WEDGE WATCH Q1

A newsletter published quarterly by WEDGE Capital Management L.L.P. • April 2009

Keeping the Faith

"The future is unknowable, but the past should give us hope."
–Winston Churchill

First Quarter 2009
Financial Statistics

DJIA: 7608.92

S&P 500: 797.87

90-Day T-Bill: 0.20%

30-Yr. T-Bond: 3.53%

Thomas Paine, author of *Common Sense* and a key figure in the American Revolution, had it right when, amidst the early onslaught of the Revolutionary War, he pronounced: "These are the times that try men's souls." It was certainly true then and we believe it is true again today (at least for those most concerned about the economy and the financial markets). Throughout history, mankind has been confronted by various challenges of immense proportion, some of which seemed overwhelmingly daunting (even relatively hopeless) at the time. Case in point: in the summer of 1940, as the Nazis marched across Western Europe, ruthless and undeterred, with their sights fixed firmly on the British Isles, Prime Minister Winston Churchill, a man of uniquely strong convictions, stood firm and resolute. This despite not yet having garnered anything close to full military support of the FDR-led US, an ally he deemed absolutely essential, nor even the full-scale support of his own countrymen (who were bitterly debating the proper course of action – stand and fight or acquiesce).

Churchill, unlike many at home and abroad, saw Hitler for what he was – a blood-thirsty monster with an insatiable appetite for power and dominance. On August 13, 1940 the vaunted Luftwaffe (Germany's air force) attacked England. Ten days later they bombed London and on September 7th, in a wholesale attempt to demoralize the British into surrender, they unleashed a massive "Blitzkrieg" (lightning war) on the city. It would continue across England, often day and night, for eight long, harrowing months. However, despite Britain being outmanned at the outset, and at a strategic disadvantage technologically, Hitler had underestimated Churchill's leadership and the unwavering resolve of the British people. **They simply refused to give in** even as the casualty toll mounted day-by-day, month-by-month. 43,000 civilians would ultimately perish during the siege, and over a million homes would be destroyed or damaged in London alone. When the dust finally settled, the Luftwaffe was forced to retreat, scuttling Hitler's primary and most vital war objective – a successful land invasion of the British Isles. Although it would not become fully apparent until much later, the tide of the war had begun to turn.

It's been said that fear can bring out the best or the worst in us (the legendary saga just highlighted clearly falling into the former camp). Last September, not long after the stunning collapse of *Lehman Brothers*, Warren Buffett, the 78-year-old Chairman and CEO of *Berkshire Hathaway*, told *PBS* talk show host Charlie Rose that in his adult lifetime he didn't think he'd "ever seen people so fearful economically," equating the evolving credit and capital markets tsunami to "an economic Pearl Harbor." In early March, he revisited that same theme in an interview on *CNBC* where he stated in no uncertain terms that "we really are in an economic war" and "job one is to win the economic war;" as is job two and job three, referring to the need for Congress to quit bickering and pointing fingers at each other, and to unite around the principal job of helping save the economy. Sound familiar?

Continued on inside...

...Faith

Investors are being tested in a very big way right now (for most it is the financial test of a lifetime) and, for many, the "fear factor" is a predominant part of the highly disconcerting equation. Although it would be easy, and certainly understandable, to get mired down lamenting what has transpired for holders of diversified stock portfolios over the past 18 months, short-term hindsight is *unlikely* to provide the critical perspective needed going forward. Since the market peak, in early October 2007, the great majority of equity investors may have *lost the battle*, however, they will only *lose the war* if they follow the herd and let their emotions get the best of them (amidst the relatively unprecedented market turmoil). With that in mind, let's step back and calmly survey the financial market landscape from a broad historical perspective.

