"Healthy Skepticism"

Market Commentary – December 2009

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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The second estimate of Gross Domestic Product (GDP) indicates that the output of goods and services produced by labor and property located in the U.S. grew by 2.8% in the third quarter of 2009. While slightly lower than the advance estimate of 3.5%, this measurement still represents positive economic growth. According to the Federal Open Market Committee (FOMC) press release on November 4, "economic activity has continued to pick up". In fact, the Federal Reserve recently boosted its GDP forecast for 2010 from a range of 2.1%-3.3% to 2.5%-3.5%. Still, there are potential downside risks. The Fed sees the weak labor market weighing on income growth and consumer confidence, and it is also concerned about credit availability remaining tight for consumers and businesses.

On November 4, the FOMC announced its decision to keep the benchmark Fed Funds rate at a record low target range of 0% to 0.25%. Moreover, it expects the rate to stay in this low range "for an extended period". Futures markets currently believe that the Fed will not raise the Fed Funds rate to 0.5% until November 2010. While low interest rates help encourage economic growth, there are unintended consequences of such loose monetary policy. From the borrower's perspective, cheap money encourages individuals and companies to leverage their balance sheets. Excess debt is at the epicenter of the economic crisis to begin with. From the investor's perspective, money market funds and short-term U.S. Treasury bills are yielding close to 0%. Income-starved investors are being coaxed to put their money at risk in order to generate some positive economic return. Such investors may potentially be blind-sided by an exogenous event that surprises the financial markets in an unfavorable way.

Cash should be considered a strategic asset in a portfolio that can help an investor capitalize on stock market opportunities. At Banyan Asset Management, our investment philosophy identifies three benefits of having cash liquidity in a portfolio. First, money invested in cash is not subject to stock market risk. This is obvious. Second, if you have cash and the stock market collapses, an investor does not have to sell a cheap stock in order to buy a cheap stock. To do otherwise is like taking money from your left pocket and putting it in your right pocket – you are no wealthier. Third, by having a portion of a portfolio in cash, an investor is able to be logical when other investors are falling victim to human nature. As Warren Buffett famously stated, he strives to "be fearful when others are greedy" and "be greedy when others are fearful". Cash helps an investor to do just that. Therefore, it is not the direct return on cash that is of primary importance; rather, it is these other benefits that make cash a strategic asset class.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. Standard & Poor's expects operating earnings per share (EPS) to be $71.31 for the S&P 500 over the next 12 months, implying a price-to-earnings (P/E) ratio of 15.4 with the S&P 500 at 1096. While stocks are higher in price in recent months, earnings have been improving, as well. There is still attractive value in stocks, although it is not across the board. Some stock prices have been pushed up to irrationally high levels when compared with the underlying companies' fundamentals. These stocks should be avoided.

As the market has continued higher without a significant correction, it is important to keep a balance of cash and stocks (in line with an investor's risk profile). Investors who have given up on the stock market and capitalism in general have been painfully watching a favorable stock market from the sidelines. On the other hand, those who become greedy and treat the stock market as a money machine are setting themselves up for financial disappointment. It serves investors well to be skeptical, both of negative headlines and positive euphoria. If the market pulls back, we will look to incrementally put more cash to work. If the market rises, we may lock in a few profits here and there. If the market moves sideways, we will enjoy income from covered calls and dividends. Such balance enables an investor to be a healthy skeptic.