The Absolute Return Letter
October 2011

Point of Maximum Pessimism?

Extreme pessimism

I can't remember having experienced this much pessimism before. 2008-09 was different. Back then it was fear more than pessimism, fostered by investors being hopelessly unprepared for what happened. The present crisis is well advertised, causing more pessimism than actual fear; however, whatever you call it, the current level of gloom and doom is quite simply overwhelming. Marc Faber must be having a field day!

I am writing these lines from Geneva. In a meeting earlier today I learned that a leading Swiss private bank currently allocates approximately 25% each to gold, cash and alternatives. In other words, three quarters of its client portfolios generate little or no income. Astonishing!

Meanwhile my brother-in-law, who is a die-hard value investor, told me of a trip he made to Germany last week in search of new investment ideas. He met with nine companies; all solid German businesses, most of them industrial. Not one talked about business being weak or weakening. Most of them asked the question: What's wrong with you finance guys? Are you trying to destroy the world?

I shall be the first to admit that we are facing unprecedented challenges. Europe has rarely been up against stronger headwinds than now. It could fall into a prolonged recession, possibly even depression, and the eurozone could quite conceivably disintegrate altogether. However, as the French economist Charles Gave of GaveKal Research is fond of saying, and I paraphrase (without being able to do the French accent convincingly), "the French economy isn't competitive but lots of French companies are".

The best performing stock in our global equity fund in recent months has been Hermes, the French luxury goods maker (which, for the record, was sold a couple of weeks ago). Charles Gave's point is that we live in a world where trade recognises few borders. Hermes may be a European brand, but the world is its market place. A European recession will only have limited effect on its fortunes. Likewise with dozens of other European companies.

Extrapolate at your peril

Why are investors not capable of recognising this fact? Because most of us tend to extrapolate and because we are all subject to a phenomenon that behavioural analysts call recency; we assign more value to recent events than we do to more distant ones.

Let me provide you with one example. As you can see from chart 1 below, emerging markets have offered the best equity returns in six of the last eight years. The majority of investors expect emerging markets to offer the best returns going forward. They will argue that the superior earnings outlook justifies their bullish expectations. In reality, or so behavioural finance theory goes, their judgement is coloured by their knowledge of recent performance patterns.