> *"Two roads diverged in a wood, and I – I took the one less traveled by, and that has made all the difference."*
> –Robert Frost, American poet (1874-1963)

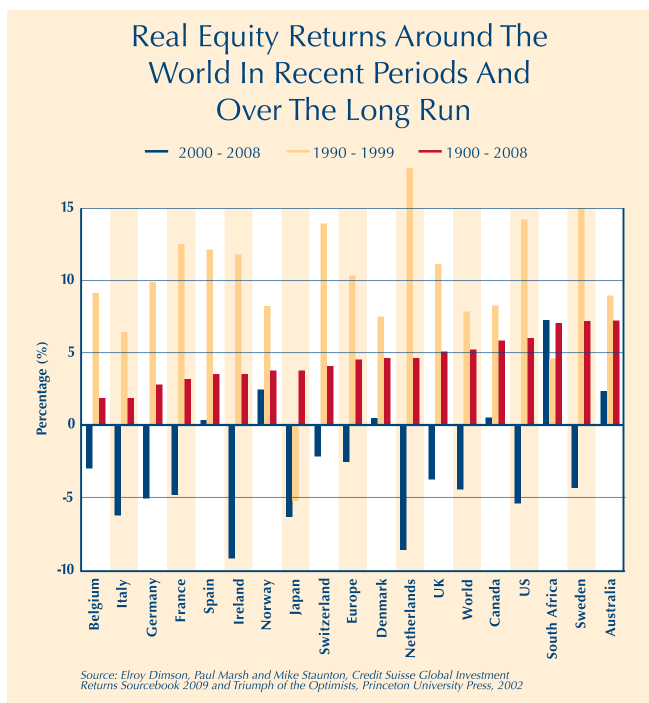
As always, the future is unknowable. However, a truly global and extended view of the historic equity-market-return landscape may help investors divine some clues to the road ahead (and even bolster their long-term outlook) despite the uncertainty that still exists. Elroy Dimson, Paul Marsh and Mike Staunton, of the London Business School, recently published an update to their outstanding book *Triumph of the Optimists: 101 Years of Global Investment Returns* (Princeton University Press, 2002). The title of the new publication is *Credit Suisse Global Investment Returns Yearbook 2009* (which includes important contributions from Jonathan Wilmot, Chief Global Strategist for Investment Banking at *Credit Suisse*). With the blessing of the authors, a large part of the following commentary is sourced and/or quoted from that document.

At its lows in late November 2008, "the **MSCI World index** had fallen 55% – a global loss of over USD 21 trillion, or USD 21,000 for every man, woman and child in the developed world." Needless to say, investor faith in equities had been shaken to the core. In fact, it is fair to say that the current decade has been the "lost decade" for stocks. "Since 2000, the *MSCI World index* has lost a third of its value in real (inflation-adjusted) terms (through year-end 2008), while major markets all gave negative real returns of an annualized -4% to -6%." In other words, for holders of diversified equity portfolios, both here and abroad, *there was virtually no place to hide*.

"To understand equity returns, the long term must be long indeed." In that regard, the *Credit Suisse Yearbook (CSY)* just referenced utilized a database tracking returns over 109 years (through year-end 2008) "for 17 countries that together represent some 90% of world stock market value." **Short time horizons, even ten-year horizons, are typically too short to provide sufficient perspective in making informed long-term asset allocation decisions** (especially in the midst of an extreme stock market meltdown such as we've experienced recently).

Chart 1 shows annualized real returns over three sub-periods, one of which encompasses the entire 109-year history measured (red bars). On a comparative basis, as it relates to real returns over the past two decades, they present a stark contrast. The 1990s (yellow bars) were far beyond normal to the upside while the subsequent decade-to-date (blue bars) has far underperformed the historical norm. *History strongly suggests that neither of these periods should frame the perspective of investors going forward.* In fact, the long-term returns highlighted in red point to what should be more realistic assumptions for the decades ahead. They "provide a reassuring reminder that, over the long run, there has been a reward for the higher risk from investing in stocks."

