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**Year End Commentary**

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The world's stock markets continued their steady rise into year-end and bond markets showed declines as expectations for a return to economic growth continued to take hold. This is at least what we have been reading in the mainstream financial press even if it does not make much sense in light of economic reports that point to a structural slowdown in the U.S. as far as the eye can see. When credit flowed and consumers borrowed with confidence, U.S. vehicle sales routinely ranged between 16 and 18 million/year. Now the analysts get excited when December edges up to an 11 million annualized rate. Before the fall of 2008 we went 25 years without the monthly rate dipping that low. The great engine of the US economy -housing, continues to be extremely weak. Housing starts are bumping along a bottom that is 75% below the 2006 peak and builder confidence is falling again. Low mortgage rates are being offset by very low consumer confidence. Consumers are being hit by falling take-home pay, rising health care costs, rising energy costs and the worst job market since the Great Depression. Job losses have slowed but they continue and the number of unemployed people per job opening is at a record high.

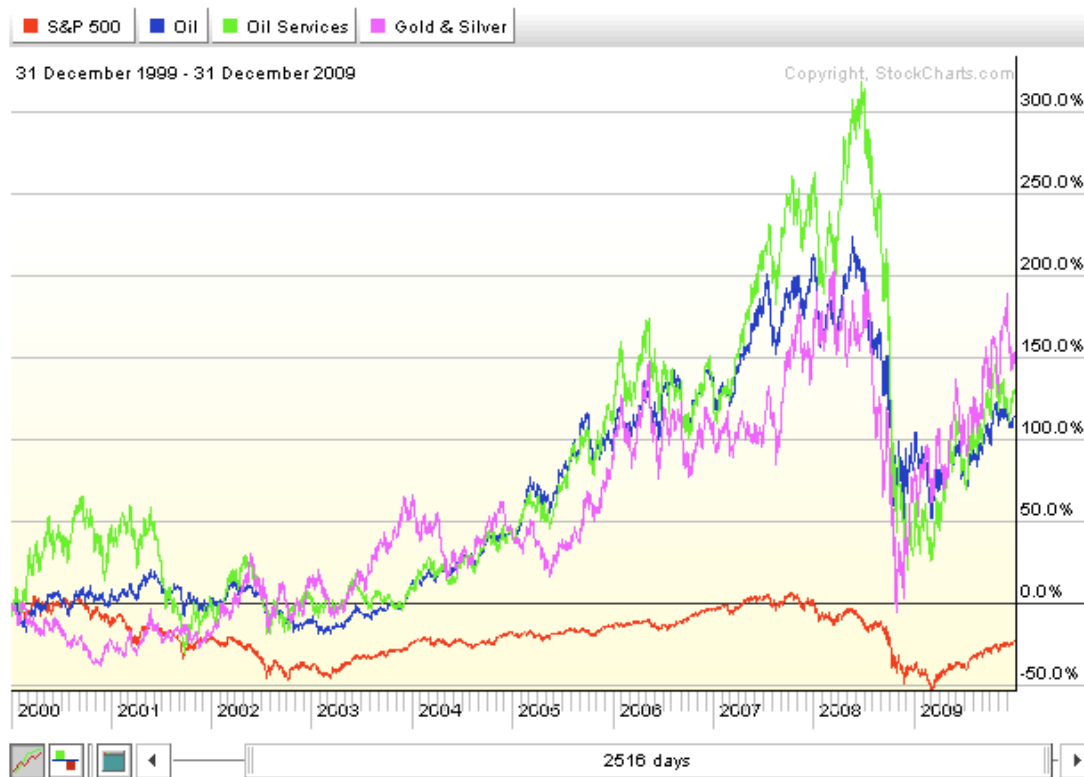
Index Performance	4Q	YTD
DJIA w/divs.	8.1%	22.68%
S&P 500 w/divs.	6.04	26.46
Nasdaq Comp w/divs.	6.91	43.89

When faced with data like this our genetically programmed human response is to look for a rebound. The cliché is what goes down must come back up. Instinctively, we look for balance. But what if our instincts are wrong in this case? Consider that the Federal Housing Administration (guaranteeing 30% of all mortgages up from under 4% four years ago) has just announced a tightening in lending standards in an effort to remain solvent. Overall spending by U.S. states last year was cut 5.4% but the revenue base is shrinking faster still leaving a massive gap that will force more spending cuts this year unless the Federal government rescues the states with a bailout. Illinois (where cash on hand has been dipping below \$1 million some days) and California (which is seeking a \$6.9 billion bailout) are perilously close to insolvency. More than three-dozen states according to some estimates are not far behind. The IMF is suggesting that the U.S. and other industrialized nations will have to inject further stimulus spending to prevent an economic relapse. This normally conservative organization is saying this while acknowledging that such spending is pushing government deficits to problematic levels.

