

# Emotionalism

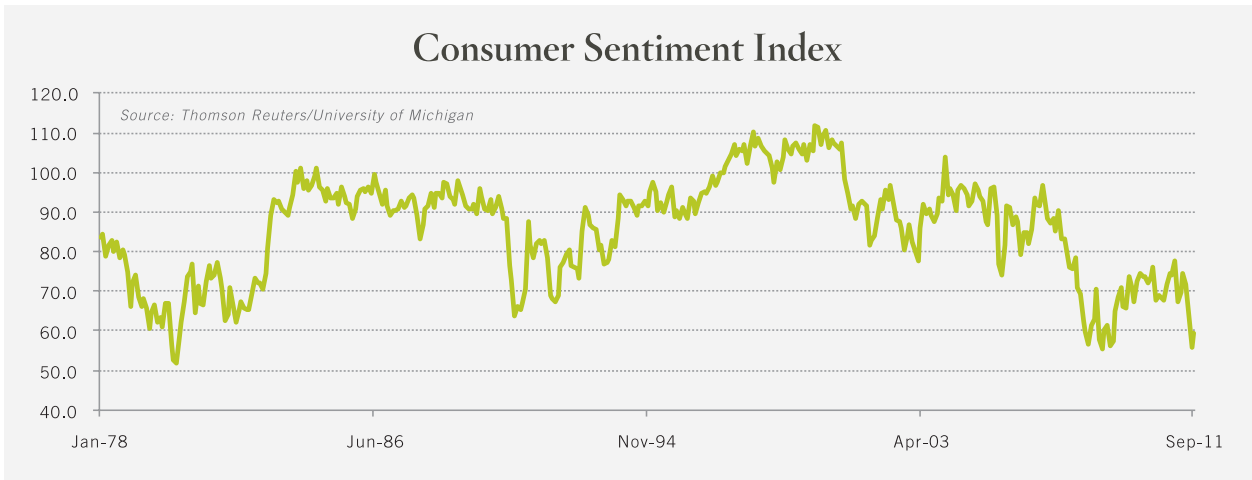
The decision to invest – whether in capacity projects, human capital or investment markets – requires making judgments about the future and often depends on confidence and a level of stability/predictability - two words no one would use to describe the investment landscape during the third quarter.

With 2008 still fresh on investors'/consumers' minds, markets remain hyper-sensitive to negative events. The 24-hour investment news (entertainment) channels recognize anxiety sells and will often over sensationalize the news. The daily debt crisis updates in Europe, a dysfunctional U.S. government and fears surrounding a slowing global economy provided no shortage of ideas for the next “Breaking News” report, creating a sell first attitude and contributing to a dramatic drop in overall investor confidence and consumer sentiment.

## **Consumer Sentiment**

The University of Michigan Consumer Sentiment Index published monthly by the University of Michigan and Thomson Reuters was created to:

1. Assess near-time consumer attitudes on the business climate, personal finance and spending;
2. Promote an understanding of, and to forecast changes in, the national economy;
3. Provide a means of incorporating empirical measures of consumer expectations into models of spending and saving behavior;
4. Gauge the economic expectations and probable future spending behavior of the consumer; and
- 5. Judge the consumer's level of optimism/pessimism.**



As one would expect, stagnant employment/wage growth combined with the heightened levels of financial anxiety discussed above led to a sharp decline in the index during the third quarter, nearly returning to its 2008 lows. While the objectives of the index do not specify the investment outlook, the connections are obvious and can be very helpful in building and maintaining successful long-term investment portfolios. In his October 2008 letter entitled, *The Limits to Negativism*, Howard Marks, Chairman of Oaktree Capital, argues that successful long-term investors typically have a healthy dose of skepticism – not blindly believing what everyone considers true. He states “Skepticism calls for pessimism when optimism is excessive. **But it also calls for optimism when pessimism is excessive.**”

Current market levels price in the consensus estimate of what will happen in the future. Therefore, at any point investors must decide if the consensus is accurate or whether things will be better than (good time to buy) or worse than (good time to sell) expected. Most of the time it does not pay to bet against the consensus; however, investing when investor confidence and consumer sentiment are low has historically been a profitable trade, as markets price in excess pessimism.

The table below shows the forward 12-month return following consumer sentiment lows.

Performance Analysis	Consumer Sentiment Level	12 Month Forward Return
May 1980	52.7	25.0%
March 1982	62.0	44.0%
December 1990	65.5	30.5%
March 2003	77.6	35.1%
October 2005	74.2	16.3%
November 2008	55.3	25.4%
Current (9/2011)	59.4	??

## October Rally

If October is any indication, it appears investors had priced in a worst-case scenario. Modest improvement in employment and growth, combined with brief periods of compromise/clarity in Europe (despite Greece's best efforts to keep things cloudy) resulted in a historic rally by domestic equity markets. The S&P 500 gained 10.9% for the month marking the third best October since Standard and Poor's began publishing data in 1926 and the tenth best month in the last 50 years!

While the month was remarkable, domestic equity investors will see an even more impressive improvement in the trailing three year return data point with October 2008 (one of the worst months in stock market history) rolling off, replaced with October 2011.

Performance Improvement	Three Year Annualized Return		Improvement	
	September 2011	October 2011	Annualized	Cumulative
S&P 500	1.2%	11.4%	10.2%	34.5%
Russell 1000 Growth	4.7%	15.6%	10.9%	39.8%
Russell 1000 Value	-1.5%	8.8%	10.3%	33.2%
Russell 2000 Growth	2.1%	16.3%	14.2%	51.0%
Russell 2000 Value	-2.8%	9.5%	12.3%	39.5%

While the trailing three year return is certainly useful information and probably the most frequently referenced measurement period within investment policies/performance guidelines, we believe proper portfolio performance evaluation should be more dynamic, comparing historical portfolio results to market results, market cycles and **return expectations (return profile)**.

Time will tell if the pinnacle of pessimism was reached during this cycle in early October and whether the subsequent gains are temporary or permanent. While markets have stabilized for the moment, many obstacles could cause the fragile investor psyche to deteriorate – European debt compromise falls through, the U.S. “super committee” fails to deliver, global growth stalls – which will likely result in heightened market volatility for the foreseeable future.

While we certainly do not ignore the potential macro headwinds, we believe investors must focus on bottom-up investing and take advantage of market volatility to discover attractive entry points. Corporations have very strong balance sheets, record high profit margins and tremendous flexibility. It is certainly easier to exercise patience after markets have rebounded by double digit levels, but the true test will be the next time the investment talking heads break the news of another top down “crisis.” Ultimately, when things become really challenging, remember comfort and returns are often inversely related.

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