

The *Blue Sheets*®

Our quarterly commentary on the economy and securities markets

Year-end 2005

“I see somesing.”

Max Schmeling (1905-2005)

*In 1930, 24-year old Max Schmeling became the first German heavyweight boxing champion of the world by beating American Jack Sharkey before a huge crowd in New York City. In 1936 at age 31, and now a **former** champ, Schmeling was brought back to the States as a sort of sacrificial lamb to fight the undefeated 22 year old Joe Louis. Max was a 10-1 underdog. In an interview with sportscasters before the fight, he was asked why he thought he had any sort of chance against America’s rising star. The always soft-spoken and humble Schmeling replied simply, “I see somesing.”*

What the former champ had seen when he studied Louis’ fight films was that the American dropped his shoulder every time he threw his famous left jab, leaving his head unprotected for a split second. Exploiting this vulnerability over and over with his powerful right, it took Schmeling until the twelfth round to finally knock out the younger fighter in what many consider the greatest upset in boxing history. All because he “saw somesing.”

We see something (several things, actually)

If we pay attention, lessons from ordinary life can give us an edge in the investment arena. Max Schmeling saw something that Joe Louis’ less thoughtful opponents had missed, and it made all the difference. He took the time to study what he was up against. He had the experience to recognize the importance of his small observation and the courage to act on his insight, ultimately confounding the professional odds-makers.

Most finance academics believe that modern securities markets process all available information so efficiently that it is a waste of time to try to “beat the market.” As a result, they contend, a prudent portfolio should be exposed to all asset classes at all times in order to reap “the market return”. These folks would never have backed Max Schmeling. They are the force behind the popularity of indexing and passive management.

At Financial Advantage, we are not so much interested in “beating the market” as we are in reaping consistently sound investment returns for our clients whether or not the overall market is being accommodative.

As we all know from recent experience, “the market” has its seasons; so one cannot expect to enjoy consistently positive returns by owning “the market” all the time. We believe that *study* and *experience* and *courage* to go against the tide of popular opinion are the keys to achieving our objective. In this issue of The Blue Sheets, we want to highlight a few of the observations our study has produced, and to review some of the investment decisions to which these observations have recently led us.

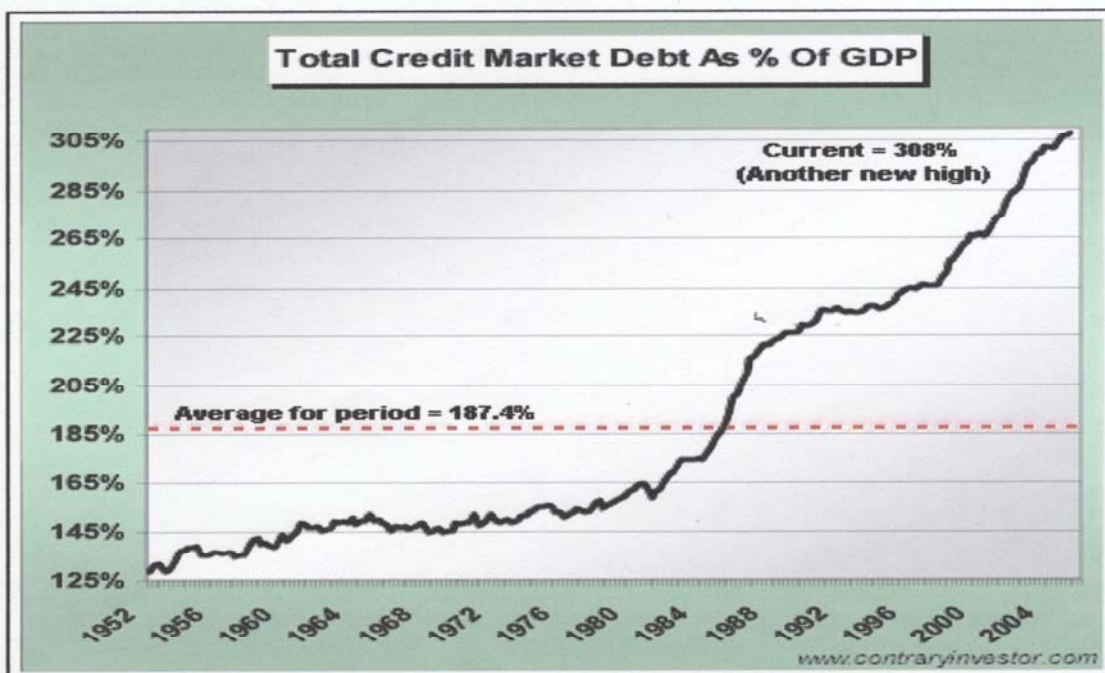
▪ **The business cycle has been overwhelmed by an extraordinary credit cycle**

