

Don't Buy Stocks for 2009!!!

Two weeks ago the subtitle of our letter was – **Investment Manager Marketing – BEWARE.** Our marketing department would be outraged by our title in this week's letter. But hold on, before we are delegated back to the "research room" let us explain ourselves. First off, we have no marketing department, secondly there is one key word in the above title, and it is for. When we say don't buy stocks for 2009 it is based on the premise that investors buy into stocks for the potential to see share prices rise as the earnings of a corporation grow. This element of earnings growth will be absent in the near term. So if you are focused on growth in earnings for 2009 you'll be sorely disappointed and probably figure it's just best to sell.

We recall that even late last year the consensus for earnings growth was still positive for 2009. Company after company which we studied had forecasted earnings growth by the market which seemed out of touch with reality. The numbers were generally based on an extrapolation of the past rather than a consideration of the future. This process of coming to grips with a more realistic outcome is imperative. Is it done? No. But the momentum has increased dramatically. The optimists are very quickly becoming the pessimists; the companies they once suggested investors BUY are now SELLS or HOLDS. It is human nature to feel more confident in buying something when you think the future will be bright. Unfortunately this human nature has historically driven people to buy at the top when things look rosy and sell at the bottom when they look grim.

We would agree that most companies earnings will fall, some dramatically, this is not a new revelation to us. We invest based on what we believe a company can reasonably generate on the assets they own into the future. The future includes the next five months as well as the next five years. We need to look through this deep valley we are in to see better days and properly value businesses based on their long term opportunity rather than valuing them in a severe contraction.

For the past couple of years our presentation materials included the previous chart. This shows the profitability corporations collectively have been able to achieve on their asset base going back five decades. There are two ways to interpret this chart: 1) we are at unprecedented levels, something is different and the prosperity will continue 2) we are at unprecedented levels, be careful.

Our interpretation was the second. In studying the history of both economics and the stock market one gets an appreciation of cycles. They come and go, each one slightly different. This past cycle was very strong on the way up and will be very weak on the way down. That should not scare us though. Two years ago very few figured it could turn down, today very few are considering the possibility that at some point it will turn up. It will, it will just take time.

Inside the Fund

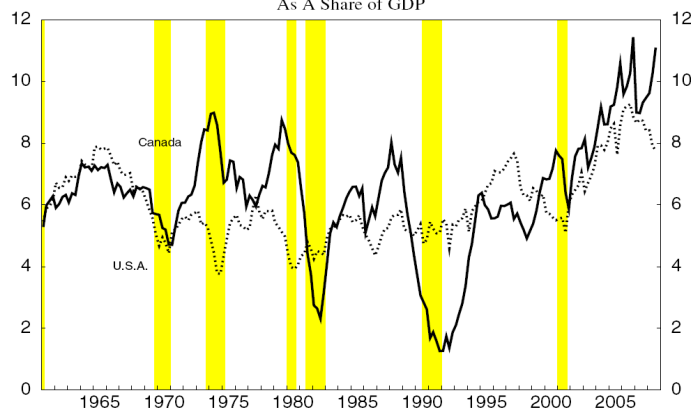
A couple of weeks ago one of our holdings, Gennum Corporation, reported weak earnings relative to the market expectations. Even worse, they suggested the economic slowdown was impacting their sales quite dramatically. The forecasted earnings were slashed, out came the downgrades and the calls to sell.

We took a look at what some of these same individuals were saying previously. In one particular example the analyst valued the business at the beginning of 2007 at \$15 per share, based on 21 times that year's earnings forecast of \$0.70. After the recent disappointment that same analyst suggested a target price for the company of \$4.50 based on 10 times his new earnings forecast of \$0.31. Oh yes, the day before the earnings release he had a \$10 target and an earnings forecast of \$0.64. He's correct on the earnings falling dramatically this year, we don't disagree. But consider the change in perspective. Gennum is in a cyclical industry. Back in 2006/2007 when times were good analysts/investors had no problem being very aggressive with their multiples of earnings, most of them over 20 times. Today in an environment of depressed earnings they throw in the towel and not only slash earnings but slash the earnings multiple as well. The stock was a buy at \$15 and a sell at \$4.50!

The inability to see through the thick gloomy fog forces individuals to sell when stocks are cheap and want to buy them when everyone thinks the backdrop will be better. They always forget that one important factor - valuation. This is the cycle, it doesn't change it just takes time to evolve.

Who knows maybe they'll be right. We will make a forecast of our own. At some point in the next five years the earnings of this company will be much higher than the \$0.31 that the market now expects. In addition, when the improvement catches everyone off guard not only will people forecast higher earnings they will also apply a higher multiple. This year and maybe the next we won't make much of a capital gain here, but when things turn it will more than make up for our patience.

Corporate Profits After-Tax
As A Share of GDP



U.S. corporate profits including IVA & CCA ADJ

Source: BMO Chartbook - February 2009