

# Ponderosa Investment Group LLC

# INVESTMENT LETTER

Fourth Quarter 2008 • V11

2008 was as bad an investment year as most of us will likely experience in our lifetime. Stocks had their worst calendar year since 1931.

Many metrics suggest that stocks should at least provide satisfactory returns going forward and possibly something better. But the near term is much less clear. While it may be probable that we have seen the market bottom, I can't be sure.

I believe high-yield bonds offer compelling return potential over coming years and have started a significant tactical weighting in most portfolios.

I expect a lengthy and deep recession, but with a great deal of negativity already priced in, the longer-term return outlook is decent. I believe we will continue to see numerous opportunities created in this highly dislocated environment.

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## Quarterly Investment Commentary

For 2008 investors experienced a once-in-a-lifetime train wreck. The year was arguably the most painful in modern investment history and is without a doubt the most painful experience in my career. Almost every asset

class was in the red for the year, with many deeply underwater, giving investors almost no place to hide. Government bonds were one of the few exceptions.

2008 Index Performance	4th Qtr.	2008
Citigroup 3 Month T-bill Index	0.29%	1.84%
Barclays Cap. US Aggregate Bond Index	4.58%	5.24%
M.L. US High Yield Master II Index	-17.63%	-26.39%
S&P 500 Index	-21.94%	-37.0%
Russell 2000 Index	-26.12%	-33.79%
MSCI EAFE N\$ Index	-19.95%	-43.38%
Dow Jones – AIG Commodity Index	-30.04%	-35.65%

As the year progressed I became more troubled about the continuing credit crisis and the possibility that it could trigger a nasty recession which could be followed by a multi-year period of sub-par growth. By mid-September, with major financial institutions falling like dominos and the money markets, freezing up (which I wrote about at the time), it became clear that we had to adjust our thinking in light of both the severe market declines and challenges facing the global economy that went beyond what most investors have experienced in their lifetimes. At that point I realized that the pessimistic scenarios I considered as possible outcomes were becoming probable outcomes. Moreover, I also realized that the worst-case scenarios might be even worse than I had imagined. So I reconsidered my asset class scenario analysis. This involved reviewing economic and market history including the Great Depression period, exposing myself to a variety of points of view by reviewing independent research, and aggressively working my network of investment professionals. After digesting all of this information I adjusted assumptions, incorporating worst cases that were in some cases significantly more negative than I had already been using. Realizing that the credit crisis would likely do severe economic damage, and that the worst-case was beyond what the vast majority of investors had recognized, led me to a third realization, which was that unlike almost every bear market of the past 50 years, buying stocks after a 20% decline might not be sensible. I had discussed this possibility back in the second quarter news letter.



Clearly we are now in the midst of a severe recession. Consumers are being forced to adjust to a new reality in which they finally have to pay down debt, increase savings and thus spend less than before. We all have wondered when the growth in consumer household debt would slow or reverse. It took a long time but I believe that time has come. If the environment plays out as I believe it could, corporate earnings growth may not get back to its long-term trend for several years after the recession ends, and the recession itself could last through 2009 or even into 2010. But as I look forward from here at beaten-down financial markets and an economy on the ropes I ask the question I always ask: what expectations are currently reflected in asset class prices? I approach this question in many ways and consider the weight of the evidence in the context of how the broader economic environment might play out over coming years. This exercise leaves me with conflicting evidence to digest.

### Encouraging Signs

Historical comparisons are sometimes helpful. There have been two extreme economic and investment environments in the last 80 years—the 1930s, and the 1970s/early 1980s. In both periods investor confidence was crushed after lengthy periods during which returns were dismal because of a continuation of negative headlines. But as it turned out, both periods presented a great opportunity for long-term investors to buy stocks. This may be a similar time. These experiences reflect the tension that investors face—when risk seems greatest it is usually a good time to invest and when risk is an afterthought investors are likely to be disappointed with their returns going forward.

