

WEDGEWATCH Q4

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A Self-Fulfilling Prophecy?

"All truths are easy to understand once they are discovered; the point is to discover them."

—Galileo Galilei, father of modern science (1564–1642)

In 2007 former Vice President Al Gore, along with the U.N.'s Intergovernmental Panel on Climate Change (IPCC), was awarded the Nobel Peace Prize, in large part for his narration of the film "An Inconvenient Truth." Earlier that year, the same film, a widely-publicized documentary on global warming, won an Oscar for Best Documentary. Accepting the award in Oslo, Norway, Gore bluntly warned that global warming "is the greatest (and most dangerous) challenge" the world has ever faced, calling it "a true planetary emergency." Now, just two years later, it appears we are getting a decidedly different view. Hacked e-mails from a small group of influential scientists at the U.K.'s University of East Anglia Climate Research Unit (CRU) reportedly showed those same scientists boasting about concealing, fabricating and manipulating important climate data. Subsequent media reports have alleged that the data showed global temperature levels over the past eleven years actually declining instead of rising, as had been widely reported. Adding fuel to the fire, following a Freedom of Information request, **the scientists also admitted to throwing away years of raw temperature data which had been integral to achieving an international consensus on climate change.** According to the Wall Street Journal, *findings from the CRU have been at the core of policy reports from the Nobel Peace Prize-winning IPCC.* Stoking the controversy even further, the Director of CRU, Dr. Phil Jones, stepped down from that post early last month amid a pending probe into accusations that he overstated the case for global warming. So, what now?

When it comes to highly complex fields like climatology, it's inherently tough to know who or what to believe, especially for the layman. Possibly even tougher though, or at least more confounding, are the vagaries of the stock market, a predictably unpredictable entity dubbed "Mr. Market" by legendary investor Ben Graham for its uniquely Jekyll and Hyde persona. *The year just ended is an excellent case in point.* Following an eye-catching rally off the Lehman Brothers-induced lows in November 2008, the equity market, in early January 2009, made a sharp and vicious reversal that culminated just nine weeks later in a *twelve-year low for the S&P 500 index.* At its nadir, which with hindsight is now apparent, fear, exasperation and hopelessness became pervasive amongst investors, as selling reached a cyclical and emotional crescendo. The late great John Templeton, had he still been living then, would likely have been an indiscriminate and enthusiastic buyer of stocks, sensing, in both the stock market and the economic cycle, a rare and historic opportunity of the type he'd famously deemed "the point of maximum pessimism" many decades earlier.

However, **the big question for investors today is, what to do now?** Like the proverbial Phoenix, the S&P 500 has risen a stunning 65 percent since those very dark days in early March, predictably leaving a large swath of investors (especially retail investors) flat-footed and wide-eyed in disbelief. However, despite this dramatic advance, a torrent of money has flowed into the perceived safe haven of bond funds since the early March lows (+\$340 billion through 12-2-09) while, over that same period, domestic equity funds have actually seen a net outflow (-\$43 billion). A recent anecdote from the ever-evolving institutional money management world sheds important light on the underlying mindset we believe is helping drive such belated, and likely mistimed, risk-aversion moves.

Late last year J.C. Penney, the third-largest U.S. department store chain, announced it was beginning the process of abandoning stocks in its defined benefit plan by gradually shifting to bonds for 100 percent of plan mix (versus a 20 percent allocation stocks several months earlier). Penney's senior management sought to justify this extraordinary move by promising to "eliminate" uncertainty for its shareholders caused by the company's underfunded pension plan. However, the timing of this announcement, from our perspective, appears far from optimal coming off the best year for investment-grade bonds since 1985 (up 21% on a total return basis through early December), and *near the end of*

