Client Newsletter

SKBA Capital Management

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Why this decade may resemble the 1970s
(Deja vu to "the Lost Decade.")

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The memo below was written in early 2004 (we eliminated reference to particular holdings as we may or may not still own them in client portfolios). It is often useful to take a look back at our internal thought pieces to assess our correct perspectives and errors of judgment, if any. In this example, it is interesting to observe how much is still pertinent. It was written towards the first half of the decade, and we are now approaching the end of it – we can, therefore, make a few more comparisons between this decade and that of the seventies alluded to in the title.

"With the Market Up, Wall Street High Life Bounces Back, Too" proclaimed a front page article in the February 4 Wall Street Journal.

2003 ushered in one of the best years ever for equity markets. This was deserved given the recent bludgeoning. The Wall Street Journal article focused on recent increases in discretionary spending by Wall Street traders. Discretionary being the operative word as the author drew readers to conclude that the bear market had unjustly deprived traders of their birthright to purchase $300,000 sports cars and charter private Boeing 737's. The article was nevertheless correct in focusing on traders rather than portfolio managers. On average, portfolio managers experienced 20% to 50% returns. Traders, on the other hand, experienced exponential growth in trading volumes and, more importantly, commissions, since volumes centered around highly liquid low-priced stocks (Cisco, Williams, Nortel and Lucent come to mind). Last year was arguably one of the most profitable environments for those left in the Wall Street trading community.

As we continuously look out a few years, the question remains "Where do we go from here?" As contrarians, let us compare recent stock market returns to that of a surfer wiping out on Hawaii's North Shore in the middle of winter. The period between 2000 and 2002 was undoubtedly a pretty big wipe out. In that sense, last year gave traders, uh, surfers, a chance to catch their breath. The sheer joy of having reached the surface was reason enough to proclaim victory over nature's fury (Mr. Market).

Similarly, last year, many on Wall Street were able to catch their breath. One wave does not a set make, however. Those rejoicing in their long awaited O2 intake may be unaware of the next mass of water about to force them once again below the surface among the jagged reefs. Persistent pummeling will ultimately force most to head for the beach and watch from the safety of land.

For long-term investors, the lesson is that following the set, a few persistent enthusiasts will remain beyond the breakwater; the crowds will have *disappeared and the environment will be profitable for those that remain. We are not there yet.*

The twenty-first century is too nascent to garner any conclusions from. It is nevertheless still our contention that investors need to experience a longer drawn out period of volatile and lackluster returns. The 1980s brought about tremendous positive global forces. Oil and commodity prices declined along with inflation and the cold war ended, enabling bonds and equities to rally over the ensuing twenty years. For bonds, the positive outcomes are currently few. Yields can remain low as they currently are, which would portend a situation similar to Japan's, and which we see as relatively unlikely. More likely, they will increase, putting pressure on prices. Equities in general should be viewed positively as an alternative but seem to have priced in a fair degree of optimism, as was so well described in the Wall Street Journal article.

For value investors, the coming years are an incredible opportunity to build portfolios as specific equities will continue to be unjustly discarded. Healthcare provides a perfect and timely example of this. The industry is currently priced at historically low valuations and is given little credit for its very attractive demographic position. Baby boomer hips will break at an increasing rate, high cholesterol levels will persist, arteries will clog at an increasing rate and our stress and diets, not to mention our longer life spans, will continue to give us irregular heartbeats. In conjunction with this seeming dire outcome, technology improvements will lower the cost curve and render all of the needed remedies more affordable. Given such overwhelming benefits, Medicare and drug pricing become tangential negative outliers that will provide greater benefits for all in need. Given the overwhelming positive undercurrents, we have slowly increased our exposure to the group over the last year.

