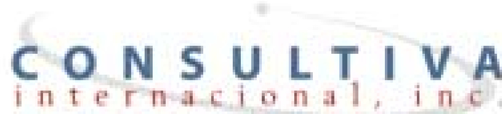
SPECIAL COMMUNICATION #3

SEPTEMBER 24, 2001



MODEST NO MORE, START A RATIONAL BUYING PROCESS BUT RECOGNIZE THAT THE CROWD IS RUNNING THE OTHER WAY

- In June this year, one of our prime reasons for modesty was that "Valuations never got really cheap, and investor sentiment never got really bearish". As a result of the weakness in the market in July and August and the collapse last week, we believe equities are now meaningfully below fair value and sentiment is showing many of the signs of extreme pessimism. Strategically we are bullish. **We assume that we will see a continued gradual process of increasing equity weightings, mindful that although we believe stocks are cheap, the market has powerful downward momentum.**

- For investors with the fortitude to endure short-term volatility and the willingness to take advantage of further weakness, we strongly believe this will prove to be a rare opportunity to buy great companies significantly below fair value and make outsized returns on a one to two year time frame. Our long-term forecast for the trend rate of return on stocks in the coming decade remains 7 – 8%, but from these levels we see the potential of 20-30% returns, simply to return to fair value.

- Investors who sell stocks in the current environment will, in our opinion, come to regret the decision. Having seen the extent to which the crowd was willing to push stocks above fair value in the euphoria of 1999 and early 2000, we are fully aware of the potential for the current mood of despair to produce, as it currently is, an equal and opposite move below fair value on the downside. We fully expect a return to the October 1998 lows of 920 on the S&P 500 and need to be prepared for worse, but **we urge investors to remember how wrong it was to follow the crowd at the extremes of optimism and not to repeat the mistake now that the crowd is so bearish.**

- Why do we believe this to be the case? The critical assumptions we are making are the following:

  1. The 50-year history of 7% trend profits growth will survive the current profit recession.

  2. We will remain in a low inflation, low interest rate environment.

3. The historical relationship between interest rates and PE ratios will hold. Throughout history, periods of high inflation and high interest rates have resulted in low PE ratios and periods of low inflation and low interest rates have resulted in high PE ratios. Current levels of interest rates and inflation are low by recent historical standards (long and short-term interest rates were meaningfully lower in the 1940s and 1950s). Based on the Federal Reserve's valuation model, a long-term study of real earnings yields and the recent work by Wharton Professor Jeremy Seigel we feel comfortable using a PE in the low 20s. In making our fair value forecast we use a PE of 22, which assumes a return to average risk tolerance from the current risk-averse environment.

4. Trend earnings for the S&P 500 are currently at 50 (See Chart) rising to 53.75 and 57.5 in the next two years.

Fair Values for the S&P 500 can thus be calculated as follows:

- 2002: 1180 (=22x53.5)

- 2003: 1260 (=22x57.25)

- At 900 on the S&P 500 the market would be selling for 16.7x next year's trend earnings number, at 800 it would be on 14.8x. We cannot predict how far the crowd will go to bearish extremes, but we need to be willing to accumulate patiently and persistently, the further we fall below fair value.

- ***Three rules for investing: Don't fight the Fed, Don't fight the trend, Beware the crowd at extremes. Two of the three are firmly on our side***. The Fed has returned to aggressive monetary expansion, and the crowd is extremely bearish. Investors can choose to wait until the trend has clearly turned and a clear bottom has been established, but if they do so they will likely miss out on the great bargains that we believe are currently on offer.

Many technical indicators support the fundamental case

Certain crucial technical indicators are showing extremely oversold levels. The 30-day moving average for the put-call ratio has reached levels not seen since October 1998. Similarly, sentiment indicators also show for the first time since the fall of 1998 that more investors are bearish than bullish. The McClellan Oscillator for the New York Stock Exchange, a gauge of market breadth, hit a record oversold low of -363 last Thursday.

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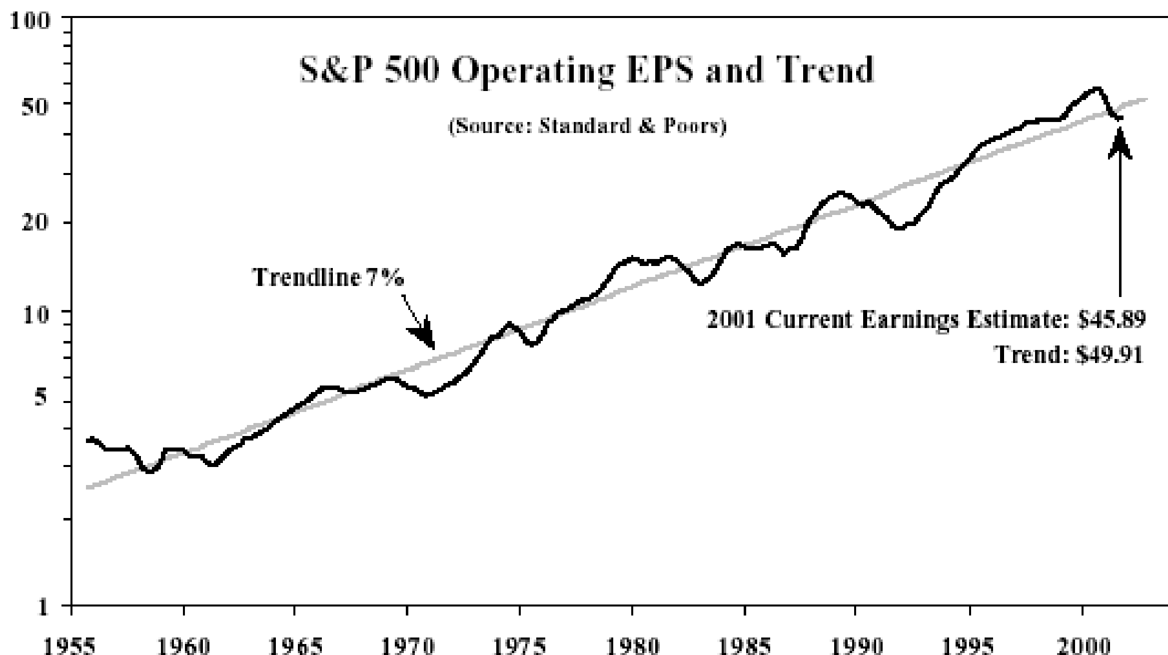
CHART OF THE WEEK – 7% TREND VERIFIED OVER THE LONG RUN



While it is impossible to predict the magnitude of earnings swings over the short-term, the consistency of 7% trend earnings over the long run is remarkable. Shown above is a 50-year history of 7% trend growth. We believe it is important to recognize this trend when valuing the stock market. Using current earnings to value the market at earnings troughs makes stocks look expensive just when they are getting cheap, whereas using peak earnings often makes the market look inexpensive when it is not. We think a more rational approach is to look at trend earnings growth. Knowing that a return to trend is the norm helps us make reasoned investment decisions, especially during difficult times like these.

Let's Start the Process

Although it may be difficult in the current environment, we think investors should begin the process of raising the equity allocation in their portfolios. Discuss with your financial advisor what the optimal range is for your equity exposure based on your risk profile and cash needs and then decide on a plan to begin buying stocks and/or equity funds to reach the upper end of your range. For example, a benchmark weighting for a moderate risk investor might be 69% for stocks. One might consider a slightly more overweight position of 72% by reducing cash. If markets get cheaper, we suggest adding even more to your equity position.

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