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2006: A Year When Patience Will Be Rewarded?

Buying good businesses at bargain prices is the secret to making lots of money.

The Little Book That Beats the Market, Joel Greenblatt, 2005

Joel Greenblatt is a successful New York hedge fund manager and a professor at Columbia Business School. Recently, he wrote a thin volume, *The Little Book That Beats the Market*, in which he lays out a simple strategy for beating the stock market. Essentially, his strategy is to screen the universe of U.S. publicly-traded stocks in search of companies with two key features: a superior earnings yield (a low P/E ratio) and a strong return on capital. He claims that if an investor periodically buys the top 25 stocks that this strategy uncovers and then sells them a year later, the results would be at least twice as good as the returns for the S&P 500 Index. And there is every reason to believe that he is right – as he has tested this strategy with U.S. stocks going back to 1988. However, there is one important caveat: An investor following this approach would underperform the stock market one year out of every four and for two years in a row in one out of every six periods. Yet, using this strategy for any period of three years or more would produce outstanding results. Aye, and there's the rub! Three years is a long time, and few money managers (or their clients) have the patience and faith necessary to underperform the market for several years in a row, waiting to reap the rewards of this approach.

Patience was also the operative word for investors in the U.S. capital markets in 2005. In spite of a strong economy, excellent corporate profits, and low core inflation, the broad stock market turned in barely positive returns. The Dow Jones (total return) and NASDAQ Composite Index showed nearly identical returns of 1.72% and 1.37% respectively, while the broader S&P 500 Index (including dividends) ended up 4.91%. The bond market was no better with the 10 year U.S. Treasury bond returning 2.82%, and shorter maturity corporate and municipal bonds had a total return of less than 2%.

Why was it such a difficult year? There were several reasons. Investors hate rising interest rates, and the Federal Reserve raised the Fed Funds rate in ¼% increments all year long, reaching 4.25% in December. Energy prices, already high and on the rise, spiked dramatically due to Hurricanes Katrina and Rita. For a while, gas at the pump exceeded \$3.00 a gallon. Moreover, the toxic tone of political discourse, the tough slog in Iraq, and the media's frequent questioning of the strength of the economy and fretting over the so-called "housing bubble" took its toll on investor confidence. Thus, the stock market made little progress in climbing back to its highs reached almost six years ago, as the charts on the following page show:

S&P 500 Index



NASDAQ Composite Index



Is a Recession Imminent?

At the moment, there are confusing cross currents in global markets that worry investors. The most puzzling anomaly is the combination of a strong global economy, led by the U.S., China, India and Japan (finally emerging from ten years of deflation), higher short term U.S. interest rates and flat to lower long term interest rates. In the past, robust economies have normally produced a yield curve with long term interest rates higher than short term rates – not one where short term rates are flat or even higher than longer term interest rates. At the moment, the yield curve is flat as a pancake. Furthermore, core inflation in the U.S. has remained modest with the core CPI increasing only 2.3% in 2005, yet during the same period, the price of gold rose more than 20%. Gold is usually on the rise when inflationary fears and/or panic from geopolitical events are most intense. These contradictory moves are not easily explained. Chairman Greenspan has called the current phenomenon of a strong U.S. economy, rising short term interest rates, and lower long term interest rates a “conundrum.” Others guess that gold has decoupled from inflation due to speculation from overseas investors with more liquidity than usual.

One plausible explanation for lower long term U.S. interest rates in the midst of a strong economy is the large U.S. trade and current account deficits, which leaves billions of U.S. dollars in the hands of foreign institutions and central banks. Many have suggested that these banks, rather than selling the dollars and investing in other currencies or spending the dollars immediately, are ready buyers of longer term U.S. government debt instruments, thereby keeping long term U.S. interest rates low. This helps support the U.S. economy and allows U.S. consumers and corporations to continue buying foreign goods and services from these countries. These same countries are thereby able to have stronger economies with more workers employed – what can be called a virtuous circle.

