

*What's going to happen next?*

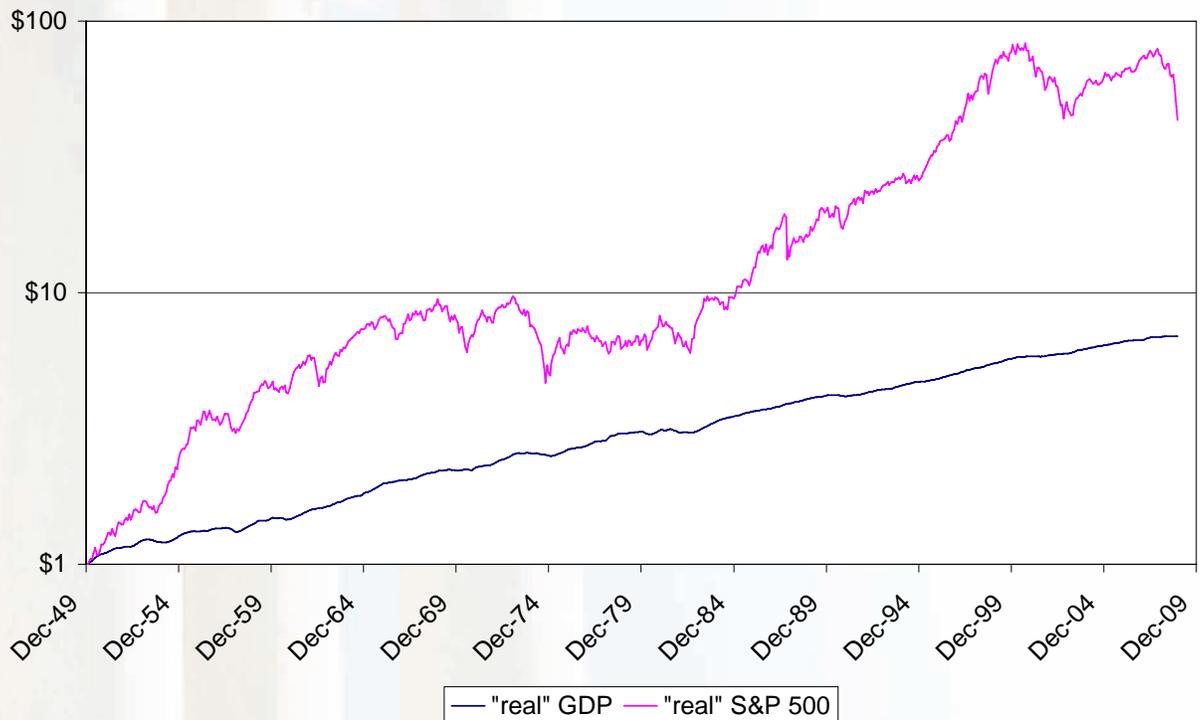
Most of our efforts on your behalf are expended pursuing relative return opportunity. Over time, we expect those efforts to payoff in market-plus returns. During extreme markets like this one, broad market moves overwhelm our stock picking and portfolio positioning with respect to Size, Style or Sector. This has been the case for the past year, and will be the case for a significant period ahead, so let's address the "what's going to happen next?" question on everyone's mind. While many view this as a tough question, history suggests otherwise.

Gross Domestic Product, or GDP, is defined as,

$$GDP = consumption + gross investment + government spending + (exports - imports)$$

GDP is a measure of total national income and is what underlies the companies that make up the stock market. To get an accurate read of GDP, one must look at "real" GDP, which means adjusting for inflation. Similarly, "real" asset class returns (stocks, bonds, real estate, commodities, etc.) are more meaningful, as growth of purchasing power is the purpose of investing. The following chart depicts real GDP and real S&P 500 change since 1950.

**Inflation Adjusted GDP and S&P 500 (log scale)**



The steadiness of real GDP growth is striking and this chart makes evident that GDP change is the underlying driver of long-term stock return, with stocks growing in real terms at roughly

twice the rate of GDP. It's equally evident that stock prices fluctuate wildly by comparison to the underlying economic change taking place.

