

## **SPECIAL COMMENTARY LETTER**

### **STEADY HANDS**

**June 2010**

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Remarkably, it's taken only several weeks to trip up the overdeveloped bullishness that was so prevalent in the U.S. equity markets in late April. As we suggested in our April commentary, a correction was probably overdue. As a result, the sell-off has not been a surprise. Nor have we been surprised by the abruptness of the decline in light of the similar computer-driven occurrences in late 1998 and early 1999. But the extreme volatility, thirty-minute meltdown, and reversal of a couple of weeks ago (now known as the "Flash Crash") was a surprise to virtually everyone. So we feel a little explaining is in order. Here are our thoughts on what is important and what is perhaps less so.

#### **Man versus Computer**

As one may recall, we first began writing about computerized trading systems in the U.S. equity markets in our October 2008 commentary (available on our web site). We don't particularly like these trading systems, even though they do provide some additional trading volume for longer term investors like ourselves. But, they can actually provide opportunity as well as risk if one approaches them properly. The keys are to have an understanding of how they work and when they have little to do with important longer term economic fundamentals.

A basic understanding of these systems will help to explain why they need to be ignored in the evaluation of longer term economic potential. This is because their behavior has nothing to do with longer term fundamentals and almost nothing to do with individual company circumstances. They make hundreds of trades in very small time periods, often in small fractions of a second (milliseconds), and attempt to generate their profit out of these very small moves in a share's price, often fractions of a cent. And each system can trade thousands or tens of thousands of times in a single day. So it quickly becomes clear that the profit motive in this kind of trading has nothing to do with economic trends three or six months from now.

These systems have become large profit contributors for some major brokerage firms and hedge funds; they will fight hard to keep them in operation. But our feeling toward them is considerably more jaundiced. Defenders of the programs claim they do provide some incremental liquidity to the equity markets, but we don't believe they add much if anything to the advancement of the U.S. economy. We won't be disappointed if the regulatory authorities start to rein them in.

#### **Fundamentals Still Count**

On the other hand, the fundamental outlook has little to do with the minute-to-minute technical behavior. In this case, the investment picture is much, much more about the outlook for the world economy and individual companies. It's here where the "rubber meets the road" for individual investors, and it's also here where one has to discriminate between the vagaries of minute-to-minute trading and the merits of long term investing, especially where tax rates are concerned.



In that regard, the investment outlook offers more promising possibilities. This sell-off has created a new set of unique opportunities thanks to the high frequency computers. For some companies whose stocks have lagged because their fundamental recoveries have lagged, they have seen 30-40% declines in their stock prices from recent highs thanks in part to the computer traders. In these cases, exceptional value has once again been created. We believe that one shouldn't let such a compelling opportunity pass without attempting to capture some of the opportunity in individual stocks that is now available. The key is to be comfortable with the belief that some of these companies will continue to progress in an overall uninspiring global economy.

## **Fundamental Global Picture**

The fundamental outlook, as compared to the trading or technical outlook, is somewhat more benign. The U.S. economic outlook remains in the muddle along category. Things are not getting worse, but they still aren't, in our opinion, getting meaningfully better. Job creation remains a challenge that we think will be a more persistent problem and a greater problem than many other forecasters believe. Additionally, wage growth will be very limited. This is why it's so important to seek out companies with sustainable global growth potential that will be less dependent on a robust U.S. recovery. They're out there and we have made every effort to see to it that your portfolio has the kinds of companies that will benefit from the evolving global growth picture. Very importantly, as lackluster as the developed economies of the world are likely to be, the prospects for the developing world are growing very soundly. By emphasizing the right economic or industrial sectors and the right global geographic locations it will be possible to experience improved results from here.

A quick tour of the globe will illustrate this point. Starting with the U.S., as mentioned above, we expect U.S. growth outlook will remain muddled. The economic statistics have generally been positive, but we remain skeptical about the ability of our economy to grow without continued federal stimulus. The OECD forecasts U.S. growth in the 3% range for the next couple of years. That's high from our perspective. We would be pleasantly surprised if it's anything much above flat. In an investing environment where the greater risk is on the side of being too optimistic, we would rather have the economy beat our expectations—not disappoint.

Europe has been an area of particular investor anxiety in the last month or so due to the European Union's need to cope with the fiscal crisis in Greece. Unfortunately, many investors fear that the fiscal problems will not be contained in Greece and concerns have grown about Spain, Portugal and others in the European Union (EU). We have written repeatedly over the last couple of years about the competitive challenges faced by many countries in an aging Europe. The fiscal problems that come with the effort to support that aging population will persist for many years. The Organisation for Economic Co-operation and Development (OECD) expects most of the major EU countries to grow modestly (1-2%) in 2010 and 2011. Once again, we are more comfortable assuming that the need for fiscal austerity in the European Union will stifle growth. Flat is the safest bet for the combined EU economy.

Japan looks better - the OECD forecast is more than 2% for Japanese growth this year and next, thanks to robust export growth for Japanese companies. This forecast seems reasonably



dependable. In the long run, they have serious demographic problems similar to those in Europe and potentially greater debt problems. The future of global economic growth will not come from Japan, the U.S. or Europe. It will come from elsewhere. The following are the bright spots:

Greater Southeast Asia is easily the most important source of future global growth. China, India and Indonesia combined represent 40% of the world's population. All three escaped the recession with continuously positive GDP. Add South Korea, Taiwan, Vietnam, the Philippines and the smaller countries of the area and you start to approach 50% of the world population. Increasingly, they are growing through increased domestic consumption and trade with each other. This lessened dependence on the U.S. and Europe will make their growth more dependable. Recently, there are wide concerns about a property bubble in China which appears to be somewhat well founded. As a result, Chinese authorities are already acting to restrain the real estate excesses and there could be collateral economic damage. This suggests that China likely will grow more slowly (high single digit rate), but it will grow, and it will therefore not stop the growth in this region. On the other hand, India is doing quite well without the more apparent bubble characteristics of China. This should also continue.