### Historical Evidence: Trailing Risk Premiums

There are many ways to consider historical stock-market performance. One is to focus on the risk premium. This compares stock market returns to the returns an investor could have achieved if the money had instead been invested in a risk-free asset. Since I date this secular bear market at about nine years old, I looked at the stock market risk premium over the past nine years (using month-

end returns). To do this I compared the S&P 500 returns to returns from three-month Treasury Bills. I then compared the returns to other periods going back to the Great Depression.

The takeaway is that by underperforming T-Bills

Worst Nine-Year Risk Premiums Since 1935							
Nine-Year Period Ending	Risk Premium	Cumulative Return		Annualized Returns in Following Years			
		S&P 500	T-bills	Next Five	Next Seven	Next 10	Next 15
Dec-08	-59%	-28%	31%	?	?	?	?
Jul-82	-58%	52%	111%	29.7%	23.1%	19.2%	19.7%
Sep-74	-67%	-5%	62%	16.8%	14.4%	15.6%	17.2%
Mar-38	-56%	-46%	10%	13.0%	13.4%	11.9%	14.1%

\* S&P 500 return less the Tbill return.

by 59% over the last nine years (as of 12/31), the risk premium was one of the worst on record—matching the worst nine years during the Great Depression but not quite as bad as the worst periods that encompassed portions of the inflationary 1970s. On a forward-looking basis, what is very encouraging is that the long-term returns were quite good following similarly horrible nine-year periods for risk premiums. And also, the end of these nine-year periods fell close to the bear market bottom.

### Forward-Looking Evidence: Scenario Analysis

I often write about scenario analysis. I look at a variety of potential outcomes over the coming five years—ranging from optimistic to pessimistic. Presently the most pessimistic scenario assumes that the economy gets through a very severe recession only to experience an extended period of slow growth as consumers retrench and rebuild savings over several years (deleverage). The assumptions are for an earnings environment that is worse than any period other than the Great Depression era (the earnings data goes back to the 1920s). If this is the scenario that plays out and I put a below-average P/E multiple on the earnings in five years, the return on the S&P 500 would be between 4% and 5% (from a starting S&P level of 900). In a somewhat less severe but still challenging climate, returns would be in the high single-digits. In



more-optimistic scenarios I could see much higher returns. While the returns I forecast in the very negative environments are not exciting, they are not terrible. That they are not terrible, in what would be one of the worst earnings environments in a century, suggests that quite negative expectations are already priced into stocks. With prices down well over 40% and well below levels of nine years ago, that is not surprising.

### **Valuation Evidence: Shiller P/E**

There are many ways to assess valuations. Most now suggest that U.S. large cap stocks range from fairly valued to bargain priced. One metric I have added to the valuation tool box is the so-called Shiller P/E, named after Robert Shiller, the Yale professor. Shiller calculates his P/E based on an average of the last 10 years' earnings in order to smooth out short-term earnings volatility and also inflation-adjusts his earnings and stock price levels. The current Shiller P/E is 15x normalized earnings, which is lower than most of the post-WWII period except for the early 1970s through mid-1980s when inflation and interest rates were generally much higher. P/E's could go lower and stay in a low range for a period of years. But this level of P/E has generally been a good long-term entry point into the stock market.

### **Dry Powder**

There is a mountain of cash sitting on the sidelines, as most my clients have seen in their statements. In fact, since the advent of money market funds more than 30 years ago, money market assets relative to total stock market capitalization has never been higher. Some of that cash is likely to find its way into stocks and bonds at some point, especially with returns on cash so low.

### **Cautionary Signs**

All of this evidence as it relates to the long-term potential in stocks is encouraging, but the near term is much less clear.

