

Letter to our partners – 3rd quarter 2008 ©

I've been buying American stocks. A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors. Fears regarding the long-term prosperity of the nation's many sound companies make no sense. These businesses will indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now. I can't predict the short-term movements of the stock market. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over.

- Warren Buffett, October 2008

Market comments

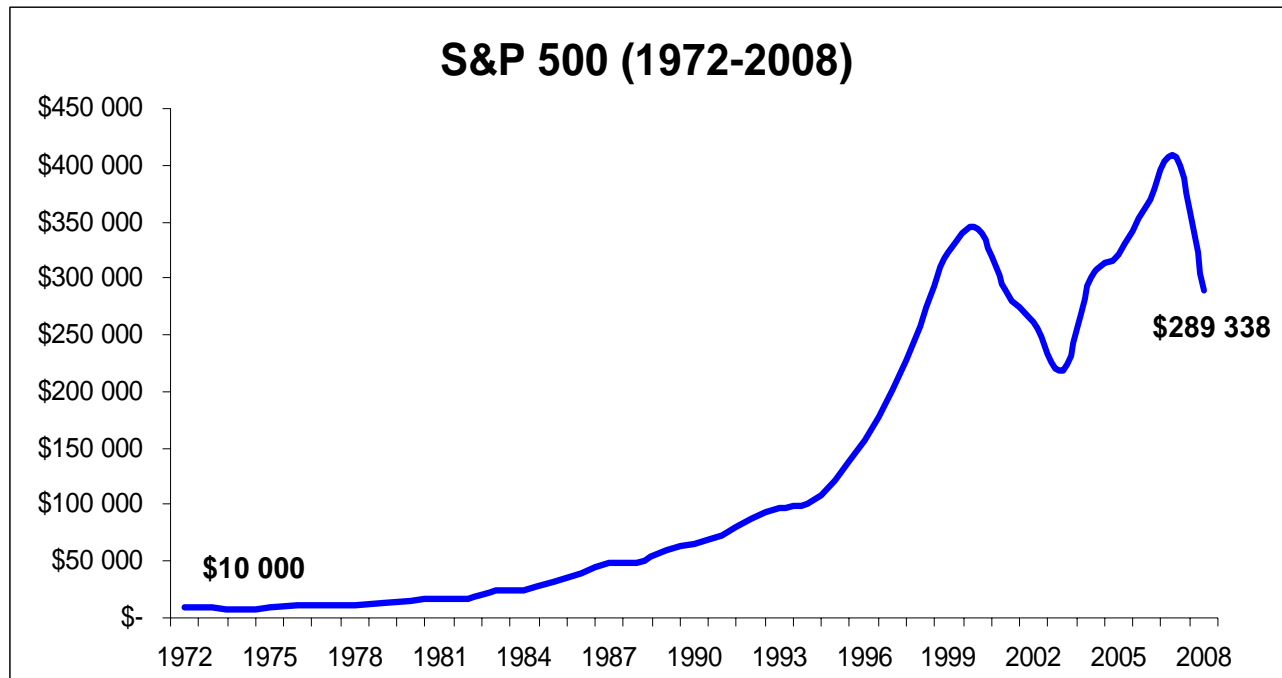
The stock market is going through its worst correction since the tech bubble burst in 2000-2002. But this time, the fall is much more broad than in 2002. All countries, all sectors and almost all stocks are down tremendously. For example, at the end of the first week of October, there were 10 new highs compared with 2901 new lows on the New York Stock Exchange. The ratio on the Nasdaq was 1 for 1514. Even oil has (finally) come down and the Canadian dollar with it. The good news is that our companies have done way better than the average (they are down less).

This market correction looks more and more like the one of 1973-1974. In those two years, the S&P 500 had gone down 45%. This was the cover of September 9th 1974 Time Magazine edition:



As frightening as market drops can be, there are disasters only to those who sell. Those that were patient in 1974 (or even bought more at better prices) were highly rewarded. Ten years later, \$10 000 invested at the average 1974 market level was worth \$31 750 or a 12% annual return. Twenty years later, the amount was worth \$127 328 or the equivalent of a 14% annual return.