The history of modern business is a history of cyclical swings from excess to restraint and back again. A grand wave of consumption generates an inventory expansion which, when consumption wanes for whatever reason, becomes excessive and unwanted, leading quite naturally to layoffs in the bloated businesses. Another time, an expansion of credit availability stokes the fires of economic activity until some marginal debtors fail in their financial obligations, leading inevitably to restraint on the part of lenders until their balance sheets are stabilized and profit margins restored. And so on. There is a natural and recognizable rhythm to the business cycle, and the various participants know how to anticipate and contend with the usual cadence.

One of the things we see clearly in the current environment is that the familiar business cycle has been distorted by the sustained availability of inexpensive credit to borrowers across the whole spectrum of credit-worthiness. Years of easy credit, uninterrupted by the ordinary periods of constraint, have extended consumer spending beyond its normal share of economic activity, sending confusing signals to the participants (consumers, lenders, producers of goods and services and the investing public to mention a few).

In our *Spring 2005 Blue Sheets* we examined the role of home equity borrowing and of the globalization of capital flows in this complex phenomenon. Consumer spending has spurted to 70% of GDP in America from its longstanding 66% level, and personal savings has plunged from 7% of disposable personal income to *minus* 1%.

In the third quarter of this year, household debt grew at nearly a 12% rate, the fastest pace in 18 years, to \$11 *trillion*. This is consistent with the following chart, which we have focused on before, showing total credit market debt in the US rising to an unheard of 308% of GDP, versus a normal 125% to 150% on the eve of the last big bull market.



Paul Volker, the widely revered Fed Chairman who whipped inflation into submission in the early 1980s, has recently gone on record concerning the current credit cycle and its risks. We quote from “An Economy on Thin Ice” in the Washington Post April 10, 2005. “Under the placid surface there are disturbing trends: huge imbalances, disequilibria, risks---call them what you will. Altogether the circumstances seem to me as dangerous and intractable as any I can remember, and I can remember quite a lot.”

Referring to the fact that the US is consuming and investing 6% more than it produces, funded by absorbing 80% of the net flow of international capital, Volker continued... “I don’t know whether change will come with a bang or a whimper, whether sooner or later. But as things stand, it is more likely than not that it will be financial crises rather than policy foresight that will force the change.”

And that’s from Paul Volker, a wise and experienced person, a plain-spoken man with no axe to grind. *He* sees something, and we think it is something that represents a danger to be respected as we develop our portfolios, but also an opportunity to weigh in against a stock market that seems oblivious to the reality that every cycle has two sides.

▪ **Earnings estimates for 2006 are too optimistic**

Analysts' estimates of profits for the S&P 500 companies next year contemplate a 13% increase from this year's levels. That's in the context of a 5% or 6% nominal GDP expansion, which itself may be overly optimistic. We see several things that cause us to believe earnings will disappoint versus these expectations:

- Aided by the extraordinarily long credit cycle, corporate profit margins are as good as they get. After-tax earnings are 8% of the GDP pie; the historic range over the course of a business cycle is 3 ½% to 8%. To expect them to go higher is a) to believe that the unusual stimulus of recent years is sustainable and b) to expect something that has not happened before; not impossible, but unlikely.
- Securities analysts' bottom-up forecast calls for an earnings gain of 13% in 2006. The top-down forecast by economists and strategists is for just a 5% gain. Historically, analysts get it right early in a cycle and strategists see more clearly later in a cycle. We are definitely late in a cycle; earnings seem likely to disappoint.

