



Passionate About Performance

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CAPITAL MARKET WATCH

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In this report, the following areas will be explored:

**Relative Value
About Ken Stern & Associates**

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Ken Stern and Eric Hoffman are Financial Advisors offering securities through First Allied Securities, Inc.,

Economic Outlook 2009

Relative Value

For my whole life, I have said to friends “Happy New Year” without giving it much thought. Just like when someone asks how you are doing and you say “fine,” it’s almost an instinctual response. This year, however, I think “Happy New Year” is not just a hope for the future, but an expression of relief that 2008 is behind us!

In spite of all the trials that 2008 presented all of us with, I think that with a new year comes the opportunity to reflect on what we did right or wrong in the past year, what lessons we learned and what actions we need to take to get ourselves onto the path that we want to be on. We get a chance to reassess our goals and to create a plan to change course where we may have veered.

In this important issue of Capital Market Watch, we will explore a behavior that we see as a common flaw in investor psychology. Evidence supports the idea that investors make poor decisions, often basing them on emotions, rather than facts. After reading this report, please consider whether your decisions could benefit from a higher level of emotional detachment. In relationships and with your family – follow your heart. In regards to your finances, however, our founder, Ken Stern, recommends that you be disciplined, follow a strategy and be a predator - an investment predator that pounces on opportunity!

As I’ve chronicled here in the past, I have a certain (hypothetical) relative, who is the strongest possible supporter of a (hypothetical) computer company that we’ll call “Orange Computer.” I’ll be the first person to admit that Orange makes some really cool computers, but I’ve never really understood the mania around the stock. People who love Orange’s products, though, often *really* love the stock. In fact my (hypothetical) relative constantly regales me with news stories that prove beyond a shadow of a doubt that, no matter what the current price is, Orange is the investment opportunity of a lifetime. To hear him tell it, Orange may eventually take over the world! (Perhaps that’s a bit of an exaggeration...)

What always surprises me, though, was that every story I ever heard from my relative about Orange had some positive implication for the company and the stock price. To hear him tell it, he has never heard even the tiniest sliver of information that would indicate anything other than an infinite increase in the stock price.

Of course, we as outsiders, realize that there are probably two sides to this story, but I think this scenario illustrates an important concept in the world of Finance. What I’m referring to is called “confirmation bias” – the tendency that we all have to find information that confirms our existing beliefs and to avoid or marginalize information that contradicts those beliefs. This isn’t a new concept - going back over 100 years, Russian writer Leo Tolstoy said, “The most difficult subjects can be explained to the most slow-witted man if he has not formed any idea of them already; but the simplest thing cannot be made clear to the most intelligent man if he is firmly persuaded that he knows already, without a shadow of doubt, what is laid before him.” In fact, I, too, have been accused of being able to find rationalization for whatever viewpoint I already hold, so maybe this is a behavior that’s passed on through the gene pool!

In addition to applying to individual stocks, I think that this applies to the overall market and to the economic cycle. Not only do we find evidence to support what we believe, but many of us tend to believe that whatever is happening currently will continue indefinitely. When the economy is strong, there’s no

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reason to believe that it won't continue, and, when we're in a recession, it's easy to believe that there's no end in sight. If the market's been going up lately, it becomes easier to follow the herd and to believe that it will go up indefinitely. The opposite is also true. In fact, there are many traders who base their decisions solely upon "reading" charts, believing that the current trend in the market will continue.

The reality of the situation, though, is economies go through up-and-down cycles and that markets follow suit – it's quite rare for any trend to continue in the same direction indefinitely.

Let's take a look at a simple model for pricing markets (or individual stocks, for that matter):

$$\text{Price} = \text{Earnings} \times \text{P/E Ratio}$$

Simplified, there are two inputs into this model – how much the companies in the market make (or are expected to make) and what kind of premium (or multiple) we apply to those earnings. Although price / earnings ("P/E") ratios are traditionally applied to how much money a company has made, they can also be applied to how much money a firm is expected to make in the future (referred to as a "forward" P/E). Assuming that the long-term average P/E ratio of the market is about 15, it would make sense that market participants would be willing to pay a bit of a premium to that number when they expect earnings growth to be above average and would be willing to pay less when they expect earnings growth to be below average.

Now let's apply this idea in tandem with the cycle concept above. It seems to me that, after a long string of strong quarterly earnings growth, investors could logically assume that this trend will have to reverse itself at some time. In this case, they should be willing to pay less of a premium for future earnings and the "forward" price to earnings ratio of the market should be lower than usual.

In situations where earnings have been poor (perhaps due to an economic recession), there is a low base for comparison, and it would seem logical that earnings will rebound at some point and that growth will be stronger than average. In this case, participants should be willing to pay a slightly higher "forward" P/E than they usually do.

In summary, I believe that after earnings and overall market have gone up, you have a high "base" and it becomes more difficult to grow from those numbers in the future. In this case, I believe that forward P/E's should be "relatively" low (i.e., cheaper) to price in moderated growth expectations. I also believe that, after a period of decline, bases and comparisons are relatively low, making growth more likely, which warrants higher forward P/E's. This really just quantifies what we already know about cycles – most trends eventually reverse and I believe that expectations for the future should take into account where we are on the cycle.

