WEDGE WATCH

A newsletter published quarterly by WEDGE Capital Management L.L.P. • July 2006

Beware the Free Fall?

"And I'm free, free fallin. Yeah I'm free, free fallin…"
–From the song "Free Fallin" by Tom Petty & the Heartbreakers (circa 1989)

Second Quarter 2006 Financial Statistics

DJIA: 11150.22

S&P 500: 1270.20

90-Day T-Bill: 4.98%

30-Yr. T-Bond: 5.19%

Some people actually like to *free fall*; the higher, the faster, the better. Take Michel Fournier, the 62-year-old French daredevil who, as early as next month, hopes to break the 46-year-old world skydiving *free fall* record held by 77-year-old retired Air Force Colonel Joe Kittinger. On August 16, 1960, Kittinger, a U.S. Air Force test pilot and future prisoner-of-war in Vietnam's infamous "Hanoi Hilton," floated his 20-story-tall helium balloon to the hostile and unforgiving edge of space; a record altitude nearly 19.5 miles above the New Mexico desert. Clad in a space suit and helmet, he peered over the edge of his open-air gondola, said a quick prayer and then leaped into the history books. Within moments, Kittinger was hurtling earthward at the adrenaline-pumping speed of 714 miles per hour - the first man to break the sound barrier without the benefit of an aircraft! Nearly four and a half minutes into his *free fall* he deployed a small parachute, which, thankfully, began to stabilize his fall. Four minutes later, a larger parachute opened; safely floating him back to earth.

Records, of course, are made to be broken, and for Michel Fournier the one held by Kittinger is no different. With the help of eager supporters, Fournier is targeting a *free fall* from the stratosphere – a staggering 25 miles above the earth's surface (somewhere over the plains of Saskatchewan, Canada). In fact, the 62-year-old former French military officer, marathoner, and champion (Olympic) pistol marksman, who has completed more than 8,500 skydives and holds the French record for highest *free fall* (from more than 39,000 feet), has, for well over a decade, relentlessly pursued his ambition regardless of cost or obstacle. More specifically, since retiring from the military in 1992 to focus solely on this endeavor, Fournier has reportedly amassed $12 million of gear and equipment while nearly bankrupting himself in the process (selling his house, antique furniture, and gun collection to help finance the monumental and costly endeavor). On several occasions over the past six years, he has been poised on the brink of realizing his dream only to be thwarted by unexpected governmental interventions, technical mishaps, health-related postponements, and even financial swindles. Despite these setbacks, however, Fournier enthusiastically presses on undeterred, his destiny tantalizingly within reach.

"To be prepared is half the victory."
–Miguel de Cervantes (author of Don Quixote, 1547-1616)

Investors can learn much from the examples set by Fournier and Kittinger, in terms of both the value of perseverance (i.e., hanging tough despite setbacks/obstacles and very difficult/challenging circumstances), and controlling one's emotions in the face of extreme fear. Few would deny that it is absolutely imperative that the skydiver learn to manage and/or overcome fear as successful and timely deployment of his or her lifeline (the parachute) could literally depend on it. The same, to a great degree,

Continued on inside…

Free Fall?

continued from front…

is true for the investor in common stocks, although in that realm it is one's financial health or that of one's clients that is potentially at risk. Much more often than not, an investor overcome with fear (in the face of extreme volatility and uncertainty) will make poor buy/sell decisions if he or she *allows emotion to trump logic and good sense*. Throughout history, this has been proven time and again at points of psychological extreme when fear and/or greed have gripped the "mind of the market." In that regard, **recent stock price swoons around the globe, coupled with a renewal of long-dormant market volatility, have begun to stir the emotions of investors**; injecting an element of fear (of the *free fall*) into their delicate psyches. Given this backdrop, we thought a short history lesson might lend some valuable perspective and help soothe the nerves (at least a little).

