NEWSLETTER #7
AUGUST 26, 2008

PERENNIAL
ASSET MANAGEMENT

Perennial Perspective

UPDATE

Our past bias for safety has continued to benefit our clients as the Perennial Equity Portfolio remains up this year. Our investment style enables us to do what many of our investment brethren cannot; be flexible. We expect that our willingness to adapt to an ever changing environment will benefit our clients in all markets.

STEP BACK

The markets continue to churn with every conflicting news item. At times like these most market experts suggest that we have invested for the long term and therefore we should remain calm and stay the course. This is a "buy and hold" strategy. Let's see what that would have earned us.

The S&P 500 index (@1271) remains at the same level it was at in August 2006, February 2001 and March 1999. By this measure long term buy and hold investors made nothing over 9.5 years. After inflation they lost buying power.

The Nasdaq index stood at 2800 in June 1999 and it is now 2362. Long term buy and hold investors lost 16% and after inflation much more.

So should an investor have been out of the market entirely?
West Texas intermediate oil stood at $18/barrel in June 1999. It has risen at a compound annual rate of around 23% to $116/barrel in August 2008. Long term buy and hold investors have made 544% in 9 years.

In June 1999 the TSX was at 7,000 and now it is 13,400. Over 9 years long term buy and hold investors made 91%; 7.5% compounded annually.

In June 1999 gold was trading at around $260/oz. At today's value of around $830 gold increased in value by a compound annual rate of about 13.8%. Long term buy and hold investors have made over 220%.

To earn better returns an investor needed to be positioned in the right market sectors.

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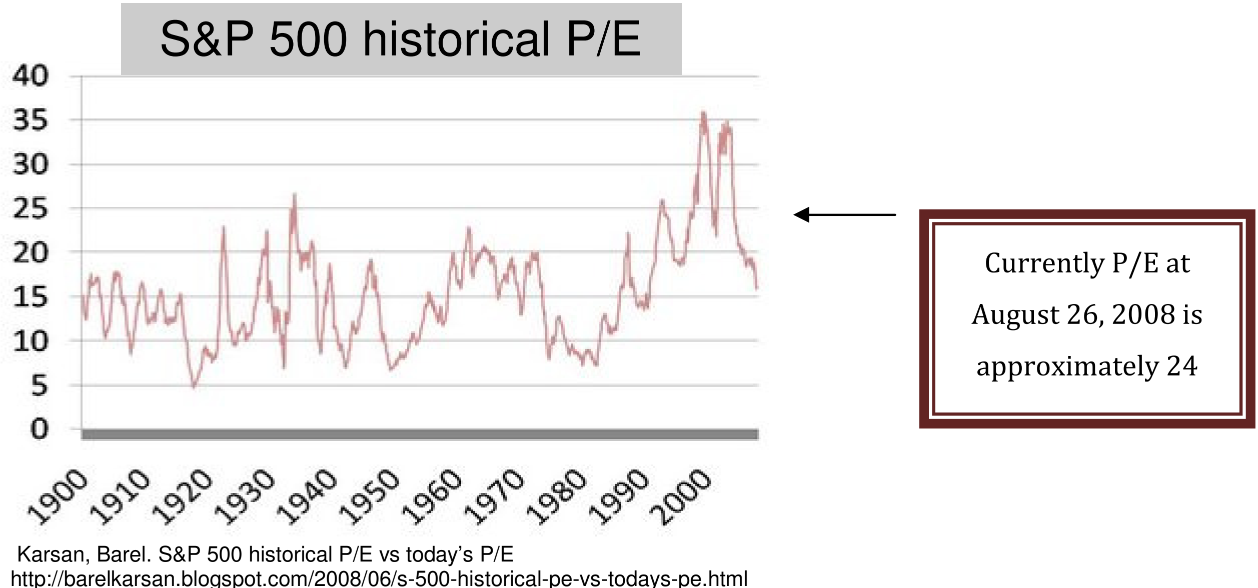
PRICE EARNINGS MULTIPLE

As you will have noticed from our previous newsletters we like to use historical information to help us understand where we are. The following graphs will tell one story as we see it.