Fourth Quarter 2009 Financial Statistics

DJIA: 10428.05

S&P 500: 1115.10

90-Day T-Bill: 0.05%

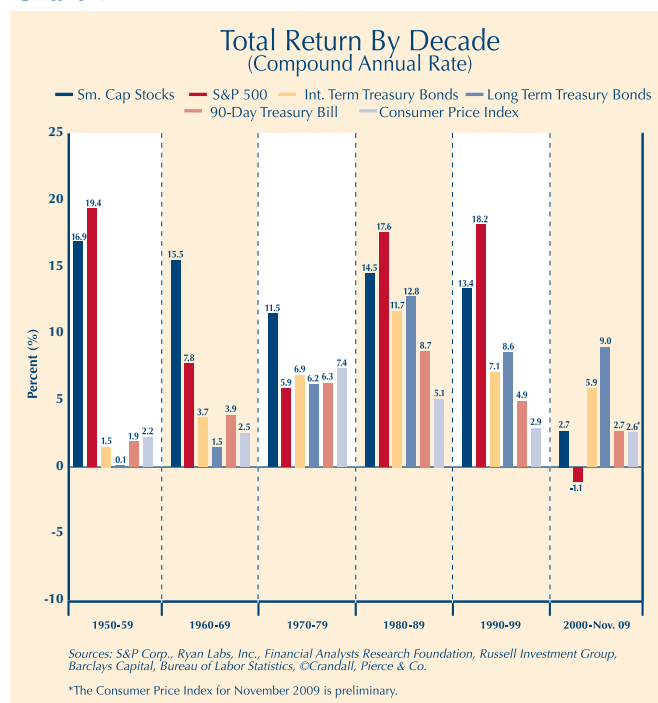
30-Yr. T-Bond: 4.64%

...Prophecy?

what has been an unprecedented twenty-seven-year bull market for U.S. Treasury bonds. J.C. Penney is not alone however. Watson Wyatt Worldwide Director of Asset Allocation, Mark Ruloff, recently told Bloomberg News that **pension funds are increasing allocations to investment-grade debt to the highest level since the 1970s**. It's also worth noting that these much-belated moves are coming at a time of record-low interest rates, and against a backdrop where corporate bond yields have compressed dramatically since their early March 2009 cyclical highs.

As is often said, *timing is everything*. This is especially true in the case of stock and bond purchases, where both good and bad timing overtly impact the magnitude of compound returns and, most importantly, the wealth accumulation ultimately achieved. In the context of today's financial markets, buyers of high-grade ten-year industrial bonds can expect an approximate 5 percent compound total return to maturity. In light of that, the asset allocation example just highlighted suggests J.C. Penney's retirement plan fiduciaries believe 5 percent per annum is a good relative bet versus stocks, and other asset classes, over its targeted time horizon. There's a major problem with this view, however. Despite the near precedent-setting rally in stocks since very late last winter, **the broad equity market (S&P 500) is coming off one of its worst ten-year performance stretches on record** (and one that produced an extremely rare *negative compound annual return* – see **Chart 1** below).

Chart 1



Against this well-below-average return backdrop for stocks, a few anecdotal observations may be helpful in gaining important long-term perspective about the future

path of U.S. stock prices. In October of 2008, near the equity market's low for the year, Warren Buffett penned a highly unusual Op-Ed in the New York Times, amidst the then still-evolving carnage of Lehman Brothers' collapse. In the letter titled, *Buy American. I Am*, Mr. Buffett told readers that *he was liquidating his Treasury holdings and buying American stocks in his personal account, and that if prices remained attractive he would soon have 100 percent of his non-Berkshire Hathaway net-worth in "United States equities."* He went on to say that, "fears regarding the long-term prosperity of the nation's many sound companies make no sense." Despite the challenges and extreme uncertainty facing the economy then (and the corporations he was alluding to), Buffett predicted that **"most major companies will be setting profit records 5, 10 and 20 years from now."**

The world's most revered investor continued, "Over the long term, the stock market news will be good," citing the myriad monumental challenges that the U.S. had overcome in the past. "In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu pandemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497." Going forward, he predicted, **"Equities will almost certainly outperform cash over the next decade, probably by a substantial degree."** Although it's still too early to accurately judge, the Oracle of Omaha's forecast is looking good so far, as the on-going stock market rally appears intact (at least for now) while puny money-market-fund yields continue to hover near record lows.

Today is a new day, however, with 14 extremely eventful months having passed since Berkshire's legendary helmsman boldly and patriotically stepped into the breach to rally fearful and chastened investors. So, let's check the numbers for an up-to-date perspective. Since the closing price the day before Buffett's Op-Ed was published, the S&P 500 is up 23 percent, a strong and well above-average performance, but not remarkable either. (However, the media, in its typically myopic way, has focused instead on the much more robust 65 percent recovery in stock prices since the March 9, 2009 cycle low.) Although there is no way for us to know for sure, it seems reasonable to assume that Mr. Buffett, at the time he penned his now-famous letter, believed the average stock (including dividends) would more than double over the subsequent decade. The logic behind this assumption follows.