In fact, in 2008, even after its recent drop, the \$10 000 invested in the S&P 500 in 1974 was worth \$350 000, for an annual return of 11%. More to the point, a “cursed” investor that would have invested in 1972 – just before the big drop in the two years that followed – would have turned \$10 000 into \$289 000 or an annual return of 10%. Stocks are the best long term asset. They are even better when purchased at great prices!

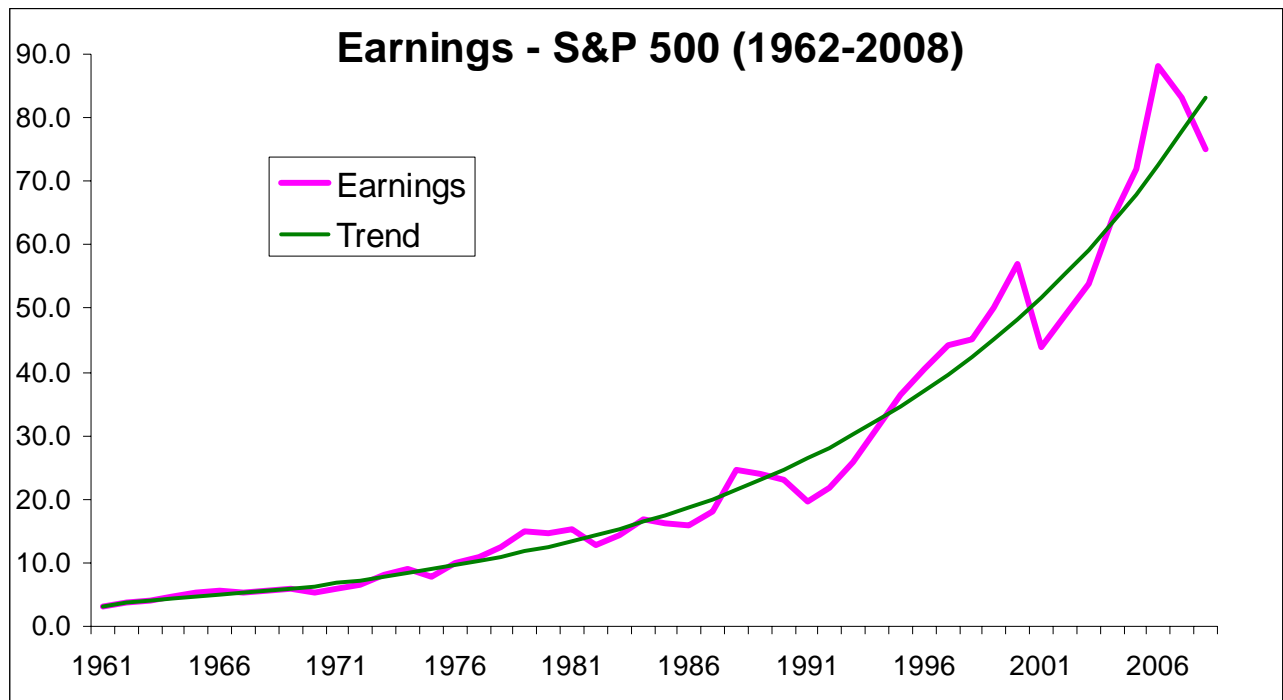


Is this the most undervalued market of our generation ?