Karsan, Barel. S&P 500 historical P/E vs today's P/E
http://barelkarsan.blogspot.com/2008/06/s-500-historical-pe-vs-todays-pe.html

The graph outlines the historical price/earnings (P/E) multiples of the S&P 500. It shows that:

- P/E multiples normally trade within a range from 8 to 20. The average is around 15.

- The market P/E ratio has fallen precipitously over the past few years but it remains above the average and well above the levels considered historically cheap.

- P/Es would be falling recently because of share price declines but earnings have been declining faster from a cyclical peak.

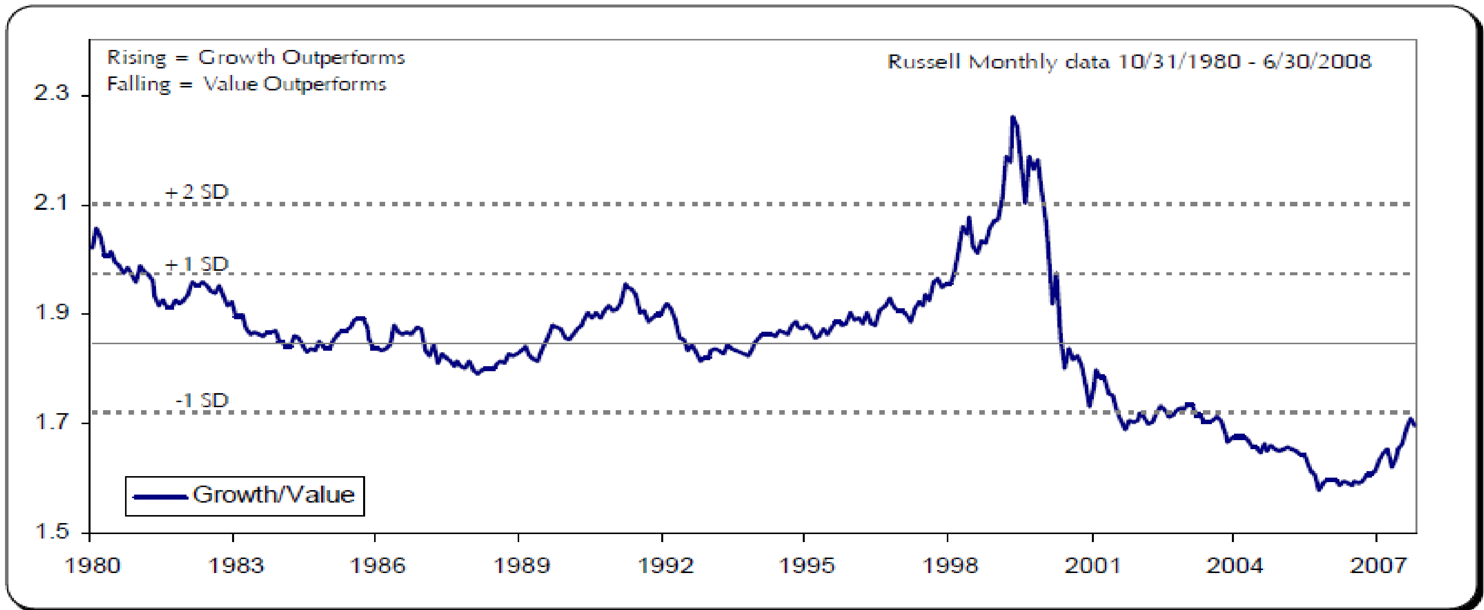
Ned Davis Research (NDR) has completed a P/E analysis and has come to the following conclusion:

- The market will pay a lower value for peak earnings than trough earnings. Over time the average is 12.9 for peak earnings and 19.0 at earnings troughs. Therefore Ned Davis believes you should look at trailing 10 years earnings. We also believe this.