### **Economic risk remains high.**

Policy makers have made it clear that they will do whatever it takes to support the economy, yet credit markets, though slightly improving, remain dysfunctional and the housing market remains

highly stressed. And while a financial system collapse has been avoided, a newly realistic consumer, attempting to reduce debt and increase savings, could mean an economic retrenchment that lasts longer than the consensus expects. This could lead to an extended period of deflation, something that I'm already getting a whiff of. In the near term, a significant deflation scare is not fully priced into the stock market.

### **Weighing the Evidence**

Overall the evidence does not clearly suggest that stocks are at highly compelling valuation levels. It also doesn't make an iron-clad case that the stock market bottomed in late November after the S&P 500 hit its lowest level since 1997. While it is quite possible, maybe even probable, that we have seen the bottom, I can't be sure. Forced selling by hedge funds and others may not be quite done and more individual investors could simply give up if the market heads back down towards its prior low. Despite the near-term caution, I think the weight of the evidence overwhelmingly suggests that investors are very unlikely to get hurt owning equities over the next five to 10 years and are likely to reap at least satisfactory returns. That is a justification for owning stocks with capital that is not needed in the near term. Moreover, periods of extreme dislocation usually create opportunities for active managers. The entire market does not have to be a screaming buy if some portion of the market is. Based on history as well as data that indicate extensive valuation discrepancies in the market currently, I believe that the next few years are likely to be good ones for active managers relative to their benchmarks. I believe the same holds generally true for foreign stocks. Because valuations there are not materially different from those of U.S. equities, I'm under weighted to foreign stocks at this time. I think it is likely at some point in the coming years that foreign stocks will see a currency tailwind to domestic investors as U.S. monetary and fiscal policy begins to take a toll on the dollar. This is something I'm evaluating now.

Thus far this discussion has focused on stocks but they are not the only game in town. I have found opportunities in high yield bonds and REITs as of lately and believe there is good potential across



the investment-grade bond market also. Other opportunities are likely to arise in coming months. Having rebounded by over 25% since a low in November, I've now put emerging markets stocks in the cheaper end of fair value with decent to very good returns likely in all but my most pessimistic scenario. Should they go lower, I may view them as a fat pitch. I also believe the dollar is likely to be a weak currency over the next several years with some risk of a sizable decline so I'm in the midst of considering the best way to take advantage of this.

### **What the Future Might Look Like for Investors**

I'm prepared for volatile markets (though less volatile than this past fall) and the possibility that many equity-type asset classes will experience wide performance swings with occasional strong rallies and subsequent sell-offs. Rallies could last for months with sizable returns, followed by sharp pullbacks. I have already seen a stock market rally of 18%, followed by a 25% decline, and a 21% rebound within the last few months. Sizable ups and downs in equity markets could play out over a period of a few years even as some equity markets stay within an overall trading range or move only marginally higher before beginning a new bull market. I don't know if this is what the next few years will look like but I believe this to be a possible scenario because this is how other secular bear markets have petered out over time. This grinding process is one way to get at more bargain-priced markets as earnings start to recover faster than prices (this could happen even if earnings growth is sub-par). An environment like this could present multiple tactical plays as volatility moves asset classes into and out of undervalued territory. I have made important adjustments to be ready to take advantage of these opportunities. These include daily updates of the valuation models and a willingness to move quickly in order to capture moves in asset class prices. Those possible opportunities, along with potentially solid returns from our fixed-income investments could translate into an attractive investment environment as we wait for a new bull market. I know that 2009 and beyond will remain challenging but I believe we are well equipped to navigate treacherous waters. I

also believe that financial assets have priced in enough damage so that sustained losses (as opposed to temporary down market blips) over multi-year periods are now very unlikely.

I understand this has been a very hard time for investors in general. I remain strongly committed to focusing everything I do on rewarding you for your confidence. – (1/30/2009)

Best Regards

Jim Cheadle  
Ponderosa Investment Group, LLC

### **Contact Information**

4888 NW Bethany Blvd. Suite K5, #154  
Portland, OR 97229

Phone # (503) 286-0005  
Fax# (503) 286-1050  
Cell # (971) 227-0097