Chart 1: Annual Returns for Various Equity Indices

The Callan Periodic Table of Investment Returns

Annual Returns for Key Indices (1991–2010) Ranked in Order of Performance

1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
MSCI Emerging Markets 59.91%	Russell 2000 Value 29.14%	MSCI Emerging Markets 74.84%	MSCI EAFE 7.78%	S&P/Citi 500 Growth 38.13%	S&P/Citi 500 Growth 23.97%	S&P/Citi 500 Growth 36.52%	S&P/Citi 500 Growth 42.16%	MSCI Emerging Markets 66.42%	Russell 2000 Value 22.83%	Russell 2000 Value 14.02%	BC Agg 10.26%	MSCI Emerging Markets 56.28%	MSCI Emerging Markets 25.95%	MSCI Emerging Markets 34.54%	MSCI Emerging Markets 32.59%	MSCI Emerging Markets 39.78%	BC Agg 5.24%	MSCI Emerging Markets 79.02%	Russell 2000 Growth 29.09%
Russell 2000 Growth 51.19%	Russell 2000 18.41%	MSCI EAFE 32.57%	S&P/Citi 500 Growth 3.13%	S&P 500 37.58%	S&P 500 22.96%	S&P 500 33.36%	S&P 500 28.58%	Russell 2000 Growth 43.09%	BC Agg 11.63%	BC Agg 8.43%	MSCI Emerging Markets -6.00%	Russell 2000 Growth 48.54%	Russell 2000 Value 22.25%	MSCI EAFE 13.54%	MSCI EAFE 26.34%	MSCI EAFE 11.17%	Russell 2000 Value -28.92%	Russell 2000 Growth 34.47%	Russell 2000 26.85%
Russell 2000 46.04%	MSCI Emerging Markets 11.40%	Russell 2000 Value 23.77%	S&P 500 1.32%	S&P/Citi 500 Value 36.99%	S&P/Citi 500 Value 22.00%	Russell 2000 Value 31.78%	MSCI EAFE 20.00%	S&P/Citi 500 Growth 28.24%	S&P/Citi 500 Value 6.08%	Russell 2000 2.49%	Russell 2000 Value -11.43%	Russell 2000 47.25%	MSCI EAFE 20.25%	S&P/Citi 500 Value 5.82%	Russell 2000 Value 23.48%	S&P/Citi 500 Growth 9.13%	Russell 2000 -33.79%	MSCI EAFE 31.78%	Russell 2000 Value 24.50%
Russell 2000 Value 41.70%	S&P/Citi 500 Value 10.52%	Russell 2000 18.88%	S&P/Citi 500 Value -0.64%	Russell 2000 Growth 31.04%	Russell 2000 Value 21.37%	S&P/Citi 500 Value 29.98%	S&P/Citi 500 Value 14.69%	MSCI EAFE 26.96%	Russell 2000 -3.02%	MSCI Emerging Markets -2.37%	MSCI EAFE -15.94%	Russell 2000 Value 46.03%	Russell 2000 18.33%	S&P 500 4.91%	S&P/Citi 500 Value 20.81%	Russell 2000 Growth 7.05%	S&P/Citi 500 Growth -34.92%	S&P/Citi 500 Growth 31.57%	MSCI Emerging Markets 19.20%
S&P/Citi 500 Growth 38.37%	Russell 2000 Growth 7.77%	S&P/Citi 500 Value 18.61%	Russell 2000 Value -1.54%	Russell 2000 28.45%	Russell 2000 16.49%	Russell 2000 22.36%	BC Agg 8.70%	Russell 2000 21.26%	S&P 500 -9.11%	Russell 2000 Growth -9.23%	Russell 2000 -20.48%	MSCI EAFE 38.59%	S&P/Citi 500 Value 15.71%	Russell 2000 Value 4.71%	Russell 2000 18.37%	BC Agg 6.97%	S&P 500 -37.00%	Russell 2000 27.17%	S&P/Citi 500 Value 15.10%
S&P 500 30.47%	S&P 500 7.62%	Russell 2000 Growth 13.37%	Russell 2000 -1.82%	Russell 2000 Value 25.75%	Russell 2000 Growth 11.26%	Russell 2000 Growth 12.95%	Russell 2000 Growth 1.23%	S&P 500 21.04%	MSCI EAFE -14.17%	S&P/Citi 500 Value -11.71%	S&P/Citi 500 Value -20.85%	S&P/Citi 500 Value 31.79%	Russell 2000 Growth 14.31%	Russell 2000 4.55%	S&P 500 15.79%	S&P 500 5.49%	Russell 2000 Growth -38.54%	S&P 500 26.47%	S&P 500 15.06%
S&P/Citi 500 Value 22.56%	BC Agg 7.40%	S&P 500 10.08%	Russell 2000 Growth -2.43%	BC Agg 18.46%	MSCI EAFE 6.05%	BC Agg 9.64%	Russell 2000 -2.55%	S&P/Citi 500 Value 12.73%	S&P/Citi 500 Growth -22.08%	S&P 500 -11.89%	S&P 500 -22.10%	S&P 500 28.68%	S&P 500 10.88%	Russell 2000 Growth 4.15%	Russell 2000 Growth 13.35%	S&P/Citi 500 Value 1.99%	S&P/Citi 500 Value -39.22%	S&P/Citi 500 Value 21.17%	S&P/Citi 500 Growth 15.05%
BC Agg 16.00%	S&P/Citi 500 Growth 5.06%	BC Agg 9.75%	BC Agg -2.92%	MSCI EAFE 11.21%	MSCI Emerging Markets 6.03%	MSCI EAFE 1.78%	Russell 2000 Value -6.45%	BC Agg -0.82%	Russell 2000 Growth -22.43%	S&P/Citi 500 Growth -12.73%	S&P/Citi 500 Growth -23.59%	S&P/Citi 500 Growth 25.66%	S&P/Citi 500 Growth 6.13%	S&P/Citi 500 Growth 4.00%	S&P/Citi 500 Growth 11.01%	Russell 2000 -1.57%	MSCI EAFE -43.38%	Russell 2000 Value 20.58%	MSCI EAFE 7.75%
MSCI EAFE 12.14%	MSCI EAFE -12.18%	S&P/Citi 500 Growth 1.68%	MSCI Emerging Markets -7.32%	MSCI Emerging Markets -5.21%	BC Agg 3.64%	MSCI Emerging Markets -11.59%	MSCI Emerging Markets -25.34%	Russell 2000 Value -1.49%	MSCI Emerging Markets -30.61%	MSCI EAFE -21.44%	Russell 2000 Growth -30.26%	BC Agg 4.10%	BC Agg 4.34%	BC Agg 2.43%	BC Agg 4.33%	Russell 2000 Value -9.78%	MSCI Emerging Markets -53.18%	BC Agg 5.93%	BC Agg 6.54%

