2012 1st Quarter Stock Market Commentary

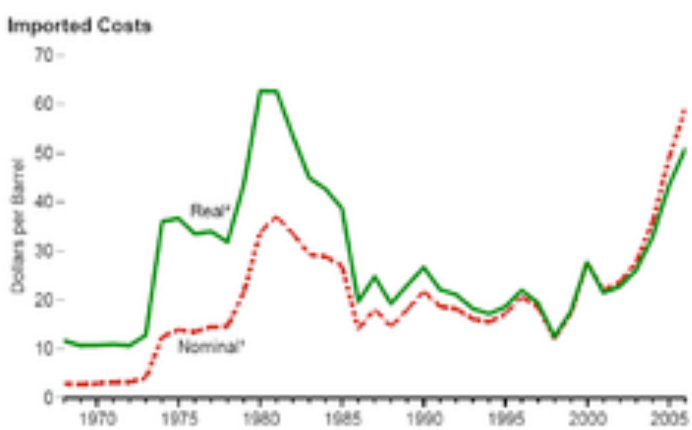
THE WORLD'S BEST DISCOUNT STORE

I have seen the future and it is very much like the present – only longer.
-Kehlog Albran

In 1944, war-weary Americans were entertained by a lighthearted movie called *It Happened Tomorrow,* directed by Rene Clair and starring Dick Powell and Linda Darnell. Powell played an ambitious turn-of-the-century newspaper reporter named Larry Stevens, who wishes he could somehow scoop the competition to find fame and fortune. A mysterious older man offers him the power to know the future 24 hours in advance, but cautions him against using this power. The lure proves irresistible, though, and Stevens sets out to reap the benefits of this newfound prescience. He beats out the other newspapers in breaking important news stories, picks winner after winner at the race track, and even curries favor with his girlfriend, Sylvia Smith (played by Linda Darnell), who runs a phony (suddenly not-so-phony) clairvoyance act. Life is good, until Stevens learns of his own impending death, and tries feverishly to figure out a way to avoid his fate.

The ability to know the future with certainty is an often utilized literary device, albeit not a particularly realistic one. But its allure is obvious. The ability to read tomorrow's headlines today should result in millions of dollars in trading profits. Shouldn't it?

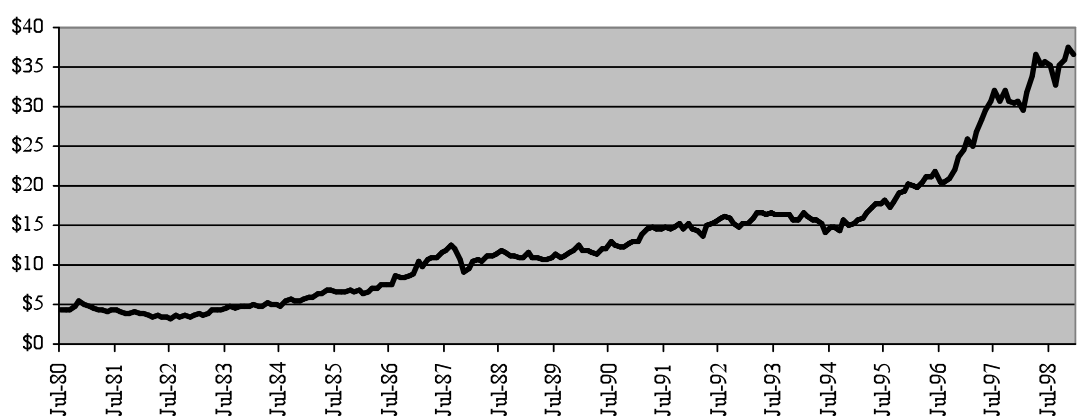
Consider the chart reproduced below, which shows the behavior of the price of a barrel of oil from 1968-2006. The bottom line is the nominal (actual) price, while the upper one represents



