

ROUNDVIEW CAPITAL

WHERE ARE WE NOW?

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Coming into 2008, I concluded in a research piece entitled “I’ll Huff and Puff...” that contraction in U.S. residential real estate would have severe consequences for worldwide economies. Accordingly, I structured client portfolios more defensively than normal (although nothing seems defensive enough given recent market declines). Since then, every major asset class with the exception of cash has suffered significant losses. As we look to the end of 2008, the steady barrage of negative news is trying – even for the most seasoned investors.

Where are we now?

- The financial world is a mess, and the news will certainly get worse before it gets better. That said, with the market at multi-year lows, I am confident that current equity and debt investments in companies that are able to withstand this severe global slowdown will prove to be rewarding. All you need is an incredibly strong stomach and a heavy dose of patience (easier said than done). If your definition of patience is less than 5-10 years, you would be wise to review your allocation to risky assets if you haven’t done so already.
- I have been using the current turmoil to trade up within client portfolios. To use a football analogy, we are paying Matt Cassel prices for proven MVPs like Tom Brady (a bad knee notwithstanding). This has meant upgrading equity holdings within portfolios, and taking positions that are more senior in the corporate capital structure (bonds over equities).
- I am not attempting to call a market bottom in the overall stock market. In my opinion – on a valuation scale from 0-10 with zero being extremely cheap and ten being the most expensive – we are currently at a three. History has shown that valuations can easily go from cheap to VERY cheap, and from expensive to VERY expensive. For this reason, we are resisting the urge to go all-in and are keeping dry powder within portfolios.

History, however, has also shown that investments made during periods of fear and low valuations have a high probability of providing fair returns over time. If you don’t buy and own assets during periods of great fear and low prices, when do you buy – during periods of giddiness and high prices?

Remember how great it felt to buy common stocks in 1999, and real estate in 2005? Valuations do matter.

The remainder of this overview will begin by addressing the most common mistake people make – investing through the rearview mirror. We will also take a look at current valuations and review some opportunities in today’s market. I hope this provides you with some insight and perspective during a period of uncertainty and fear.

OVERVIEW

- I. IS EVERYONE BELOW AVERAGE?
- II. KNOWING THE PRICE OF EVERYTHING, AND THE VALUE OF NOTHING
- III. MATT CASSEL PRICES FOR PROVEN MVPs LIKE TOM BRADY
- IV. TAKEAWAYS

I. IS EVERYONE BELOW AVERAGE?

ALMOST ALL INDIVIDUALS ARE BELOW AVERAGE INVESTORS
BECAUSE THEY INVEST BY LOOKING THROUGH THE REARVIEW MIRROR

	Annual Performance
S&P 500	12%
401k Participants	6%

Source: Vanguard

From 1984 to 2004, the stock market as measured by the S&P 500 averaged a 12 percent annual return. Vanguard found that participants in its 401(k) plans earned only about one-half the average — 6 percent a year.

Why the discrepancy?

Individual investors commit the classic market sin of chasing performance and investing through the rearview mirror. People buy after things have gone up, and sell after things have gone down.

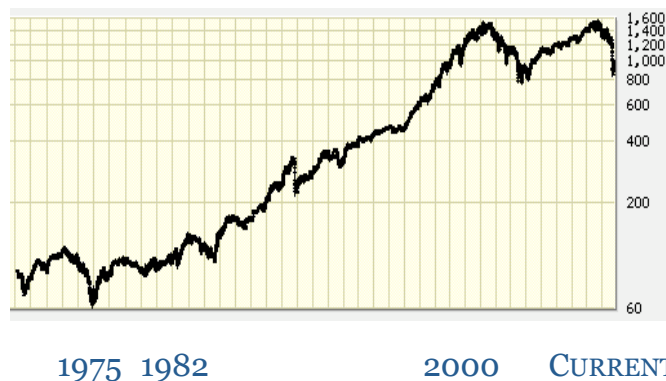
YOU'RE NOT ALONE

INSTITUTIONAL INVESTORS ALSO INVEST THROUGH THE REARVIEW MIRROR

EXPECTED PENSION FUND RETURNS FOR GM AND IBM

COMPANY	1975	1982	2000	CURRENT
GM	6.0%	7.0%	10.0%	8.5%
IBM	4.8%	5.5%	10.0%	8.0%

S&P 500: 1970-CURRENT



Individual investors are not the only ones guilty of investing through the rearview mirror. The chart above shows current and previous expected pension returns by professional investment managers at General Motors and International Business Machines. Public companies with defined benefit plans are required to report these expectations, and you will find similar assumptions in the annual 10-K filings of other companies. As you can see, expectations for future performance rise after the market has risen, and fall after the market has fallen – just the opposite of what’s rational.