Source: http://www.callan.com/research/download/?file=periodic%2ffree%2f457.pdf

We have been structurally bearish on equities since Absolute Return Partners was established in 2002. 'Structurally bearish' does not imply that we, or our clients, have had no exposure to equities throughout this period. Neither does it mean that we have been expecting equities to post a loss every year for the past nine years. No, 'structurally bearish' is a term we (and others) use to express our view on multiple trends. In a structural bear market, price/earnings (P/E) ratios decline; i.e. corporate earnings need to outgrow the decline in valuations for equities to post positive returns. Equity investors are swimming against the tide, so to speak.

The opposite is the case in structural bull markets where P/E ratios expand, sometimes dramatically so. In the last structural bull market, lasting from 1982 to 2000, P/E expansion was the single largest contributor to stock market performance, dwarfing the contribution from dividends and corporate earnings.

Chart 2: The Link between Valuation and Returns

20 Year Periods Ending 1919 - 2010 (92 periods)

DECILE	NET TOTAL RETURNS BY DECILE RANGE FROM	TO	S&P500 DECILE AVG	AVG BEGIN P/E	AVG END P/E
1	1.2%	4.5%	3.2%	19	9
2	4.5%	5.2%	4.9%	18	9
3	5.2%	5.4%	5.3%	12	12
4	5.4%	6.0%	5.6%	14	12
5	6.2%	7.9%	6.9%	16	16
6	8.0%	9.0%	8.6%	16	19
7	9.0%	9.6%	9.3%	15	19
8	9.7%	11.0%	10.4%	11	20
9	11.5%	11.9%	11.7%	12	22
10	12.1%	15.0%	13.4%	10	29

Note: P/E ratio based upon average 10-year real EPS (P/E10)

Source: Crestmont Research

That said, our decision to turn structurally bearish on equities back in 2002 was a function of P/E multiples at the time. Following an 18 year bull market, valuations had reached dizzying levels which we considered unsustainable. It is a well documented fact that long-term equity returns correlate negatively with valuation levels at the point of entry[1]. As you can see from chart 2, 20-year returns have averaged 13.4% per annum, assuming you bought into the market when P/E levels were rock bottom (decile 10) as opposed to 3.2% per annum if you made your investment when P/E levels were at their highest (decile 1)[2].

Our call has been broadly correct, although it has worked better in some markets than others. It is also fair to say that since we first made our call, market gyrations have been a great deal more spectacular than we would have expected, providing plenty of trading opportunities within a market that has offered only modest returns for buy-and-hold investors.

Value is on offer again

Now, nine years after having made that call, we begin to spot real value again with European equities trading at 9.4 times trailing 12-month earnings and 7.6 times next year's earnings (see chart 3). A price-to-

[1] *See for example the research from Crestmont Research.*

[2] *The Crestmont Research study is based on S&P500 returns, as we do not have access to long-dated European return series; however, there is no reason to believe that a European study would reach a different conclusion.*

book value just below 1 and a dividend yield of 5.3% does not exactly make the value story any less compelling.

