April 19, 2013

"The higher the stock market advances, the more reason there is to mistrust its future action. Hence, a large advance…is basically a sign for caution and not a reason for confidence."
-BEN GRAHAM; GENERALLY CONSIDERED THE FATHER OF SECURITY ANALYSIS AND CREATOR OF THE GRAHAM-DODD P/E RATIO.

The Oracles's oracle. One of America's least known genius investors is Howard Marks, co-founder and key personage behind $77 billion Oaktree Capital. Because Mr. Marks runs mostly institutional money, he doesn't attract the rock star adulation of a Bill Gross. Yet, his long-term track record with bonds in general, and distressed debt in particular, is among the best in the business. Moreover, *Barron's* recently quoted Warren Buffett to this effect: "When I see memos from Howard Marks in my mail, they're the first thing I open and read. I always learn something." (Oddly, the Oracle of Omaha has never been on record with a similar comment about the Evergreen Virtual Adviser and its scribe.)

My reason for bringing Howard Marks to your attention is his recent memo, "The Outlook for Equities." Undoubtedly, Mr. Buffett opened and read this missive with the speed of light in a vacuum, not just because of its author but also due to its theme, which is supportive of the Oracle's generally upbeat view of stocks. As usual, Mr. Marks' musings contain some really good stuff, including this section echoing the main message from the March 22nd, EVA: "Many of the important things about investing are counterintuitive. Low-quality assets can be safer than high-quality assets. Things get riskier as they become more highly respected (and thus appreciate)."

Therefore, it is possible that at times stocks can be safer than bonds, as conveyed in the aforementioned EVA, even though a share of stock in a company is, by definition, less secure than a bond in the same entity. Basically, if the price of the stock is low enough and the price of the bond is high enough, the latter may have more risk of producing a negative return than the former, assuming that it is a solvent enterprise. (This is especially true on a long-term bond when it may not be possible to hold it to maturity and also considering inflation.)

Or, looking at the stock market overall, it's also feasible for it to be less risky than the bond market. Obviously though, it takes some highly unusual factors to create such a condition—like the Fed whipping up and then injecting a trillion dollars a year into bonds.

Consequently, Messrs. Marks and Buffett, and I, are all on the same page about the long-term outlook for stocks: They offer the prospect of higher return over the next decade with potentially less risk and, certainly, much lower risk compared to bonds, than is generally the case.

The key phrase here is "compared to bonds." Now we are entering the realm of relativity and with that, emerges another maxim of the investing world.

Slight Off the Marks?

The equity risk premium (ERP) is one of those things you've probably heard bandied about on TV or in the *Wall Street Journal* but never really understood. For better or worse, I'm going to do my best to explain what it means as it is an important concept.

In fact, the erstwhile maestro, none other than Mr. Alan Greenspan, appeared on CNBC last month and declared: "The basic way of looking at the degree of exuberance or non-exuberance (my note: toward stocks) is to take a look at what we call the 'equity premium'…and right now, by historical calculation, we are significantly undervalued."

Based on Mr. Greenspan's forecasting record, with both stock and home values, letting him be your market compass is much like, as one wag recently noted, "getting a lecture on seamanship from the captain of the Titanic." But, I digress.

The point he's making is that if you take the current P/E of the market, which is around 16 based on profits generated over the last year, it equates to an earnings yield of 6.25%. The easiest way to think about this is to visualize a stock selling at $10 earning a dollar a share, meaning that based on the price you are paying you are receiving a 10% profits return, or $1 divided by $10. For the overall market today, you have to pay $16 to receive $1 in profits, hence the 6.25% earnings yield. (For those of you with a real estate orientation, this is the equivalent of the "cap rate" for stocks.)

The next step is to compare that 6.25% to risk-free interest rates. Here it gets a bit murky. Do you use the 10-year Treasury note or short-term cash? Let's be generous to stocks and use present short-term interest rates of zero. Voila, the market has a spread over risk-free interest rates, otherwise known as the equity risk premium, in excess of 6%! And, as Mr. Marks points out, the average over the years has been 5% to 6%. Even better, since WWII it has been just 3.25%. Hence, at least superficially, it's not unreasonable for Mr. Greenspan to be touting stocks.

As usual, Mr. Marks doesn't buy this simplistic reasoning: "The problem with basing a pro-equities argument on the yield comparison is that most of equities' current attraction on that basis comes from the lowness of interest rates." He further comments that anyone with a pulse should realize that these rates are due to the Fed's monetary incontinence and, accordingly, won't last. Thus, it is silly in the extreme to value very long lived assets like stocks on the basis of unquestionably distorted short-term interest rates.