The January 31st retirement of long-time Federal Reserve Chief Alan Greenspan is not an irrelevant factor in the market's recent gyrations, in our opinion. Investors had become accustomed to his steady hand at the wheel of the economy (since 1987), especially during times of extreme economic and/or market stress. With the Fed, now led by newbie Chairman Ben Bernanke, having just completed its 17th consecutive interest rate hike on June 29, investors are confronted with a series of salient concerns: 1) on-going uncertainty in regard to the trend in inflation (which the Fed is no doubt trying to snuff out while exacting as little collateral damage as possible); 2) the duration of the Fed's future rate hikes (if any from here) as well as the general reduction of liquidity by central banks around the world; 3) the apparently open-ended turmoil in Iraq; 4) the emerging nuclear threat from Iran and North Korea; 5) a sizable and still growing U.S. trade deficit; and, 6) a less than sturdy underpinning to equity markets around the globe (i.e., at its low on June 13th, the Morgan Stanley Emerging Markets equity index had fallen 25% from its May 8th high). That's surely enough to make anyone nervous. However, history shows that such macro concerns are far more common than not (i.e., there's always something to worry about). On the other hand, what *appears* to make these emerging investor jitters more relevant today is the fact that stocks have done so well for so long during the current economic cycle (despite a sideways move year-to-date). We are in the midst of the second longest bull market on record without a correction of 10% or more (not to mention that the S&P Industrial's profit margin hit a record high in 1Q06). In addition, the absolute duration of this bull market move (from the October 9, 2002 low for the S&P 500) is beginning to push the limits of history as only one post-WWII bull market has exceeded the current one in duration. Couple these two things with the fact that the earnings cycle has been remarkably resilient, with year-over-year earnings growth for the S&P 500 exceeding 10% every quarter since December 2002, the longest such stretch on record, and you might begin to wonder *when the music stops*.

The Federal Reserve's objective is not a surprise. They are attempting to slow the economy in an effort to contain what they perceive as emerging inflation risks. This is what they always do (or are supposed to do) when the economy gets ahead of itself. However, many investors had come to expect that the Fed's work would be done by this spring, at the latest. That expectation, of course, has now been shelved. With this in mind, let's review some important market history to try and gain perspective on what a slowdown in economic growth might mean for stock prices going forward. According to *Ned Davis Research* (NDR), a long-tenured producer/aggregator of insightful stock market data and economic research, **a slower economy is not necessarily a bad thing for stocks, as moderating earnings growth often leads to better stock price performance**. Using March 31, 1927, as a starting point, NDR's database shows that "the S&P 500 has gained only 2% per annum when year-over-year earnings growth exceeded 20% (which it did in 1Q06) while it has gained 5% per annum when earnings growth has been between 5% and 20%." However, "the best gains historically have occurred when earnings growth has decelerated and negative news has already been priced in, with the S&P 500 gaining 13% per annum when earnings growth has been between -20% and 5% (i.e., so bad, it's good). It's not until earnings growth has fallen sharply that the message has shifted toward concerns about economic growth - the S&P 500 has declined at a -15% per annum rate when earnings have declined -20% or more over the previous year (i.e., so bad, it's bad)."

It seems reasonable to assume, given the recent hawkish commentary from both Bernanke and other key members of the FOMC, that they will ultimately achieve their goal of slowing the economy (after all,

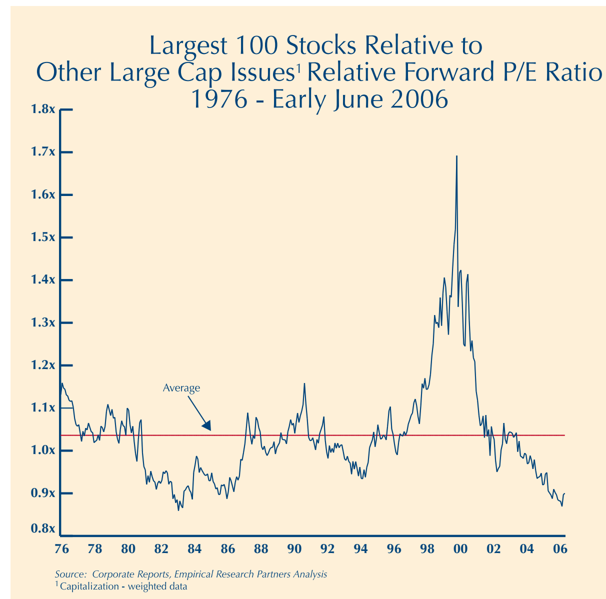
mean reversion, especially when Fed-induced, is a relatively powerful and persistent market force). As a result, we would expect corporate earnings growth to moderate going forward. What's not clear is how quickly and/or how much earnings and the economy will decelerate. **Housing markets on both coasts, especially those in highly appreciated markets, have already begun to show meaningful signs of slowing, if not outright retrenchment.** If this weakness spreads more broadly, from a geographic perspective, we would expect to see a pretty significant ripple effect across the economy (given the important role housing has played during the current expansion). The proverbial "soft landing" is, of course, what the Fed and investors are rooting for most. However, *slowing an overheated economy is a very delicate and imprecise process; especially when tight energy markets are thrown into the mix*. As pointed out earlier, the degree and velocity of slowing in the months ahead will likely dictate the return outlook for stocks over the next 6 to 18 months. Too much slowing and investors could bail; a relatively soft landing, however, and stocks should resume their ascent.

