



# Bradley, Foster & Sargent, Inc.

## Quarterly Market Commentary

January 2008

### Making the Most Out of a Market Correction

Bear markets are the long-term investor's best friend – because ... they create bargains in the high-quality stocks that are so frequently overpriced.

H. Bradlee Perry, *Winning the Investment Marathon*, 1999

Since the turn of the millennium, investors in large capitalization, quality U.S. stocks have had a tough slog. Eight years ago, the S&P 500 Index closed the 20<sup>th</sup> Century at 1469. On the last trading day of the year in 2007, the S&P 500 Index finished at 1468. Several weeks into 2008, the S&P 500 Index has dropped about 5% to approximately 1400. The chart below tells the story:

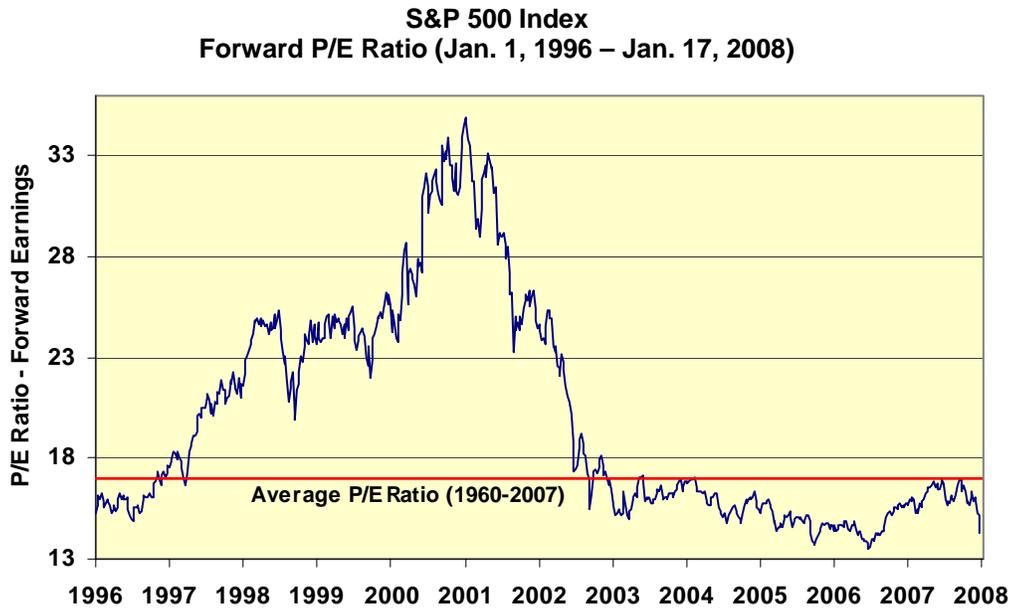
**S&P 500 Index**  
**Jan. 1, 2000 – Jan. 15, 2008**



Source: StockVal

This has been a long, discouraging period for investors who bought S&P 500 Index funds eight years ago. There is much similarity with the 10-year period of 1973 through 1982, which is discussed on the following page. Including dividends, the average annual return for the S&P 500 Index since the start of 2000 has been 1.7%. During this period, the operating earnings of the S&P 500 Index have increased approximately 80%. Why, then, has the S&P 500 Index performed so poorly – especially with the U.S. economy turning in six uninterrupted years of growth starting in 2002? The answer has to do with the dizzying level of valuation that the U.S. stock market achieved during the late 1990's and first months of 2000. In spite of the near doubling of earnings in the S&P 500 Index since 2000, it has taken the better part of a decade for the extreme level of valuation reached in 2000 to return to more normal levels. The graph of the market's P/E level on

the next page shows the U.S.'s "irrational exuberance" in 1999-2000 and the long, painful decline to reality this decade:



Source: StockVal

### Déjà Vu: 1973-1982

The U.S. economy and the stock market were strong during most of the 1950's and 1960's. However, commencing in the late 1960's and throughout the 1970's, the economy and the stock market foundered. Real GDP growth in the 10-year span between 1973 and 1982 was only 2.1% a year – well below the 3.4% average annual real GDP growth from World War II through 2007. This period was characterized by the political unrest over the Vietnam War, the formation of OPEC and the two oil price shocks, Watergate and the resignation of President Nixon, high inflation and unemployment peaking at over 10%. During the early 1970's, many institutional investors poured money into the so-called "nifty fifty." These were the leading, established growth stocks whose P/Es were pushed to levels not dissimilar from the Internet and technology darlings of the late 1990's. The potent mix of sky-high valuations and a poor economy produced the following stock market results:

### Dow Jones Industrial Average Jan. 1, 1973 – Dec. 31, 1982



Source: StockVal

Investors should carefully note what happened during the second half of 1982. After 9½ years of poor stock market results, the market took off in August of 1982 (with the Dow Jones at 815) and never looked back. The Dow rose more than 50% in the next year and was up threefold by the end of 1989. Now, we are not suggesting that the market is as undervalued as it was then, or that the economy can grow as fast over the next several years. But the stock market can act as a spring which is coiled up – ready to launch, when the time is right. This often happens when economic conditions appear unfavorable, stock valuations are low, and investor expectations even lower. With the challenges listed below facing the U.S. economy during the coming year, patience is required, because it may well be one or more years before the countdown to the next launch is complete.