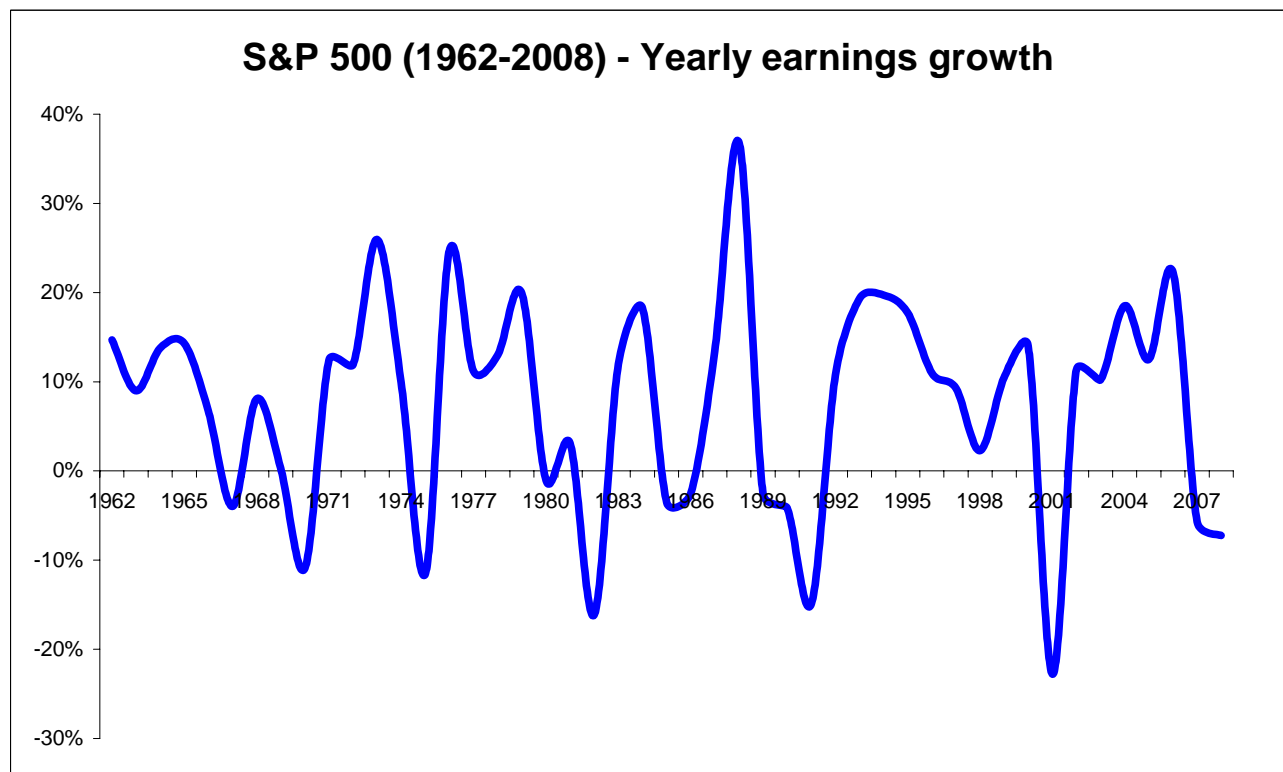
The key to understanding market valuations – and the subsequent returns that they yield – for the S&P 500 depends on three main variables:

1. Earnings for the companies that make up the index.
2. Earnings adjusted for the economic environment. Not just for a specific year but in line with the historical trend of profit growth. This growth has been 7% per year for decades. This rate is the combination of a real GDP growth of 4% (3% linked to the increase in the efficiency rate plus 1% for demographics) and an average inflation rate of 3%. This 7% growth is almost a constant parameter.
3. Long term interest rates.

If we look at the data since 1962, earnings went from 3.2 at the beginning of 1962 to 83 in 2007. It's a compounded annual growth rate of 7.0%. For 2008, I have taken estimates of 77 (a 8% decrease). In fact, earnings could be down around 13% since their 2006 high. Here is the chart of the S&P 500 earnings and the long term earnings trend :