Around the time the Op-Ed was published, Mr. Buffett could have purchased ten-year investment grade industrial bonds at a yield-to-maturity approximating 8.5 percent and, therefore, it seems reasonable to assume that he would have been concurrently pricing equities to yield at least 10 percent per annum (considering the required risk premium adjustment over bonds). Assuming he was, in fact, anticipating an approximate 10 percent compound annual return over the subsequent ten years, the implied

price of the S&P 500 at the end of that period would have been 2355. Given today's level near 1100, if nothing else of significance regarding Buffett's long-term outlook has fundamentally changed (more on this in a moment), he likely still sees an approximate 9 percent per annum compound return for stocks over the next 8.8 years. Such a result would closely mirror the median post-WWII ten-year rolling return for the Dow. Looking at it from a relative perspective, a return of that magnitude would exceed the estimated 5 percent per annum yield-to-maturity currently available on ten-year investment grade industrial bonds by nearly 400 basis points a year, a highly satisfactory risk-adjusted return.

Against the backdrop just described, we believe it's instructive to try and actually surmise whether anything of significance (as referenced above) has fundamentally changed, at least in terms of the long-term global growth opportunity, since Buffett's October 16, 2008 investor *call-to-arms*. Although he hasn't written another Op-Ed recommending stocks recently, we do know he continued to make significant additions to Berkshire's equity portfolio during the second-half of 2009, targeting such venerable dividend-paying blue chips as Johnson & Johnson and Wal-Mart among his long-term investment vehicles of choice. More importantly, from our perspective, was his early November \$26 billion agreement to purchase all the Burlington Northern Santa Fe shares Berkshire didn't already own. Not only is this, by far, the largest acquisition in Berkshire Hathaway's history, the company is paying a substantial premium and an above-market multiple to acquire 100 percent control of the railroad (18x forward-year consensus estimates). Given that the broad equity market, represented by the S&P 500, was selling at approximately 14x our estimate of forward-year earnings at the time (and is up only 6.9 percent since then), it seems implausible that the world's preeminent investor has soured on blue-chip stocks long-term; especially relative to other high quality publicly-traded alternatives such as investment grade industrial bonds. That said, it's important to note that **the easy money off the early March 2009 low has almost certainly been made**. *Given their dramatic rise, stocks are now potentially vulnerable to a pullback, and one that could be an eye-opener, especially if the economy were to roll over again in 2010. Such an economic about-face, though aberrational historically, nonetheless remains a possibility.*

"In so many areas of life, you need to be a long-term optimist but a short-term realist."

—Captain Chesley "Sully" Sullenberger, pilot of US Airways Flight 1549 which he miraculously landed in New York's Hudson River on January 15, 2009

Absent an unwelcome economic set-back, the tried-and-true football analogy of *three yards and a cloud of dust* may prove the most common call from the playbook for patient holders of high-quality equities (with a few deep passes mixed in to keep the stock market bears on their toes). As close observers of the institutional marketplace well know, everything is relative in terms of risk and return. That said, **high-quality dividend-paying stocks**

appear to be a good absolute and relative bet over the long-term (especially since they've lagged the most, by far, over the past decade, and given that their franchises, in many cases, possess significant global reach). In the interim, however, if the widely feared market retrenchment manifests, we anticipate being opportunistic buyers of such high quality dividend-payers amidst the downdraft. Either way, *we're prepared to ride out whatever may come (with an unwavering and steady eye on the long-term horizon).*

Given Warren Buffett's pending multi-billion outlay for Burlington Northern Santa Fe, *we believe it would behoove the serious investor to carefully consider what Buffett sees, as he peers out over the far horizon, to give him the confidence to swing so hard and so big in the current, reputedly overbought, environment for stocks. A few important clues follow.*

During a nationally-televised interview after the Burlington deal was announced, Mr. Buffett garnered worldwide headlines by emphatically stating that *the purchase was "An all-in bet on the future of the United States."* This undeniably strong statement was seen as especially strong coming at a time when the S&P 500 was up 54 percent from its early March lows (and while the economy was, at best, struggling to exit recession). He went on to say that "America has – our system has just gotten started. We've had a couple hundred years of progress but we have not exhausted our potential in this country." Responding to his interviewer's question on the future threat of higher taxes (on income, dividends and capital gains) to help balance bloated federal and state budgets, Buffett observed that, "People have paid a lot higher taxes in the past and the economy has done just fine. Our system works. It unleashes human potential. We can take higher taxes."