Now, here's the curve ball - **history does not bear this out!** In fact, my research indicates that exactly the opposite is the case – forward P/E's often come down AFTER a sell-off in the market and increase AFTER the market has gone up. Think this through logically - once earnings are down, you would think that earnings would be poised to rebound. That's how cycles work, right? Historically, yes. But due to psyche and pessimism, after the market goes down, valuation measures seem to discount earnings getting worse, rather than better. The table below illustrates this. We reviewed the quarterly performance of the Standard & Poor's 500 Index from the third quarter of 1996 through the third quarter of 2008. For

each of these quarters, we looked at the percentage increase or decrease in the “consensus” forward P/E, as recorded by Thomson First Call. The seven quarters with the greatest percentage increases and declines in forward P/E are listed, along with the performance of the index itself.

Seven Quarters with the Greatest Decrease in Forward P/E

Based on S&P 500 Analyst Consensus Estimates
Third Quarter 1996 to Third Quarter 2008

<u>Quarter Ending</u>	<u>S&P 500 % Change</u>	<u>Forward P/E - Beginning of Quarter</u>	<u>Forward P/E - End of Quarter</u>	<u>% Change in Forward P/E</u>
Sep-02	-17.63%	19.20	16.04	-16.45%
Jun-02	-13.73%	22.83	19.20	-15.91%
Sep-99	-6.56%	27.32	24.13	-11.69%
Sep-98	-10.30%	23.26	21.22	-8.79%
Sep-08	-9.00%	14.55	13.35	-8.26%
Jun-00	-2.93%	26.56	24.45	-7.93%
Dec-00	-8.09%	23.57	21.83	-7.38%

Seven Quarters with the Greatest Increase in Forward P/E

Based on S&P 500 Analyst Consensus Estimates
Third Quarter 1996 to Third Quarter 2008

<u>Quarter Ending</u>	<u>S&P 500 % Change</u>	<u>Forward P/E - Beginning of Quarter</u>	<u>Forward P/E - End of Quarter</u>	<u>% Change in Forward P/E</u>
Dec-02	7.92%	16.04	17.07	6.38%
Dec-04	8.73%	16.40	17.47	6.52%
Dec-96	7.77%	16.97	18.27	7.67%
Dec-99	14.54%	24.13	27.15	12.51%
Jun-03	14.89%	16.35	18.57	13.55%
Mar-98	13.53%	20.24	23.02	13.69%
Dec-98	20.87%	21.22	26.46	24.72%

What’s interesting to note is that, of the seven quarters with the largest percentage declines in consensus forward P/E multiples, all of them occurred after the market had declined. Similarly, all of the quarters with the greatest percentage increase in forward P/E multiples occurred with when the market had gone up. This implies that investors base their expectations for future earnings growth on what has already happened!

I believe that this illustrates why some market watchers believe that the best deals are to be had in economic troughs – not only do you have the ability to purchase a stock with depressed earnings

(presumably with the potential for recovery), but valuation ratios make those earnings cheaper (relative to potential growth) than they have been during the rest of the cycle.

Now, many of you are probably saying, “this recession is different.” In fact, every recession is different. History is full of examples of investors believing that good situations only get better and bad situations only get worse. It’s the simple extension of the Confirmation Bias phenomena discussed above. Every recession has caused investors to believe that we were coming to the end of the world as we know it, yet somehow the economy eventually recovered from all of them. 9/11, the Tech Wreck, Black Monday, the oil embargo of the 70’s, the Great Depression – they all looked terribly bleak, but, in all cases, the economy recovered, along with the market. The takeaway is that human nature is often quite wrong and that this nature often leads to incredible opportunity.

I’ll be the first to admit that I am unable to predict when the economy will come out of the recession that we are currently in. What I will venture, though, is my belief that we will, at some point, emerge and that earnings will eventually start to improve from their currently reduced levels. It is for this reason that I believe that forward P/E multiples should be higher right now than they were when the economy was going full-steam and had twenty consecutive quarters of earnings growth. Just as the phenomena of “confirmation bias” makes it easy to find information to back up beliefs that we already hold, I believe that there is a natural tendency for us to believe that trends in the economy and earnings growth will continue indefinitely, although the cyclical history of both contradicts this.

In emotional times like this, it becomes more difficult to follow a system, which makes it even more important to do so. Following a system helps to minimize some of the detrimental emotional decisions your brain tries to make to “help you survive” and puts you in a position to use economic uncertainty to your advantage – pounce!

About Ken Stern & Associates

Ken Stern & Associates (“KS&A”) is passionate regarding advanced wealth management. Every area of wealth management from investing to legacy planning requires a sound strategy. We pride ourselves on our discipline of investing. We execute our strategy effectively and with purpose. The desired outcome is to work toward the goal that the wealth management strategy created.

Chaotic markets, turbulent times, and booms and busts allow the skilled wealth manager to exercise this discipline and create long-term alpha on behalf of their clients. Our alpha objective is to help you make more money, reduce your risk, pay less taxes, and define your legacy.

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