He also points out, quite validly, that a normal risk-free rate is 3%. This is about 1% above the current subdued level of inflation of around 2% but, in normal times, there is a small real reward, like 1%, on short-term cash. Using 3% instead of zero changes the math dramatically. Suddenly, stocks are now selling at an equity risk premium of 3.25% (the 6.25% earnings yield minus a realistic and historically justifiable risk-free return of 3%).

Past EVAs have made the emphatic point that earnings need to be adjusted for the fact that profit margins are at record highs. The same "normalization" should be done with interest rates as well. This leads to one of my key points of this EVA: *To accurately determine whether the market is cheap or dear, both interest rates and profits need to be normalized.*

Mr. Marks did the interest rate reconciliation but not the earnings adjustment. At the risk of correcting a legend, I think he needs to complete the calculation. The problem, admittedly, is that it's tougher to determine a "normal" profit margin than it is to come up with a credible risk-free interest rate.

Coincidentally, I recently read the transcript of a speech given by Ben Graham on November 15, 1963 (yes, exactly one week before a much more historic event). As many EVA readers are aware, Warren Buffett worked for Dr. Graham early in his career and to this day gives his mentor considerable credit for his rather unusual success.

In Dr. Graham's talk, he outlined his adjustment process for fluctuating profit margins: He took an average of the prior 10 years' earnings from the 30 constituents of the Dow Jones Industrial Average. As astute EVA readers recognize, today's increasingly popular Shiller P/E, often cited in these pages, is a variation on this theme based on the S&P 500 rather than the Dow.

Thus, it's interesting to consider what this old metric has to say about market valuations today.

The Oracle's mentor. Looking back at this past decade's Dow earnings, the average of reported annual profits is $738. Based on the current closing quote of 14,600, this means the Dow is trading at nearly 20 times that number. (By comparison, in 1963, it was trading at 23 times the same calculation, a valuation that struck Dr. Graham as excessive. Given that nearly 20 years later the Dow was still bouncing around 750, essentially where it was in the early 1960s, one would have to say he had a valid point.)

Using a "Graham" P/E of 20, the normalized earnings yield is essentially 5%. When compared to a more realistic 3% risk-free rate, the vaunted equity risk premium shrinks to less than 2%, which is well below the very long term average and even below the mean since WWII.

Earlier this year, I approached this issue from a different angle, incorporating the fact that US corporate profit margins are in a two-decade uptrend. My attempt at normalizing earnings produced a more flattering adjusted P/E of 18, equating to an earnings yield of 5.5% and an equity risk premium of 2.5%, again comparing against a more typical risk-free rate of 3%. Given that stocks have a nasty habit of trading at much higher ERPs than 2.5%, as has happened myriad times since Dr. Graham gave his speech in 1963, this would imply that stocks have a fair amount of downside at some point.

Moreover, our partners at GaveKal Research were early advocates of the concept that US corporate profits (and hence margins) have been trending up as a percentage of GDP since the early 1990s, as the following chart makes abundantly clear. They also reasonably attributed the steadily rising percentage of profits relative to the size of the US economy, to the increasingly overseas nature of US corporate activities.

Yet, GaveKal recently ran the chart below indicating that profit margins are at risk of materially reverting to the mean. If you do the math, lowering the current 7% level of profits to the 5% average, you are talking about nearly a 30% earnings contraction. That, dear reader, is a big deal. It basically implies that the market's current P/E ratio is understated much more than the 15% I assumed with my adjusted P/E, as described above. Therefore, stocks might be selling at more like 20 times normalized earnings. (By the way, the respected "Shiller P/E" is now at 22.3, versus its historic average of 18.2 since WWII.)

1

Image not found or type unknown

Therefore, even though stocks may look better than bonds in the long run, as I believe, with plenty of good company, they still have a much higher level of risk than they did four years ago. Of course, back then, the *perception* was that they were extremely risky.

There are about $2.5 trillion reasons why stocks are broadly believed to be a much surer bet today than when they were 60% cheaper—basically, the size of the increase in the Fed's balance sheet, all done with funny money.

2

Image not found or type unknown

Yet, while Mr. Marks acknowledges most of the above (though he pays only passing attention to the importance of peak profits on market valuation), he feels that sentiment among investors is negative enough to drive further appreciation. But when I look at the facts, such as the charts below show, I question how valid that conclusion truly is, again with apologies to one of my heroes.

3

Image not found or type unknown

Additionally, though I didn't hear it firsthand, a CNBC commentator said last week that one of his colleagues actually enthused: "This market will never go down."   While that's merely an anecdotal example of irrational exuberance squared, if not cubed, the evidence of this becoming a widespread attitude is growing. As you can see below, margin debt is back up to where it topped out in 2000 and 2007. Perhaps coincidentally, perhaps not so much, the market also peaked at those high margin levels.