Further along in the much-publicized exchange, addressing the still-burgeoning and oft-lamented federal budget deficit, last year's highly questionable Congressional stimulus program, and the apparent (and widely-reported) hollowing-out of the U.S. manufacturing base, Mr. Buffett struck a note of staunch optimism. *"This country will solve its problems. We're not so good necessarily at avoiding problems, but we're pretty good at solving problems."* He recalled that "back in the early '80s, we thought Germany and Japan were going to eat our lunch and we'd all just be working at McDonald's and cutting each other's hair or something. But (instead) we added tens of millions of jobs since then. So, we do come up with things. You can't (necessarily) predict we'll have a software industry or you can't predict we'll have a great aircraft industry, but those things come along. And the world right now, 12 percent of our GDP is going to exports and 35 years ago only 5 percent was. So we are making some things the world wants." He closed by urging investors to have faith that people (here in the U.S.) will tap their deep reservoirs of creativity and ingenuity to come up with new things the world wants: "Historically we've been very good at that and I think we'll be good at it in the future."

“Human beings are not just more mouths to feed, but are productive and inventive minds that help find creative solutions to man’s problems, thus leaving us better off over the long run.”

–Julian L. Simon, economist and author who extolled the virtues of population growth (1932–1998)

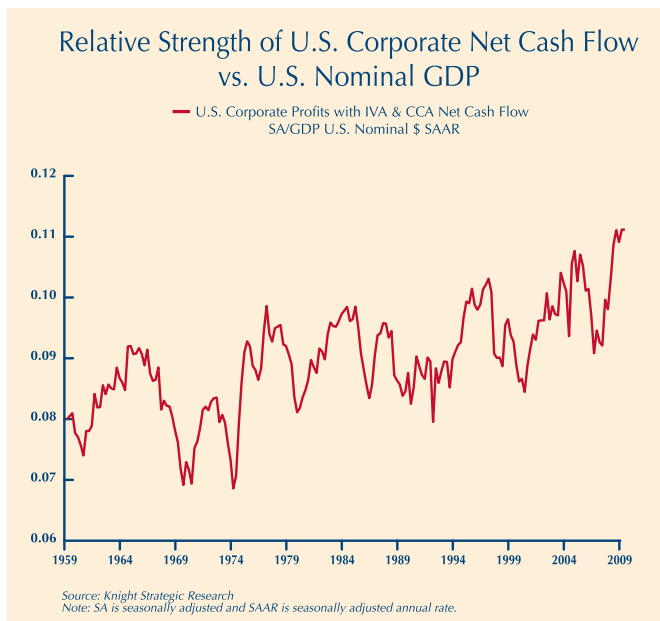
Of course, no one, including Mr. Buffett, is infallible, especially when it comes to investing. However, we’d fervently argue that his buy and sell decisions, along with his publicly-articulated opinions on all things investment-related, contain as much, if not more, valuable insight as any. That said, it’s important to note that, at present, *it does not appear Buffett is a raging bull on stocks since he’s on record saying the Burlington Northern deal should provide his shareholders with a “reasonable” though not spectacular return.* He did, however, suggest that it would take more than twice the enterprise value implied by the deal price to replicate the railroad and its infrastructure today (suggesting a very *hefty* margin-of-safety even at the above-market deal price of 18x estimated 2010 earnings).

So, with that in mind, let’s venture back across stock market history to see if we can garner additional insight into the longer-term relative opportunity in stocks (versus bonds). According to data compiled at the University of Pennsylvania’s Wharton School of Business, U.S. equities have generated average annual real (inflation-adjusted) returns of 6.7% across all 127 ten-year periods since 1871. In addition, over that same time frame, there have been 14 ten-year stretches where stock returns have been negative, including the most recent ten-year period (through 12-31-08) which was, unfortunately, the fourth worst on record. However, **in each of the previous 13, the subsequent ten-year compound returns averaged over 10 percent per annum on a real basis, 50 percent more than the historic average, and more than double the return of U.S. treasury bonds.** Of course, that stellar history provides no guarantees going forward. However, for fiduciaries harboring extreme trepidation about equities following the explosive rally off the early March 2009 lows, these statistics should, at a minimum, give them serious pause about adopting or maintaining an overly conservative asset allocation posture (especially in long duration portfolios).

