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A PERSONAL VIEW FROM PETER BENNETT

MID-YEAR STRATEGY UPDATE PART 2

Equity Investment

USA

I shall not repeat the main graphs – CAPE and "q" – that I have featured before. The market is probably 40%-50% over-priced as I write. A recent study suggested that it would be about 50% lower had it not been rigged by the FED's QE. (and possibly the end to mark to market accounting by the banks).

Incidentally, re. all the vaunted QE's – FED, Bank of England, European Central Bank (ECB) – each successive QE has had a lesser effect than the previous one. The last ECB effort has had almost no effect. Similar, I understand, to what happens to alcoholics and addicts.

Reality

By far the largest determinant of long-term loss or profit is the valuation when you buy. For what it is worth, John Hussman, who analyses these things most carefully, looks for a USA ten-year total return of about 4.5% **nominal** and also before costs, starting here, i.e. pretty much zilch in real, inflation adjusted, life. GMO posit a near zero **real** seven year return. As for dividend yields, I repeat a table from my 17.02.05 bulletin, Richard Russell listed top and bottom of bull and bear market yields (USA) from 1921:

Yield %	
At Top	At Bottom
2.6	7.8
3.2	6.9
2.9	6.5
1.4	6.5
3.1	10.2

Current showing 2 ½%! A low only exceeded in the most hysterical bubble of all US market history – the end 1990's. Also of interest is the fact that we never approached any of the bear market bottom yields at the 2009 (?temporary) floor.

Again and again, certainly in my investment lifetime, what is going on is obvious – but the market fails to react until the crisis point hits. The timing of the latter is typically unpredictable in advance. I suspect we are in one of those situations now. That is why I have often described this game as simple but not easy. That the background is pretty much rubbish is blindingly obvious. But that does not mean that the stock market is going to collapse tomorrow, although it could.

As I write the bulls are in charge on Wall Street, bellowing their usual moos. Like Pavlov's dogs with the bell, they slaver at the hope of yet more reckless monetary abandon, alias QE. QE solves nothing – probably, indeed, the reverse (Per last bulletin).

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On the other hand ...

Europe and Japan equities are indeed cheap, looking at historic, long-term value. Value is, as you know, **never** a timing indicator. But, as you also know, patience and discipline are amongst the very most important required characteristics for investment success. It really does boil down to "buy cheap(ish); sell dear(ish)". End of story. You don't need PhD's or exams to get that.

If you feel your timing is awry – **and** you are able to trade-then you can try to trade round the problem. Admittedly almost no-one is able to trade consistently – I read the long-term failure rate is about 80%. By failure rate I mean net money is lost. This is not dissimilar to the percentage of active fund managers who under-perform an index benchmark long-term.

Europe

The problems need no further comment. Early, possibly 'any', sustainable solution appears a long way off. **But**, never forget, investors buy companies, not economies. **And** business is robust and adjusts. This is free-ish market capitalism. Remember, German and Japanese industrial centres were flattened in WWII and...

The graph below shows the Shiller (cyclically adjusted) PER valuation measure:

European cyclically adjusted PE back to rock bottom

Source: Datastream

Courtesy: David Fuller/Tim Price

The overall European market yield is some 4 % + (USA 2½ %). Also:

1. Price to book 1.2x (2.2x)
2. Price to sales 0.7x (1.4x)
3. Price to cashflow 6 x (10x)

Markets usually get bored with worrying about the same thing after it has been obvious for some time. Clearly this is not to say that there is no more downside to come as matters remain fraught and there is no guarantee that much better comes next as opposed to much worse, which could shift the market.

So the value is good, even if the timing is impossible to judge.

Conventional fantasies

These bulletins have, over the years, done necessary demolition jobs on much prime economic theory on investment. *Inter alia*, I referred to Andrew Smithers' superb pamphlet on the Risk Premium concept, "Believing six nearly impossible things before breakfast" (04.05.2000); then there was James Montier (and self and others) on the Bond Equity Relationship twaddle; DRKW and self on "C.R.A.P.M." – as you would guess – the Capital Asset Pricing Model. The new, new thing – alias "growth" – approach to investing was dealt with on numerous occasions (numerous studies, e.g. Dreman plus self again). I dealt with hedge funds (numerous studies). Also the idea that you should automatically hire 'active' investment managers, instead of using trackers/ETFs, (a mountain of research, plus self). Needless to say, the latter recently denied by a vested interest spokesman. Latest and just seen; you were told that volatility = risk = higher return. (I have myself never equated volatility with risk, if by risk you mean permanent, serious loss of capital). A study by Robert Haugen, President of Haugen Custom Financial Systems, a California research house, and Narden Baker, Chief Strategist of Global Alpha, Guggenheim Partners Asset Management, looked over the period 1990 to 2001. 21 markets. Their study showed a strong inverse correlation between volatility and return, i.e. the boring old stuff actually did far better. I suppose this is more or less another take on buy value and leave the fancy stuff alone (bar **momentum** trading). All 21 countries covered showed similar results. Average +8.7 % pa for the less volatile stocks; -8.8 % pa for the most volatile. That's some difference. Well, Europe is fancy stuff no more. It's in the dog house – and it is value. Ditto Japan.

Next time I will deal with Japan in some detail.

Good luck

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