Resource Economies - the second important group of growth contributors will be the strong resource economies. This group includes Australia, Canada, Russia, Brazil and the major Middle East oil producers. Diversified global growth will ensure that most of their resources remain in demand, with only construction resources like steel or copper susceptible to much of a slowdown in the event of a sharper decline in China. On balance, these economies should continue grow.

Collectively, we see the sum of the global parts as more positive than negative. Even if we're too optimistic about the ability of these countries to contribute sufficiently in pushing global growth higher, we are comfortable in the belief that they will offset the weak links elsewhere. That should provide a good enough backdrop for the right companies to produce steadily better results. After all, if one thinks about the small difference between zero and three or four percent global growth, it should not weigh heavily on the fundamental outlook for particularly well positioned companies. In the following comments, we'll reiterate what we believe it means to be in the "right" companies.

### **Looking in the "Right" Places**

Anyone who has been an investor for very long knows that a phrase like investing in the right companies can often be a heroic overstatement. Many smart people compete each day to find value where others have overlooked it. The result is that performance results end up bunched much closer together than one might expect. But there are some specific aspects of the investing process that we have long believed will improve an investor's odds, especially in volatile or uncertain markets. They are the core principles underlying our investing approach. Here are the key principles.

1. Don't pay up for things. Investing in the unloved when they are out of favor significantly reduces the risk of over-paying for investments. It's plain, old "straw hats in winter".
2. Understand that value is generally most compelling when everyone else is moving in the opposite direction. Right now with the computer driven turmoil in the markets many investors are shying away, right at the point of best recent opportunity.



3. Operate with a different (longer) timeline than the crowd. It is very difficult to out-invest the competition if your timeline is too short and the same as many others. This is especially true if you're a taxable investor.
4. As a general rule, don't do what the crowds are doing with their conventional wisdom. Many investors are currently buying bonds and neglecting stocks. Bonds certainly have their place in today's portfolios but yields are down significantly and investors are not paid well for taking the risk.
5. Broaden your horizons. The best growth will come from parts of the world with which most Americans are unfamiliar. Whether in American companies with international prowess or foreign mutual funds, you will have to go international to maximize returns. Some of these markets are somewhat illiquid but the future growth from their economies may, in fact, be more dependable.

### Weighing the Tradeoffs

Investing in the financial markets is *always* about weighing the trade-offs between various perceived risks and rewards. In the larger sense, the present environment is no different, only the current set perceived risks and rewards are different. Here's how we believe they stack up this time:

#### The Negatives

1. The U.S. economy is decelerating. It does not appear to be able to grow meaningfully without government stimulus. It probably can muddle forward though. The problem for the equity markets will come if investors "throw up their hands" and question the valuation that should be put on the equity markets in a no-growth environment.
2. There is still no evidence that individual Americans are interested in returning to the equity markets. Incremental money flows into equities would be helpful but don't appear to be on the horizon and conversely, the equity markets will suffer if individual investors lose confidence thanks to the high frequency trading.
3. The computerized and momentum trading which currently dominates daily trading in our equity markets makes them particularly vulnerable to a great deal of day trading around so-called technical levels. This trading increases volatility and discourages more fundamentally motivated long term investing. A decline below certain levels could break the market down and trigger a new wave of selling.

#### The Positives

1. The U.S. banking system is unequivocally stronger than two years ago when Bear Sterns collapsed and most investors were only beginning to appreciate the magnitude of risk which the banking system had created in the prior decade. There are still risks in the event that we experience further declines in U.S. real estate values, but the banking system is strengthening fast enough that it should stay ahead of any incremental deterioration.
2. America's corporations are in very good shape. The Federal Reserve just reported that non-financial corporations in the U.S. had accumulated \$1.84 *trillion* in cash and other liquid assets by the end of March 2010—26% higher than a year before and the largest increase in the almost sixty years of the survey.



3. Interest rates are very low by post WWII standards and we remain convinced that they are unlikely to rise significantly in the next couple of years. The combined effects of a weak American consumer, tough global competition and major turmoil in the European Union are trends which will keep the U.S. dollar relatively popular and interest rates depressed for a while longer. This in turn will reduce the competition for stocks and help provide a floor for valuation.
4. The aforementioned computer and technical based trading has now created a new batch of depressed stocks of appealing companies based on virtually no fundamental assessment of the companies. This has created a new set of compelling bargains in a similar manner to what happened when we grew bullish in late 2008 and again early 2009. We remain convinced that many of these companies have very compelling upside potential over the next year or so, independent of the broad market's potential.

### **Staying the Course**

In light of the above pros and cons, where would we expect the equity markets to head? If pressed to make a single prediction, it would be flat to slightly lower over the next few months. So, one should not overweight equities in their portfolio. But money market rates are near zero and bond rates are low as well. And good companies with solid balance sheets still offer their global growth potential.

We believe the sound decision is to stay the course. ICM's approach is not to buy the market. Our emphasis has always been on individual stock selection, especially with the difficulties associated with predicting the direction of markets. With the opportunities that have once again presented themselves, the risk reward favors bargain equities once again.

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