"You got to be very careful if you don't know where you're going, because you might not get there."
–Yogi Berra

As value investors, we pay extremely close attention to underlying valuation when researching individual stocks here at *WEDGE*. Our approach, as always, is to try and exploit valuation anomalies (on a stock-by-stock basis) across the capitalization spectrum. As we survey the landscape today, valuation spreads are remarkably narrow, both across the market and within sectors (though there appears to be one important exception which we'll address in a moment). Going forward, given the Fed's apparent commitment to a slower growth economy, we expect earnings growth to moderate (from the +20% y-o-y growth rate in 1Q06). In such an environment, especially if earnings growth fades to single-digits, which would not be a surprise, history suggests that the largest capitalization stocks (*mega-caps*), the most out-of-favor and deeply discounted group in today's market, could begin to regain some of their long lost luster (following sustained and severe multiple compression over the past six plus years).

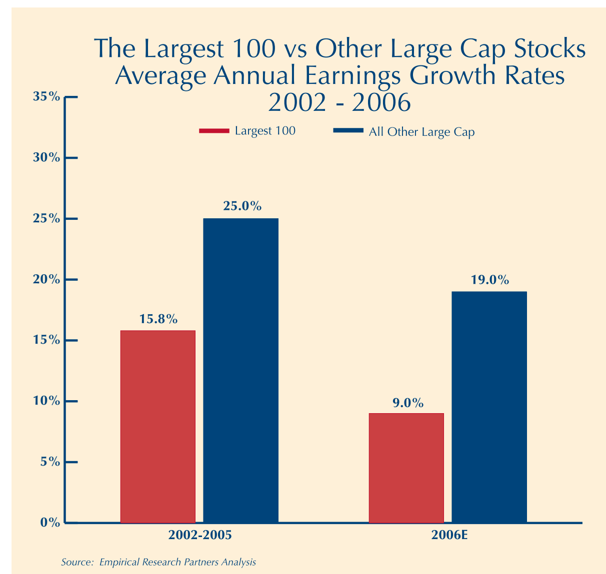
Chart 1, courtesy of *Empirical Research Partners*, shows that **mega-cap stocks are near thirty-year lows on a relative P/E basis versus other large cap stocks**. At first

Chart 1



glance this anomaly seems odd, given the superior profitability of these companies versus their broader peer group (trailing six-month ROE - 21.5% vs. 18%). On closer inspection, however, it is apparent that *the law of large numbers* has acted as an anchor in terms of relative earnings growth this cycle (see **Chart 2**). As we look ahead though, especially with relative multiples now very compressed and with the increasing probability of a Fed-induced slowdown, we believe the inherent advantages these companies possess (i.e., strong and remarkably liquid balance sheets, high-class business models, above-average dividend yields) may begin to generate renewed investor interest. To the contrary, when the world's central banks drain liquidity from the system, as they

Chart 2



are proactively doing today, *negative cash flow trades or inflation-dependent trades* (such as commodities, real estate and emerging markets) tend to fare poorly (though the secular demand backdrop for commodities still appears relatively robust). Given the dramatic gains posted by these types of assets in recent years, a meaningful pullback and/or extended consolidation in prices would not be a surprise if the economy were to weaken materially from here.