4

Image not found or type unknown

The 100 year dud.

It's certainly possible that stocks can keep running from here.   But it's essential to realize that almost everything is being pumped up by easy money these days and that won't last forever.   It's also important to be aware that historically extremely low interest rates have actually been associated with periods of low market returns. This contradicts the notion that low yields are supportive of high stock valuations. This could be due to the reality that when rates are extremely depressed economic growth is anemic; in other words, the situation we have today.

5

Image not found or type unknown

Also showing that investors may need to ratchet down expectations, crack quantitative fund company AQR recently ran a calculation based on the currently low level of bond yields and the above-average valuation (using factors such as I've outlined). Its conclusion is that a balanced portfolio of half stocks and half bonds offers the *lowest* prospective return seen in the last 100 years. That's kind of a long time and should cause today's stampede of rabid bulls to double-check their reasoning.

Similarly, my great friend Louis Gave wrote not long ago that even if you assume stocks will provide decent returns, despite the dual risks of interest rates and earnings both eventually normalizing, you are still inarguably stuck with the reality of rock bottom bond yields.

Due to the fact bonds make up about two-thirds of most institutional portfolios (with Ford's pension fund for one stating that it intends to move from 55% bonds up to 80%), then, by definition, stocks will have to carry a lot of mail. As Louis notes, should stocks produce 8% average returns over the next five years, and if bonds produce at best break-even gains, due to eventually rising rates, overall gains will be quite disappointing. Consequently, it's almost certain returns won't match the assumptions used by nearly every corporate retirement plan and university endowment fund.

More likely, both stocks and bonds will get slammed at some point in the not-too-remote future with the most likely trigger being when the Fed needs to be a seller rather than a buyer of trillions of dollars of securities.

Which leads me to my final point of this week's EVA…

Hence the name. Once again riding the formidable intellectual coattails of our partners at GaveKal, they have repeatedly conveyed the fundamental concept that there are really only three ways to make money in the financial markets. The first is to borrow short-term money at a low rate and then invest longer term at a higher rate, the so-called carry trade that blew up so spectacularly in 2008 and once again is attracting massive sums (likely in the trillions) in pursuit of apparently easy profits.

The other is to be a momentum investor, essentially riding the market's wave whichever way it is running. Unquestionably, that strategy, like the carry trade, is working beautifully right now in this bull move that has been charging for over four years. More and more investors seem to believe that, even if they concede the market will eventually go down, it won't be anytime soon. And, of course, "they," in their uncommon wisdom, will be long gone before it heads south.

The third way to make money is positioning for reversion to the mean, whether this pertains to valuations, interest rates, profit margins, volatility, risk aversion, or a host of other similar critical factors. This is clearly the Evergreen way. My team and I are convinced it works best, at least for us, in the long run. Yet, it has a serious flaw that crops up from time to time, particularly when the first two money-making methods are hitting on all cylinders.

By definition, being able to take advantage of the inevitable reversion to the mean during a time when the market has been on an extended roll requires becoming more defensive as prices inflate. To do this, Evergreen has been using a number of hedges, including cash, that are for sure inhibiting us from attaining the full return of the latter stages of this Fed-stoked bull market.

The reason hedges are called hedges, if they are the real deal, is that they should go down when the market is rising and vice versa. Evergreen clients saw this illustrated vividly in the late summer of 2011 when the market was in free fall and our real estate investment trust (REIT) hedge was producing profits to help offset the losses on our long holdings. Since then, our hedges have also cost us return, *which is what they are designed to do when the market is in rally mode*.

Of course, with the dazzling clarity of perfect hindsight, we would not have had any hedges over the last couple of years. We would have been fully invested, running with the herd, and enjoying all the upward momentum of this liquidity-propelled rally.

Yet, the massive problem with both the carry-trade and momentum approaches, which we believe is much worse than the challenge of being a return-to-the-mean investor, is when to get off your surfboard. After all, it’s a ton of fun to be in the pipe and ride the big breaker. But as any experienced surfer knows, there is a time to get down and prepare for the inevitable cresting. When it comes to investing, precious few have shown the ability to hunker down in a timely manner. Rather, they have tended to be hanging out there, fully exposed and fully invested, when the roaring waters of a crashing market engulf them.

Consequently, it’s my contention that there is only one way for investors to achieve durable high returns at these valuation levels for the financial markets and that is to be defensively positioned until the next crisis of confidence comes along. Then, when fear has driven down prices, prospective returns truly will be worth the risk. Based on the latest ominous news out of Europe, and now even China, the wait might not be that lengthy.

13

Image not found or type unknown

IMPORTANT DISCLOSURES