Chart 3: European vs. US Valuation Metrics

	Actual P/E	2012 P/E	P/BV	Div Yld
Eurostoxx 50	9.36	7.65	1.05	5.32%
S&P500	12.62	10.73	1.89	2.26%

Source: Bloomberg. Based on valuations as at 6th October, 2011.

At first glance, European equities look a great deal more attractive than US equities; however, comparing P/E and other multiples across borders can be misleading due to the fact that the underlying economies can be at different stages in the economic cycle. Professor Shiller has addressed that problem by developing the so-called Shiller P/E (also known as the cyclically adjusted P/E or CAPE). Shiller evens out the impact from the economic cycle by calculating the P/E ratio as a 10-year average and inflation-adjusting it.

Some readers will ask the question, how is this line of thinking consistent with our equity selection approach which completely ignores valuation?

We believe that equity valuations should only be used to determine when investors enter and exit the stock market. Equity valuations should not be used for trading or for determining which equities to buy as, in our opinion, there is no correlation between valuation and relative performance.

This view is substantiated by years of research by Stockrate Asset Management in Denmark. In conjunction with Stockrate we run a hedged global equity fund which has outperformed the MSCI World Index by over 10% this year.

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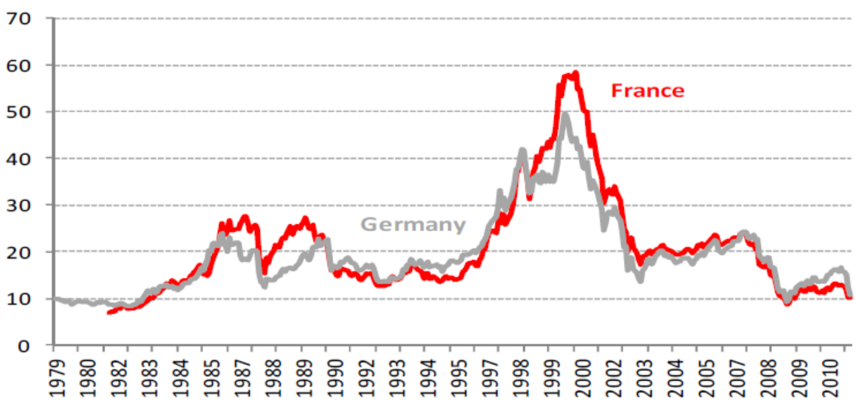
The results can be seen in charts 4 and 5. On a cyclically adjusted basis, the divergence in valuations is even more pronounced. While Germany and France are back to 1981-82 levels (chart 4), the Shiller P/E ratio for the S&P500 at almost 20 is still well above its long term average of 15-16 (chart 5).

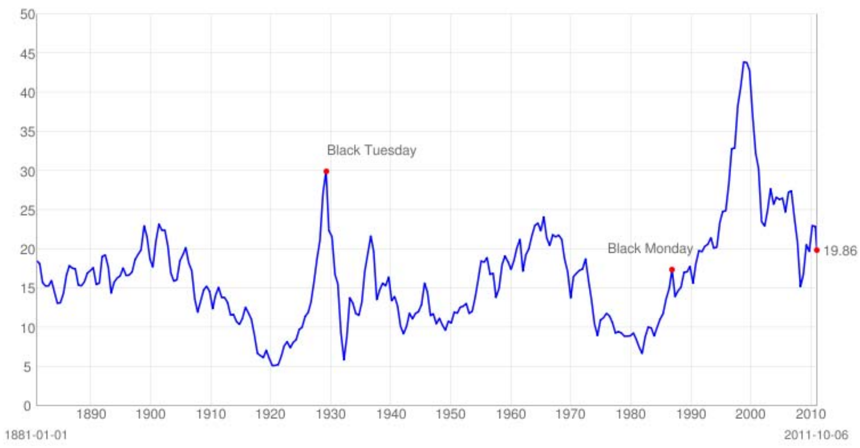
Chart 4: Shiller P/E Ratios for France and Germany



Source: SocGen

The ability to buy European equities at 1981-82 valuations ought to make everyone sit up and listen. I remember the dark days of the early 1980s when nobody wanted equities in their portfolios. 18 years later, when earnings multiples were 50-60, everyone did. Guess who had the last laugh.