During the “Nifty Fifty” bull market of 1971, pension managers put more than 90% of their net cash flow into stocks. By 1974, stocks were significantly cheaper, but only 13% of net cash flow went into stocks. Has the “smart money” learned anything over time? In 2000, the GM pension did not have significant exposure to real estate or alternative investments. By 2007, close to the peak of these two asset classes, almost 20% of GM’s capital was allocated to these investments.

MARKET TIMING

SHORT MEMORIES & THE FORD F-150

“Let’s sell now and get back in when things look safe.”

You don’t know how many times I’ve heard this sentence during periods of market weakness. No one sells during a market downturn with the intention of buying back when prices are higher. Conversely, no one buys when prices are going up thinking that they will sell when prices are low.

In practice, however, that’s exactly what happens. How else do you explain the discrepancy between individual 401k performance and a passive index like the S&P 500?

Why doesn’t market timing work consistently over time? The market moves in quick spurts that are almost impossible to predict. Like in the game of poker, anyone can get lucky with one hand. The key to success for experienced poker players and investors is to be consistently successful over time.

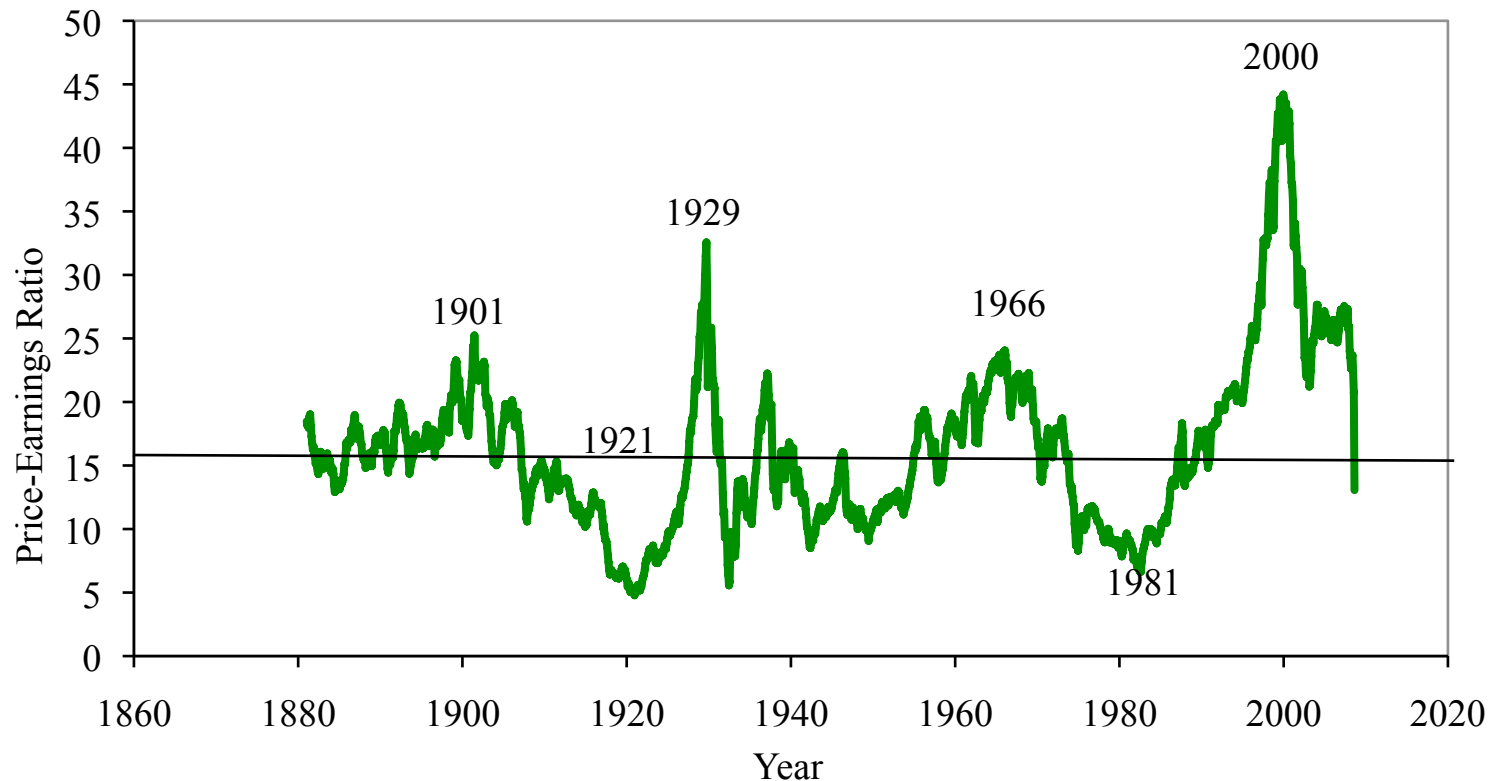
The decisions most people make are dominated by recent events. If the market has recently been down, we extrapolate this trend and forecast the worst.