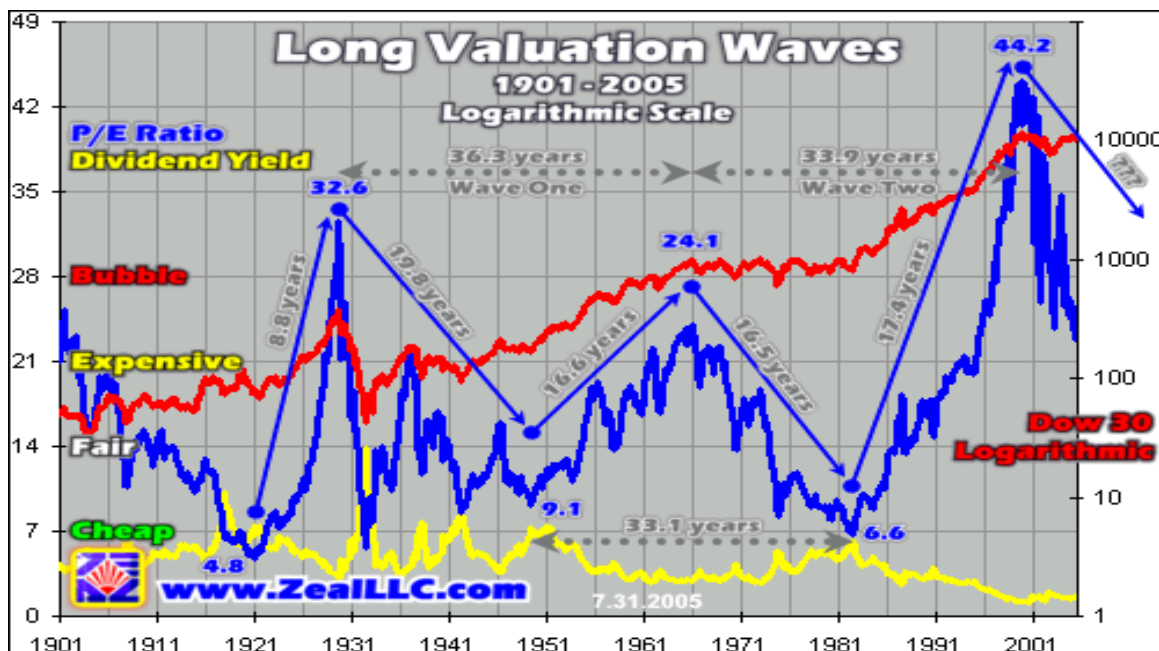
In the past three years, stocks prices bobbed happily upon a rising tide of better-than-expected quarterly earnings reports. It seems to us that earnings surprises are prone to turn negative in 2006. A shift of investor emotion from giddy to wary often marks a change of tide.

▪ **The cyclical contraction of Price/Earnings ratios has only begun.**

Speaking of tides...we have busied ourselves with research into the history of P/E ratios this year, which has enabled us to see a few very important things.

The Price-to-Earnings (P/E) ratio is the most basic reflector of investor enthusiasm about future stock prices. When folks are more optimistic, they'll pay more for \$1 of corporate earnings (e.g. 20 X earnings) than when their enthusiasm for equities cools (e.g. 10 X). We have studied the following chart the way Max Schmeling studied Joe Louis' fight films. Thanks to Adam Hamilton who prepared the chart, (www.zealllc.com, where you may see this and related charts) we can see that...

- Investor enthusiasm for stocks tends to wax and wane in long cycles. We are currently early in a P/E compression phase of the cycle.



The red line that wiggles up from left to right in the middle of the chart is the price index for the Dow Jones Industrial Average over more than 100 years of trading history; its logarithmic scale is on the right side of the chart. The more volatile blue line superimposed on it is the P/E ratio for the Dow at each point in time; its scale is on the left.

Several historic verities jump off the page. First, the P/E ratio, while *very* volatile in the short run, has tended to move in long, sweeping cycles, both up and down. During these 104 years there were three long periods of P/E compression, each followed by a long period of P/E expansion.

The three compression cycles were 17- to - 20 years long. The two most recent expansion cycles lasted 17 years, while the earliest one (the roaring '20s) soared from 5 times earnings to 33 times earnings, from abject pessimism to unbridled euphoria, in 9 years!

Since the current valuation compression began, just 5 years ago, the Dow's P/E has contracted from a previously unheard of 44 times SEC reported GAAP earnings to about 23 X recently. (Please note that P/E's quoted by Wall Street sources sound much lower because a) they use *estimated* future earnings and b) they typically use "operating earnings" which ignore various write-offs as well as the cost of options.)

