CUBIC ASSET MANAGEMENT, LLC

2010 1st Quarter Stock Market Commentary

THE DOCTRINE OF PEOPLE INFALLIBILITY

"If Columbus had an advisory committee he
would probably still be at the dock."
- Arthur Goldberg

On January 28, 1986, the engines of the space shuttle Challenger roared to life after six consecutive days of postponements. The rocket carrying the shuttle rose majestically, seemingly in slow motion, to the applause of the assembled onlookers. It had a crew of seven, which included Christa McAuliff, the first member of the Teacher in Space Project. To the horror of millions of viewers who watched a live broadcast of the launch, the rocket exploded seventy-three seconds into the mission, killing everyone on board. Almost immediately, the stocks of the publicly traded companies that were contractors to the Challenger program started to drop: Rockwell International, the builder of the shuttle and its engines, Martin Marietta, who made the external fuel tanks, Lockheed, the company responsible for ground support, and Morton Thiokol, who built the solid fuel booster rockets. In a study of the behavior of those stocks on that day by Michael T. Maloney of Clemson University and J. Harold Mulherin of Clarement McKenna College, the authors showed that all four companies dropped between 3-6% within minutes. Trading was soon halted in Morton Thiokol, as sell orders so overwhelmed buy orders that the specialist assigned to the stock on the New York Stock Exchange was unable to maintain an orderly market. When trading resumed, Morton Thiokol continued to decline, finishing the day down 12%, for a total loss of $200 million, while the other three stocks staged a small rally to each finish down 2-3%. Immediately after the tragedy, President Ronald Reagan appointed Secretary of State William Rogers to investigate the cause. Four months later the Rogers Commission published its findings in a 225 page report. While the Commission cited poor communication within NASA as a contributing factor, the primary cause was deemed to be "failure of the O-rings on the aft field joint on the right solid rocket booster." The O-rings were manufactured by Morton Thiokol. Stock investors had seemingly solved the mystery within hours of its occurrence.

The stock market behavior described above is a stunning example of what James Surowiecki has dubbed *The Wisdom of Crowds*, in his 2004 bestselling book of the same name. His thesis is that under certain circumstances, the collective wisdom of a large group of non-experts can produce a better solution to a complex problem than a single expert. His book is full of amusing anecdotes and case studies supporting this thesis. The crowd, though, will only produce a reliable conclusion if four criteria are met: 1) there is a diversity of opinion, 2) individuals draw their own conclusions independently of the other members of the crowd, 3) the crowd is decentralized, so that each individual views the problem from his/her own local perspective, and 4) there is a mechanism for aggregating the data.

The idea of exploiting the wisdom of crowds predates Surowiecki's book. In fact, there are any number of (hopefully) profit making companies based upon the supposed accuracy of "prediction markets". As one example, consider Hollywood Stock Exchange, or HSX, an online multiplayer game designed to forecast the success of upcoming of movies. On HSX, players buy and sell virtual shares of films, using virtual money. As in any other market, enthusiastic buying causes the price of shares to rise, while selling causes it to fall. The ultimate value of stock in any particular movie will be its box-office take during the first four weeks following its release. Thus, if the stock for the next James Bond movie is trading for 60 "Hollywood dollars", this implies that players think that the latest 007 adventure will take in $60 million in its first month in theaters. In 2007, HSX players correctly predicted 32 of 39 Oscar nominees in the major categories and 7 of 8 of the major category winners. After the tech bubble burst in 2000, HSX's venture capital backers sold the company to the brokerage firm Cantor Fitzgerald, who uses it to accurately set the odds of a movie's success for its London bookmaking operation.

