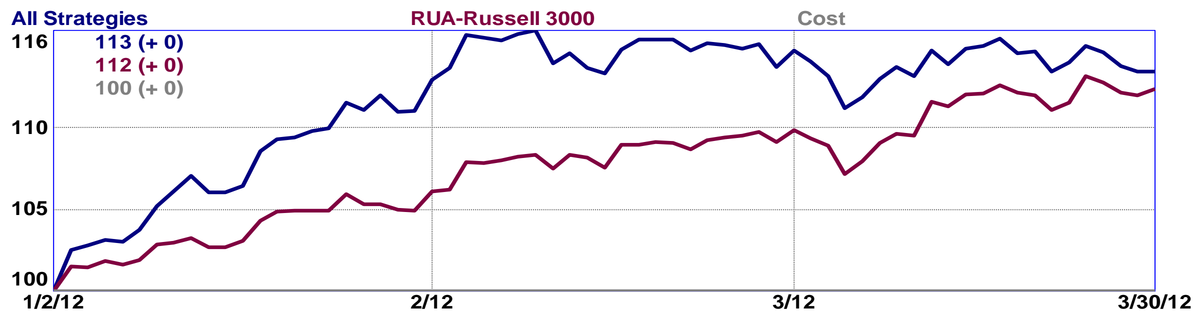
March 31, 2012

Clients,

Market Perspectives



By early February we were up 16% year-to-date while the market was up about half that amount. Expecting a correction, I began selling and not buying, thus moving to cash. Instead of a correction, the market began differentiating, with technology (read Apple) and then financials in March moving up sharply, while the correction came in energy or commodity related and utilities (High Income portfolio), plus the Russell 2000 smaller companies plus Emerging Markets.

Still expecting a correction in the main indexes as all the studies by Jason Goepfert in Sentimentrader.com were suggesting, on February 28 5% of each client's accounts was put in an ultra-short hedge which goes up $2 in value for each $1 the S&P goes down. Shortly, the market did correct, but not as much as I feared, with the result that we still hold the hedge. By March 20 the Smart Money (big contracts) was 29% confident in a rally while the Dumb Money (small contracts) was 67% confident in a rally, a 37.5% difference. Goepfert wrote that "In the past 20 years, there has never been a time when a market rally continued uninterrupted after such a wide negative spread."

Whether we get the 3-5% correction I have been expecting, obviously this market has a lot of steam pushing it. Stock market investing is not a matter of steady even gains every year. I'm expecting this year to be one that makes up for the nearly flat market of the last ten years. Earnings have increased dramatically while stock prices have remained relatively flat. Dr. James Paulsen of Wells Capital Management has identified cycles where this happens followed by a few years of both earnings and stock prices moving up, followed by a few years of stocks continuing to rise while earnings are flat. Bond sentiment is finally starting to collapse, leaving domestic stocks as the least-bad alternative no matter what fears persist. There is certainly significant cash on the sidelines to drive prices higher.

If you haven't been watching, Apple is the elephant in the middle of the room for any perspective on the market. The stock is up 50% on the quarter. The implications are bigger than "the one that got away" (since we do not hold the Apple). In terms of the value of its stock or capitalization, it is almost half again as large at $550 billion as the next biggest stock, Exxon-Mobil at $403 billion. Apple is larger than the whole retail sector, and larger than a third of the combined capitalization of a third of the 30 companies making up the Dow Jones Industrial Average. And it is not in the DJIA-30, which is a big part of why the DJIA-30 trails the Russell 3000 by about a fourth (see chart next page). Maybe Apple needs to be its own index and withdrawn from all the others.

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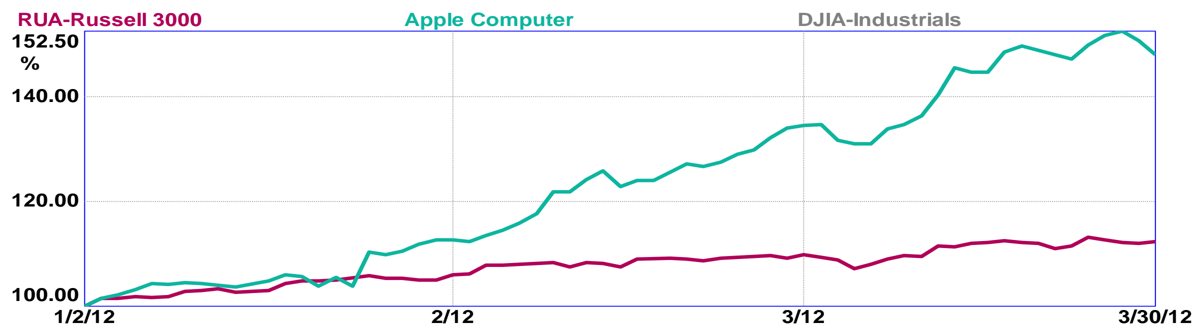

Obviously, Apple would have been a good buy in the past, but should one own it now? Is it a bubble, or can it continue to absorb all capital like the financials were doing leading up to 2008? Based on earnings, it is not that expensive with a P/E of 17. But can the earnings and stock price increase be sustained? After public alarm about the wage and working conditions of its supplier in China, working hours have been reduced and wages increased 25%. In a relatively paranoid fashion, Apple is involved with high-stakes legal battles with its suppliers (i.e. Samsung) and its competitors when it can reach them. It is fearful of Google's Android which at a little over 50% has double the market share of Apple's i-phones, but is not legally reachable since Google doesn't sell the product but rather gives it away as open code.

What draws Apple's investors? Many asset managers don't dare to not hold it for fear of not matching their benchmarks. Investors like a company that makes products that are tangible, familiar and well-liked. And a momentum stock is good until the music stops. My statistical research has found that stocks that have dropped in price are a much better bet than those pushing new highs. Some of those pushing new highs keep going, but identifying them is not as predictable.

Understanding your Portfolios

I have heard from some of you that it is not easy to understand my reports, how I pick stocks, or what all these companies are about. The way I crunch numbers seems rather esoteric, and most of the companies you own you have never heard of and have little idea of what they do. Besides that, I watched a presentation given to the Denver AAII chapter by Dr. Kathleen Vohs, a psychologist researcher at the Carlson School of Management. Her experiments find that when money is brought to people's attention, they withdraw and become less social, they trust less and tend to do things themselves, and do the opposite of what an authority tells them to do. It was an interesting but distressing presentation. So I'm starting to understand why over half of all financial advisors are paid a 1% wrap fee in addition to any money management fees, not for financial planning but to maintain a relationship and keep people invested in the funds or money managers selected by the advisor. Indeed, when performance is largely but not entirely random, and methodologies are complex to understand, it is an act of faith to put your trust in me. It takes someone who is comfortable with and knows how to delegate while maintaining accountability. I'm not very good at shaping our relationships. My personality inclinations are to let others seek to define our relationship, and I then either take it or reject it. So let me say that I welcome a lunch or other opportunities to review reports and how I work plus better understand your needs.

Besides Apple, another familiar and tempting company with stellar growth taking over the world is Amazon. In contrast to Apple, Amazon is very expensive in terms of earnings with a P/E of 149. To translate, that means every dollar one owns of the company only has earnings of $.0067, hardly a very adequate rate of return. The reason for the low earnings is that everything is poured into growth and infrastructure. The story is seductive and with the price at 80% of the October high, maybe we should be in Amazon.

Lee