Chart 5: The Shiller P/E Ratio for the US



Source: www.multpl.com

How much is discounted?

Having said that, there is no question that valuation levels are attractive for a reason. Europe's outlook is murky to say the least. It could very well be that earnings estimates for 2012 are wildly optimistic and that earnings will actually fall from this year to next. It is also possible that we could be entering an extended period of subdued economic growth. However, we must remind ourselves that it is not a question of what happens next but to what extent such calamity has already been priced in.

Bloomberg publishes a quarterly survey of global investors. The most recent one was published on the 26th September. The results reveal an astonishing amount of gloom directed at Europe:

- 88% say the eurozone economy is deteriorating while 75% expect it to fall into recession within the next 12 months.
- 40% predict the eurozone will lose at least one member in the next year and 72% expect at least one country to abandon the eurozone within 2-5 years.
- 51% say the euro zone will collapse eventually but only 8% expect it to happen within a year.
- 93% say Greece will eventually default while 56% expect Portugal to face the same fate.
- 67% believe US officials have handled their economic challenges the best; only 11% believe European officials have done the best job.
- Less than 20% expect the EU's markets to offer the best investment opportunities over the next 12 months whereas 53% suggest that they actually offer the worst opportunities in the world.

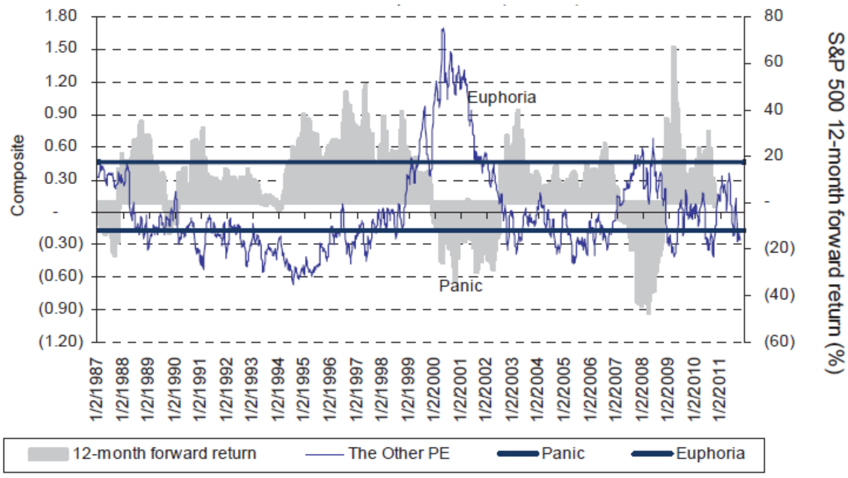
Source: Bloomberg.

Frank Veneroso kindly pointed me towards this study, stating that "this is simply enormous pessimism." The Bloomberg survey confirms to me what I already suspected. I believe a Greek default is now fully discounted. So is a eurozone recession within the next year. The one risk factor which is probably not fully discounted yet is the systemic risk associated with Greece defaulting on its debt. If the authorities cannot contain the domino effect, European equities could fall further.

The extreme level of pessimism is further documented in Citibank's euphoria/panic model which shows that investors are currently extremely bearish (see chart 6). While Citi's model is US centric, it goes to show that even if the drawdown in US equities has been less dramatic than losses on this side of the Atlantic, pessimism is widespread.

According to the model's originator, Citigroup strategist Tobias Levkovitch, the current reading indicates a roughly 90% probability that equity prices will be higher in six months and a 97% chance of gains in 12 months.