Another company based upon the presumed accuracy of the opinion of crowds is Piqqem (pronounced "pick 'em." Piqqem uses proprietary statistical techniques to aggregate the sentiments of a large number of individuals to provide forecasts of stock price movements. Its backers include Mike Markkula, the first investor in Apple, and its CEO is Jett Winter, who has headed numerous high-tech startups over the past two decades. In the second quarter of this year, Piqqem permitted users to vote on the likely direction of eight different stocks. In six of the eight cases, the crowd predicted that the stock would continue moving in the same direction that it was already going. But in two cases, Amazon and Microsoft, the users' sentiment ratings dropped sharply as the dates for the release of earnings approached. In both cases, the stocks continued to move higher, until both companies missed earnings forecasts, causing their stock prices to fall. Thus Piqqem's users were more accurate than the stock market, which is itself a form of prediction market. The company is in the process of expanding the number of stocks it analyzes to 20. Piqqem is only one of several "wisdom of crowd" stock market forecasters. PredictWallStreet, Motley Fool CAPS, Cake Financial and Covestar are some others.

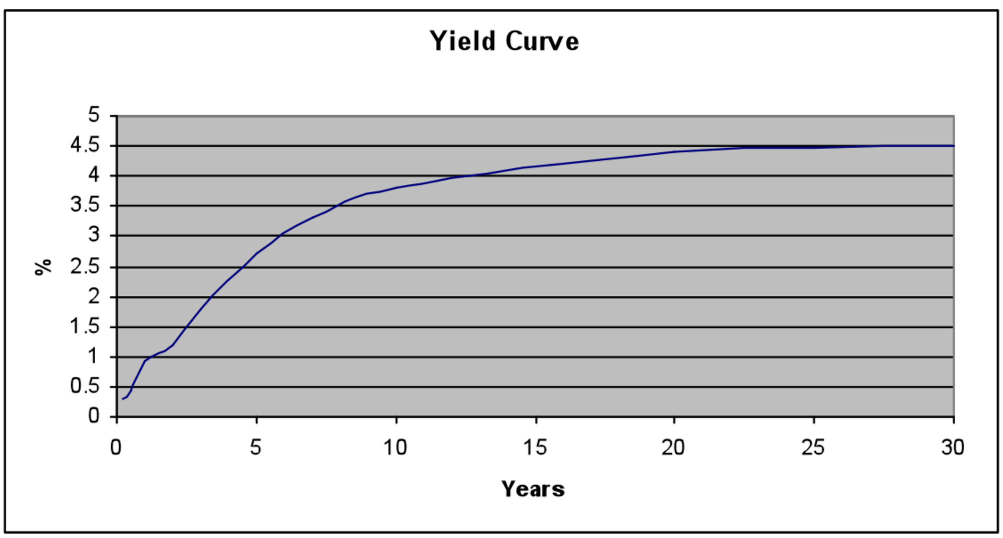
Betfair.com is yet another prediction market, this one oriented toward sports wagering. Betfair is the largest online betting company in the world, with over 2 million members who wager roughly $4 billion/annually. In this case, this is real, rather than virtual, money. It is not well known in the United States, since U.S. law forbids online gambling. Some studies have indicated that Betfair's users set odds which are 15% more accurate than traditional bookmaking operations.

Obviously, author James Surowiecki, and the backers of the various companies discussed above, cite example after example of the predictive ability of the masses. But the crowd is far from infallible, and proselytizers rarely cite contrary evidence. On February 1, 2003, disaster once again struck the U.S. space shuttle program, when the Columbia disintegrated over Texas during re-entry to the atmosphere at the conclusion of its mission. All seven crew members were killed. The mission had been postponed on eighteen separate occasions over two years. The biggest loser in the stock market the next day was Alliant Techsystems Inc, the then owner of Thiokol, which made the booster's rockets. The stock fell roughly 12%, the same percentage decline as in the previous Challenger disaster. Boeing, which owned Rockwell International, fell slightly over 1% and Lockheed Martin dropped 3%. The market, recalling the earlier tragedy, once again concluded that Thiokol was responsible. Subsequent study showed that the shuttle failure was the result of damage sustained during takeoff when a suitcase sized piece of foam insulation from the rocket broke off and dislodged some of the tiles forming the Shuttle's thermal protection system. But the foam insulation was manufactured by Lockheed's Michoud division, not by Thiokol. Oops! It would seem that traders with memory of the previous disaster immediately rushed to (an incorrect) judgment.

