THE DECISION MAKER

KING

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He who fears something gives it power over him.

—Moorish Proverb

The year-over-year growth rate in corporate profits has hit its near-term peak. The index of leading economic indicators recently declined for three consecutive months. The U.S. budget deficit continues to climb inexorably higher. Crude oil futures prices rose 17% during the third quarter as domestic crude inventories declined for eight straight weeks. Some hedge fund managers say oil will reach $90 to $100 a barrel next year, a development that surely would drive inflation through the roof. Government officials and private sector security gurus have continued to maintain that terrorists, most likely Al Qaeda or an affiliated group, are planning a major attack in an effort to influence the November 2nd election just as the terrorist attack in Spain influenced that country's election. Authorities girded for an attack as a series of "high profile events" took place over the summer, and the city of New York was turned into a fortress once again as the terror alert level was raised in response to intelligence gleaned from a source in Pakistan. In Iraq, attacks on U.S. soldiers and car bombings have escalated significantly over the past several months.

Still reading after this litany of paralyzing pessimism? The recent investment climate has been one of continual fear and uncertainty, obviously the kind of environment that is typically very bearish for stocks and one marked by extreme volatility as skittish investors await the next macroeconomic or geopolitical sell signal. Surely one would predict that the broad S&P 500 Index would be solidly in the red for the year after a healthy 25+% gain in 2003, right? In fact, through the end of the third quarter, the total return of the S&P 500 including reinvested dividends was *up* 1.5%. Perhaps even more amazing is the lack of volatility—through the third quarter there has not been a single day when the Dow Jones Industrial Average or the S&P 500 Index has risen or fallen by at least 2%. In 2003, there were 30 such days. Sellers have yet to gain the upper hand for any extended period even through the tumultuous third quarter.

Many pundits have pointed to the so-called "second derivative" of earnings growth in arguing for lackluster market returns. This argument refers to the fact that earnings are increasing at a decreasing rate. S&P 500 earnings are expected to increase approximately 14% versus the prior year for the just-completed third quarter. Though this increase obviously falls short of the 20+% earnings increases turned in during the last several quarters, it is certainly not a harbinger

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of a stock sell-off. First of all, a 14% increase is well above the post-World War II average earnings growth rate of 6%. Secondly, consider the lofty level from which earnings are decelerating. Starting with the third quarter of 2003, S&P 500 earnings have climbed by more than 20% for four consecutive quarters, something that has happened only seven other times since the end of World War II. Ned Davis Research recently analyzed the performance of the equity markets emerging from those seven periods. In the 12 months after the end of the seven streaks, the S&P 500 rose 8.3% on average. The median increase was approximately 15.3%. These numbers offer little comfort to the second derivative bears and should help to place the market's current consternation over decelerating earnings growth in proper perspective.

An extrapolation of the trends of the 1880's would show today's cities buried under horse manure.

— Norman Macrae
English journalist

Any conversation about the equity markets is far from complete without a discussion of energy prices; one could argue that the price of crude oil has been the main determinant of stock prices this year. As previously mentioned, crude oil futures rose almost 20% during the third quarter and recently climbed above the $50 per barrel mark in the wake of hurricane-related production disruptions in the Gulf of Mexico and the latest geopolitical developments in Nigeria. Investors of late have paid more attention to the daily swings in the price of crude oil than during any other period of recent memory. When was the last time the main driver of several days' stock price direction was the hourly whim of the Russian Oil Ministry? Over the course of a few days some weeks ago, the oil market and the stock market were pulled back and forth based on the mercurial Russian government's stance regarding whether Yukos, the large Russian oil company with the sizeable back tax bill, could have access to frozen funds to fulfill demand. An important point to remember, however, is that Russia will produce its oil whether or not Yukos remains a going concern.

Another sign of the myopic market focus on crude prices is the hypothesis by one equities trader that the recent stock market rallies during the last hour of trading reflected the fact that the New York Mercantile Exchange (NYMEX), where crude oil futures change hands, had closed. In other words, stocks can't get hurt anymore by oil during that last hour, notwithstanding that the NYMEX will of course reopen in the morning! Whether or not this theory holds any validity is beside the point—that it was even voiced speaks volumes about the minute-to-minute trading mentality that has permeated the market. A little perspective and an inkling of an investment time horizon longer than an afternoon would surely be nice.