The long term *average* Dow P/E has been about 14, which is well below current levels. More sobering to us, each long cycle of P/E compression has ended in single digits. Regression to the mean is a dependable phenomenon, but the mean is achieved by overshooting in both directions. History suggests that the end of the current cycle of P/E compression is quite a bit below our current perch.

Reverting to our boxing analogy, the P/E compression is the market's killer left jab; it has been the ruination of many a contestant. Knowing where we are in the cycle may just give us a critical advantage in the battle for investment survival.

- Over the long term, the waxing and waning of investor enthusiasm for stocks, as evidenced by the P/E ratio, is a far more powerful determinant of stock prices than even company earnings!

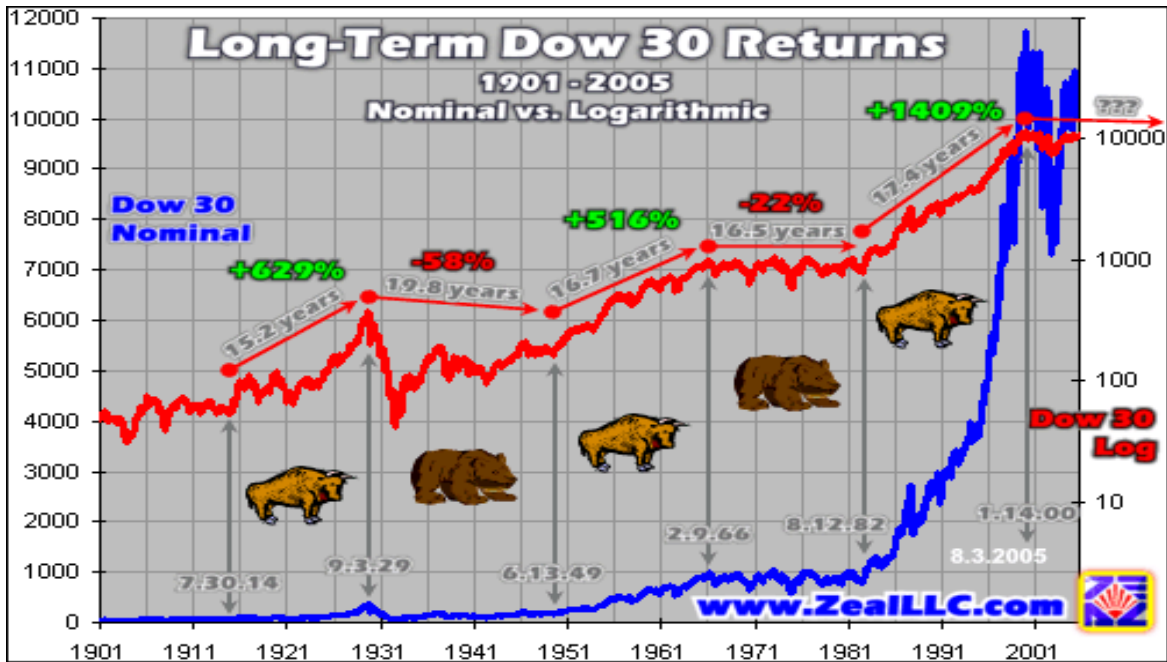
The daily banter from Wall Street goes something like this... "GDP is growing, earnings are rising, so stocks will do well." When prognosticators are able to add, as they have recently, "Interest rates are low and inflation is low", then their mantra is *very* appealing and we are emotionally inclined to be optimistic about our stock market exposure. After all, the economy is good, so why should stock prices fall?

Here's the insight: smoothing for the business cycle, corporate earnings tend to rise roughly in line with GDP during both the up and down legs of a valuation (P/E) cycle. So the investment return experiences of bull and bear markets is really NOT about earnings. What distinguishes the bull market experience from the bearish one is not earnings but whether investor expectations (as evidenced by the P/E ratio) are rising or falling.

For example, from the valuation peak in 1966 (at 24 X) to the valuation low in 1982 at 8 times earnings, GDP grew 9% a year, DJIA earnings grew 5% a year, but the DJIA index of stock prices was *flat for the whole period!* The falling P/E overwhelmed 17 years of business growth!

In sharp contrast, in the five years from the end of 1981 to the end of 1986 earnings were flat and the Dow stock price index nearly *doubled!* In this case, rising valuation overwhelmed 5 years of dismal earnings.

As the next chart shows, the P/E cycle has had a radical influence on investment returns over the years.



