



NO LONGER HEDGED

We are at the midpoint of the fourth quarter – a period which has been as volatile as the third quarter. We thought it might be helpful to bring you up to date with our current thinking. Markets around the globe have continued to deteriorate. Volatility has reached levels never before seen; swings in daily stock prices on the Dow Jones of 1000 points have occurred; rationality seems to have disappeared; logic is gone; emotions are running rampant; and fear is palpable. The “herd” is running in many different directions and in no direction.

An important contributor to the recent “market meltdown” has been the hedge funds, which according to some estimates control in excess of \$1 trillion. They are selling billions of dollars of securities to meet lender demands and investor requests for fund redemptions. Why? Because in spite of their supposed investment style which is to hedge positions and to protect investors in market maelstroms, investors have discovered that positions are not hedged or not hedged well enough. Consequently, large losses have been registered in many funds. Complicating matters is the fact that hedge funds borrow significant funds to “lever up” ideas. Leverage in an up market is a fine notion and makes people a lot of money. Leverage in a down market is a lethal idea and quickly “wipes out” investor funds and necessitates banks (who have lent the money) to call in loans which requires that the hedge funds sell – further pushing down prices. So a “vicious cycle” has developed. Asset prices have fallen, which has forced bankers to call in loans and scared investors who have demanded redemptions, which has pushed funds to sell securities in a falling market, which has pushed prices even lower, which has forced banks to demand even more repayments and has further scared investors who call for more redemptions, which has forced more liquidations in a falling market, and so on, and so on, etc. etc.

“The recent rush of withdrawal notices to hedge funds comes as investors including endowments, pension funds and wealthy individuals, see other investments shrink; in some cases these investors need cash to meet their own obligations. It also marks a sharp reversal of sentiment among these big institutional investors, which jumped into hedge funds and similar investments in recent years. The University of Virginia with an endowment of \$4 billion in mid-October, recently said it plans to sell \$400 million of its \$1.8 billion in hedge funds in the next couple of years to fulfill its commitment to other investments.

The result is a downward spiral where hedge funds sell off... driving down their prices, and leading to bigger losses and more demands for cash. When hedge funds can't meet the demands for cash, lenders seize their assets and try to sell them, further driving down prices and putting more funds in trouble.

In mid-October, redemption levels were in the 5% range but all of a sudden now it's cranking up to as high as 25% for some funds”, says Greg Horn, president of Persimmon Capital. ¹

Forced selling is not reflective of corporate performance or macroeconomic situations. Forced selling by hedge funds is simply the result of lender demands for deleveraging or investor demands for cash because they are scared of getting wiped out due to the hedge funds' debt. These are reasons which are exogenous to market and company fundamentals. Investors who are not so leveraged do not have these problems and can wait out the downdraft in asset prices. Nevertheless, the waiting is disagreeable.

Valuation levels in just about all domestic and foreign markets are inexpensive according to most any valuation standard. This does not mean that prices will not get cheaper, because who can control investor emotions? But it does mean that assuming any reasonable return to market normalcy, there is a great deal of “upside” in markets today. By way of example, let us assume that the S&P 500 will earn \$70/share in 2009, which represents a 23% fall in earnings from 2008. This would be a sharp contraction in anticipated earnings, reflective of the recessionary environment expected next year. U.S.Trust has studied interest rates, inflation rates and corresponding P/E ratios over time and has concluded that in our present low inflation and interest rate environment an appropriate P/E ratio range would be 17x – 18x earnings. Well, $17 \times 70 =$ an 1190 value on the S&P 500, while $18 \times 70 =$ a 1260 value on the S&P 500. At a recent 931 level, the S&P 500 could advance 28% - 35% in the next twelve months.

¹ Wall Street Journal, November 7, 2008

S&P 500 Earnings vs. Valuation Matrix

		S&P 500 Earnings										
		50	55	60	65	70	75	80	85	90	95	100
S&P 500 P/E Ratio	7	350	385	420	455	490	525	560	595	630	665	700
	8	400	440	480	520	560	600	640	680	720	760	800
	9	450	495	540	585	630	675	720	765	810	855	900
	10	500	550	600	650	700	750	800	850	900	950	1000
	11	550	605	660	715	770	825	880	935	990	1045	1100
	12	600	660	720	780	840	900	960	1020	1080	1140	1200
	13	650	715	780	845	910	975	1040	1105	1170	1235	1300
	14	700	770	840	910	980	1050	1120	1190	1260	1330	1400
	15	750	825	900	975	1050	1125	1200	1275	1350	1425	1500
	16	800	880	960	1040	1120	1200	1280	1360	1440	1520	1600
	17	850	935	1020	1105	1190	1275	1360	1445	1530	1615	1700
18	900	990	1080	1170	1260	1350	1440	1530	1620	1710	1800	
19	950	1045	1140	1235	1330	1425	1520	1615	1710	1805	1900	
20	1000	1100	1200	1300	1400	1500	1600	1700	1800	1900	2000	

At present as you can see displayed in the chart above, the S&P is selling at approximately 13x next year's anticipated depressed earnings – CHEAP, CHEAP, CHEAP! Dividend yields are higher than they have been in years and are higher than Treasury yields. The story is the same in many markets elsewhere in the world – only even more dramatic. We do NOT believe that we are going into a depression or anything close to it. We are in a recession and many levers are being pulled to make that as short and “painless” as possible. We have had recessions in the past and will have them in the future. They are always uncomfortable – but we have always emerged and we will this time. Successful investors are those who have “stayed the course” through good and bad times. Emotion must be stripped away. Facts should be our only guide through these rough waters.