Do most people really have such short-term memories? A recent announcement about the Ford F-150 pickup truck answered this question for me.

High gasoline prices over the summer pushed Americans to drive less and look for more fuel-efficient vehicles. The recent slide in oil and gasoline prices has already raised the prospect of backsliding by American drivers. Ford Motor Company recently announced that it would call back 1,000 workers to a truck plant in Dearborn, Mich., saying it expected growing consumer demand for its new F-150 pickup truck.

II. KNOWING THE PRICE OF EVERYTHING, AND THE VALUE OF NOTHING

VALUATION: PRICE-TO-10-YEAR-TRAILING-EARNINGS



To loosely paraphrase Oscar Wilde, most people “know the price of everything, and the value of nothing.” That said, let’s review current market valuations since this is the basis by which intelligent investment decisions are made.

This chart by Professor Robert Shiller provides insight into the valuation of the S&P 500 by looking at a price-to-earnings multiple that utilizes 10-year rolling earnings. Looking at 10 years of earnings smoothes out short-term adjustments and provides a longer-term perspective for equity market valuation. Valuations are cheap, but not the cheapest they have been historically. This is why I continue to maintain a relatively defensive allocation in client portfolios.

VALUATION: PRICE-TO-10-YEAR-EARNINGS

In 2001, Warren Buffett provided the following insight on market valuation in Fortune magazine:

*On a macro basis, quantification doesn't have to be complicated at all. Below is a chart, starting almost 80 years ago and really quite fundamental in what it says. The chart shows the market value of all publicly traded securities as a percentage of the country's business--that is, as a percentage of GNP. The ratio has certain limitations in telling you what you need to know. Still, it is probably the best single measure of where valuations stand at any given moment. And as you can see, nearly two years ago the ratio rose to an unprecedented level. That should have been a very strong warning signal. For investors to gain wealth at a rate that exceeds the growth of U.S. business, the percentage relationship line on the chart must keep going up and up. If GNP is going to grow 5% a year and you want market values to go up 10%, then you need to have the line go straight off the top of the chart. That won't happen. For me, the message of that chart is this: **If the percentage relationship falls to the 70% or 80% area, buying stocks is likely to work very well for you. If the ratio approaches 200%--as it did in 1999 and a part of 2000 -- you are playing with fire.***

The market has been a wild thing

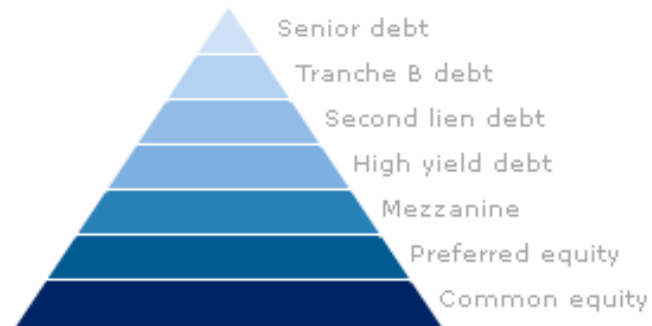
The value of U.S. stocks vs. GNP has avalanched since 2000. But October's ratio of 133% still tops the 1929 peak.