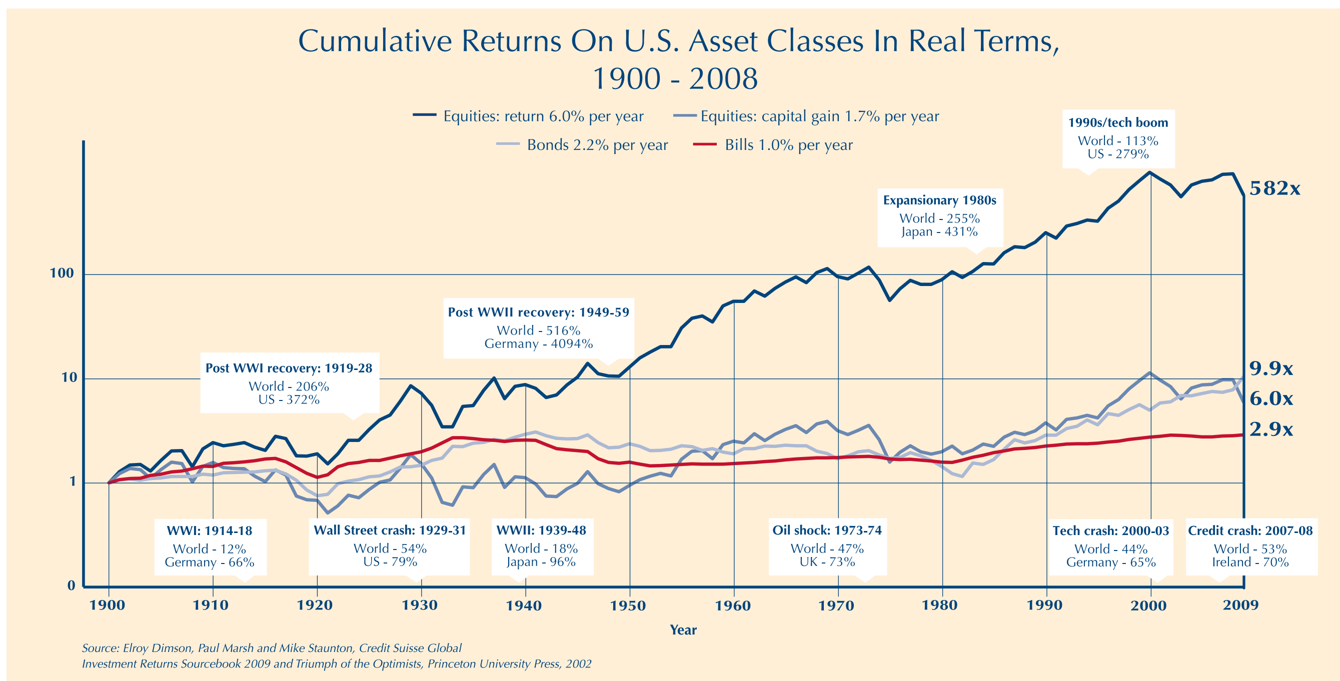
Chart 1



Source: Elroy Dimson, Paul Marsh and Mike Staunton, Credit Suisse Global Investment Returns Sourcebook 2009 and Triumph of the Optimists, Princeton University Press, 2002

"An initial sum of USD 1 invested in US equities in 1900 grew, with dividends reinvested, at an annualized nominal rate of 9.2% per year to become USD 14,276 by the end of 2008. Such is the power – over 109 years – of compound interest." However, "since US consumer prices rose by almost 25-fold over this period, it is more helpful

Chart 2



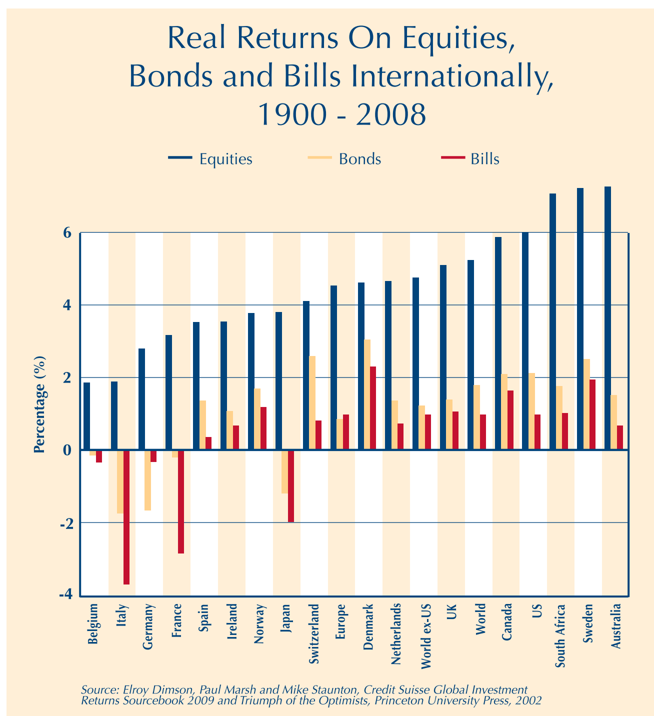
to compare returns in real terms." **Chart 2** "shows that an initial investment of USD 1 would have grown in purchasing power by 582 times. The corresponding multiples for bonds and bills are 9.9 and 2.9 times the initial investment, respectively. These terminal real-wealth figures correspond to annualized real returns of 6.0% on equities, 2.2% on bonds and 1.0% on bills."