Daily media coverage of "sky-high" energy prices is inescapable, and an ever-increasing number of players want a piece of the action. Morgan Stanley purchased 24 million barrels of Gulf of Mexico production for almost $800 million from Anadarko

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Petroleum. Wall Street banks have been on a hiring binge, snapping up the same energy traders who last made their bets with formerly high-flying companies like Enron and Dynegy. Hedge funds have made enormous wagers on expectations of rising prices; as of this summer, the total value of crude oil futures contracts has more than doubled in the past year. Four years ago, there were only approximately 136 commodity trading advisors managing about $20 billion on the NYMEX. Today, there are approximately 450 commodity traders managing about $70 billion. Further, because most of these traders are highly leveraged, their buying power is considerably greater than $70 billion. Here in Houston, arguably the energy capital of the world, energy-only hedge funds have become as commonplace as the energy companies themselves.

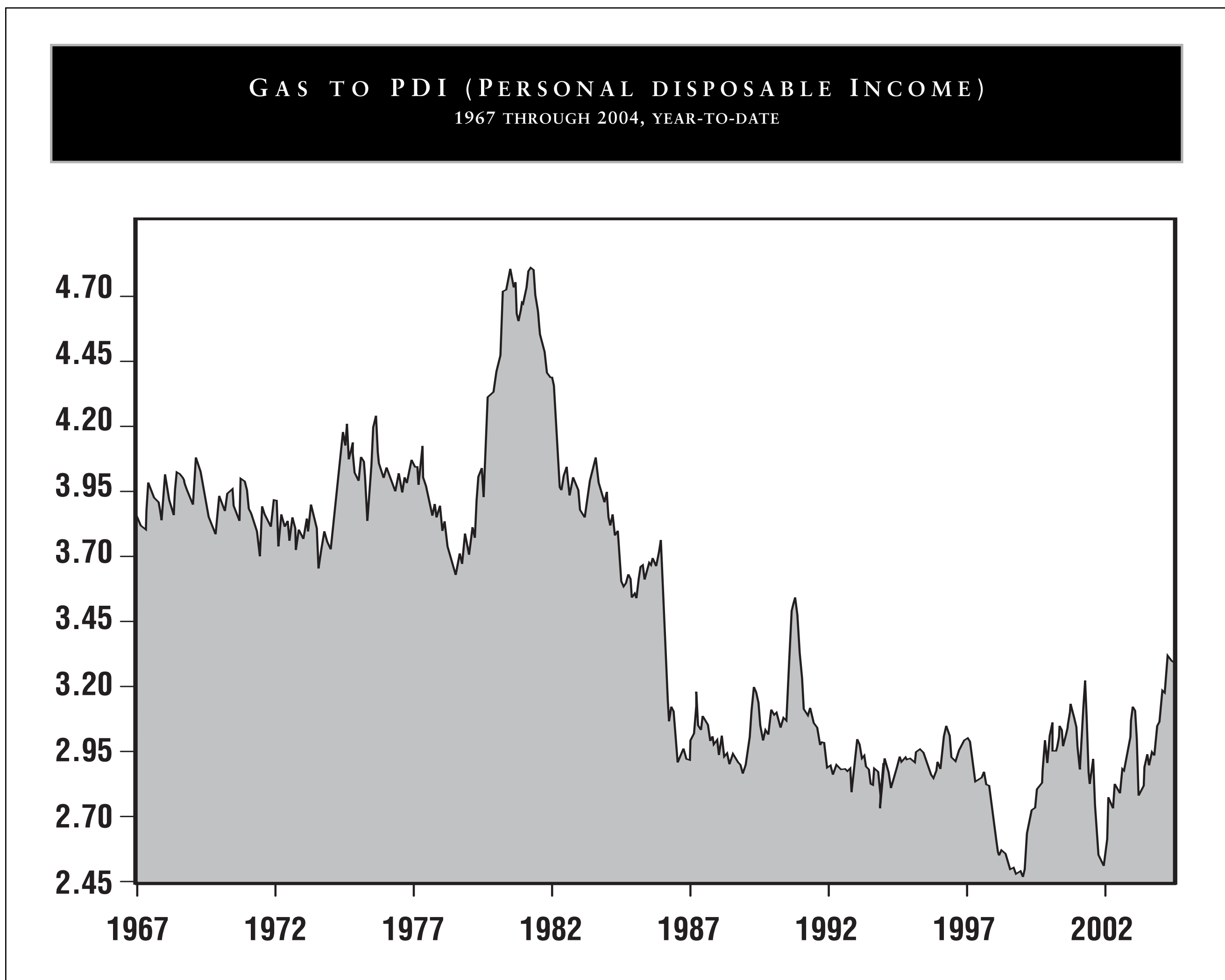
Crude oil and other commodity prices are certainly determined in large part by supply and demand factors, but it would be foolish to assume that all of the above financial players have had no influence on the oil price increase that has taken place this year. These funds have bid up the price of oil in a textbook example of a momentum-driven market, and their traders are usually quick to book profits when the market turns in the other direction. As an example of the impact of fund speculation on the price of oil, look no further than the weekly data released by the Commodities Futures Trading Commission (CFTC). For the week ended September 10th, speculative net-long positions in crude oil futures declined 24% from a week earlier. Not surprisingly, crude oil futures for that week declined approximately 3% from the week earlier. Importantly, the CFTC data may actually be *understating* the influence of speculators. This data does not include trades conducted away from the NYMEX on the over-the-counter market, and numerous analysts believe this market is even larger than the NYMEX's market.