The National Bureau of Economic Research (NBER) defines a Recession as,

*"A significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP growth, real personal income, employment (non-farm payrolls), industrial production, and wholesale-retail sales."*

Since 1945, NBER has identified 10 recessions. One must carefully scrutinize the real GDP line of the chart above to discern these periods of contraction. Much easier is to examine the real S&P 500 line, as there is always a sharp stock market response to a recession, and sometimes dramatically so. With the benefit of hindsight, we can look back and see how little a recession impacts long-term real GDP growth. Given this, we can also see how over-reactive stock market responses are. But in the moment, each recession and corresponding stock market meltdown fills investors with dread. This inevitably leads to investor panic, and consequently the big selloffs.

Several conclusions are plain from an historical examination of the facts. First, real GDP can only be stalled for relatively short periods of time. Since 1945, the average duration of a recession has been 10 months. Second, investors always overreact to these events. Finally, stock market recoveries tend to be sharp, which means they're unexpected, and that begs the question, how can investors repeatedly be surprised by an event that recurs so consistently?

The simple answer is that we ignore both history and underlying fundamentals in the heat of the moment. We read into price declines informational content that doesn't actually exist (we learn this only with the benefit of hindsight), which means exaggerated price declines beget greater fear and even greater price declines. This self-fulfilling mechanism reaches an extreme when investor supply (sellers) and demand (buyers) become artificially unbalanced, which is a reason this selloff has gotten so out of hand. While the stock market has been accurately characterized as, "*the great weighing machine*," in the short run, only investor supply and demand matters.

The Crash of '87 was an example of this sort of extreme short-term supply/demand imbalance. Program selling overwhelmed buyers on October 19<sup>th</sup>, 1987, resulting in the largest ever one-day stock market crash on record. This is the only panic to exceed the present one during my experience. We're again facing similar investor supply/demand imbalances, with Hedge Funds rather than Program Trading the culprits today.

Hedge Funds are in the business of creating outsized returns. Rather than diversify, they make concentrated bets and then magnify those bets by piling on enormous debt. When they're right, they make fantastic returns. Hedge Funds that bet against the market by shorting it have made money hand-over-fist this year. Those that bet the other way, leveraging their bets up oftentimes five- to ten-times-to-one, have been destroyed in this market. Forced sales by these distressed Hedge Funds, as they work to generate capital to satisfy both their margin calls and the massive redemptions underway, are driving the incredible volatility we're experiencing. This is also the reason no rally can be sustained.

Like Program Trading twenty years ago, market forces are at work to render Hedge Funds once again marginal rather than dominant players. Because of their leverage, a large number of



Hedge Funds have already or will soon fail. Massive redemptions from the surviving Hedge Funds will make them shadows of their former selves, and without question, this unregulated industry will become regulated and closely monitored as a first order of business of the new administration. Market volatility will drastically lessen once this liquidation process is complete, but until then, expect the present artificially high volatility to remain. Media coverage and their penchant for fanning the flames also contribute significantly to the heightened volatility.

While “*when*” remains a \$64-dollar question, “*what’s going to happen next?*” is fairly obvious. We’re going to endure a recession of a magnitude we haven’t seen in several decades. At great expense, the credit crisis that triggered this fiasco will be resolved, and Hedge Fund liquidations underway will conclude. While the vast majority of corporate America will weather this storm, a significant number of weak companies will fail. And then the economy will recover. GDP will resume its growth track, and that will in turn propel stock prices higher. Early in this process, long before the actual problems are fully resolved, a dramatic stock market rally will occur. We know to expect the above because historically this is what always happens.

Another way to peer into the future is to use an old-fashioned form of stock analysis, i.e., computing a company’s fundamental worth, to “see” where prices are headed post-panic. This process involves discounting the long-term earnings capacity of a company to a Net Present Value. Today, stocks are priced at about 50- to 60-cents on the dollar compared to their underlying fundamental worth, which is extraordinary. As the present panic subsides, stock prices will move toward these fundamental valuations.

We can’t help but feel anxious, however, as stock market investors we are by definition long termers. Because we’re long termers, we have the time to wait this mess out and simply need to exercise patience to see this through. Hard to imagine, but we will not only fully recover from this selloff, but in time we will move on to much higher ground, so continue to keep the faith to realize this eventuality!

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