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October 16, 2009: Third Quarter

Consider the following comments offered by various pundits in the media. The tone is decidedly downbeat. The good news is there is none of the panic that was heard widely a year ago at this time. The negative commentary comes at a time when the Dow is crossing 10,000 for the first time since early October 2008.

"We've come too far, too fast?" (these comments started in early May); "Take some chips off the table!" "Shouldn't we be worried that the Fed will take back the rate cuts too fast?" (Translation: the markets won't like it when the Fed raises rates which is viewed as inevitable); "The consumer is tapped out and unemployment is rising" (Never mind that 90% are working and there are signs the recession is over); "What about a double dip?" (The ECRI, which has an excellent record of predicting these things, has ruled that out); "Be discerning if you are going to be in the equity market." "The future improvements in the economy are priced in." "Commercial real estate defaults will be the next shoe to drop." References are made to "headwinds." "We're in uncharted territory; another bubble may well form." "For ten years stock investors have made no money" (this assumes that you bought and held, or had an index fund or the like). One short-term bond fund manager speaking on CNBC, recommended "being strategic," which he went onto explain meant taking profits in stocks and investing in short term bond funds--like his own, as if that wasn't what investors have been doing since The Reserve Fund broke the buck. He went on to say that the strategy he recommended was based on his view that Fed funds would be 7 to 7 ½% by 2011. "Isn't it appropriate to take profits here?" he was asked. The questioner may have been asking whether a profit-taking was appropriate in short term instruments. The manager assumed she was talking about stocks. Risk is rarely where you expect to find it. "Be careful," we are told, as if you shouldn't always be. Presumably these are unusual times. Others have questioned the future of capitalism. We are told that, "the market is ahead of the fundamentals."

The facts are that there have been four pullbacks, each inflicting little damage on the indexes and three of four lasting about two weeks. The first was in mid May, when the cries of "too far, too fast" were initially heard. The second occurred during July 4th week, the third around Labor Day and the fourth started on September 23 after the Fed delivered a sanguine report on the economy. Each of the first three resolved to the upside within eight trading days, the most recent coming just ahead of earnings season, has lasted a little longer. A telling datapoint came from Investor's Intelligence which tracks investor sentiment. This week, the contrarian gauge is pointing to better things for stocks. The portion of bears rose two points to 26.4%--the highest level in 11 months. Remember where things stood eleven months ago? Elevated bearishness is traditionally positive. In addition, an index of leading stocks, as measured by superior technicals and fundamentals, has been outperforming the major indexes in the past several weeks in spite of the overall lackluster performance.

Another commentator said recently "If you were down 50% and now you are down 10%, what would you do?" The answer he supplied was that investors should take profits, which is exactly what investors are wont to do when they get close to breakeven. In market parlance, this selling creates "overhead supply" or resistance. Doing as everyone else does rarely results in profits. And what about the declining US Dollar? No research has demonstrated the there is a correlation between the dollar and market direction.

One of my favorite quotes speaks to current market conditions which are more positive than most market observers would have it. The 19th century humorist, Artemus West, the editor of Vanity Fair and contributor to Punch said:

> It ain't so much the things we don't know that gets us into trouble.
> It's the things we know that just ain't so.

There are few places where there is so much knowledge and expertise as on Wall Street. Many, at least among those quoted most frequently, rely on what they "know." Opinions are plentiful, but frequently wrong; just don't attempt to point out "what just ain't so" to them. I've forgotten who said it, but it nevertheless holds that "It's not what you know, but what you see that counts." Capitalism is not dead. Markets are doing what they have always done--recover from nasty falls. The best companies, as measured by superior metrics like high return on equity, superior and accelerating earnings and revenues, innovative management introducing new products that serve big new markets, are the best performers. These are the kinds of companies we look for to include in portfolios. If you buy companies with superior metrics, those superior to 98% of all stocks, and buy when the market is in an uptrend and before they become extended, well-better-than-average results will likely follow.

Remarkable as it may seem after the market bottomed in March, the major averages have performed admirably year-to-date:

NASDAQ :	+34.6%
NYSE:	+20.0%
S&P 500:	+17.0%
Dow:	+10.6%

Since month's end when the market was going down, the averages have firmed and added several percentage points to their year-to-date gains. Earnings season is underway and the results for companies that have reported are encouraging, companies like Google and Intel, both in the tech space and economically sensitive.

If you have questions about your holdings or portfolio, please call or email.

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