

**Pessimism Takes Hold**

Whatever method you use to pick stocks... success or failure will depend on your ability to ignore the worries of the world long enough to allow your investments to succeed. It isn't the head but the stomach that determines the fate of the stock picker"  
—Peter Lynch

On March 1<sup>st</sup> the Nasdaq launched a new uptrend. During the prior year, the Nasdaq had risen 83% from its bear market bottom of 2100. Over that span, the market successfully resisted several bouts of selling, avoiding declines of 10% or more. The market was remarkably resilient until the end of April. An April 26<sup>th</sup> headline read “Strong Q1 Earnings Trouncing Forecasts: On Pace for 50% Growth.” The article noted that sales gains had improved also. 83% of the S & P 500 firms that had reported had beaten views. However, during April the headlines began to turn negative. The SEC accused Goldman Sachs of fraud in their mortgage dealings, the Greece, Spain, Portugal, Italy and Ireland debt situations deteriorated. Investors became fearful of the unintended consequences of financial reform. On April 22<sup>nd</sup> the Deepwater Horizon rig in the Gulf of Mexico sank after catching fire following a blowout. This unleashed an unprecedented oil spill, an enormous ecological disaster and an as-yet uncontrolled spill. The spill was aptly described by Peggy Noonan in the Wall Street Journal as

a Videotaped metaphor for all the public's fears: that clip... of the well gushing black oil into the Gulf of Mexico and toward our shore. You... don't get deadlier as a metaphor than... the monster that lives deep beneath the sea.

The timing of the spill could not have been worse as markets saw the gusher as symbolic of the explosion of American debt and its potentially disastrous consequences. As Noonan also pointed out, Americans, despite their divergent views on the other issues, are fiscal conservatives, who see high debt as undesirable. The markets were dealing with increasing institutional selling. Distribution days had piled by the end of April, leaving the uptrend under pressure. A correction began on May 4<sup>th</sup>; adding to the fear was the “Flash Crash” on May 6<sup>th</sup>, a still inadequately explained event that saw the Dow decline 1,000 points in minutes.

Despite the growing negativity in May and June, positives have emerged. Historically, June rallies have proven fruitless, but August rallies have proven sustainable. In early June the Nasdaq reached its lowest level since February 10<sup>th</sup>. Meanwhile, many fundamentally strong stocks continued higher. The Nasdaq low of the 30<sup>th</sup> killed the rally that was confirmed on June 15<sup>th</sup>. Investors had many reasons to be confused,

But a silver lining is emerging in the form of growing cash levels, increased bearishness among advisors and attractive valuations. One highly respected advisor noted last week that the S & P 500 is undervalued by 28% based on historical data. The appearance of the Black Cross, a technical condition in which the 50 day moving average crossed under the 200 day average, caused increased bearishness among market strategists and investment advisors. The Investors Intelligence Sentiment Survey in April showed 55% of strategists bullish, 18% bearish. With the “Black Cross”, strategists became even more bearish as bullishness dropped to 40 % and bearishness rose to 30%. Recent Investors Intelligence readings show only 37% bullish advisors and 35% bearish, increased bearishness among advisors is bullish. In other words, negative readings are contrary indicators, as markets frequently rally when strategists are abnormally bearish and insufficiently bullish<sup>1</sup>. The P/E of the 500 on 2011 earnings is 11, corporations have \$973 billion cash. hedge funds have \$500

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<sup>1</sup> On July 14<sup>th</sup>, the bulls versus bears survey showed the percentage of bullish advisors at its lowest point (32%) since March 27<sup>th</sup>, 2009 just after the bear market ended. Bearishness rose to 34.8%, more bears than bulls.

billion. The T-bill rate is 0.19% and \$8.7 trillion sits in money market funds. The June 30<sup>th</sup> Journal headline read “Fear Returns for Quarter’s Final Act: Dow... on Pace for First Quarterly Decline since Bull Market began.”

A recent blog written by Matt Ridley entitled “Down with Doom” offered perspective on the history of negativism. Ridley was a college student in the 70’s when “the world was coming to an end.” He mentions events that were supposed to hasten the end: the population explosion, air pollution, nuclear winter, the world running out of oil, acid rain, and a lost ozone layer. Two decades later, as he was researching a book he was about to write, Ridley discovered this predicted terrible future had not turned out so bad. The doomsayers’ idea was that “prosperity and freedom were advancing at the expense of poverty and tyranny...” His conclusion supported by a wealth of objective data:

Not only are human beings wealthier, they are also happier, more tolerant, less violent, more equal. Check it out- the data are clear. Yet... the pessimists had only grown more certain, shrill and apocalyptic.

Ridley noted that “every single one of the calamities predicted by doomsayers failed to materialize.”

Michael Lewis’ book, The Big Short, on the mortgage crisis offers many insights into the dangers of uncritical thinking. As illuminating, disturbing and insightful as the book is, it was the introductory quote from Leo Tolstoy that struck me as germane:

The most difficult subjects can be explained to the most slow-witted man if he has not formed any idea of them already; but the simplest thing cannot be made clear to the most intelligent man if he is firmly persuaded that he knows, already, without a shadow of a doubt, what is laid before him...

The market is human psychology on display. The message of the market cannot be ignored, but if doomsayers direct your actions it will be difficult to be influenced by the data or objective information. The late Johnny Wooden, the definitive optimist, and legendary UCLA basketball coach, had a sign in his office that read “It’s what you learn after you know everything that counts.” Unfortunately, investors’ recent experience, the bear market of 2008-09, and the recent correction have exerted undue influence on current thinking. Like the continuously playing videotape of the Gulf Spill and its metaphorical impact on psychology, recent news has cast a shadow on the outlook for the future.

Investors need to be alert to changing conditions and new information served up by the market. On a portfolio basis it will pay to continue to invest in innovative companies with superior fundamentals and strong market positions. Disregard world worries and allow your stocks to succeed.

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