

Six Reasons for Optimism

“Sometimes life is going to hit you in the head with a brick. Don’t lose faith.”
Steve Jobs, Co-founder, Apple

With all of the news and chatter suggesting a challenging road ahead for the economy and investment markets, it is tough to find a reason to be optimistic. It feels like we are lying on the mat after being punched and everyone is screaming, “you can’t get up, so don’t even try.” A reduction in confidence is natural after the punches we have taken, and getting up will not be easy, but an important first step in doing so is to believe that we can and will prosper again.

Famed investor, Sir John Templeton, once stated... “The four most dangerous words in investing are ‘This time it’s different.’” Without a doubt, the influencing factors and the degree of challenge we currently face are atypical, but the fact remains that our challenges are but a bump in a road that is heading toward a more prosperous future. The pundits state that this is not a bump, but instead is a path-altering event. Sir John Templeton would warn they are making a dangerous prediction.

Compiling a list of reasons to be pessimistic is easy these days and we don’t have to do much digging to find the supporting information. The evidence is all around us. However, there are reasons to be optimistic, and it is our belief that by looking at a more balanced picture and by avoiding the temptation to buy into the theories of those who predict we are on a new course, you will make better investment decisions. Here is a list of six reasons to be optimistic...

1. Pessimism is creating opportunity – Consumer sentiment surveys show that recent confidence in the U.S. economy has revisited lows not seen since the end of the recession in mid-2009. Investor sentiment echoes this. *Just consider how many of the people around you believe the stock market will thrive in the next few years.* The overwhelming pessimism does have a silver lining, however. Pessimism results in selling, which is why the market has fallen from its highs, and selling activity drives prices down. Lower prices obviously create better buying opportunities and increase the likelihood of stronger performance moving forward.

2. Investors are more susceptible to extremism – When you take inventory of the uncertainties we face and add the memory of two major downturns in the past 11 years, it is natural for investors to be frustrated and nervous. These emotions make investors prone to extreme thinking, which is a primary driver of increased market volatility. During the 3rd quarter, the stock market seemed to price in extremely bearish predictions, but a more likely outcome is somewhere toward the middle of those and more bullish predictions, as is most commonly the case. If economic results surprise on the upside by even a modest amount, stock prices should reflect the better outcome.

3. Prices are being supported by value – As prices fall, price-to-value ratios improve, which is the ultimate cause of market stabilization and bottoming. To determine the fair value of stocks and bonds, money managers use valuation models and they are being forced to price in the uncertainties we currently face. Let’s divide the management teams into

three camps: those who believe our economy will easily overcome current uncertainties and have factored these beliefs in their pricing models (“the bulls”), those who believe current uncertainties will cause great challenge (“the bears”), and those who are more balanced (“the realists”). Based upon our interaction with the management teams, recent stock prices appear to have fallen well below the fair value estimates of the bulls, below the estimates of the realists, and in some cases below the estimates of the bears. This leaves us with a general sense that prices have fallen to levels where underlying values are providing significant resistance to further price deterioration. Could it happen? Of course, anything is possible, but it is less likely than it would be if prices were higher relative to value. *Price to value ratios suggest that managers are being presented with compelling buying opportunities. At some point in the future, we will look back on this period wishing we had bought more.*

4. Global population growth and expansion continues – The primary drivers of long-term growth in aggregate global demand are population growth and the emergence of new markets. Fortunately, there have been no significant changes to these drivers. This is the reason that Sir John Templeton’s quote has been so accurate over the years. Policymakers make mistakes, consumers overspend, asset bubbles are formed and burst, but we have a persistent wind at our backs that helps us overcome short and even medium-term setbacks. This has been a significant setback, but ten years from now there will be more consumers in the world than there are today and our companies will be selling in new markets. Evolution continues! Keep your chin up - our bowling lane is tilted downhill and has bumpers in the gutters.

