

Market Outlook

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Wall Street's New Math:

2 + 2 = 4

Bernard Baruch was one of the most celebrated and successful investors of the 20th century, and his counsel was sought out by businessmen and top politicians alike. He made his early fortune in the 1920s, and wisely preserved it by recognizing that enough was enough. It was in the late stages of the 1920s speculation that he cautioned investors that *“two plus two equals four, and no one has ever invented a way of getting something for nothing.”*

Wall Street had unfortunately lost sight of this bedrock maxim over the past dozen years. First the internet era espoused the idea that in the “new economy” cash flow was an archaic concept, and that the lower costs of doing business the internet way would render traditional accounting obsolete. This belief spread like wildfire as the rally in technology and telecom stocks reinforced the idea that the world had entered a “new paradigm” of investing. But two plus two still equaled four, as incredulous investors found out when many companies simply ran out of money and failed, taking their stock prices to zero. The old rules of profit and loss still applied.

The housing bubble quickly provided another example of Wall Street's (and this time, the banks) desire to use their financial alchemy to convince investors that two plus two equaled five, six, or even better, ten. This time around, the speculation was built on the belief that US home prices never go down. No down payment mortgages, sub-prime lending, and the securitization of mortgages combined to fuel a home building boom that was recklessly financed, and the risk of which was put onto the shoulders of many naïve investors in the form of mortgage derivative securities so complex even their originators didn't fully understand them.

But Baruch's simple observation held true: if leverage exceeds the capacity to pay, the result for the lender is probably going to be bad. It's just common sense. The marketing genius and herd mentality of Wall Street had trumped common sense for many years. Fortunately, it looks like common sense is reviving as a viable investment strategy.

The “green shoots” of this new thinking were evident in a late June speech given by Jeff Immelt, CEO of General Electric. The speech was remarkable for the *mea culpa* it offered from

America's premier industrial company. Immelt remarked, *“Throughout my career, America has seen so much economic growth that it was easy to take it as a given. We prospered from the productivity of the information age. But, we started to forget the fundamentals and lost sight of the core competencies of a successful modern economy. Many bought into the idea that America could go from a technology-based, export-oriented powerhouse to a services-led, consumption-based economy – and somehow still expect to prosper.”*



“That idea was flat wrong. And what did we get in the bargain? We've seen a great vanishing of wealth. Our competitive edge has slipped away, and this has hit the middle class hard.”

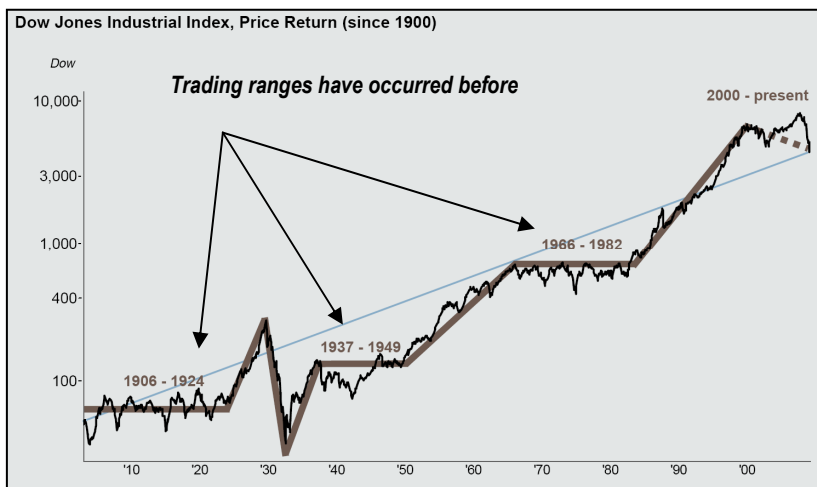
He also addressed our over reliance on the financial economy: *“While some of America's competitors were throttling up on manufacturing and R&D, we deemphasized technology. Our economy tilted instead toward the quicker profits of financial services. While our financial services business has performed well, I can't tell you that we [GE] were entirely free of these errors. We weren't.”*

He also took America's CEOs to task, saying *“We must end the impression that American CEOs are short-term speculators.”*

While welcoming the public-private partnership that is evolving as a result of the profound recession, he cautioned, *“At the same time, we are going to get more regulation. And this could be dangerous. The administration has proposed financial regulation, tax reform and health care reform. Quite honestly, some of the policies I have seen concern me about the long-term impact on economic growth.”*

But business must engage, because status quo is not an option. The country has massive problems and social unrest. Fighting to protect the past is just wrong.”

He concluded by reiterating his call for a new approach to today's dilemma: *“Over the last generation, America's “service strategy” was too weak and our goals were too low. This approach must be abandoned. In its place, we should create an American Industrial Renewal by moving on five fronts: invest in new technology; win where it counts in clean energy and affordable health care; become a country that is good at manufacturing and exports; embrace public-private partnerships; and promote leaders who are also good citizens.”*



signaling that consumers were finally spending again. CEO expressions of “prosperity just around the corner” will soon begin to wear thin without this evidence.