The basic message we want to impart is that no matter what happens (beyond something like a catastrophic nuclear strike) **it is not time to panic**. Stocks go up and stocks go down. The economy expands and the economy contracts. Interest rates rise and interest rates fall. A key question of relevance, however, is whether or not stocks (or at least certain types of stocks) are currently cheap enough to buy and/or hold? With slowing growth now on the horizon, we know that the Fed will eventually initiate another cycle of monetary ease. Such a scenario, when it unfolds, would likely favor stocks since the broad market, measured by the capitalization-weighted S&P 500, does not appear expensive versus history on a forward P/E basis (14x projected 2007 operating EPS). In fact, **we have not seen the S&P 500 multiple this low for over a decade**. Of additional note is a comparison of the forward earnings yield of the S&P 500 (7.1% at a 14x P/E) with that of the ten-year treasury yield (5.2%, which is the equivalent of 19.2x the cash [coupon] return of the bond). Matched up against its multi-decade history this ratio now appears relatively attractive, as recently highlighted by veteran value investor Ron Muhlenkamp who cleverly stated:

"Somehow many investors are willing to pay 20 times earnings for a bond but won't pay 14 times earnings for a stock unless it's growing. What I keep wondering is, how much the bond is growing?"

The point is that bonds yield fixed returns (there is no upside if held to maturity) while the average publicly-traded company will typically grow earnings at least in line with nominal GDP (which in recent years has averaged approximately 5 to 6% per annum). Add a dividend yield to the equation (just under 2% currently) and you produce per annum total return potential of 7 to 8% for the S&P 500. Over a longer time horizon, however, if interest rates and inflation stay near current levels or decline, P/E multiples (especially among the largest companies which dominate the capitalization-weighted S&P 500 index) are likely to expand at least two or three points (adding additional upside to the total return equation). Were stocks to fall materially from current levels (via interest rate and/or inflation fears), we believe valuations *could* become relatively compelling, especially for stocks with capitalizations above $25 billion (the 100 largest in the S&P 500 index). Given the recent skittishness displayed by equity markets around the globe, and the vast amounts of accumulated leverage embedded in the financial system, we would not totally rule out such an outcome (especially if Fed tightenings trigger a U.S. recession), though valuations of *the largest of the large* appear to *reasonably discount* such a risk already.

In the months and quarters ahead, were a material sell-off in stocks to occur, we believe it would be important to keep in mind that "the median price correction in a bull market since 1900 has been -11% (with a median duration of 37 days) while the median bear market decline since 1929 has been -27% (with a median duration of 273 days)." If either environment evolves from here, especially the latter, we would anticipate a rather aggressive easing response from the Fed; which would likely generate a sizable rally in stocks (albeit from levels potentially well below where they trade today). In addition, it's important to remember that *recessions, which are widely feared by equity holders, are an inevitable part of the economic cycle*. They've typically occurred on an infrequent basis (only 16% of the time since 1950) and have been of relatively moderate duration as well (the median contraction in real GDP since 1950 has lasted just 10 months).

Throughout history "fear and greed" have been primary drivers of equity markets and, as we've just articulated, how one reacts to these emotional extremes will often dictate the relative degree of investing success (or failure) achieved over time. With the recent reemergence of stock market volatility around the globe (after a protracted lull), we believe a relatively broad-based historical perspective can help investors prepare (psychologically) for the majority of potential outcomes that may evolve from here. Just like the skydiver who must overcome fear of the *free fall*, the stock market often attempts to scale a "wall of worry." In certain cases, of course, that worry is well-placed, as some stocks (i.e., those trading at inflated multiples with a significant contingent of speculators driving their price) should be sold. On the other hand, especially in today's market, there are plenty that appear to offer

continued on outside flap…

continued from inside flap…

attractive risk/reward at current prices (i.e., *mega-caps*). **So if the bottom drops out of the market and you begin to feel like you're in a *free fall*, be careful not to pull the proverbial "rip cord" at the wrong time. *When valuations are right, history has a way of favoring the patient long-term bull.***

Index	06/30/06 Price	2nd Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	11150.22	0.4%	4.0%
S&P 500	1270.20	-1.9	1.8
Value Line Composite	423.11	-5.3	2.6
American Exchange Comp.	1928.59	-0.4	9.6
NASDAQ Composite	2172.09	-7.2	-1.5

**Does not include dividend income.*

Fixed Income

Disclosure Evolution and the Great GASBy

During the last few decades, regulators, accountants and investors have pressured corporate managements to disclose more information about the true financial status of the corporation. As a result, new accounting procedures involving long-term assets, off-balance-sheet financing, acquisitions and derivatives have been implemented. In addition, further scrutiny of financial disclosure in the wake of *Enron* and other high profile corporate scandals culminated in the passage of the *Sarbanes-Oxley* legislation, which, among other things, required senior management of public companies to explicitly certify the accuracy of periodic financial statements.