In assessing *the underlying cause of the recent stock market rally*, it strikes us that **remarkably resilient and surprisingly robust corporate cash flows, along with historically depressed valuations, were the key drivers** to the relatively breathtaking “melt up” since early March. More specifically, corporate America’s performance, excluding that of most lenders, investment banks and real estate-related companies, has actually been quite stellar (when measured against the extraordinary magnitude of the economic downturn). In fact, despite the most significant and destabilizing financial collapse since the Great Depression, *U.S. corporate cash flows as a percentage of GDP have not been this high at any time over the past*

50 years, not to mention during an actual recession (see **Chart 2** below). Given the unprecedented magnitude and speed of corporate downsizing (the decline in employment was more than double the average downturn since 1950), and the outsized benefits we suspect are being reaped from multi-year investments in new technologies, and perpetual process re-engineering, we believe it’s plausible that even a slower growth, “new normal” economy would prove sufficient to push profits and stock prices higher over time. Looked at another way, despite the most obvious mispricings in stocks having been cured since the March lows, free-cash-flow yields for equities remain provocative at approximately 8 percent (using annualized 3Q09 numbers), and appear to stand up well on a relative basis versus today’s comparably low (investment grade) industrial bond yields.

Chart 2



“I have no doubt about the future of America. We have a system that unleashes potential and it’s going to keep doing that. You can bet on the future of America with enormous confidence.”

–Warren Buffett, commenting on the long-term outlook for U.S. stock prices during a recent CNBC interview

As repeatedly chronicled by the press in the months since Lehman Brothers collapsed, the structural headwinds facing the U.S. economy appear quite daunting, and we’d be highly remiss if we didn’t acknowledge these well-placed concerns (as we have in the past). However, despite such formidable obstacles, a relatively subtle and nuanced dynamic might, in time, be the key that helps unlock economic revival. Famed market seer and Yale economist Robert Shiller believes economic recoveries “may be based on little more than **self-fulfilling prophecy**,” a concept attributed to the late Columbia University sociologist Robert K. Merton who wrote about it in a 1948 magazine article titled “The Self-Fulfilling Prophecy.” Referencing this alleged phenomenon in a recent New York Times

article, Shiller was quoted as suggesting that *the mere thought a recession is ending builds confidence and encourages consumers to start spending again*, generating visible signs of recovery. Elaborating on this, he went on to state that, “The notion isn’t as farfetched as it may appear. Recessions generally last no more than a couple of years” and the current recession is now approaching two years old (having begun in December 2007 according to the National Bureau of Economic Research). “Given this backdrop,” again according to the professor, “the mere passage of time may spur our confidence, though no formal statistical analysis can prove it.”

Only time, of course, will tell if Shiller’s theory on economic recovery proves as prophetic this cycle as his two most famous forecasts did in years past. First, when he sounded the alarm regarding over-inflated prices for major stock market indices, amidst the insanity of the dot.com bubble; and second, several years later when he warned that U.S. home prices had dramatically overheated.

Right or wrong, however, both today’s equity and bond markets are clearly acting as if an economic recovery, if not already underway, is relatively imminent. Nevertheless, *we’d caution overly optimistic investors to temper their enthusiasm and lower their expectations following what has been the most prolific nine-month stock market rally in over seventy-years.*

In many aspects of life contagious enthusiasm is welcome, and as described by Yale’s most famous professor, quite often **self-fulfilling**. However, when it comes to stock prices, that uniquely human emotion is prone to trigger extremes. That said, we suggest investors take a deep breath, count their blessings, and dig in for both the New Year and, most importantly, the very long-haul. **In the world of investing, it’s the only way we know of to truly make time your friend.** *As always, thank you for your continued support and confidence. It’s both an honor and a privilege for all of us here at WEDGE to work on your behalf - Happy New Year.*

Index	12/31/09 Price	4th Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	10428.05	7.4%	18.8%
S&P 500	1115.10	5.5	23.5
Value Line Composite	308.97	3.4	36.8
American Exchange Comp.	1824.95	2.6	30.6
NASDAQ Composite	2269.15	6.9	43.9

*Does not include dividend income.