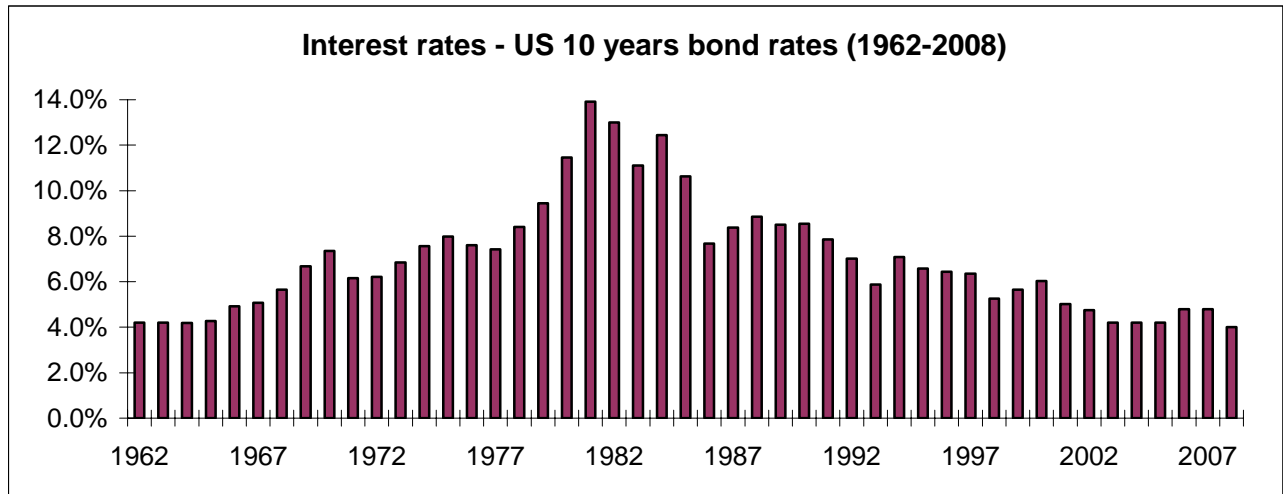


In the preceding chart, each drop in the S&P 500's earnings (in magenta) is caused by a recession or at least an economic slowdown. In the upturn that always follow recessions, earnings return to their historical trends and reach new highs. So the second chart would be yearly earnings growth:



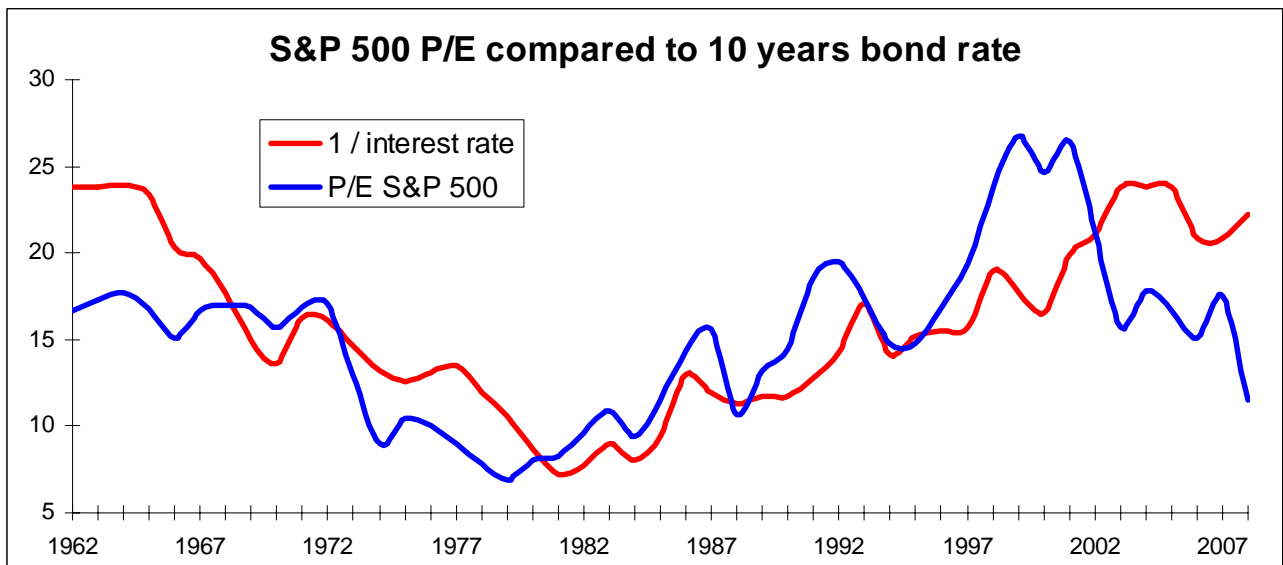
We are going through the 6th recession since 1962 (1970, 1974, 1982, 1991, 2001). Each time, to value the S&P 500 more appropriately, normalized earnings should be used in calculations.