We believe that we are in a trading range type of market, rather than a classic bull market, at this time. While many pundits are looking to the lows of 2003 for clues as to the “bottom,” the better model is likely to be the 1970s, where broad up and down, but ultimately sideways, moves prevailed. These broad swings provided ample opportunity for profit making for alert investors. Now, as back then, investors who focus on individual securities, rather than the market, will add value. Those using index funds or ETFs only will likely find progress harder

to come by.

In the depths of the depression, Bernard Baruch reprised his famous equation, this time as a reason for optimism, saying “Two plus two still equals four, and you can’t keep mankind down for long.” Hopefully, that is the point we are at today. Things will be different, and the easy stock gains brought on by high leverage and its attendant reckless speculation are over. But looking around, there are plenty of companies that still make useful products or provide valuable services. Moreover, bargains are to be had, though they are not plentiful. This does not automatically make it a bull market, but, to all our benefit, it does make clear that Baruch’s simple cipher and common sense skepticism will likely rule investors’ decisions for years to come.

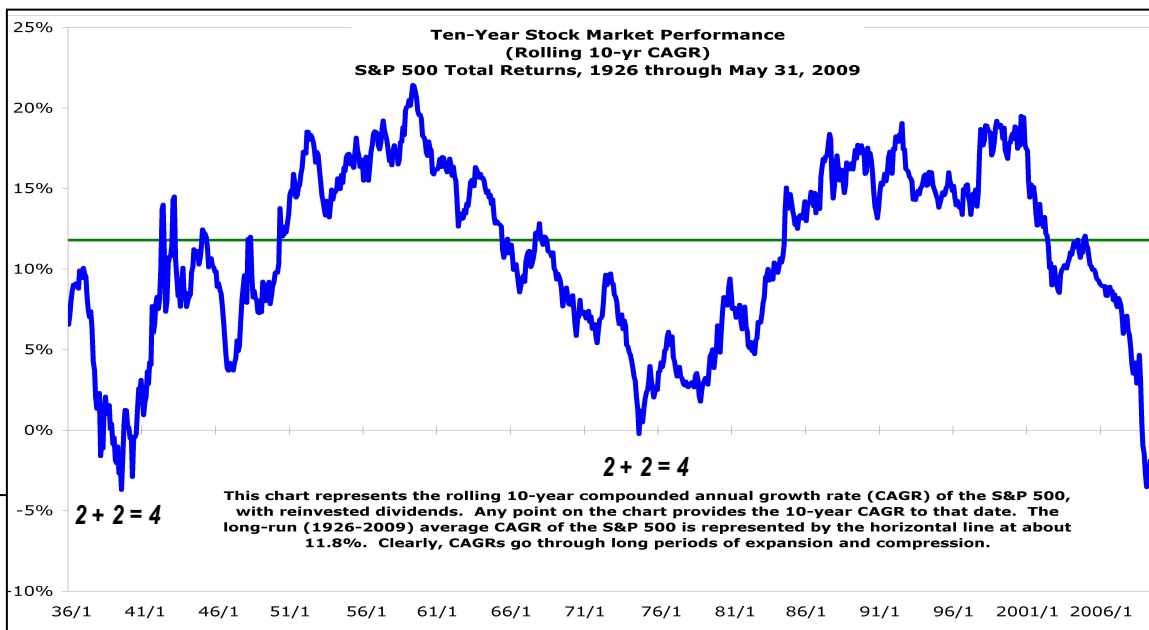
Stock Markets—Is It a Bull Market?

Stock rallied strongly from the early March lows to rest about where they were in November of 2008. NASDAQ and mid-cap stocks have done a little better, the blue chips a little worse. But the market faces major tests ahead. The rally from the March lows was based on expectations of better times ahead, and an end to the recession by year-end. Investors now want some concrete proof pointing to the end of the recession before they are willing to buy heavily for capital appreciation. This includes increasing corporate sales (not simply earnings!),

While the short-term view is cloudier than usual, the long-term view may be rosier. The chart below plots the 10-year compound annual growth rate (CAGR) for the S&P 500 (and its equivalent) going back to 1926. Any point on the line represents the 10-year CAGR up to that time. The most recent peak was August of 2000 at 19.5%. No wonder people were crazy about stocks back then. To get nearly 20% on your money for 10 solid years was nothing short of amazing. S&P Index funds were the single most popular mutual funds. And that turned out to be the exact wrong time to buy.

For today, 10 years on, the shoe is on the other foot. People hate stocks; Wall Street and the banking system are in disgrace. The CAGR is for the 10 years through May 2009 was -1.9%, after reaching a low of -3.5% in February. This includes dividends.

Will history prove the current low on this chart to be a major buying opportunity? We won’t base our investment decisions on the outcome, but just like Immelt’s speech, it alerts us to the possibility of a sea change ahead. America has a canny knack for reinventing itself, and there is no reason to believe it can’t do so again. If so, the wisdom of Bernard Baruch’s timeless math may prove itself once again.



2 + 2 = 4 ?