My conclusions are (1) that the major equity indices may reflect too much optimism (but also see below for an alternative theory on this); (2) any talk of the Fed's exit strategy is premature; and (3) a true economic recovery with strong job growth could be years away. It is very hard to see what may rescue the U.S. economy from this long deep slowdown and not hard to envision a variety of problems that could pile on and turn a bad situation into something worse.

An alternative explanation for the relatively high valuation being accorded the equity market could be that in a world in which key central banks feel obliged to debase their currency, and sovereign debt default in developed economies must now be recognized as a distinct risk, the ownership of productive enterprise may offer greater relative security. In other words it might not be that stocks are really getting overvalued but that there is an unconscious consensus belief that the value of cash dollars, pounds and euros is about to take a tumble. The massive quantitative easing programs are well documented and major news organizations like The New York Times have prominently reported on the “printing of money”. Reuters reported that at a December summit of top money managers “Concerns about potential government insolvencies took the spotlight”.

December 31, 2009 was not just the end of the year but it also brought the curtain down on the worst calendar decade for stocks in the nearly 200 year history of the U.S. equity markets. One dollar invested in the S&P 500 on January 1, 2000 would have been worth just 91 cents (including the reinvested dividends) at the end of those ten years. The chief economist at Ibbotson Associates called it a “nightmare” decade and the statistics may understate how badly the average investor fared for two reasons. First, “survivorship bias” tends to make indices come out ahead of the components because underperforming or failed companies (think Enron) are frequently replaced with more vibrant companies. Secondly, academic research shows that investors tend to worsen their performance with emotionally driven purchases and sales of stocks and mutual funds.



Roughly ten years ago I started discussing the notion that things were changing and that we were probably entering a period of low investment returns. I wish I could say that I thought of this myself but I got the idea from a Morgan Stanley strategy piece. I took this concept to mean that we should not invest in the manner that had become the standard doctrine in a generally rising market. Broad diversification would increase the likelihood of mediocre or even negative returns. I believed that instead we should target specific areas of opportunity. We went looking for market niches that were relatively unloved (and thus undervalued) where we could identify the ingredients of future demand and pricing power. Ten years ago

virtually everyone was enthusiastic about technology, drug and financial stocks and these groups were heavily represented in the benchmark S&P 500 index. I felt for varying reasons that these sectors should be broadly avoided. By contrast, I saw little enthusiasm but strong prospects for energy, basic materials and precious metals. Strong representation of these sectors for most of the time has enabled our portfolios to perform substantially better than the broad market over the past decade.

Such an approach is by definition not diversified in the standard sense and therefore we are at times subject to greater volatility. This method is not suitable for all investors, however, investors who share my conviction must ask if the benefits outweigh the drawbacks. I believe that over “investable time-frames” (defined as periods of at least three to five years) we should continue to experience higher returns that compensate and make the strategy worthwhile. The chart (on the previous page) tracks the price performance of the S&P 500, the Amex Oil Index (XOI), the Oil Service Index (OSX) and the Philadelphia Gold/Silver Sector Index (XAU) for the past decade. With the clear caveats that past performance does not predict future returns and that, secondly, none of these indices represent any of my managed portfolios, it is truly instructive to see how poorly the popular S&P 500 index (the bottom line) performed both on a relative basis and in an absolute sense. It is diversified and clearly less volatile than these other indices, but it is difficult to understand why anyone would consider it preferable or even more sensible during a period of unprecedented challenges to the status quo.

Looking forward to the next ten years, I am convinced that the economic and market environment of the past decade will continue many of the trends that started in the past several years and that our current strategy will again prove to be more rewarding than the overall equity market.

M.S.