With those well-documented scandals now beginning to fade from the headlines, a new area of focus has begun to emerge: **the proper accounting treatment of pension and health care costs**. Over the last several years, a confluence of several events finally thrust the pension/health care albatross into the limelight, both in the halls of Congress and across the board rooms of corporate America. More specifically, the high profile bankruptcies of the major domestic airline companies along with the Chapter 11 filings of several notable automobile suppliers (not to mention the still evolving financial crises at both Ford and General Motors) laid bare the deficiencies of the existing pension/health care accounting and funding methods. In addition, the declining investment returns of plan assets during the 2000-2002 stock market meltdown further exposed these deficiencies. This festering problem has become an important public policy issue because the *Pension Benefit Guaranty Corporation*, set up to insure pension benefits by the 1974 ERISA legislation, is facing the unpalatable prospect of a taxpayer-funded bailout. In response, competing pension reform bills are now set to be sorted out by House and Senate conference committees, though prospects for near-term passage have apparently waned.

continued on back cover…

continued from outside flap…

From an accounting standpoint, the *Financial Accounting Standards Board* is proposing a two-phase general comprehensive review of not only pension but also **OPEB (other post-employment benefits)** accounting. The first phase would essentially remove these items from the footnotes of financial statements, and in turn recognize them on the balance sheet. **For some companies, with large unfunded pension/health care liabilities, the reported amounts will be staggering, with the most visible impact being sharp declines in reported shareholders' equity.** However, the impact on cash flow, in the near term, will likely be minimal.

As a follow-on to these proposed changes, *state and local governments are now also preparing to experience the spotlight of increased accounting inspection relative to their unfunded OPEB costs*. A new accounting pronouncement called **GASB** (Government Accounting Standards Board) 45, which takes effect next year for governments with annual revenue greater than $100 million, will convert the current "pay as you go" method to an actuarially determined (accrual) method. Essentially, governments will have to determine the present value of future OPEB expenses and then an "annually required contribution" (ARC) will be calculated. In many cases, the ARC will be a significant multiple of the current annual cost. **Some studies have suggested the unfunded OPEB liabilities could approach the prodigious sum of $1 trillion. To put this figure in perspective, state and local government total debt outstanding at the end of the first quarter of 2006 was almost $2 trillion.** *Therefore, it seems fairly certain that, at some point, efforts will be undertaken to eliminate, reduce or, at least, more efficiently provide these benefits as their true magnitude is ultimately revealed.*

How will these issues affect the fixed income markets? With so many cross-currents, it is impossible to say with certainty. One possibility is that the markets could see an **increase in the demand for long-term bonds** as companies seek to structure pension assets in a manner that would minimize the balance sheet volatility that would result from implementing the new FASB reporting requirements. On the other hand, state and local governments may **drive up the supply of long-term bonds** by choosing to fund a portion of their OPEB liabilities by issuing long-term bonds, which is how some municipalities have funded their pension obligations.

In structuring client portfolios, we are mindful of these coming changes to disclosure requirements and how they may impact corporate and taxable municipal valuations. In that regard, we will continue to carefully factor these pending changes into our credit analysis on a company-by-company basis. Although it's too early to accurately assess the future impacts, it will be interesting to see, at a minimum, what impact the continuing evolution of disclosure requirements will have on investors, politicians, the rating agencies, taxpayers and the fixed income markets. *Stay tuned.*

Written by J. Scott Jeffords, James F. Walters, and Bradley S. Fisher of WEDGE Capital Management L.L.P.

301 South College Street, #2920, Charlotte, NC 28202-6002 (704) 334-6475