Chart 6: Citibank's Euphoria/Panic Model



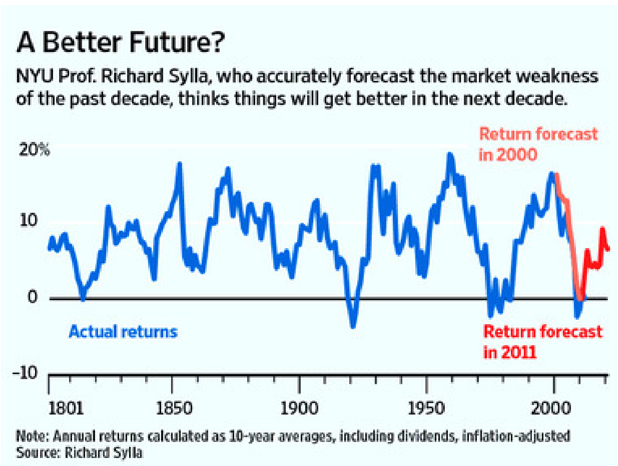
Source: Citibank

Time to buy for the long term?

One further piece of 'evidence' for those who are still doubtful: Professor Richard Sylla of New York University's Stern School of Business has researched US equity returns over the past 200 years and found some remarkably consistent patterns. Using 10-year average inflation-adjusted returns, Professor Sylla found that when returns drop below 5%, markets are likely to bottom out and begin a recovery. Years later, at the end of the secular bull market when average returns exceed 15%, the cycle peaks and a new downturn commences (see chart 7).

Drawing upon behavioural finance, such consistency in equity return patterns can be explained by investor over- and under-confidence (or greed and fear as some prefer to call it). Not surprisingly, 10-year average returns are now below 5%, both in the US and in Europe, suggesting that now may not be a bad time to begin accumulating equities again *if you are a long term investor*.

Chart 7: Professor Sylla's Return Forecasting Model



Source: Wall Street Journal

Rel. value favours Europe

One final note on the valuation gap between Europe and the US: Less than two decades ago, European valuations were higher than they were in the US. The balance shifted with the dot.com bubble and has never reversed. It begs the questions – why? In my opinion, the Greenspan (now Bernanke) put plays a big part. In the US, for years, it has been a widely held belief that the Fed will not allow a wholesale fall in asset prices - a perception which provides an invisible hand under US financial markets. Such views do not prevail in Europe, exposing European equity markets to the full force of the current bear market dynamics.

Secondly, financial markets have a curious inability to focus on more than one problem at the time. For this reason the undeniably large problems facing the US economy have received limited attention when compared to the massive coverage of the eurozone crisis. At some point the markets' focus will change and the Bernanke put will be seriously tested.

For precisely this reason, a relative value trade - long Eurostoxx 50 and short S&P500 – may not be a bad idea (easy to do with ETFs these days) as opposed to an outright long position in European equities. I feel pretty strongly that whether markets fall further or rebound from here, the valuation discount currently on offer in Europe is likely to shrink once Europe gets itself sorted out (and it will).

One note of caution: Financials account for 24% of the Eurostoxx 50 and only 14% of the S&P500. If the eurozone crisis worsens and more banks require bailouts, the European index could be badly impacted.

Conclusion

Despite the storm clouds, we have recently begun to add to our European equity exposure again for the first time in years (we are avoiding financials). Please note that this is <u>not</u> a trading call. One cannot predict near term performance with a value approach. I could easily look foolish a year from now. However, I vividly remember the darks days of early 2009. The world was coming to an end, or so we all thought. By early March of that year the probability of bumping into a bull in the streets of London was on par with Gordon Brown winning Strictly Come Dancing. Yet we were reminded shortly afterwards that the darkest hour is often just before sunrise. Within weeks, global equity markets had shaken off the misery of the previous six months and we went on to register one of the greatest bull runs of all times.

I shall be the first to admit that the current situation is different on several accounts (it always is); however, investor behaviour rarely changes, and there is no reason to believe that they haven't fallen victim to the same behavioural patterns they have been subjected to in the past.

Buy while the opportunity is there, but buy only if you can afford to see through the short term volatility that I fully expect to plague markets for some time to come. I am convinced you will be amply rewarded. Eventually.

PS. Hedge the euro. Not so sure about that one...

Niels C. Jensen
7 October 2011

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