Further study of **Chart 2** helps put in perspective both the long-term relative return advantage of stocks and the severe dislocations that have occurred intermittently along the way. "Events that were traumatic at the time" now appear as mere temporary "setbacks within a longer-term secular rise." More specifically, "the lower boxes highlight *real* equity returns in the World Wars and the four worst bear markets – the (1929) Wall Street Crash, the 1973-74 oil shock/world recession, the bursting of the internet bubble, and the credit/banking crash that (for equities) began in earnest in November 2007. They show that the two world wars were less damaging to world equities (real returns of -18% and -12%) than the peacetime bear markets (real returns -44% to -54%). The worst bear market to date was the Wall Street Crash from 1929 to 1931, when the **world index** fell by 54% in real, US dollar terms. However, as of year-end 2008, it remained a very close call. The peak-to-trough *real* return at that point of the current banking/credit crash (stood) at -53%." Subsequently, however, a further substantial decline drove the world index down below the prior November 20, 2008 trough, *making the most recent global bear market the worst on record* (per the March 9, 2009 trough). **"In its short nine-year life, the 21st century already has the dubious honor of hosting two of the four worst bear markets" since 1900.**

"Until recently, most of the long-run evidence cited on historical asset returns drew almost exclusively on the US experience. This gives rise to a serious danger of 'success' bias, since in the 20th century, the United States rapidly became the world's foremost political, military and economic power. *By focusing on the world's most successful economy, investors could gain a misleading impression of equity returns elsewhere, or of future equity returns for the USA itself.*" The data compiled for the *CSY* allows for global comparisons. **Chart 3** (see next page) "shows annualized *real* equity, bond and bill returns over the last 109 years for the 17 *CSY* countries plus the world index, the world ex-US, and Europe, ranked in ascending order of equity market performance. *The real equity return was positive in every location, typically at a level of 3%-6%. Equities were the best performing class everywhere.*" Needless to say, given the higher-risk nature of stocks, it is not a surprise that equities outperformed the other, lower-risk asset classes.

It is also imperative to note the highly consequential impact of dividends as it relates to total returns in equities over time. "Reinvested dividends dominate long-term returns" and reinvestment of those dividends is key. **Chart 2** highlights "the large difference in terminal wealth that arises from reinvested income." As noted earlier, the darker blue line shows that over the 109 years measured, an initial investment of USD 1 in stocks "would have grown in purchasing power by 582 times (with dividends reinvested)," producing a compound per annum total

Chart 3



return of 6.0%. To the contrary, the dark gray line "shows the return obtained by a fund that paid out all of its income to beneficiaries, rather than reinvesting dividends." What is shown is that a "USD 1 initial investment would have grown just six times its initial value, equivalent to a real capital gain of 1.7% per year. Thus a portfolio of US equities, with dividends reinvested, would have grown to almost 100 times the value it would have attained if the investor had spent or squandered the dividends." Bottom line: **the longer the investment horizon, the more important dividend income and reinvestment become**.

"He that can have patience can have what he will."
–Benjamin Franklin

With the prior backdrop in mind, *it's absolutely critical to reiterate that it is the fundamental nature of the markets and, therefore, investor psychology, to move back and forth (over long periods) from optimism to pessimism and back again*. For example, given the promise that was apparent at the dawn of the 20th century, "only a pessimist would have believed that the next 50 years would involve widespread civil and international wars, the Wall Street Crash, (the) Great Depression, episodes of hyper-inflation, the spread of communism, and the start of the Cold War." That series of very extreme, unanticipated and destabilizing challenges helped temper equity returns over the period measured (1900-1949), leading to a below-average, though still positive, annualized real return on the world equity index of 3.5%. "By 1950," as a result, "only the most rampant optimist would have dreamt that over the following half-century, the annualized real return would be 9.0%. Yet the second half of the 20th century was a period when many events turned out better than expected."