Where are we now? The ratio is within 70-80%.

III. MATT CASSEL PRICES FOR PROVEN MVPs LIKE TOM BRADY

MOVING ON UP

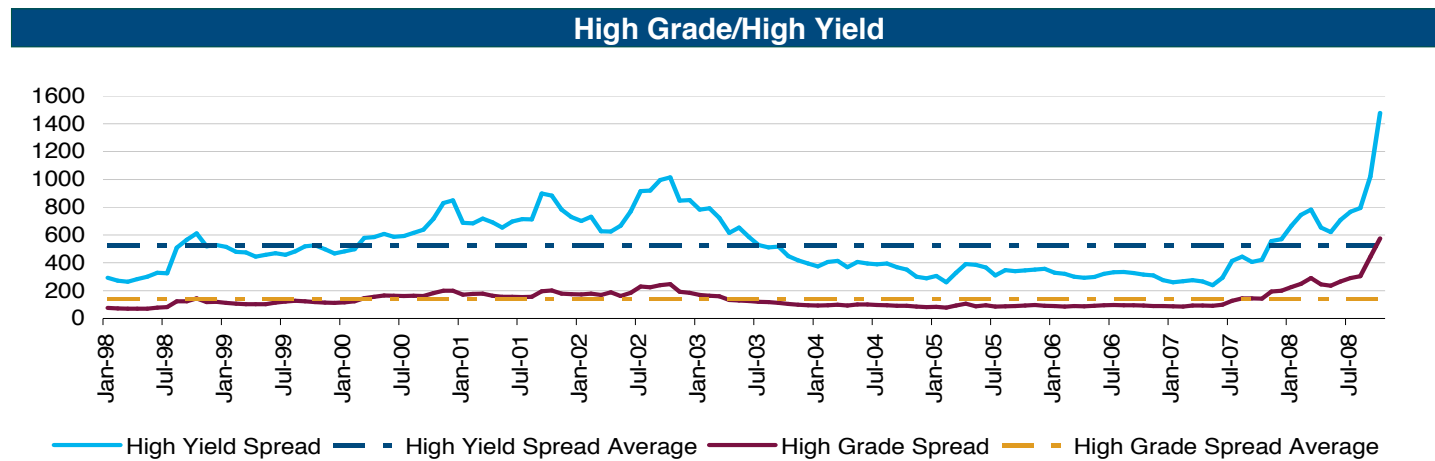


I have been using the recent turmoil to trade up within client portfolios. This has meant upgrading equity holdings within portfolios, and taking positions that are more senior in the corporate capital structure (bonds over equities).

For example, the chart above depicts the capital structure of a generic company. Debt, for example, is senior to common equity which means debt-holders must be paid by a company before equity holders. Typically, bond investors settle for lower expected returns because of their relative safety in the corporate capital structure.

We are currently finding bonds and other senior issues that provide equity-like returns. The market is providing us with Matt Cassel prices for proven MVPs like Tom Brady, and we have been taking advantage of this.

GETTING PAID



Source: Barclays

Investment grade corporate bonds are offering their biggest yield premium over Treasuries since the early 1930s, and now provide equity-like returns. Randall Forsyth of Barron's recently observed that the low end of investment grade corporates yield about 550 basis points (5.5 percentage points) more than comparable Treasuries. You have to go back to the early 1930s, when the lowest level investment grade corporate bonds yielded 700 basis points over Treasuries, to find a comparable situation.

IV. TAKEAWAYS

1. The market is cheap. Investments made during periods of fear and low valuations have a high probability of working out over time. If you don't invest during periods of panic and low valuations, when do you invest?
2. Cheap, however, can become VERY cheap. We continue to stay relatively defensive.
3. We are using the current environment to upgrade portfolios. The risk-adjusted returns from investment grade corporate bonds, for example, are compelling.
4. The market has been, and will always be, very volatile. As a result, don't just focus on near-term prices – understand value.
5. Most individuals hurt their long-term investment returns by trying to time the market.
6. Successful investing is 90% perspiration and 10% inspiration. Have the discipline to buy and hold when the world looks ugly and assets are cheap. Don't get carried away with excitement when the world looks great and assets are expensive.