Saybrook Capital
Investment Outook

June 30, 2005

"The market will do whatever it can to prove the consensus wrong."- Wall Street Truism

Investors are often surprised at how frequently the consensus is incorrect. Paradoxically, the more unanimous the opinion of the 'crowd', the more likely it is to be reversed. This is not the case with all public opinion, however. When it comes to predicting the odds of actual events, whether it be the likelihood of the sun rising in the east in the morning (100%) or the chances of Lance Armstrong winning yet another Tour de France (85% on July 14), odds are a fairly reliable predictor of future occurrences. In fact, past U.S. presidential elections have shown that trading exchanges such as *tradesports.com*, which allow speculators to bet on future events, are more accurate at forecasting election results than traditional opinion polls.

A consensus on a 'market', however, differs greatly from a consensus on an event. The dynamic nature of a market dictates that when the vast majority of participants are already betting on one of the outcomes, there are few remaining investors whose shift in assets can fulfill the prediction. The most obvious example of this self-defeating prophecy is a situation where the sentiment on a stock is overly bullish. When most analysts and investors have positive expectations for a particular company, industry, or market, and have invested accordingly, there are few left to pursue these ideas, and values have only one way to go – down. The euphoria over information technology in the late-1990s proved a real-life example of this dynamic.

An interesting trend for the financial markets in the first half of 2005 was the sharp reversals of several formerly very widely-held conclusions. Reading the ubiquitous 2005 forecasts produced by Wall Street's pundits last December, we were struck by the conventional wisdom that long-term interest rates would have to rise and the U.S. dollar would continue sinking, both due to a variety of factors, not the least of which is the so-called "twin deficits" (budget and trade). With most of the investment community lined up behind this narrow forecast, the opposite occurred. In the first half of 2005, the US dollar appreciated 14.2%, while the 10-Year U.S. Treasury yield fell from 4.22% to below 4%. With the benefit of hindsight, commentators are now pointing out the reasons for these unexpected moves (including record U.S. bond investments by Asian central banks, the deceleration of U.S. economic output, milder than expected core inflation, and even lower European interest rates driven by weak economies and the rejection of the EU constitution).

We do not claim to have predicted these reversals, but we do benefit from a healthy dose of contrary thinking. One of our core “preservation of capital” beliefs (printed boldly in our investment brochure) is our commitment to “doing something different than the crowd” and avoiding the seduction of “shooting-star themes”. These dictates not only help prevent capital losses caused by over-exuberance, such as the “dot-com” phenomenon, but they also can assist in capitalizing on opportunities where investors are impacted by a fear-driven bearish consensus.

A constructive exercise now is to examine current areas of strong belief, which could be reversed in the latter half of 2005 and into 2006. Contrarians need to look no further than magazine covers (both popular and financial) to determine where there is a growing consensus. A forever-rising trade deficit, $100 oil, and the certainty of a catastrophic real estate decline are three fields where popular and expert opinion has left little room for alternative outcomes. While we do not assert any superior knowledge on these seemingly strong convictions, history demonstrates the potential for surprises in these important areas.

An issue of particular relevance to our investment strategy is that of future expectations for U.S. equity returns and the popular opinion that U.S. markets are destined to earn low returns for the foreseeable future. Some market strategists forecast continued multiple contraction, while others predict deteriorating corporate profits. These forecasts have in common an anticipation of “low single-digit” total returns, well below the long-term average annual performance of domestic equities of 10%+.

This “low-return” sentiment has spawned a wave of interest in “absolute-return” alternative investments. This style of investing seeks to use a variety of long and short securities to generate a small, but positive, monthly profit regardless of the direction of the overall market. Absolute-return vehicles do offer portfolio diversification benefits, assuming a low correlation to other assets within an allocation strategy. However, over-reliance on this approach, whether for capital growth or loss prevention, brings three potential problems. First, supposed “low-risk” strategies can be anything but “low-risk” if the unexpected occurs. The generous use of leverage and the tendency of traders to "follow the investment herd" can magnify volatility on the downside. The second issue is one of mediocrity. With thousands of new funds using a similar "absolute return" strategy, one should question how many talented investors and traders can successfully pursue the same ideas. A possible outcome is middling returns whittled down by hefty performance fees.

The third, and least examined, problem stems from the very idea of a low-return environment. As mentioned at the beginning, the strong consensus that has formed around expectations for low equity returns is reason in itself for doubt, but it can also be challenged by fundamentally and statistically analyzing the stock market. The multiple on the S&P 500 is 16.5 times this year's expected earnings and 15.5 times estimated 2006 EPS. The market is fairly valued compared to its long-term average and is undervalued versus the 1960-66 period of comparably low inflation and interest rates. Although we cannot be certain that multiples will not further contract, continued earnings growth and rising dividends should lead to future equity returns surpassing investors' low expectations. On a statistical basis, a return in any one year of 0 - 10% is fairly unlikely. A distribution table plotting returns from 1928 to 2004 (see following table) shows that annual total returns have been between 0 and 10% only 13 percent of the time. Surprisingly, returns have surpassed +20% 38 percent of the years and have been negative 30 percent of the years. (The compound average annual total return for the S&P 500 since 1924 is 10.4%. During a shorter, but also relevant, period, 1973 – 2004, the S&P 500 total return compounded at 11.2%.) The lesson here is that stock market performance is unpredictable, sometimes nerve-wracking, but ultimately quite rewarding. It is difficult to predict the market's performance accurately over the next twelve months. However, as long-term oriented investors operating in a positive economic environment with a reasonably priced equity market, we do anticipate achieving equity total returns that are superior to those expected by the "low single-digit" bears.

S&P 500 Annual Returns Rarely Equal Their Long-Term Average Return of 10%

Distribution of S&P 500 Total Returns Since 1928

					29
					1928
					1933
					1935
					1936
					1938
					1942
					1943
					1945
					1950
					1951
					1954
					1955
					1958
				15	1961
				1944	1963
		13		1949	1967
		1929		1952	1975
		1932		1959	1976
		1934	*10*	1964	1980
		1939	1947	1965	1982
		1940	1948	1968	1983
		1946	1956	1971	1985
		1953	1960	1972	1989
5	*5*	1962	1970	1979	1991
1930	1941	1969	1978	1986	1995
1931	1957	1977	1984	1988	1996
1937	1966	1981	1987	1993	1997
1974	1973	1990	1992	2003	1998
2002	2001	2000	1994	*2004*	1999
<-20%	**-20%-10%**	**-10%-0**	**0-10%**	**10-20%**	**>20%**

S&P 500 Annual Total Return Ranges

Source: ISI Group