As it stands today, **coming off the worst ten-year stretch on record for US equities, we believe it would behoove investors to give very serious consideration to what might actually go right in the years ahead**. Over the 17 months following the S&P 500 peak in early October 2007, investors did a yeoman's job of deeply embedding that which has and might go wrong into the price of stocks both here (through the March 9, 2009 cycle low for the S&P 500) and abroad. On a related and highly important note, for those debating the style-merits of *growth* versus *value*, we would call your attention to the performance of the largest US companies, as measured by the *Fama-French* value and growth indexes from year-end 1926 to year-end 2008 (the longest period available). Over that 82-year timeframe, on a per annum basis, **value outperformed growth by a very wide margin (+2.5%)**. In the UK, over the longest period available (1900-2008), the difference between the returns on the Dimson-Marsh-Staunton value and growth indexes was even better at 3.1%. Not surprisingly, from our perspective, *the disciplined exercise of optimistically buying pessimism has worked extraordinarily well over time;* a road practitioners of the *value style* know to be **far less traveled** by investors.

We'll close on a somewhat light-hearted note. According to *Ned Davis Research*, over the 43 years ended 12-31-08, the S&P 500 (on a daily price basis only) has compounded at a healthy 5.8% clip when Congress has been out of session, while producing a negative return when they are not (-0.2%). Given the relatively checkered track record of Congress, past and present, these numbers should not come as a surprise. *As the late Charles Schulz's inimitable Charlie Brown would say:* ***Good grief!***

Continued on outside flap...

Index	03/31/09 Price	1st Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	7608.92	-13.3%	-13.3%
S&P 500	797.87	-11.7	-11.7
Value Line Composite	193.74	-14.2	-14.2
American Exchange Comp.	1359.33	-2.7	-2.7
NASDAQ Composite	1528.59	-3.1	-3.1

*Does not include dividend income.

Fixed Income

Deficit Attention Disorder

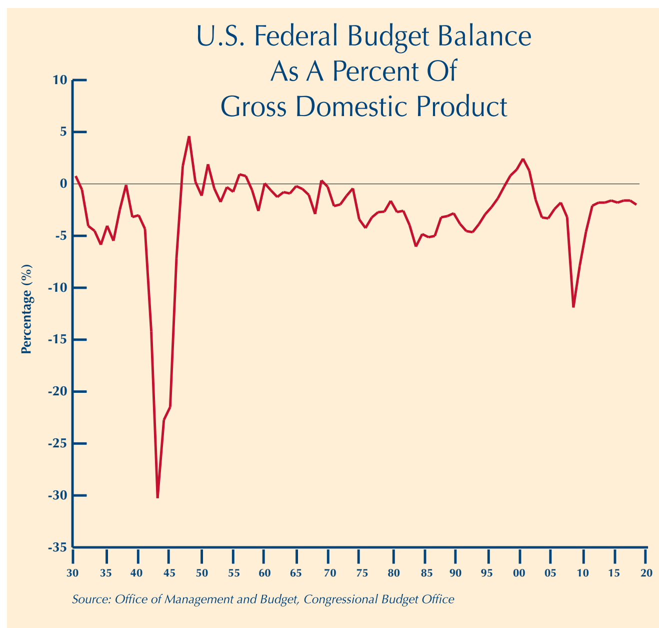
"We might hope to see the finances of the Union as clear and intelligible as a merchant's books, so that every member of Congress, and every man of any mind in the Union, should be able to comprehend them, to investigate abuses, and consequently to control them."

–President Thomas Jefferson writing to Secretary of the Treasury Albert Gallatin, April 1, 1802

There has certainly been a lot of attention paid to the **Federal budget deficit** in recent months. In the most recent *Flash Report*, we commented that the 2009 fiscal deficit would likely well exceed $1 trillion and surpass 10% of GDP – a level not seen since the World War II years. The Congressional Budget Office (CBO) now estimates the 2009 fiscal deficit could total $1.7 trillion, or approximately 11.9% of GDP. **This is almost $500 billion larger than the CBO estimated as recently as January 2009.** The main reasons for the difference are, of course, higher-than-estimated spending based on recently enacted legislation, and weaker-than-expected revenues due to the worsened outlook for the economy.