Local News

Prichard, Alabama and Vallejo, California are geographically a country apart and neither come to mind when one thinks of trendsetting hot-spots. From a financial perspective, however, they are side-by-side as both municipalities are operating under **bankruptcy protection**.

Although different in some respects, both cases point to strains that are being felt throughout the country at local levels. The weak economy, though apparently in recovery mode, has severely impacted state and local government budgets. Declining tax revenues coupled with a relatively fixed cost base have sent public officials scurrying to limit the budgetary damage. Many have implemented tax and fee increases, along with layoffs, furloughs and mandatory unpaid leave for employees. Although the \$787 billion Federal economic stimulus bill passed by Congress early last year provided a temporary lifeline to a number of state and local governments, budgetary challenges will return in 2010 and beyond.

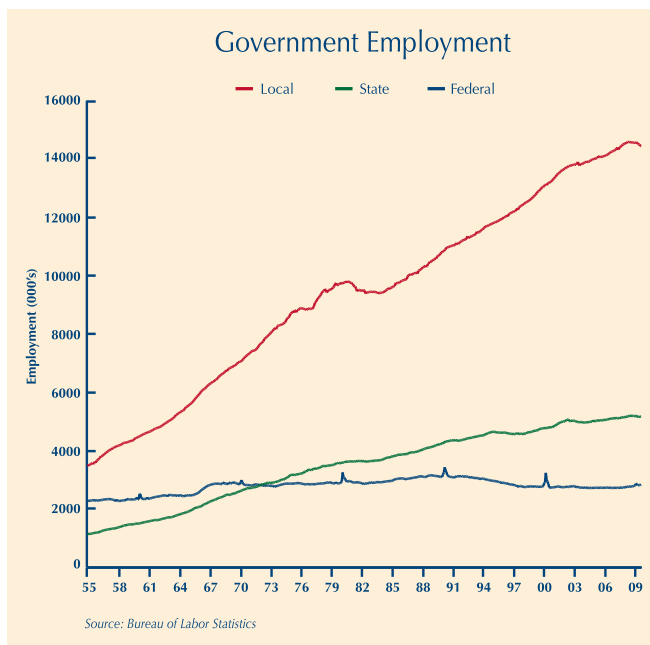
At the heart of the matter, a very fundamental problem exists in many state and local governments. Quite simply, their cost structures are out of line with economic reality. Adding further pressure, pension and other post-employment benefits (OPEB) are devouring an increasing percent of revenues, and the problem looks set to get worse before it gets better. Despite the huge stock market rally since early March 2009, the cumulative damage done by the historic swoon off the market's 2007 highs has left already actuarially underfunded pension plans even further behind, requiring higher *current* contributions to help take up the slack. Given relatively recent mandates that OPEB liabilities must be disclosed, along with an "annual required contribution," it is evident that many states and municipalities face daunting financial pressures. (Regular readers of WEDGE Watch may recall our second quarter 2006 discussion of GASB 45 disclosure requirements.)

Is there a way out? Certainly. An economic recovery will eventually lead to an improvement in tax revenues; but, there is always a lag. In the interim, however, the all-important municipal bond market remains open to the great majority of issuers (recall that the hyper-stressed state of California has been able to fund some of its massive budget deficit through more borrowing). Nevertheless, one thing seems abundantly clear: states and municipalities are going to have to reduce their workforces, make changes to benefit plans (for both

prospective, current and former employees), and lower service levels. In other words, *the pain of change is going to have to be shared*.

Along these lines, it appears a long-term trend may be in the early stages of breaking down. **Chart 3** shows the trajectory of government employment at the federal, state and local levels. Noting, in particular, the path of local government employment, a "correction" in the trend occurred in the early 1980's in conjunction with the severe recession of that period. Recent data suggests we may be topping out again. Given the economic and budgetary realities of today, **the shrinkage of local and state employment seems to no longer be a matter of choice**.

Chart 3



As always, we are closely watching these important trends, as they will very likely impact the creditworthiness of many states and municipalities. So, stay tuned for more *local news* updates.

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