Beacon Investment Management
The Friday Brief

Distributed to our clients and friends weekly
http://www.beaconinvest.com
Toll Free 888-621-5885
Friday, March 20, 2009

Vote or Weigh?

Today, there is a strongly held belief that financial markets are efficient. The efficient market hypothesis maintains that prices of traded assets such as stocks, bonds, or property adequately reflect the sum of all known information at any given point in time. With today's rapid flow of information, we see prices adjusting ever more quickly and with greater volatility. The hypothesis also asserts that it is impossible to consistently outperform the market by using any information the market already knows, except through luck. There are strong and passionate opinions on both sides of this hypothesis and it is not our goal to defend or to debunk them today. Rather we aim to point out that *because* of the widely held belief in market efficiency there are some exciting opportunities that have strong potential if we lengthen our timeframe beyond nest week or next year. We want you to know about them.

The grandfather of modern investing described the market as a voting machine in the short-term and a weighing machine in the long. Today's markets provide striking examples of the characteristics of Graham's voting machine analogy. Every piece of new information blabbed on television, computer, newspaper, magazine, Blackberry, or cell phone moves stock prices these days with seemingly greater volatility. It seems to make little difference whether the information is economic, financial, or political; they all have tremendous leverage on the market.

An investor takes a long-term view and is able, *in theory anyway,* to stand above the fray, ignoring the chaotic swings caused by the panic or greed ruling the day. In a sense, he ignores the market's short-term 'voting' mechanism in favor of its more reliable long-term 'weighing' abilities. While traders, technicians, and speculators chase every wiggle or waggle in a stock, index, or market, investors 'weigh' investment opportunities of today against historical fundamental measures that have stood the test of time. These measures also tend to vary little over long periods of time. Examples of these measures include corporate earnings related to the price of stocks, book value of a company compared to its stock price, and the ratio of cash generated by a business related to the sum of its market value. These measures have been confidently relied upon by investors throughout the history of modern investing to identify value in the marketplace. So why isn't everyone buying if measures of value are at near extreme lows?

We submit that today's markets offer significant long-term opportunities; perhaps more than almost any time in history. Bargains exist in numerous parts our efficient (or inefficient) market not because they are being ignored by investors, but because numerous uncertainties remain in our banking sector for one. As Mr. Bernanke pointed out, we will not have a sustainable economic recovery until the financial sector is returned to health. While the Fed's moves to restore confidence have been met with market approval and have demonstrated significant effectiveness, much work remains.

Another concern facing investors is that the political response to the crisis has been largely mishandled and counterproductive (one glaring example; the idea of complicating the tax code to confiscate bonuses from AIG employees who were rightfully paid under the stimulus legislation actually approved by the congressmen complaining the loudest makes no sense). Is there any wonder why investors are less than confident in their traditional measures of valuation when they find themselves in and environment dramatically shifting from private-sector driven free-trade to one of Keynesian big-government socialization?

So where are today's values? To be sure the answer is mixed and qualified. There are some great values among the emerging markets, China in particular. And there are some fraught with peril, such as those of long-term bonds of most any kind. The prospect of economic recovery is gaining confidence almost daily, but the specter of inflation may engulf it once things get rolling. We don't argue with economists who seem more comfortable accepting the evil of inflation than its alternative; a debt-drive deflationary spiral. At least with inflation debt can be paid for with cheaper future dollars.

In earlier speeches Mr. Bernanke hinted that he was worried about the lack of political resolve to see this crisis through to a successful conclusion. As an historian of the Great Depression he worried that the government might come up short in providing sufficient stimulus. On Wednesday he pulled out the biggest gun he had and fired it straight at the problem. It was a shot heard round the world on every currency trading floor.

The Fed's announcement to re-inflate the US economy by buying long-term Treasuries effectively caps long-term government rates at 3% and will have some very good short-term consequences for investors in US assets. The Fed is essentially creating dollars to buy the bonds. The move has the effect of devaluing the dollar and alternatively inflating the value of dollar-denominated assets. The dollar, which had been rising strongly for weeks ended abruptly on Wednesday when the Fed announced its bond-buying plan. The dollar index quickly dropped 5.6% on the news. Yields on 10-year Treasuries declined the most since 1962 and the stock market closed up another 2%, adding to its strong seven-day rally of 17%.

Re-flating an economy can be a good thing in the intermediate term, but it has consequences – namely inflation. For now, it means higher stock prices, higher home prices and higher 401K values. As these assets rise, or just stop going down, confidence returns and people begin to spend a little more. Businesses begin to invest and hire more workers as well.

The last few months have shown the pitfalls of investing or speculating in individual stocks or bonds. We are advocates of broad diversification and believe that is the best way to invest over a lifetime. There are significant opportunities ahead that cry to be noticed, but selection and allocation are vital. Assets involved in bubbles generally take years to recover. The most recent example comes from the technology sector which is yet to recover from the dot com bubble. Price earnings multiples of tech stocks relative to the market remain a fraction of the levels they averaged pre-bubble. It is likely that financial and real estate stocks will suffer lower valuations for years to come due to destroyed confidence for the former and speculative excesses for the latter. It could also be strongly argued that US stocks in general will suffer lower valuations due to the current crisis in confidence, an astronomical country debt, and a government shifting policies toward socialism.

There are opportunities in US stocks given their near-historically low valuations and we like them going forward, but we recognize that selectivity is important to navigate around the lingering effects of recent asset bubbles, the looming threat of inflation, and government policy shifts. The really exciting opportunities lie beyond the borders of the US; particularly in China, much of Asia, Russia, Brazil and parts of Latin America. There are indeed many US companies that will capitalize on the growth abroad and we believe their outperformance will drive US markets higher, significantly higher in years to come. But greater growth opportunities lie abroad. Additionally, we think commodities are especially attractive. We like them as an inflation hedge and as an investment in the growing global economy. These gems are in plain sight for all to see in today's markets. They wait to be gathered by discerning investors who can weigh their value on the market's scale, rather than its constant and often irrational polling.

That's it for now. We hope you have a great weekend.