Recently, the CBO updated its baseline forecast for the budget deficit as a percent of GDP, **under current law**, over the 2009-2019 period. (For simplicity, we will leave aside the CBO's estimate of the President's 2010 budget, since it has not yet been enacted.) If we combine this forecast with **actual** deficit or surplus results (**Chart 4**), we gain a good historical perspective of the federal budget balance over time, relative to its projected path. Certainly, the 2009 and 2010 deficits look less daunting when viewed in this context.

Chart 4



In addition, as we have noted before, there doesn't currently appear to be any difficulty in financing these huge borrowing needs in the bond market – after all, as we go to press, the Treasury has just completed a $98 billion week-long auction of various-maturity notes and bonds – **all at yields less than 2.40%.** With economic uncertainty still running high, demand for safety and liquidity continues unabated. Further, the Federal Reserve has pledged to buy large amounts of Treasury and other securities as part of its quantitative easing stance.

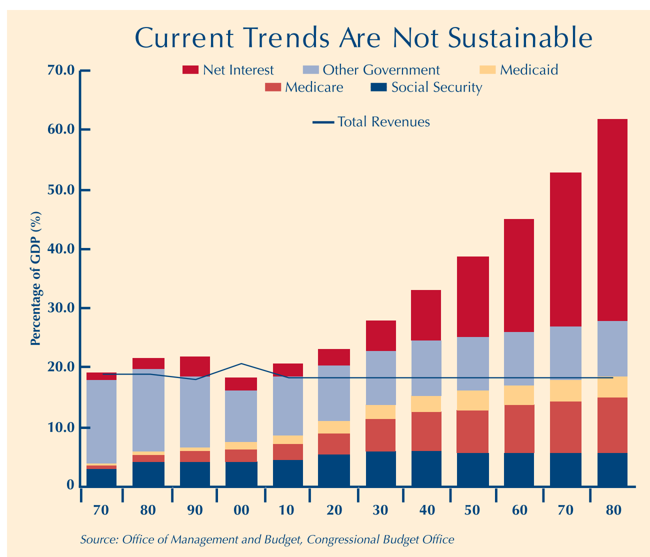
Continued on back cover...

Before we get too comfortable though, we should keep in mind that deficits are **cumulative**, meaning that the amount of debt outstanding continues to grow, and that eventually it must all be refinanced. Further, as debt grows, so does the burden of servicing the debt. This is where the powerful effect of compounding begins to work against us.

Again, drawing attention to the recent *Flash Report*, we reference a relatively obscure government publication entitled, "The Federal Government's Financial Health: A Citizen's Guide to the Financial Report of the United States Government." (Published in December, 2008, it summarizes the Treasury's annual report.) The brief 11-page document makes for some interesting reading, but the section entitled "Where We are Headed/An Unsustainable Fiscal Path" really caught our attention.

We reproduce here **Chart 5** from the report, which shows current law federal budget items as a percent of GDP for the next 75 years. Note that beyond 2020 (a mere 11 years from now) the fastest growing item in the budget is **net interest**. Further, note that as time passes, it consumes a larger and larger share of GDP – to a clearly unsustainable level. The aforementioned section concludes with the following: "It is important to note that precise expenditure projections change with different forecasting assumptions (e.g., life expectancy increases and health care cost growth), but even under a wide range of reasonable assumptions, budget deficits and debt are projected to increase dramatically. Should such dramatic increases occur, interest costs would increase, **making the Federal Government's fiscal path even more unsustainable," and possibly affecting the government's ability to borrow.**

Chart 5



Given these disconcerting statements, we have to wonder if today's buyer of a 30-year Treasury yielding less than 4% to maturity might be suffering from ***deficit attention disorder.*** Bottom line: **something eventually has to give.**

This information is not intended as investment advice or a recommendation to purchase or sell specific securities. These opinions may change at anytime without prior notice. While every effort has been made to verify the information contained herein, we make no representation as to its accuracy. Index and commodity changes are based on price-only percentage change. It is not possible to directly invest in an index. Past performance does not predict future results. All data presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. Company names are used for illustrative purposes only and should not be construed as a recommendation to buy or sell any financial securities. There is no guarantee that any forecasts or opinions expressed in this material will be realized.