### **Economic and Political Headwinds in 2008**

Reflecting on the economic and political challenges on the horizon, investors sold U.S. stocks in the fourth quarter of 2007, causing the first negative performance for the S&P 500 during the last quarter since 1997. The S&P 500 Index hit its all-time high of 1576 on October 11, 2007 (attaining our year-end target for the S&P 500 Index several months early). Now, three months later, the index has corrected 11.1% to 1401. Over the past month, evidence has mounted of a worsening economy with the jobless number jumping from 4.7% to 5.0%. Retail sales over the holiday season were disappointing, and economists now forecast that there is a 50% likelihood of a recession in 2008. There have been three recessions since 1980, and two of the three (1982 and 1990) were caused by the Federal Reserve’s tightening monetary policy. The most recent recession in 2001 was largely produced by businesses trying to right-size capital expenditures, capacity utilization and employment post Y2K. Real GDP was essentially flat in 2001, and economic growth resumed in 2002. If there were to be a recession in 2008 (and we still believe that there will be modest economic growth this year of 1%+), it will not happen because of the Fed tightening. The Fed is committed to lowering interest rates as necessary to assist the economy. It would probably result from some combination of the following list of challenges facing the U.S. economy and financial system:

- Sub-prime mortgage collapse
- Weakness in the housing market
- Rising unemployment
- Banks' tightening of credit standards
- Recapitalization of many banks
- Deteriorating consumer credit
- Huge asset write-offs at banks
- \$100 per barrel of oil
- Collapse of inter-bank liquidity

In regard to the last bullet point, a joke or story often makes the point better than many paragraphs. According to reliable Wall Street sources, the latest quip circulating on the street, as banks seek capital from abroad is, "It is either Singapore, Shanghai, Dubai ... or bye-bye."

### **Election Year**

Investors hate uncertainty. Generally they would rather know bad news that they can process than endure the uncertainty of too many possible outcomes. In 2008, there is a wide open race for the Presidency. It may be months before either political party knows which candidate will stand for election in November. Moreover, the positions of many candidates on key issues have not been fleshed out and subjected to intelligent criticism, so investors tend to imagine all manner of dreadful things that might afflict the economy for the next four years. This is why the U.S. stock market often drops in the early months of a Presidential election year. As the candidates lay out their policies, investor anxiety drops, leading to a market rebound. In addition to the uncertainty factor, investors are processing the fact that all three leading Democratic candidates are in favor of raising taxes – including the current 15% tax rate on dividends and long term capital gains. If, as the year progresses, the final Democratic presidential candidate does not alter this position, it could represent another significant headwind for the U.S. stock market.

### **Making the Most Out of a Correction or Bear Market**

There is an old stock market aphorism, allegedly stemming from the Napoleonic wars, attributed to the Rothschild family: "Buy at the sound of the cannons, sell at the sound of the trumpets." When the city is surrounded and the cannons are being fired, fears are rampant, and expectations are lowest. So are prices. That is often the time to buy. When victory is declared, the trumpets sound, fear and caution are banished, and expectations are high. So are prices. One only need reflect on the halcyon days of late 1999 when the economy was strong, the U.S. appeared to face no external dangers, and the new era of the Internet was upon us. It was, of course, the worst possible time to buy most U.S. stocks. So now, with fears of an imminent U.S. recession, the huge problems of the banking system, and a wide-open Presidential election, is the time to prepare a buy list. Here is a sampling of familiar stocks the last time there was such economic uncertainty in the U.S.:

<b>Company</b>	<b>1990 Low</b> (split-adjusted)	<b>2007 High</b>	<b>Recent Price</b>
Citigroup	\$1.50	\$56	\$29
Bank of America	\$5.00	\$55	\$38
JP Morgan	\$3.60	\$52	\$40
Wells Fargo	\$1.80	\$38	\$28
ExxonMobil	\$9.00	\$95	\$90
General Electric	\$4.00	\$42	\$35
Intel	\$1.00	\$28	\$22
Microsoft	\$1.00	\$37	\$34
Coca Cola	\$9.00	\$65	\$63
Hewlett Packard	\$4.00	\$53	\$45
Wal-Mart	\$5.00	\$51	\$48
Johnson & Johnson	\$6.00	\$68	\$67

During a tough correction or even worse, a bear market, the stock market often does not distinguish between the really exceptional companies and the others; the stock market marks them all down in price. A falling tide lowers all boats. So, when this occurs, investors need to make sure that they seize the opportunity of selling stocks of their average or even below average companies and buying the best companies at bargain prices. Top-notch companies usually sell at exalted P/E ratios. 2008 may be the year when investors can buy these companies at reasonable valuations. Don't miss the chance. This kind of opportunity only happens once or twice a decade. And, at Bradley, Foster & Sargent, we intend to make the most of a down market in exactly this way.