As we look back, one of the prevailing similarities between the seventies and the latter half of this decade has been that of increasing inflation. Whereas the late nineties were defined as a period of high growth and low inflation, this decade is very similar to that of the Ford - Carter era. Most commodities and hard assets have continued to increase since 2004, some even surpassing levels we thought would be excessive. At the same time, growth has slowed significantly. Currently, we are experiencing both undesirable cost-push and emerging-market demand-pull inflation. While this trend has been building for some time, 2008 is the first year in which it has had a noticeable impact on consumer behavior (although we don't want to discount the impact of the elimination of the "housing ATM.") Economic growth, not simply in the United States, but globally, has slowed, while input costs have increased significantly. Consumers are switching to private labels, or generics, at grocery stores – a phenomenon we have not witnessed since the 1991 recession. There are long lines at certain gas stations, not because of shortages as in the 1970s, but because one station may have slightly lower prices per gallon. Gas guzzling SUV's and light trucks, which accounted for half of all passenger vehicle sales recently, have been staying on lots. In their place, the less thirsty Prius and Smart cars have multi-year long waiting lists. While Honda and Toyota had been exporting cars to the United States since the 1950s, they came to prominence in the 1970s. This year, Toyota will sell more cars than GM, and Honda is not far behind. Unfortunately, we do not think domestic auto manufacturers' declining sales will reverse until they start offering more fuel efficient vehicles.

This decade has also been one of geopolitical tensions. We are surprised at, and did not anticipate, the similarities between the seventies and the current decade in this respect. The concept of a return to "Cold War" status is becoming ever more vociferous as various blocs strategically position themselves. While Russia has risen in stature over the last few years as a result of its natural resource-driven wealth, as with the end of the original Cold War, we are skeptical at the long-term sustainability of its growing prominence.

Additionally, as we experienced in the seventies, rising inflation rates typically translate into poor equity returns. It is therefore no great surprise that returns so far this decade have been mediocre. Unless the economic, inflationary and geopolitical environments change drastically, which we doubt despite an upcoming change in the U.S. administration, we will fittingly label this a "lost decade" for the broad market. So far, it has not paid to invest in the broad market. It has paid, however, to be invested in active management with an emphasis towards protecting capital.

Mohamed El-Erian of Pimco recently stated at a Morningstar conference, and I paraphrase, that when he worked at Harvard, his team categorized investment managers as guilty of one of two mistakes. The first mistake is that of leaving something on the table and the second mistake is that of losing capital. At SKBA, our mistake is more often that of leaving something on the table. We have always been comfortable leaving something on the table (for the greater fool) and we will continue to do so. We are not, however, comfortable with the second mistake – squeezing the last basis point out of stock returns, thereby increasing the risk of losing capital. During this decade, the latter mistake has been responsible for many of the headline "blow-ups," whether in traditional equities, structured products or alternatives. There are few better examples than the recent past to demonstrate that risk-taking has hindered performance over this period.

Another way to look at El-Erian's statement is to examine volatility and one's ability to navigate through it. At SKBA, we welcome volatility. Volatility, when appropriately evaluated, provides attractive opportunity sets. Volatility does not equal risk. Volatility provides the ability to leave something on the table which in itself enables us to avoid losing capital. Expounding on El-Erian's message, volatility renders us guilty of the first mistake, which is precisely what makes us avoid the second. As a result, what has so far been a "Lost Decade" for the markets has in contrast been a very respectable decade for our strategies.

Back to comparing both periods. What conclusions can we, as investors, make? First, investor expectations remain somewhat elevated. In fact, due to certain actuarial and funding shortfalls, many plans believe that they need to increase risk in order to increase returns. Given the current environment, this is precisely the wrong tact. Low-risk strategies are likely to continue to outperform in this environment. This is not to say that equity markets will not experience bursts of strong returns. Between 2003 and 2007, equity markets provided lofty returns – they were nevertheless insufficient to overcome this decade's shortfalls since and prior.

Second, because our outlook is longer than the typical investor's, the current environment also holds hope. While the seventies were horrendous for equity returns, public companies able to manage through the period had the unintended consequence of having very undervalued securities. As a consequence, the early eighties ushered in one of the best periods from which to increase equity exposure. In short, the 1980s were one of the greatest periods in which to invest. We do not expect great returns for markets as a whole over the next few years. High investor expectations, geopolitical tensions, the likely rise in income tax rates, slowing growth in many parts of the world and rising inflation pressures combine to present a treacherous landscape. It is this landscape, however, that should usher in tremendous investing opportunities as we look out to the next decade.