We would never be so presumptuous as to maintain that we can predict where energy prices are heading. Similarly, those speculators who are calling for oil to reach $100 in the near future would do well to remember past predictions made by "energy experts." In 1929, the Independent Petroleum Association of America predicted that the United States only had about ten years of oil and gas left to produce. Forecasts of $100 per barrel were commonplace during the 1970s, and some maintained that the floor on oil was $5 just five years ago when the price of oil lingered at slightly over $10 per barrel.

Today, no one can deny that demand for oil has increased significantly, specifically in ever-developing regions such as China and India. Spare capacity is low by historical standards, and U.S. inventories were depleted during the third quarter due to hurricane-related production halts, though obviously the hurricane damage should prove to be relatively short-lived. Given this scenario, the

doomsday proponents would have you believe that U.S. economic growth will grind to a halt as high energy prices stifle consumer spending. This summer, each penny increase at the gas pump was heralded as further evidence of an imminent economic slowdown. Higher prices undeniably act as a tax that lowers growth by diverting disposable income that could have been spent elsewhere, but again, some perspective is in order.

The U.S. economy has been growing at close to a 4% pace this year in the face of the oil price jump. Media headlines have trumpeted the first $50+ closing price of crude on the NYMEX. Adjusted for inflation, however, this $50 price is well below the record level reached during 1980 of approximately $90 in 2004 dollars. Also, the percentage of the American consumer's disposable income that is devoted to expenditures on gasoline has been trending downward over the last two decades and is at a low level by historical standards. Gasoline sales represented about 4% of income until 1979 when hydrocarbon price increases outstripped income, and in 1980 gas sales reached a peak of



Source: Bloomberg; Thomas R. Keene

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slightly under 5% of disposable income. Since 1980, consumers have benefited from lower inflation-adjusted energy prices and rising incomes, and currently gasoline sales represent just slightly above 3% of disposable income.

Again, we have no crystal ball that tells us where energy prices are going. After all of the aforementioned players have become positioned to profit from rising prices, however, there are fewer people left to bid the price considerably higher. Moreover, though supply and demand factors drive the price of a commodity up, they can also exert the opposite force. If oil continues to rise at its current pace, eventually demand destruction and softer prices will inevitably result. Various geopolitical risk premia and the net-long positions of speculators will also play a part in price setting—it is important to remember that there are other factors that determine that $50 price of oil beyond simple supply and demand. More than a few industry watchers maintain that these factors are currently adding anywhere from $10 to $15 to the price of a barrel of oil. In other words, based strictly on supply and demand dynamics, oil should be priced closer to the $35 to $40 range.

Buy when you are scared to death, sell when you are tickled to death.

—The Cabot Market Letter

Considering the full spectrum of prognostications put forth by this country's economic laureates this year, it is no wonder that the field of economics is often referred to as the "dismal science." Early in the year, the U.S. supposedly had a nagging deflation problem that would not disappear. Prevailing sentiment then shifted to fears of a "jobless recovery." Following a few months of strong job creation numbers, the concern du jour shifted to potential higher interest rates and inflation driven by economic growth that would be too strong. After a few months of tepid job creation, an economic "soft patch" was proclaimed. Various economists called for the yield on the 10-year Treasury to end 2004 at 5% and above. Its yield at the end of the third quarter was 4.12%. With this level of "precision," it is no wonder that economists have been accused of predicting nine out of the past five recessions!

Given ever-changing economic forecasts, a series of hurricanes ravaging the Gulf of Mexico's energy infrastructure, incessant news on the latest geopolitical hot spot, and fears of an economic lull turning into a recession, what should the average investor believe? In the investing world, the usual outcome is somewhere in between the most pessimistic scenario and the utopian vision, and we believe the underpinnings have been laid for the market to break out of its narrow trading range and move higher.

