

INVESTMENT QUARTERLY

Frogs and Foibles

On a quiet afternoon in his lab, Dr. Rocket pulled a frog out of the supply pool and began an experiment. He placed the frog on the lab table and yelled “Jump!” The frog jumped. Dr. Rocket wrote an entry in his notebook: “frog jumps on command”.

He then took a piece of cord and tied the frog’s two front legs together. “Jump!” he yelled at the frog and again, the frog jumped. Dr. Rocket wrote another entry in his notebook: “with two front legs tied together, frog jumps on command”.

Intrigued, the scientist took another piece of cord and tied the frog’s two back legs to the two front legs and placed the frog back on the table. “Jump” he yelled, but the frog didn’t move. Eager to share his research finding with others, Dr. Rocket, scrawled in his notebook: “with all four legs bound together, frog goes deaf”.

Probably most of us encountered the above parable somewhere around 3rd or 4th grade when we were being encouraged to think beyond those concrete multiplication flashcards. But most, if not all of us have recently perused financial data and drawn unfounded conclusions either because we carry a predisposition to its meaning or, focus on the specific report rather than its place in a larger context. The past two years have provided the perfect environment for such “research” whether it was the influx of financial negatives or more recently the intermittent economic data and corporate news paving the way out of the recession; between the internet and the news media you can find that nugget of data that supports your theory.

If one merely tunes into CNBC on a weekday morning you can share in the banter about the pending 8:30 economic data release and then watch the futures jump up or down in reaction to it. And, as third quarter earnings announcements begin to permeate the morning “Breaking News” flashes you can watch the reaction of the specific stock to that bottom line earnings number....was it above or below the estimates and if it wasn’t in synch with estimates, what about that “whisper number” which in the final days before the release becomes louder and louder.

The point is that when we are bombarded with data and opinions, particularly in a financial environment that is fraught with emotion, one should be diligent not to pick and choose only that which concurs with the desired outcome of your research. An example might be the long awaited bottom in housing which has been declared by some to have arrived based on recent upticks in new starts and housing sales as well as a decline in supply (inventory). On any of the mornings when the data was announced there was a strong positive reaction in the markets and individual housing stocks. But such reactions are frequently short lived as other factors are tossed around and investors realize that the data is only one ingredient in a far more convoluted industry/market. The “bottom” is not a point on a chart but rather will be a long, and likely drawn out, process. Despite positive trends in starts and sales, historical demand remains uninspiring and since employment is directly related to housing

demand it is likely to remain so. That coupled with tighter lending standards by banks suggests that although we may be hovering near the bottom, there will not be a quick reversal in demand and price.

It is an all-too-human foible to react to information and jump into or out of the markets and/or specific stocks. Whether that information is the absolute sure tip at a cocktail party, the most recent durable goods data, a seemingly non-stop downward or upward drive in the market or the earnings per share announcement of a stock, it should not shake you out of a solid long term strategy. Emotions are a powerful force in short term thinking and can lead to less than astute conclusions.

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The third quarter continued a sustained rally in equities that surpassed our expectations in its ability to keep plugging without any significant pullback. Several times during the period the market has technically appeared to be poised for a downturn only to see it break out decisively and continue upward. As significant as the rally has been (I heard it referred the other day as a “monster rally) it actually is quite normal as a retracement after a major sell off. In reality, the market has not yet even recouped one half of what it lost in the late 2007 to March 2009 downturn. However, it has been a welcome relief as the equity markets appear to have factored in at the least, the end of the recession and quite possibly a return to some degree of growth. For the quarter ended September 30, 2009, the Standard & Poor’s 500 returned 15.5%, the Dow Jones Industrial Average 15.7% and the Lehman Brothers Intermediate Government Index 1.75%.

The question we must ask is if the equity markets are in fact, on a valuation basis, priced to perfection and if so, should they be?

In our last Investment Quarterly, Jack Driscoll noted that although we were cautiously optimistic that the worst was behind us there remained a number of challenges to be faced in the coming months (and quite frankly what we believe will ultimately be years). Although technically the recession may be over, the consumer continues to face rising unemployment, tight credit and a level of fear that has driven their savings rate to levels not seen in decades. That does not bode well for jumpstarting an economy that is 70% driven by the consumer. Corporate earnings as expected are down but attention is now focusing on the deterioration in revenues. With few remaining options to cut expenses to increase the bottom line, revenue growth will be essential to a recovery in earnings and at the moment, it is not there. Industrial production has been picking up as corporations begin to rebuild inventories but without consumer demand, it can be expected that trend will slow. And of great importance is the unemployment situation which is expected to continue to worsen over the next two quarters despite unprecedented government stimulus. In addition to the immediate domestic economy concerns there also remain other challenges including the necessity of financial institution reform, for some the threat of deflation, for some the fear of inflation, a continuing recovery in the global economy and a weak dollar.

We do believe the worst is behind us but that any meaningful recovery will take more time than the equity markets have priced in. We remain cautious and consider the lackluster volume for the last two months an indication that despite few alternatives, the current risk premium in the market may not be justified. We have maintained reserves in anticipation of a pullback and do not consider it prudent to join the crowd and chase the current rally.

As Chris McIsaac of Vanguard recently noted, *“We have short memories I’m afraid. We’ve been at this for a long time and any time there’s a sharp decline or rise, it prompts people to take actions that aren’t in their best interest.”*

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DJIA (09/30/09)	9712.28
S&P 500 (09/30/09)	1057.08