the real price (that is, adjusted for inflation). Oil prices peaked in 1980, reaching a high of roughly $40/barrel ($63 in today's dollars), and began a steady twenty year decline, bottoming out at approximately $10 in 1999. Imagine that, like Dick Powell, you could read future headlines, so that you knew with certainty that the spot price of oil was about to begin a whopping 75% decline over two decades. How might you monetize this information? One reasonable approach might be to sell short one of the major oil companies. (For those not familiar with this concept, a short seller sells stock he does not own at today's price, and then hopes the price will decline so that he can buy the shares he owes at a lower price and pocket the difference.) Intuitively, the producer of any commodity, whether an energy producer or a copper miner, would be expected to struggle in an environment of a decline in the price of its only product. After all, these are high fixed-cost businesses whose revenues are tied directly to the cost of the underlying commodity. As the world's largest energy company, Exxon Mobil (formerly simply known as Exxon) might be a logical candidate. How would that have worked out?

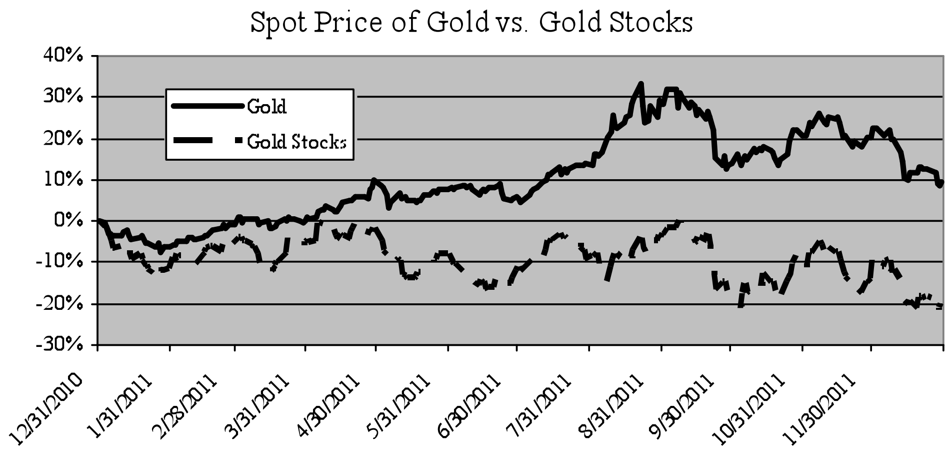
It would have been an unmitigated disaster. We have reproduced a graph of the price of Exxon Mobil stock over the period from July 1980 through the end of December 1998. Including dividends, an investment in Exxon over this period would have returned 22,797%, more than 18% per year compounded. This is more than 12 times the gain of 1,801% in the S&P 500 over that same period.

Exxon Mobil 7/1989-12/1998



What accounts for the stunning dichotomy between the price of the commodity and the price of the largest producer of the commodity? For one thing, Exxon's management astutely perceived the global forces putting pressure on oil prices. They reined in capital spending, and allocated financial resources towards share re-purchases and dividend increases. Micro-decisions trumped macro-forces. But another factor was that stock market participants collectively "knew" that oil prices were too high relative to fundamentals in 1980. Investors dumped energy company shares in anticipation of the price decline that had yet to occur. This mechanism is known as "discounting". The crowd essentially acted as if it had read tomorrow's newspaper, and moved to price stocks for the coming reality.

This phenomenon of stocks moving contrary to current headlines is extremely common. Last year, one of the best performing assets was gold, which finished the year up 10% after soaring nearly 35%, as shown in the chart below. Once again, though, an investor with foreknowledge might have loaded up on a basket of gold producers, only to find that the basket declined 20% over the course of the year.