This chart shows the total return on the Dow 30 Industrials for each of the valuation cycles. The red line gradually rising across the center of the chart is the Dow Jones Industrial Average on a log scale (right side). The blue line that soars upward after 1981 is the actual index (left side scale).

The chart indicates that the total returns for the three periods of rising P/Es (marked by the bull icons) were +629%, +516% and in the recent 1982-2000 bull market an astounding +1,409% which translates to a phenomenal 18% a year!

For the last two periods of P/E *contraction*, the returns were -58% over 20 years and -22% over 17 years... and that doesn't even include the buying power lost to inflation... which was enormous in the '70s.

We are only 5 years into the current wave of compression and the P/E is still higher than at any time except 1929 and the late stage of the recent dot.com boom! The P/E is higher today than in 90% of the previous hundred years.

Naturally, we would all rather own stocks while P/Es are expanding. But we may not have that opportunity for a long time. The lesson of history seems to be that when we invest at high P/Es the odds are stacked against us. These charts will not help us forecast near-term moves in the stock market. (As John Mauldin points out in "Bull's Eye Investing", in both up and down P/E cycles, the statistical odds of the market rising or falling in any given year are 50/50.) But the charts do help us understand that there tend to be great, long moves in valuation which can overwhelm economic or corporate growth.

And they help us see where we are in the cycle. We think that is a valuable insight.

▪ **Speculative enthusiasm has returned.**

It is always pleasant to experience a broad rise in stock prices such as investors around the globe have enjoyed the much of the past several years. We suppose it is natural to let the glow of good returns lull us into an Alfred E. Newman (“What, me worry?”) frame of mind. Most of today’s professional investors began their careers during the great bull market of 1982-2000; it is perfectly understandable that such folks might interpret the painful losses of 2000-2002 as an aberration and the decent returns of 2003-2005 as a return to normalcy. We think, in fact, that is the prevailing view. Our perspective is different.

Based on the record low cash reserves in equity mutual funds, it appears that managers are more worried about missing a rally than about suffering a serious decline. Evidence of investor complacency toward risk and disregard for historic valuation benchmarks abounds...

- High Price/Earnings ratio for broad market indexes: The S&P 500 trades at 19 times reported earnings (considerably higher on GAAP earnings) versus an historic mean P/E of 14x; NASDAQ 100 (based on the ETF QQQQ) is at 40 times earnings.
- Google mania: Poster child for growth stocks, GOOG has soared almost 400% since its IPO 14 months ago! It trades at 90 times trailing earnings. Analysts are estimating a 45% growth in profits next year, not a shy forecast considering the uncertainties of the intensely competitive environment in the internet advertising business.
- Hot IPO market. In November, Sunpower (SPWR) made its debut; offered at \$18 it opened at 28. A year before a money losing semiconductor company (Cypress) bought it for \$3 a share. Sunpower’s prospectus is a scary read! Nine months (unaudited) revenues \$49 million and losses of \$15 million. Manufacturing costs are soaring but they sell to their four customers (four!) under fixed-price contracts, so margins, such as they are, are being squeezed. But the stock (only 13% of which has been sold to the public, representing only 2% of the voting power!) is up nine-fold in 12 months!

Maybe it is because clients pay us to worry over their nest egg, but we think we see something that portends a coming change of environment, possibly an abrupt case of sobriety. And we have a detailed plan for exploiting the opportunity to earn positive returns in what may become a more difficult investment environment.

Our Investment Strategy Response

These, then, are the observations that have emerged from our recent studies and ruminations. We have made an effort to translate them into investment actions that should bear fruit if the observations themselves prove valid in the months and years ahead.

We do not want investment returns for our current portfolio to depend on rising corporate profits or a high market P/E ratio. We think both of these metrics are at risk. Hence we try to avoid the broad stock market indexes and mutual funds that are closet indexers. Instead we will emphasize stocks that we believe have some sort of upside “surprise potential”; some value that we do not think is fully reflected in the current market valuation. We will also own mutual funds that are managed with a similar discipline.

Since we believe the valuation pressures are probably going to work against stock prices on balance, we think it is a good idea to salt our portfolios with investments that may actually benefit from a rough stock market... we call them our hedges. They are securities the value of which is either uncorrelated with or negatively correlated with the popular equity indexes.