- NDR's research shows the lower the normalized P/E at the time of purchase the better the rate of return will be. Buying at an 8.5 P/E would have produced a 10.9% real rate of return while buying at a 17.7 P/E would have yielded only 5.7% after inflation.

Simple - being able to buy stocks that are under valued will provide higher investment returns.

GROWTH VS VALUE



Most of the investment industry is divided into two camps. “Value” investors look for bargains and try to buy companies when they are selling for less than they are worth today. “Growth” investors are willing to pay high prices for companies that are growing quickly with the belief that the growth will create investment value.

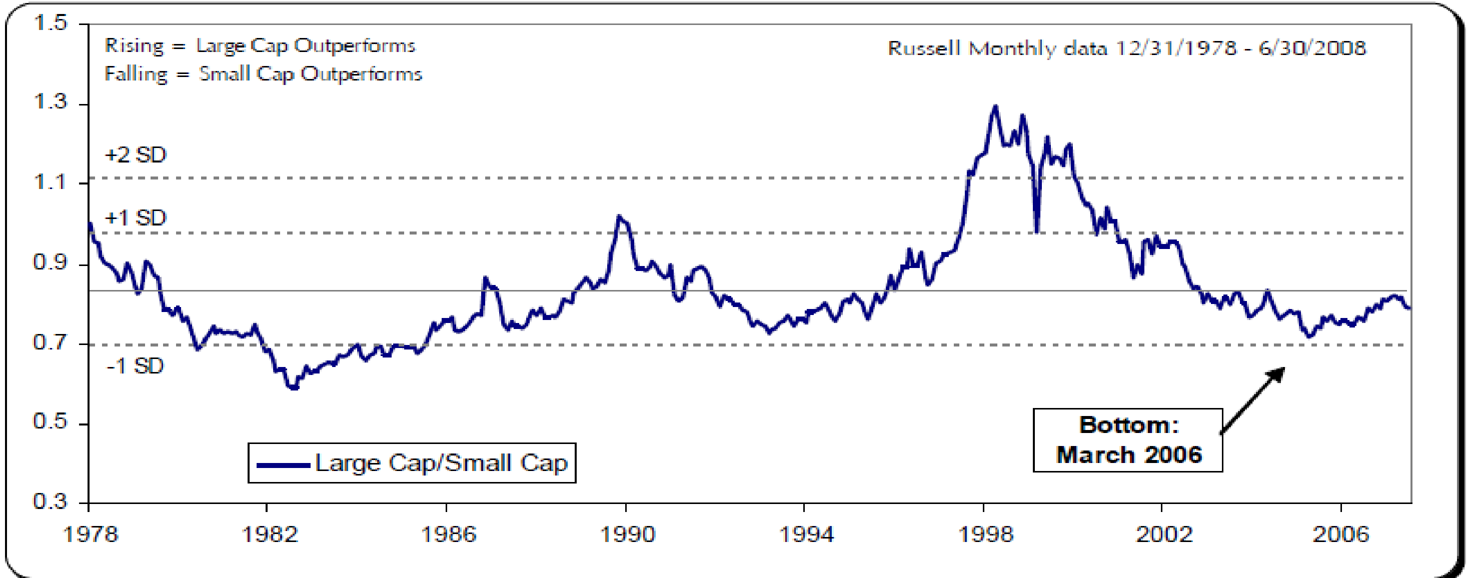
While the graph above only represents 28 years of information, which is short in our view, it shows over that time frame there are times when each discipline outperforms. Being stuck in the wrong style can be quite exasperating for long periods of time. During this 28 years there were two “growth” cycles with an average duration of 58 months and three “Value” cycles lasting just under 65 months each. During the “Growth” cycles, that style outperformed value by 112% on average and during a “Value” cycle that discipline outperformed by 51%. In all instances the returns were substantially different.

We believe these cycles are explainable. As investors observe what is working they will grab onto that trend to try and maximize their return. After they have done this for some time their demand will have caused share prices to rise to a level where the underlying companies can no longer justify the share price and the trend reverses.

