The Long & Short of It

Quarterly Newsletter
Third Quarter 2010

Rising Despite Uncertainty

During the third quarter of 2010, market performance was strong despite continued unusual uncertainty faced by investors—indeed, by most Americans. Expectations for economic growth around the world fell significantly as the United States and other industrialized nations saw nascent job creation stall and the threat of deflation rise. The result was a broad decline in interest rates and a strong return for bonds during the quarter. While falling interest rates can help stocks, declining growth expectations can hurt them. The strong performance of stocks during the third quarter indicate that the negative impact to valuations from declining growth expectations was minor compared to the positive impact of falling interest rates. The increase in stock prices appears to have meaningful underpinnings.

Investors never like uncertainty. Without even addressing the issue of whether one agrees with the "Change" in Washington, the mere fact that many of the rules and regulations affecting companies are changing is enough to impact valuations negatively. Indeed, we would assert that the level of uncertainty born by the stock market during the first two years of policy shifts by this administration has been a significant damper on valuations. This is not unusual. Americans have a history of being uniquely capable of innovation and wealth creation. Yet, during most presidential administrations, the first two years frequently provide some accommodation for loftier goals, such as promoting the social good or rectifying the injustices of the previous administration. These initiatives almost always are disruptive as the changes are contemplated and enacted. Later, as the next election approaches, voter's wallets again take center stage. This moment you have heard before: "It's the economy, stupid."

So, we have to ask, "What if the uncertainties were to dissipate?" Valuations are certainly compelling for many equities, especially the old blue, tried and true—as discussed in last quarter's newsletter—stable, growing companies with dividend yields greater than yields found in the bond market. All the money currently being printed will surely make its way into prices at some point. If, for the next two years, Washington backed off of "Change" and promoted "Stability" and "Predictability" instead? The combination of these elements could be very constructive for the stock market.

However, although the Fed may succeed at keeping CPI in a targeted range, there is nothing to stop normal price discovery in individual markets. Housing will remain weak relative to the CPI. Commodity prices should remain firm. In fact, if the decline in housing and commercial real estate prices resumes, then we could see significant raw materials inflation being allowed in order to maintain stable overall price levels.

Manufactured goods—or at least those produced without patent protection or other significant barriers to entry—will likely remain weak for a bit longer. Productivity gains and slowing demand growth (due to aging populations and over-leveraged balance sheets of government and consumers) are combining to limit pricing power for the average manufacturer of consumer products. The same may be said of industrial companies if they are unable to escape the slowing growth of government spending in the industrialized world. Industrial companies can benefit from exposure to emerging and exporting countries that deploy some of their wealth to build out infrastructure. The story is not all that new, but is unlikely to change in the short run, except for one major threat that bears close watching: the growing protectionist sentiment in the U.S. and other countries.

Fundamental to Our Thoughts

Those who participate in the economic system and believe in the wealth-creating capacity of capitalism share a common vision that values truth, integrity, and trust. As Adam Smith said, "All money is belief." As our ability to believe in one another, our monetary system, and our form of government improves, wealth is created. Conversely, as these elements are cast out, wealth is destroyed. Yet, to build faith in something, including our laws, monetary systems, and one another, it must be leaned on, and indeed, tested.

The principles for creating and sustaining a free economy hold that owners of capital, no matter how modest, are responsible for making their capital active and allocating that capital to its most productive use. Doing so requires thought and analysis. Thinking is good. We believe that investing using index funds or capitalization-weighted funds (passive investing) is a shortcut in thinking. It is an abdication of responsibility by members of the capitalist system and not a methodology in which we have any faith.

The damage done by passive investing is most clear in the tendency for those vehicles to "overweight the overpriced"—as seen when financial sector holdings became 22% of the S&P 500 Index in late 2007, just before the credit crisis. This same weighting subsequently fell to 9% of the S&P 500 by early 2009. An even better example is the S&P 500 Value Index, in which financials grew to about 33% by late 2007. 33% in one sector clearly makes no sense. Yet, indexes are the standard against which all managers are compared and to which most managers compare their holdings. Similarly, in early 2000, mega-caps dominated the holdings of the S&P 500 just before beginning their 10-year odyssey of zero return, which finally seems to be nearing an end. Moreover, in 1980, although indexing was less popular at the time, the calculation methodology was the same, leading energy stocks to become over 25% of the S&P 500. The weighting of the energy sector subsequently fell for 20 years, ending up at 6% by 2000.

Insomuch as investors have embraced indexing, they have also been sorely disappointed by the results of their decisions. Oftentimes, index investors have most concentrated their exposure in areas just as they become the most overpriced, and conversely underweighted those sectors that were out of favor just as they begin to make significant rebounds. The end result may be a return that is similar to those of other active methodologies, but with significantly greater losses during economic disruptions. Economically, the result is that scarce capital is over-allocated to an opportunity that has already been fully funded. It is human nature to seek the "easy" button, a solution where one formula answers all questions. For index investors, the result is clearly definable moments—especially at major turning points in our economy—when prudence takes a vacation.

At RVM, we do not define risk as deviation from a benchmark. For us and for our clients, risk is defined as the loss of purchasing power. When economic and investment return histories are studied in light of this metric, the answers to the question of how capital should be deployed become quite different. Formulas are valuable to the degree that they convey information from which judgments can be made, but there are no shortcuts that allow the machines to prudently and successfully take over. As Adam Smith said, "The robot is going to lose, not by much, but when the final score is tallied, flesh and blood is going to beat the damn monster." The popularity of indexing thus provides an opportunity for those who recognize its shortcomings. We will continue to avoid "over-weighting the over-priced" and seek opportunities where indexing methodologies have under-weighted the out-of-favor. In the words of Warren Buffett, "If you've been playing poker for half an hour and you still don't know who the patsy is, you're the patsy." We hope your fourth quarter brings you a winning hand.

This newsletter is furnished only for informational purposes and does not constitute an offer or solicitation to sell or buy securities mentioned herein. Although the information contained herein has been obtained from sources believed to be reliable, its accuracy and completeness cannot be guaranteed. Opinions expressed herein are subject to change without notice. Past performance cannot guarantee comparable future results.

Robinson Value Management, Ltd. (RVM) is an independent investment management firm, not affiliated with any parent organization. Founded in 1997, Robinson Value Management, Ltd. is registered with the SEC and serves both individual and institutional clients. The name was changed to Robinson Value Management, Ltd. from Robinson & Wilkes, Ltd. on December 31, 2008.

Robinson Value Management, Ltd. claims compliance with the Global Investment Performance Standards (GIPS®). To receive a complete list and description of our composites and/or a presentation that adheres to GIPS, call (210) 490-2545, email amy@robinsonvalue.com, or go to our web site at www.robinsonvalue.com.