March 5, 2009

TCM Update
Commentary

A publication of Trent Capital Management, Inc.

We wanted to share with you our most current thinking about the overall environment and our investment positioning. Perhaps the biggest question we are being asked is whether we've fully factored in the extent of economic damage that is now becoming apparent and being reflected in the form of major declines in the stock market. The short answer is that we are confident we have.

We understand that the powerlessness of watching the value of your wealth decline creates a strong desire to "do something" about it – to take control and end the pain. Converting to cash may lock-in losses, but at least it creates a certainty amidst a great deal of fear and uncertainty. These are the conflicting forces that every investor faces right now: the certainty of locking-in a set (albeit painfully lower) level of wealth, versus the uncertainty of possibly more near-term losses and the hope of better longer-term returns. We want to give you perspective and information.

Focus

There is a great deal of economic uncertainty that could take a further toll on stocks in the near term. It also makes it more difficult to forecast the longer-term value of stocks. What we can do about this is make assumptions that are so negative that we believe we have a good margin of error on the downside and a high degree of confidence, at least in the lowest end of our longer-term forecasted return ranges. In collaboration with other experts, we have identified the most negative scenarios possible and factored those into our analysis. While we are unsure of what the shorter term will bring, we are confident that our scenarios fully consider the possibility of a lengthy and extremely poor economic environment (where the earnings decline is comparable to the Great Depression).

Based on that analysis, the stock market can still earn good returns from current levels over a five-year time horizon. It may also help to note that we are not alone in this assessment; even some very negative investment professionals, among the few who saw this crisis coming, now forecast positive multi-year returns for stocks. Importantly, however, capturing these positive returns will require maintaining that longer-term focus through what may continue to be a very trying period.

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Analysis

Remember that markets do their best to see into the future and reflect that future in their prices. So, the key question is what is priced into stocks today?

- One metric is the Shiller P/E, which is now down to 12x normalized earnings (using the S&P 500's recent price of 700) See below.
- Another metric is the 9-year risk premium (which is the comparison of stock returns to a "risk-free" return—we use the S&P 500 and Treasury Bills). Based on this measure, stocks are coming off of their worst ever nine-year return relative to T-Bills—including the Great Depression period (we looked at returns since 1926). This strongly suggests stocks are not expensive and annualized returns over multi-year periods after the lowest risk-premium periods were double-digit.
- Expected annualized S&P 500 returns in our *most pessimistic* five-year scenario are 7%. If equity P/E multiples turn out to be even lower than what we are now using in that scenario, returns could be further reduced by 1% to 2%. That would be quite harsh and would result in unprecedented bad returns based on the other metrics mentioned above. But even in that case, returns are positive and probably in line with what the bond indexes deliver, and better than cash.

Shiller P/E

There are many ways to assess valuations. One metric we have added to our valuation tool box is the so-called Shiller P/E, named after Robert Shiller, the Yale professor. Shiller calculates his P/E based on an average of the last 10 years' earnings in order to smooth out short-term earnings volatility and also inflation-adjusts his earnings and stock price levels. The current Shiller P/E is 12x normalized earnings, which is lower than any post-WWII period.

Rallies and Declines

It may seem impossible to imagine a market rally from here. It can happen, and it will at some point. By definition, investors are most pessimistic at a market bottom. There is a huge amount of cash on the sidelines, which is good. When everyone is highly pessimistic there are few investors left to sell. Then, as bargain hunters start to step in, a powerful rally can develop. Our expectation is that we could see several rallies and declines before we move on to another bull market. We are confident in our longer-term expectations.

While we are confident that from current levels, stocks offer good longer-term return potential, we don't know what might happen in the shorter term. This uncertainty creates a dilemma that is very important to understand. Stocks could drop further or they could rebound sharply. If we try to predict this and invest accordingly, we have to consider the consequences of being wrong. If we go to cash, the market could rebound sharply before we can get back in. It is possible we could see a rally of 20%-30% before concrete signs of sustained economic improvement begin to show up. This is because the market is forward-looking and nearly always reaches a bottom well before the economy reaches a bottom. If that happens, we could see a material portion of the good multi-year return potential that we believe exists appear in a short time. At that point, we would need to decide whether the market's turn was going to be sustained and get back in, or continue to wait and risk losing further upside. If we did get back in, we could be whipsawed if the upswing proved to be temporary, as commonly happens during severe bear markets.

Opportunity Mixed With Difficulty

On the other hand, if we remain invested, our analysis gives us confidence we will earn a good return over our five-year investment time horizon, independent of what the short term brings. We also know that we will continue to see tactical opportunities amidst the near-term weakness, and that our active managers will have opportunities to add value by buying stocks that have been oversold due to fear rather than fundamentals. Longer time horizons have the highest value when short-term fear is greatest because that is when the greatest opportunities are created.

Like you, we find this environment literally gut-wrenching. We are focused, thinking clearly, and analyzing data and information every day. We will continue to work extraordinarily hard to make informed and rational investment decisions, over the longer term that work will pay off in the form of good returns on your behalf.

As always, we greatly value the trust and confidence you place in us to manage your investments.

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