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Valuations and Path Dependence

Valuations

Bottoms-up forecasts of earnings for 2010 are very strong. S&P 500 operating earnings for 2009 were $57. The forecast for 2010 is $78, a 37% jump. Top-down forecasts are more subdued at $64.

A strong earnings year is certainly a possibility, but the real question is whether or not results are sustainable.

Our view is normalized S&P operating earnings are closer to the mid-$50s than the mid-$70s. This estimate is based on our analysis of historical trends in growth and margins. Our hypothesis for the underlying cause is government financing and spending: monetary and fiscal stimuli are supporting a one-time spike in demand and profitability.

Expectations for normalized earnings can be segregated into three scenarios:

1. $60-$70 – 20% probability
2. $50-$60 – 60% probability
3. $40-$50 – 20% probability

Note the probabilities are expressed precisely but their meaning is anything but precise. Language like possible (20%) and more likely (60%) is more apt.

Path Dependence

We hazard to guess that the market is expecting the more optimistic case. Should earnings come in below $60 in 2010, we suspect the market will be disappointed and stock prices will decline. We view this scenario as unlikely. Government support and renewed confidence relative to the panic of early 2009 will likely produce a strong year in 2010, even if it lacks sustainability.

The bear case remains a concern, however, because of the repercussions it could produce. Should earnings start to come in lower in 2010 than 2009, a market sell-off could very well trigger a downward spiral of weakened consumer confidence and spending, and in turn renewed weakness in financial institution balance sheets and a double-dip financial crisis. While unlikely, the double-dip scenario is possible.

Our Strategy

Our strategy is, as always, centered on valuations. Protecting capital at this juncture requires a mix of caution and opportunism. New capital will be worked in judiciously which will help assure a satisfactory absolute return. We are finding spots of opportunity to earn reasonable returns above our typical

8-12% cost of capital requirement, though great buys are not in abundance.

If the bull case emerges as the most likely scenario, new accounts may lag in the short term. However, we would rather lag in the short term than commit capital to so-so opportunities, which if the bear case develops, turn out to be not-so opportunities, or worse, leave new clients starting off in a large capital hole.

Long-time client portfolios today contain a mix of good buys, solid holds with unrealized gains, and a decent amount of cash. We expect to work this cash in judiciously if markets continue to rise or remain flat, and aggressively should they decline.

Nick Tompras
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