“Value” outperformed since the tech bubble peaked in 2000 until mid 2006. For the last 27 months “Growth” has resumed leadership. Investors should expect that “Value” investment managers will underperform for some time until “Value Stocks” have underperformed enough to again represent the best value.

There is still time to reduce “Value” and emphasize “Growth” in your portfolio.

SMALL COMPANIES VS LARGE COMPANIES



Most investors believe that one can earn higher rates of return in small companies than in large companies. That is true at times but the above graph shows that over the past 30 years a buy and hold investor would have earned similar results in both sectors. However if an investor was willing to adapt, changing gears would have enabled an investor to improve their results dramatically.

Small Cap Cycles

- 3 cycles lasted an average of 59 months
- When in favour they outperformed by 38%
- The last cycle was from April 99 to March 06

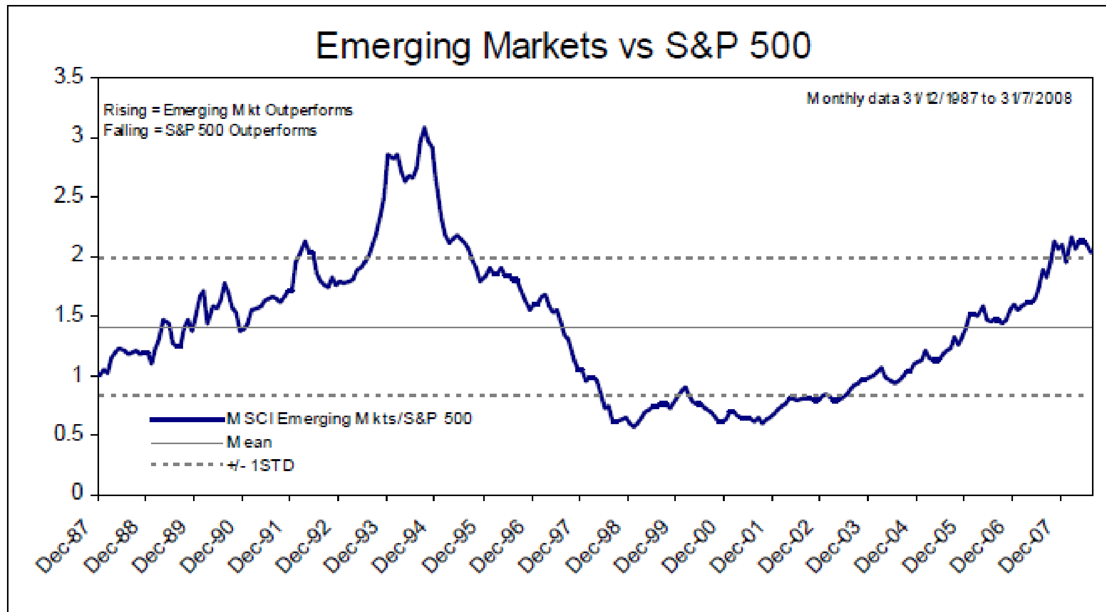
Large Cap Cycles

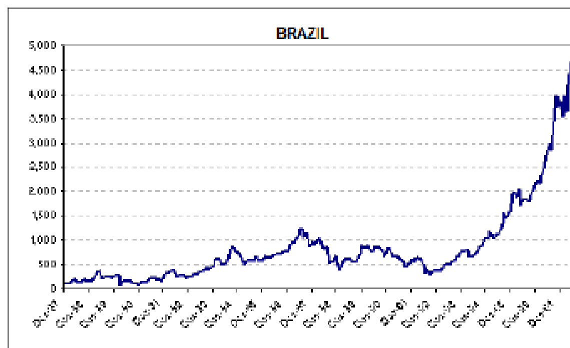
- 2 cycles lasted an average of 75 months
- When in favour they outperformed by 75%
- The latest cycle started in April 06 and is 27 months in duration so far