The U.S. equity market is one of the greatest discounting mechanisms in the world; it is a forward-looking distillation of anticipated future

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events. Largely lost amidst the barrage of negative headlines, the S&P 500 began a slow but steady advance in the middle of August that by the end of the quarter on September 30th resulted in a gain of approximately 5%. The market shrugged off the three consecutive months of declines in the index of leading economic indicators. The index declined at a 0.2% annual rate in the six months ending in August, yet a considerably larger annualized decline of 3.5% or more is a typical recessionary signal. The basis for this 5% gain in the S&P was demonstrated in some recent economic news that showed that the proverbial "soft patch" may soon be receding in the rearview mirror. The government's final revision to second quarter GDP growth was certainly disappointing to the bears. The real GDP growth rate in the second quarter was revised upward to 3.3% from the previous estimate of 2.8%. During the month of August, orders for durable goods including computers and communications equipment rose by the greatest amount since March. The Institute for Supply Management's factory index for the month of September showed continued expansion in the manufacturing sector, and the employment component showed a strong gain. Real consumption growth accelerated significantly in the third quarter despite some softness in autos.

Despite these positive signs, bearishness is just around every corner. A broad measure of market sentiment tracked by Ned Davis Research was at its lowest level in 18 months in mid-August. Portfolio managers of many large mutual funds are sitting on ample cash positions. Interest in downside protection has been rampant; there was a period this summer when the Put/Call ratio exceeded 100 for 17 out of 31 days. In the challenging year of 2001, the Put/Call ratio exceeded 100 for only seven days the whole year, and four of those came after the market reopened after 9/11.

In terms of short interest, we have moved from a market where most short sellers were Specialists who had developed significant expertise in the practice of the short sale to a market where most of the shorting is done by hedge funds. Given the huge proliferation of hedge funds over the past few years and the closures of many that the world never hears about, it is a safe bet that the sophistication level of the average short seller has dropped precipitously over the past several years. Today's short sellers love to short Exchange Traded Funds (ETFs) because they can be shorted on the way down; they do not require a "plus tick" to go short. Incredibly, at one point this summer short sales represented nearly half of the Nasdaq 100 ETF and approximately 25% of the S&P 500 ETF. In stark contrast, the percentage of short selling by

Our Business Valuation Approach focuses on identifying intrinsic value independent of the most recent macroeconomic concern.

Specialists on the NYSE in mid-summer was only approximately 25% of all shorting compared to 56% in March 2000 at the market top. When the market finally began to rally in March of 2003, specialists accounted for 32% of all shorting. The bottom line is that Specialists are doing less shorting now than at the March 2003 low—everyone wants to be hedged except the Specialists who have the most experience at shorting!

What do all these dry statistics mean to investors? Well, no one made much money buying the Nasdaq at 5,000. When everyone is exuberant and the clear consensus across the land calls for a continuation of above average returns, there are few investors to drive the market higher. Most everyone has already boarded the train and made their bet. The opportunity to build positions in undervalued stocks presents itself when the picture is less clear and uncertainty is prevalent. Though no one should be "scared to death," the point of the previous quotation is that pessimism and negativity allow the astute investor to find investment bargains. Several companies issued profit warnings in September yet saw their stocks advance as the news was not as bad as the worst-case scenarios predicted, a typically reliable sign of an oversold condition. Given this dynamic, the equity markets are now poised to move higher on good news.

With interest rates still at very low levels and the S&P 500 trading at a mid-teens P/E multiple on 2005 earnings estimates, there is room to run on the upside.

The American public will decide in early November who will lead this country for the next four years, removing a part of the uncertainty that has had stocks locked in a tight trading range. The constant political "spin" has added another layer of daily information bombardment that has impacted the equity markets. Some investment strategists have put together different portfolios that they think will outperform the market based on each of the two possible election outcomes. We believe it is important to remember that the markets, as always, will adapt to the occupant of the Oval Office and move forward. Our Business Valuation Approach focuses on identifying intrinsic value independent of the most recent macroeconomic concern. Those with time horizons matching their attention spans may disagree, but the search for attractive long-term investment opportunities should not be influenced by the headlines of the day, political or otherwise.

Ryan C. McCleary
Vice President

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Over the past twenty-three years, we have successfully navigated through both good and challenging markets by adhering to a discipline of value investing geared to evaluating ever-changing data and markets.

Our philosophy focuses on the valuation of businesses and their economic worth as measured through cash flow and not accounting artifice. Our work in equity and balanced accounts, which includes fixed income instruments, helps each type of account. Many excellent fixed income opportunities develop as a result of our research in equities, and vice versa.

We eschew "market timing" as theoretical nonsense divorced from the real world of investment decision-making and investing. Cash will accumulate in client portfolios when we do not find stocks that meet our selective criteria.

We are confident that the knowledge, experience, and dedication of our investment team, and the application of a disciplined process which has worked successfully over long periods of time, will continue to reward our clients in the years to come.

SOURCES: Bloomberg; Thomas R. Keene; Ned Davis Research, Inc.; Schwab Soundview Capital Markets; *The Leader Market Letter*; *The New York Times*; *The Wall Street Journal*

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