The third dimension is interest rates. Here is a chart of long term US treasury bond rate since 1962 :



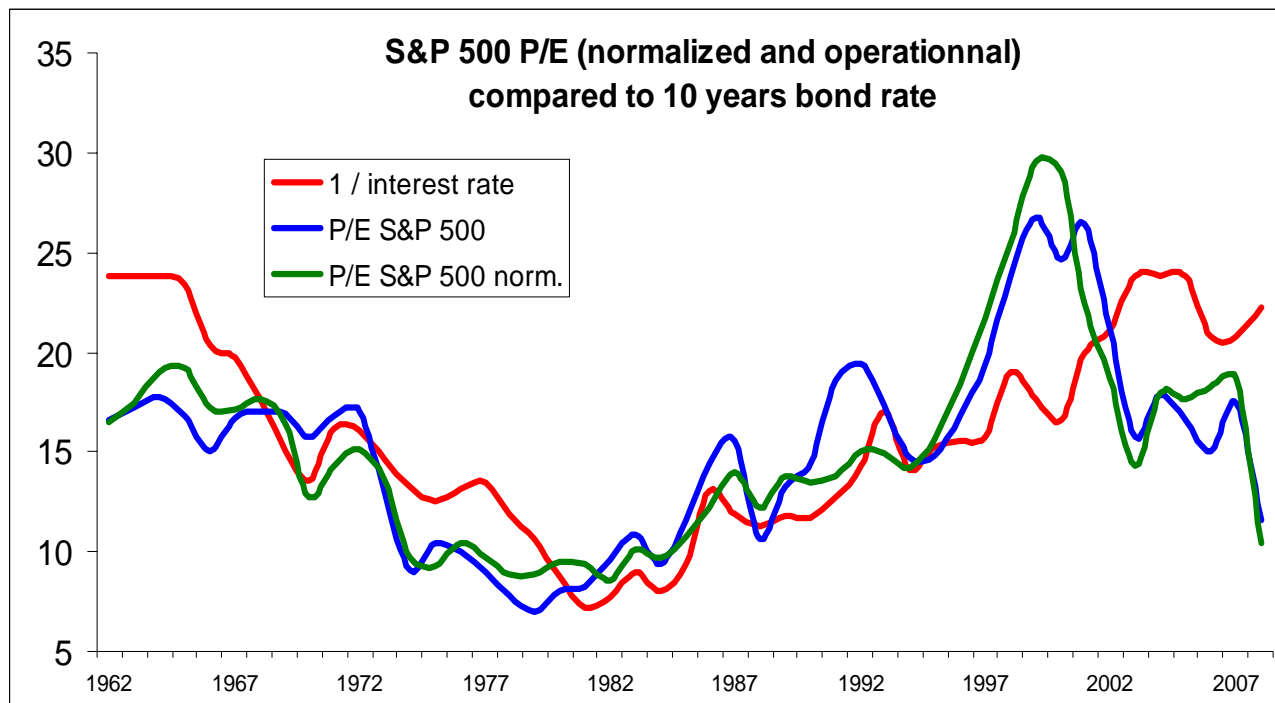
From 1973 to 1982, the US bond rate went from 6% to 14%. It was quite devastating for P/E ratios. But today, interest rates are at 4%. Occidental countries learned from the inflationist period of the 1970s and have fought against inflation since then. So it turned out that the 10 years period from 1974 to 1984 was an exception in the history of interest rates in the US.