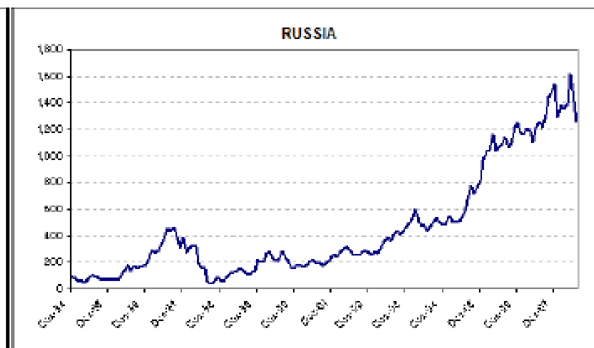
The increase in small companies' share prices over the last cycle caused small caps to become expensive in relation to large companies. The outperformance of large companies since March 2006 reflects some unwinding of this valuation differential and as investors seek safety in this declining market, the revaluation should continue.

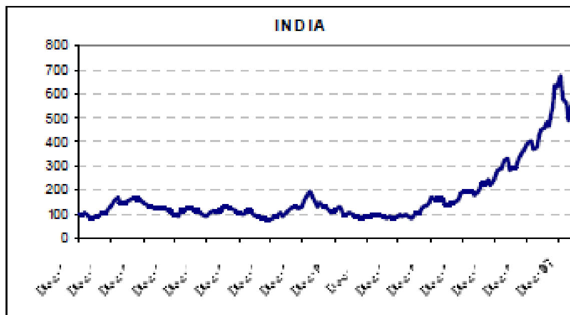
Valuation levels continue to favour large companies.

EMERGING MARKETS









Investing in emerging markets has been very rewarding over the past five years. As most of the developed markets began declining in October, the emerging markets corrected at an even sharper pace. This points to the developing markets being affected by the same influences as the developed markets; only with greater volatility. Just like small companies, emerging markets perform best when investors are not fearful of assuming greater risk.

A rising U.S. dollar and the desire for safety will cause the North American markets to outperform.

SEARCHING FOR ANSWERS

Predicting the future is no easier today than it has ever been but certain things become evident when reviewing market history.

1. Markets are cyclical.
2. Predicting market cycles is very difficult.
3. Recognizing that a new cycle has begun is important.

All investors try to buy companies when they offer “good value”. “Good value” can be found in small or large companies, “growth” or “value” companies and emerging markets or developed markets. Recognizing the relative value of one sector versus the other can reduce volatility and improve returns. A seasoned fisherman knows that choosing the best place to fish is where one should begin before deciding what is the best lure or fly.

Once one narrows the field to areas where the best relative value exists, an investor must still search for companies that offer the desired mix of return potential and security.

Next, an investor needs to create a portfolio. A portfolio is made up of numerous different holdings that when put together will achieve an investors’ objective. In doing this an investor must also consider the chance that they are wrong. Diversification helps deal with the chance that either the initial investment premise is incorrect or that something will happen in the world to change the market direction. Diversification means more than just holding a variety of stocks. One must consider all of the risk parameters and understand the implications all scenarios will have on the portfolio. Even if one believed the price of a barrel of oil was going to $500, oil companies should still represent only a small part of the whole portfolio. Before committing to an investment an investor should always consider the downside as well as the upside.

Given the above where are we expecting to position our portfolio?

1. Low P/E stocks based on “normalized” earnings.
2. Overweight “growth” stocks.
3. Overweight “large cap” stocks.
4. Focus on domestic North American companies.

Leave absolute commitment for your spouse, not your portfolio.

FINAL IMPACT

Be Flexible.

Look for the best value today.

Cycles mean that markets change. Because it worked yesterday does not mean it is the best opportunity for tomorrow.

The tailwind that accompanied ever lower interest rates is gone. Selling becomes an extremely important component of improving portfolio returns

* * *

To earn a good investment return, you need to avoid following the crowd; you do not need to be a nimble trader and you do not have to own the hottest new stock. All you need to do is be reasonable and own stocks at prices that underestimate their potential.