Probably the most dramatic example of the disconnect between headlines and market performance can be found by looking at the behavior of stocks and bonds in 1982. The United States was in the late stages of an extremely deep recession. Unemployment was rising, and ultimately peaked at a whopping 10.8% in November and December, higher than the level reached in the recent financial crisis brought on by the bursting of the housing bubble in 2008, and in fact a level only exceeded in the Great Depression. Inflation seemed out of control, and the Prime Rate soared to a staggering 17% in February, 1982. Money market funds yielded an incredible 22%, and investors could have bought riskless, long-term United States Treasury bonds with call protection which would have yielded 14% for thirty years. The stock market was in the doldrums. In 1966 the Dow Jones Industrials had first crossed the 1,000 level, and sixteen years later it was trading below 800, meaning investors' purchasing power had been badly eroded by inflation for almost two decades. Imagine again an investor in the summer of 1982 who got an early delivery of the next few months' newspapers, with headlines about increasing job losses and persistent high interest rates. It would have been hard not to be gloomy. In fact, Business Week ran an edition whose cover was titled "The Death of Equities".

And yet, the stock market troughed at 776.92 on August 12, 1982, and began the longest bull market in history. It peaked some 18 years later at 11,750.28, resulting in a gain of nearly 2,700% when dividends are included. Admittedly, the headlines in 1982 were gloomy, but the problems were so well known that the stock market had discounted all of the bad news into pricing. As bad as the news, the prices of stocks had over-adjusted, making them a bargain.

Today, investors can picture a variety of possible headlines for tomorrow's newspapers, and none of them look like good news. While Greece has been bailed out, it is by no means certain that the Greek government will be able to reach mandated debt reductions. Potential defaults loom in Spain and Italy, and it is possible that the Euro zone itself may fracture. But stocks in Europe have a dividend yield 88% higher than the average U.S. stock and trade at a nearly 30% discount on a price/book basis.   That discounts at least a fair amount of headline risk. We face the potential for a continuation of gridlock in Washington, with Democrats in charge of the White House and Senate, and Republicans holding a majority in the House. But this situation has been in place since the 2010 election, and it did not prevent stocks from staging a powerful 25% rally from the fall of 2011 into the first quarter of 2012.

But the future headlines that most frighten investors are probably not those from tomorrow's newspaper, but rather those that may appear years from now. A significant number of people are fearful that we are on the tail end of the American era, and that our children will live in a world dominated by the rapidly growing Asian economies. After all, the United States offers unsettling parallels with the fall of Rome - a decline of shared central values, a loss of political civility, an overextended military, an inability to control national borders, and out-of-control growth in entitlement spending by irresponsible political leaders. There is a general sense that our society has become so big and complex that it is unmanageable.

While dire outcomes are certainly possible, they are by no means certain. In the 1980s every financial magazine was touting the inevitability of Japan achieving superpower status. After all, it had a large, hard-working population, huge gross domestic product, and rapid growth. But the same homogeneity that allowed it to prosper in the post World War II era caused it to be inflexible in dealing with harder times, and Japan has now endured two decades of stagnation. More recently, in a 2002 best-selling book entitled *The End Of The American Era*, author Charles Kupchan argued that Europe's growing economic and political solidarity would soon naturally give rise to geopolitical power.   A mere nine years later, how does that prediction look?

And even if the headlines turns out to be accurate, that does not necessarily spell gloom for investors. The British Empire, which lasted nearly 500 years, reached its zenith around World War I. Today the country is a second rate power both militarily and economically. But for the past decade the British stock market has outperformed the U.S. market.

The examples cited above are just anecdotes, incidents where investors with foreknowledge of tomorrow's headlines might have been drawn into making poor investment decisions. There were literally thousands of such examples that we could have chosen. But no one with a knowledge of behavioral investing (the interplay between finance and psychology) would be surprised. Amos Tversky and Daniel Kahneman, pioneers of this field, are credited with demonstrating a bias known as loss aversion, in which investors' fear of losses is typically twice as strong as their desire for gains.   It follows that when peering into the future, headlines with negative implications for the stock market weigh disproportionately heavily on investors. The bias is to over-discount potential bad news.

The solution is simple to say, but hard to do: figure out what a company is worth, and then see whether or not shares can be bought at a big discount to their value. If so, buy them, regardless of the headlines that may appear tomorrow. The worse the news, the more likely that there are bargains to be had.