In the next chart, we show the link between the inverse of interest rates and P/E ratios:



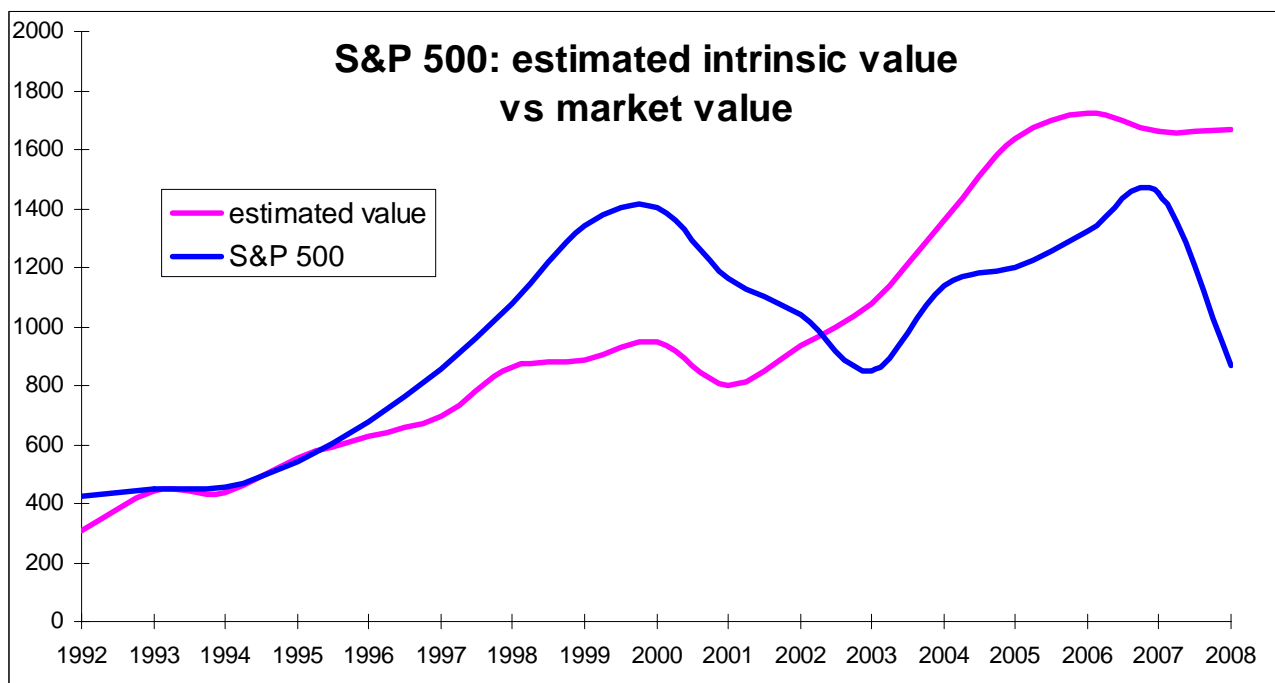
Over the long run, interest rates and P/E ratios have an important correlation. It makes sense that when rates are higher, the market capitalisation rate (P/Es) should be lower because investors want a higher rate of return. We can note in the chart the gap between rates and P/Es is very high these days. It is in the exact opposite situation from 1999 when the market P/E was much higher than what was warranted by interest rates.

In the next chart, we add more precision by also comparing price to adjusted (normalised) earnings for the S&P 500 (using the trend line in the first chart) :