Despite the counterexamples, the wisdom of crowds is well documented. What is it telling us now?

As everyone not living in a cave knows, the downturn was initiated by an increase in the default rate on sub-prime mortgages, defined to be mortgages offered to people who are not credit worthy by lenders who should know better. The trouble soon spread to Alt-A and Prime loans, bringing the banking system to the brink of collapse. Banks, in turn, began rationing credit. Businesses down-sized their workforces, and consumers tightened their belts, faced with the triple whammy of job losses, declining investments, and plunging home values. Given this progression, one would not expect those industries at the core of the economic maelstrom to be doing very well. But the sector index for home construction stocks has risen over 110% sine the market's low on March 9, 2009. Retail stocks have risen 98%. Financial company stocks are up an unbelievable 156%. Thus, for the last twelve months, the stock market has aggregated the opinions of millions of large and small stock investors to produce a clear forecast – an economic recovery is underway, it is going to be vigorous, and will likely be led by the very industries which led the way down. The fact that fourth quarter real GDP growth came in at an annualized rate of 5.6% would seem to confirm the wisdom of the crowd.

But stock traders on Wall Street are only one of the two major "crowds". There is also the crowd of bond investors, who, collectively, are sending a quite different message. First, yields are near record low levels across the entire spectrum of maturities. This is what one would expect if there was a widespread expectation of deflation, rather than a recovery which would likely bolster prices. Second, at the long end the yield curve (shown below) is flattening, suggesting that consumers (both domestic and foreign) are reducing consumption and increasing savings, absorbing the massive supply of government bonds being issued to finance the record deficit. Since consumer spending comprises over 70% of gross domestic product, an increased savings rate does not bode well for demand. These pessimists point out that the



recent GDP growth was bolstered by a tax credit for first time home buyers and the "cash-for-clunkers" program, so that the economy may not really have grown at all. Consumer sentiment continues to slide, personal spending is declining, and unemployment is still climbing.

So how can we reconcile these radically different crowd forecasts? Who's likely to be right? Probably nobody.

Surowiecki points out that in order for the aggregated views of the crowd to produce a reliable result, there must be diversity of opinion. But bond investors are, by nature, a cautious lot. According to

Investopedia, an online investment-oriented site affiliated with Forbes magazine, bonds "are known for their consistency. Large swings in prices have been known to occur as interest rates fluctuate or during downturns in the health of the issuer, but they are not the norm." The site goes on to say that "many people who are attracted to debt or make it a substantial portion of their portfolio are more risk averse than their stock holding … counterparts. A bond investor may also be a little more even-keeled in terms of demeanor in that they may not be looking to make a killing in the market …"

By contrast, the site goes on to describe stock investors as seeking high risk and high excitement, and as people who have the patience to hold their investments through periods of volatility. It would appear that neither the crowd of stock investors, nor the crowd of bond buyers, meets Surowiecki's requirement for diversity. Instead, each group is somewhat homogeneous. In order to obtain a truly heterogeneous view, I would suggest that we should aggregate the two forecasts. This would suggest that the economy will recover, but slowly, disappointing stock market bulls and resulting in positive, but modest returns. But it also suggests that bond investors are likely to be disappointed, too, since even a modest recovery will force interest rates higher than the record lows of today. It would only take a rise of 0.5% on ten-year bond rates to produce a negative total return for bond investors over the next twelve months. If this is correct, the stock market will be a much better place to be than the bond market over the next few years. This type of forecast seems quite probable to me, even if it is less likely to produce the dramatic headline "Economy Enjoys V-Shaped Recovery", that the stock market's behavior is hinting at, or "U.S. Suffers Double Dip Recession", that bond market investors are implicitly predicting. There is wisdom in crowds, provided we look at the right crowd.