We think the speculative tempo is a bit heated right now; maybe not as wild as in the late 1990s, but dangerous enough that we want to be extra careful not to be lured into a momentum style of investing. We may continue to hold a few favorite securities that have become temporarily over-priced, but we will remain, on balance, value investors. We will emphasize our stable investments (money funds, short-term bonds) when we cannot find enough good values elsewhere, even if those stable investments give us low single digit returns. Protecting our reserves will put us in a position to take advantage of lower securities prices later.

There are two ways to make money in stocks... cash dividends and price appreciation. Compared with other periods in history, today’s investor disdains dividends. Contrarians at heart, this seems to us an opportunity to emphasize in our portfolios securities with better-than-average yields. History shows that dividends tend to be more highly prized in a slumping market. We are taking extra care to diversify our sources of dividend payments because the business cycle seems ready for a correction, which usually causes some dividend cuts.

Some Examples

Surprise Potential: Most of our portfolios own shares of Capital Lease Funding (LSE) a diversified REIT that invests in net lease commercial properties. This company, although it has a ten year track record, only became a public company a year ago. We first noticed it as a holding in one of our mutual fund portfolios. The stock trades at a 7.9% dividend yield. The dividend seems very secure because it is backed by cash flow from investment grade tenants with leases of 10-20 years with inflation escalators, and because the company’s debt maturities are typically 7 years or longer, so not vulnerable to a changing yield curve. We expect the dividend to rise from the current 80 cents a year to as much as \$1.00, perhaps in 12 to 18 months, when the assets are fully invested. Because it is a new stock and a small capitalization, only one “street” analyst is on record with an estimate, so there is plenty of room to be “discovered”.

Hedges: We currently own two kinds of market hedges. We have invested in gold bullion via StreetTRACKS Gold Trust (GLD), an Exchange Traded Fund (ETF). Each share represents ownership of 1/10th oz. of gold bullion in a vault in London. Gold has a long history of price behavior uncorrelated to the stock market. Bullion is widely regarded as an “insurance policy” against political crises and weak paper currencies. The supply is very tight and could become even tighter if some central banks begin to accumulate gold as a reserve asset rather than selling it as they have in recent years. Furthermore, demand could strengthen due to a) central bank buying, b) rising demand for jewelry as Asian and Pacific countries enjoy greater prosperity, and c) Investment demand in the developed countries, aided by the creation of gold ETFs that simplify bullion ownership.

Second, as clients and other readers are aware, we own a meaningful position in “Inverse” funds that rise in value when a market index falls (and vice versa!). Recently we added a new inverse fund, Rydex Venture; this is a 2-to-1 inverse fund tied to the NASDAQ 100 rather than the S&P 500. We have introduced this fund to create more volatility that we can use to our clients’ advantage by using it as a rebalancing tool. We expect that the inverse funds will only be a feature in our portfolios while stocks generally are in the top 20% of their historic valuation range.

Stable assets: Our portfolios are between 32% and 60% invested in money market funds and short-medium high grade bonds, including Treasury Inflation Protected bonds (TIPS). The allocation depends on the risk tolerance and target return of each investor. We currently expect only about a 4% nominal annual return from the stable assets. That’s not much, but the principal risk in this group of securities is small. In a dangerous market this can be an advantage from both a long and short-term point of view.

Dividends: We own Allied Capital, a seasoned business development company (making both debt and equity investments in privately-owned businesses). ALD has a quarter century track record of responsible growth; its current dividend yield is 8.2%. We also own Thornburg Mortgage (TMA), the leader in ARM loans to prosperous borrowers. TMA matches the duration of its borrowings to that of its mortgage loans, reducing its exposure to changes in the yield curve. The dividend yield is north of 10%.

Footnote: In 1938, Louis dispatched Schmeling in the first round of a hugely attended rematch. Max Schmeling passed away this year, just months short of his 100th birthday! Besides his legendary victory against the Brown Bomber in 1936, he left a legacy of kindness and integrity. He and Joe Louis eventually became friends; in later life Max paid medical bills for the impoverished American champ. During his prime, he refused to be used by Der Fuhrer as an example of Aryan superiority and he helped Jewish friends escape to America. May we all live as well. And may he rest in peace.

*For the Investment Committee:
J. Michael Martin, J.D., CFP
December 12, 2005*

DJIA 10,766 S&P 500 1260 NASDAQ 2261 30-yr Treasury 4.74%