncertainty around that estimate will always be quite large.

So to get back to the question posed in the first paragraph of this section, do I think this is a good time to decrease equity allocations, increase them, or leave them pretty much the same as they have been, I believe it most prudent to go with the last one.

Equity valuations do look quite tempting based on the standard numbers. The forward P/E ratio of the S&P 500 is currently less than 14, which is lower than it has been in many years. On the other hand, the "E" part of the P/E ratio is pretty shaky. The "E" is the aggregate of analysts' earnings estimates for the coming year, and if the economy sinks deeper into recession than the perennially optimistic analysts are assuming, then the actual P/E ratios could end up being quite a bit higher. It's hard to get excited by a plea of "don't just do something, stand there!" But as it applies to broad equity market timing, the more action oriented alternatives would be more foolish than brave under current conditions.

Despite the evidence of how difficult it is to profitably practice equity market timing, I do not rule it out under all circumstances. If I felt the market valuations were enormously attractive or notoriously overblown, I would not be "religiously" opposed to altering our equity targets in the indicated directions. But for the reasons outlined above, the valuation metrics and/or my conviction about future economic trends would have to be very compelling indeed before I would take such actions. And that is not the case right now, even despite all the market turmoil we have been experiencing.

Best Regards,

Bob Marshalla
Your Financial Advisor