5. There has been improvement in two of three pillars – The three pillars of the global economy are corporations, households and governments, and all three were challenged in 2008. Currently, there is a disparity in the financial strength of corporations, but overall, the companies that are publically traded in the stock market have made the tough decisions necessary to improve their cash flow and have set records for cash on their balance sheets in recent quarters. They have also taken advantage of low borrowing costs (due to low interest rates) to repair their balance sheets and fund future growth initiatives. Households are making tough adjustments to improve their cash flow and repair their balance sheets, as well, and debt to income ratios are improving. Keeping rates low to assist with this process is a primary goal of government stimulus efforts. As for global governments, they have purposely levered up to help corporations and households get back on their feet. The fact that government debt totals in developed countries are climbing is not a surprise, but the level and acceleration of debt is a concern. Ultimately, we need all three pillars to move in a positive direction to return confidence to the markets. We expected global governments to be the last pillar to improve given the type of problem we face (*i.e.* an asset correction), and we are encouraged by the amount of attention that is being given to government spending and debt imbalances.

6. The global economy has self-corrective mechanisms – When demand slows, sellers are forced to reduce prices in an attempt to stabilize and repair demand. In other words, sellers provide economic stimulus. A more specific example is commodities. During periods of stronger economic growth, consumer demand increases, which results in companies buying more commodities to produce the additional goods and services being sold. Obviously, this results in a rise in commodity prices, which is typically passed through to the price of the goods and services. These higher prices often slow consumption, which keeps demand and ultimately price inflation in check. Periods of slower demand negatively impact commodity prices, which reduces production costs and allows companies to lower the prices they charge consumers. The point is that the burden of maintaining healthy long-term economic growth is not entirely on the shoulders of policymakers. The economy has an immune system. Policymakers can shorten or lengthen the duration of a



cold, but the power, adaptability and self-corrective mechanisms of the economy are what ultimately cure it.

Conclusion

During periods such as the 3rd quarter, it is tough to maintain a balanced perspective. The consistent bombardment of negative news and persistent reminders of the uncertainties we face have shaken our confidence. However, it is important to remember that the most pessimistic periods often prove to be the best times to invest. Lower price-to-value ratios are supporting prices and presenting investors with opportunity. There is great debate about the direction moving forward, but we are confident that we remain on the path to prosperity. We will continue to face challenges along the way, but as long as the drivers of long-term growth remain, the challenges will be bumps, not path-altering events.

Market Comments

The global economy continues to muddle its way through a challenging recovery as investors lack the confidence necessary for the markets to gain solid footing. During the quarter, there was no shortage of macroeconomic concerns including unsettling economic results, a U.S. debt downgrade, a contentious political environment, and continued European financial distress. These negative influences resulted in a powerful flight to quality, and for the quarter the Russell 3000 Index (total U.S. stock index) returned -15.3% and the MSCI AC World ex-US Index returned -19.9%. Within the stock market, significant reversals took place as a result of the flight to quality. In the first half of 2011, small and mid cap stocks outperformed large caps – continuing a trend that generally has been in place for ten years. However, the macroeconomic events that occurred during the quarter resulted in a shift in investor preference toward more stable large cap companies. Investors also preferred more stable stock sectors, with those less economically sensitive significantly outperforming those more economically sensitive (e.g. Materials, Financials, and Consumer Cyclical).

The bond market was not immune to the investor appetite for quality. While bonds in general performed well during the quarter (the Barcap Aggregate Bond Index gained 3.8%), there were significant differences between the performance of bond sectors that are generally viewed to be safer and those that carry greater risk. For example, the Barcap Intermediate Treasury Index (low risk) returned 3.5% during the quarter and the Barcap High Yield Corporate Bond Index (higher risk) returned -6.1% during the quarter.

The investment environment is testing the nerves of investors, but there are reasons to be optimistic, which we outlined above. We continue to stress the importance of using fundamentals to guide your investment decisions.

Disclaimers: While Veratis Institutional Advisors, Inc. uses reasonable efforts to obtain information from reliable sources, Veratis makes no representations or warranties as to the accuracy, reliability or completeness of information obtained from third party sources presented herein. Any forward looking statements or forecasts are based on assumptions and actual results are expected to vary from any such statements or forecasts. No reliance should be placed on any such statements or forecasts when making any investment decision. The views expressed herein reflect information as of the publication date only and may change at any time without notice. The information provided is confidential and shall not be copied or distributed without the express written approval of Veratis Institutional Advisors, Inc. No guarantee of investment performance is being provided and no inference to the contrary shall be made. Copyright © 2011 Veratis Institutional Advisors, Inc. All rights reserved.