Another explanation for this anomaly might be that a recession is on its way. Over the last four or five decades, every recession in the U.S. has been presaged by an inverted yield curve. An inverted yield curve happens when short term interest rates are higher than long term interest

rates, and it has usually happened when the Federal Reserve has been raising short term interest rates in an effort to contain inflation and its harmful effects – just as the Fed has been doing for the past 18 months with 13 hikes of the Fed Funds rate from 1% to 4.25%. The charts below show that the yield curve is close to being inverted:

90 Day T-Bill / 10 Year T-Bond



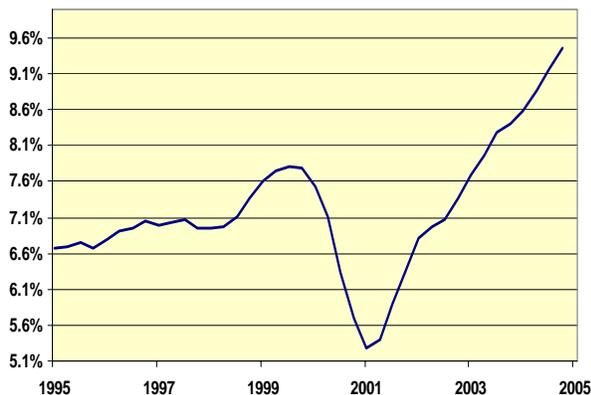
2 Year T-Note / 10 Year T-Bond



Economists have also been pointing out that higher interest rates have slowed the housing boom in various parts of the U.S., and flat or lower housing prices will keep consumers from refinancing their mortgages, leading to reduced consumption. Higher energy prices may also cause slower spending.

Do we see a recession coming in 2006? No. While all U.S. recessions in the last 50 years have been preceded by an inverted yield curve, not every inverted yield curve has turned into a recession. This is, we believe, what will happen in 2006. Currently the economy is showing real GDP growth of 4%, and U.S. corporations appear to be in very sound shape. By some measures, corporations have over \$1 trillion on their balance sheets. Debt as a percentage of capital is at a reasonable level from an historical perspective, and margins and return on capital have never been better – as can be seen from the charts below:

S&P 500 Index Net Profit Margin



S&P 500 Index Return on Capital



Expectations for 2006

At Bradley, Foster & Sargent, Inc., we believe that the Federal Reserve is nearly finished raising short term interest rates. After 13 increases in the Fed Funds rate, we believe that there are only two or three rate hikes left – one likely in January to 4.5%, when Chairman Greenspan turns the reins over to Ben Bernanke. Then perhaps one or two increases more throughout the balance of 2006. We also see energy prices remaining high with oil at \$50-\$75 per barrel and natural gas above \$8.00 per MMBtu. This, we believe, will cause the U.S. economy to slow from its current pace of 4% GDP growth to 3%, which will help keep inflation contained at the 2-2.5% level. Unemployment recently fell below 5% – lower than it was for most of the 1990's. In short, we believe that the Federal Reserve has an excellent chance of engineering a soft landing – especially if the Asian economic powerhouses of China, India and Japan continue their robust growth.

How will the U.S. stock market perform? At this time last year, we hazarded a prediction that the S&P 500 Index would end the year at 1275. While we were slightly off on the date, the S&P 500 Index reached 1270 on December 15th and climbed to 1283 on January 6, 2006. While again disclaiming how the market will perform over the next twelve months, we do believe that an S&P 500 Index at 1360 at year-end 2006 would not be overvalued. We arrive at this number by taking the 2006 S&P 500 estimated operating earnings of \$80 and applying a market multiple of 17. Although corporate earnings rates have maintained double digit increases for 13 consecutive quarters, stock prices have moved up much more slowly. This means that the stock market in 2006 might well experience both a slightly expanded P/E ratio and higher earnings. This, in an environment with inflation at less than 3% and with investors no longer anxious because of the Fed's constant increase of short term interest rates, *could mean a total return of 10% or more* – absent unforeseen geopolitical or terrorist events.

We also believe that growth stocks will begin to outperform value stocks, reversing the trend over the past few years, and we see large capitalization quality stocks with rising dividends being a beneficiary of this environment. We also think that energy stocks will continue to do well. With interest rates continuing to rise in 2006 – especially longer rates, we see bonds continuing to underperform the stock market.

The methodology of Joel Greenblatt, the author who we quoted at the start of this essay, will lead investors to buy good companies at bargain prices, many of which are out of favor cyclical companies. At Bradley, Foster & Sargent, Inc., our approach is to focus primarily on quality growth companies (most of which have a “moat” to discourage competitors and pay a rising stream of dividends). But like Greenblatt, we seek to buy companies with superior returns on capital at reasonable prices. This price discipline provides for a “margin of safety,” as Ben Graham, the Dean of security analysis, once wrote. And we maintain, as does Greenblatt, that consistently buying good businesses at reasonable prices, in good markets and bad, is the secret of producing wealth for our clients over the long term.