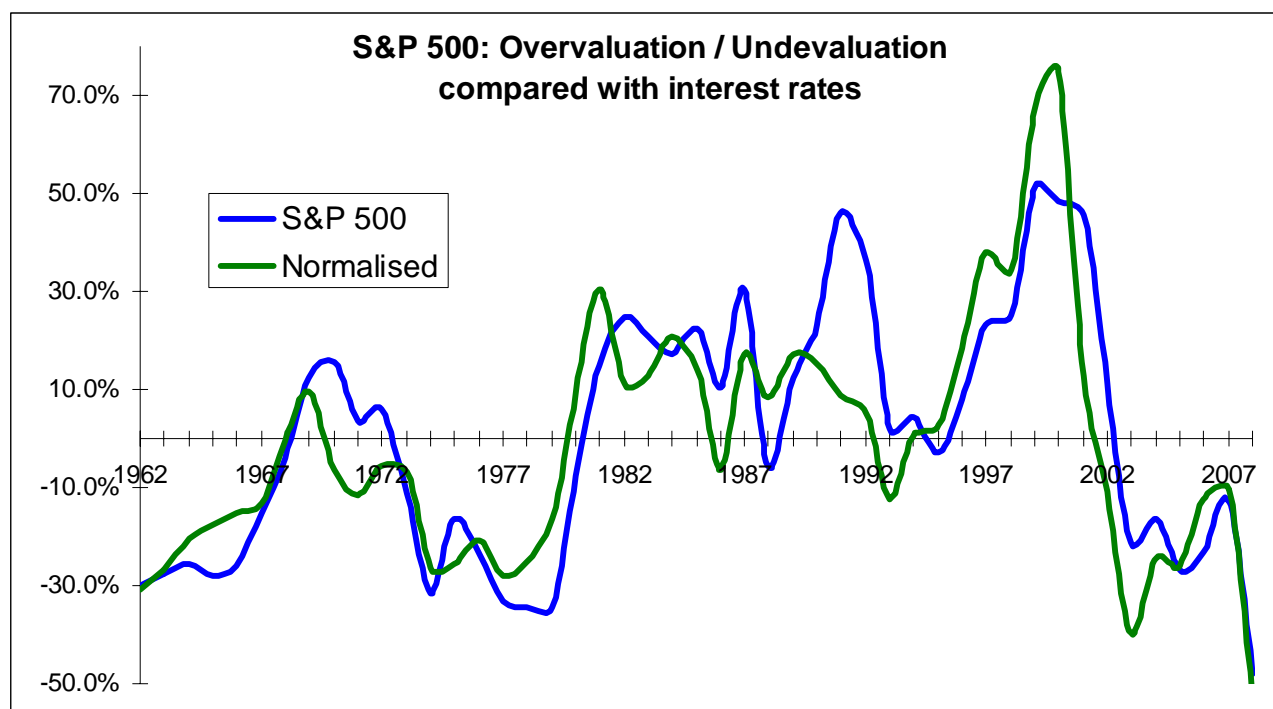


So the green chart is a better indication of long term market valuation. Today's level (11x) is the lowest since 1984 (when interest rates were 12%). The gap between the inverse of interest rates is the widest it has been since probably the beginning of the 1950's.

So we can then derive an estimate of the S&P 500 value compared to the market level since 1992 (the starting point of my career). We can note on the following chart that from 1996 to 2001, the market was overvalued compared to its intrinsic value but since 2002, it's been the other way around. Today's market is at a level way below its estimated intrinsic value.



In the last chart, we try to measure the degree of undervaluation / overvaluation of the S&P 500 since 1962, comparing P/Es for both earnings and normalised earnings with interest rates:



We can conclude from the last chart that the S&P 500 seems undervalued by 45% today. Such a level of undervaluation have not been seen since 1979. This conclusion could change if interest rates were to climb substantially. But even if they went up to 7%, stocks would still be undervalued at current prices.

And the higher the undervaluation, the higher the future potential return of stocks in general.

The most important organ...

Peter Lynch used to say that in market corrections, the most important organ is not the brain but the stomach. Because all the best valuation analysis that investors could gather are futile if they panic and sell their stocks during market drops. Emotions are the enemy of investors. No one knows when the stock market will come back up but it will go up way before any signs of economic improvement. As Warren Buffett said lately : *"if you wait for the robins, spring will be over."*

In these difficult times, it is useful to remind ourselves that past market corrections and recessions have all one thing in common: They were all temporary!

I wish you, dear partners, a great quarter.

François Rochon
And Giverny Capital's team.