Morgan Stanley

Philip W. McCauley III, CFA®
The Madison Group
Managing Director, Wealth Management
Senior Portfolio Management Director
Financial Advisor

Wealth Management
4969 US Highway 42
Suite 1200
Louisville, KY 40222

direct 502 394 4034
fax 502 434 6467
toll free 800 626 1592

NMLS # 1255533
philip.mccauley@morganstanley.com

This letter is dated October 2008

When others are Fearful

In turbulent markets it is natural to get caught up in the moment. The long term seems to pale in importance next to the glaring threats of the day. Today's steady drumbeat of negative news has made it especially difficult to maintain an objective view of the current investment environment. The purpose of this letter is to help investors gain perspective on the current financial crisis and make more fully informed investment decisions.

To start, we must keep in mind that the media generally gets paid to draw audiences. Larger audiences lure more advertisers at higher rates driving more revenue. Dramatic stories attract more attention than dull ones and frightening events lure more viewers than inspiring ones. The reasons for this, best explained by psychologists, are beyond the scope of this letter. I share the observation simply to remind investors that the media generally has a profit incentive to focus on whatever seems most sensational on any given day rather than providing a full and balanced view. This may explain why, in my experience, investors that spend a lot of time watching financial news have more difficulty sticking with a disciplined investment strategy. Investment education tends to strengthen resolve while watching financial news tends to chip away at it.

Indeed, some recent positive developments are getting less attention than they may deserve. Over the past few months commodity prices, including the price of oil, have fallen significantly.[1] During the same period the U.S. dollar stabilized against most major currencies.[2] Not long ago the financial media was filled with frightening projections of ever higher oil prices and a collapse in the value in the dollar. Detailed forecasts of the potential economic fallout were frequently featured. The recent 50% plus decline in oil prices and strengthening of the U.S. dollar have not been given nearly the same level of attention. The focus instead has shifted to financial market volatility and the credit crisis. While effective at attracting a large viewing audience, these features do not necessarily tell the full story. A single plane crash draws more viewers than reports of a thousand safe landings. This is the nature of media and I think investors are well served to keep that in mind as they tune in.

It appears that leveraged speculation is again at the root of another crisis. Loose lenders provided easy money to eager speculators who bid up prices of real estate and related securities as well as commodities and emerging market stocks.3 The borrowing and buying fueled a self-reinforcing boom that, not surprisingly, ended in a bust. This, of course, is not the first boom/bust cycle nor will it be the last. To be sure, debt problems and falling home prices have received plenty of media coverage. For a more complete perspective, however, it is important to note that a majority of investors and businesses did not get caught up in the leveraged speculation. Many investors and companies are in a strong financial position. In fact, today investors and corporations hold more cash than at any time in history.[4] In other words, investors and American corporations have more money to invest than ever before. This fact may get less attention than it deserves.

Historically, low cash levels have been a danger sign and peak cash levels have been followed by higher stock prices.[5] Over the past 25 years cash balances as a percentage of household investments have ranged from as low as 8% to as high as 20%.[6] The low of 8% occurred in 1999 and coincided with a peak in stock prices. The high of 20% occurred in 2002 just as stock prices hit a bottom. The relationship between cash levels and stock prices is logical given that cash can reflect future buying power. Today cash as a percentage of household investments is at 20%, a level reached only one other time in the last 25 years.[7] Additionally, the amount of money invested in cash represents 27% of the value of the S&P 500 market capitalization—the highest seen in the 25 years of recorded data.[8] The previous peak was 22% when stock prices bottomed in October of 2002. The 25 year average has been 12% and the low of 8% occurred just prior to the stock price crash of October 1987. The percentage came close to 8% again as stock prices pushed near highs in 1998.

In the past, high cash levels have coincided with low stock market valuations. Today is no exception. The price earnings ratio for the S&P 500 is at its lowest level since 1990 when the market was spooked by Iraq's invasion of Kuwait.[9] This reflects an extraordinarily high level of investor pessimism particularly, in light of today's relatively low interest rates. The last time PE ratios were this low 10 year treasury notes paid approximately 8%, about twice current rates.[10] Low stock price valuations reflect widespread negative sentiment about future earnings. This gloomy view may prove correct but it is worth keeping in mind that historically popular sentiment has been wrong at market extremes.[11] The pervasive dread felt in the investment community today may prove to be unjustified much like the widespread euphoria of 1999 that was followed by so much disappointment. The combination of high cash balances and low interest rates on cash may serve as a powerful combination to drive stock prices higher in the not too distant future. The unprecedented amount of cash earning less than 2% will likely not stay in cash forever. When this money is reinvested it will push prices up wherever it goes. While most investors are worried about just when the market will bottom, they may be better served by bargain hunting. Warren Buffett, widely recognized an astute long-term investor, has invested billions of dollars in just the last few weeks.[12] In an Op Ed letter printed in the October 17th edition of the New York Times, Mr. Buffett shared that he is buying stocks in his personal account. In the letter, he explained his rationale:

> A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors. To be sure, investors are right to be wary of highly leveraged entities or businesses in weak competitive positions. But fears regarding the long-term prosperity of the nation's many sound companies make no sense.[13]

Mr. Buffett went on to make the important point that he does not and cannot predict short term stock price moves. The unpredictability of short term price swings is reason enough for investors to keep money that may be needed in the near term in cash. But there may be a more profitable place for long term money. Again, according to Buffett:

> Today people who hold cash equivalents feel comfortable. They shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value……..Equities will almost certainly outperform cash over the next decade, probably by a substantial degree.[14]

Clearly, there are serious financial problems both on Wall Street and Main Street and it is unlikely that they will be resolved quickly. Even so, the current environment of high cash balances, low interest rates, and low stock prices may lead to better days ahead for equity investors. In any event, investors are likely to be better served by focusing on long term opportunities and turning down the volume on those sensational financial news media reports.

Phil McCauley III
October 2008

[1] Thomson Baseline
[2] Thomson Baseline
[3] Thomson Baseline, Wall Street Journal
[4] Thomson Baseline/Thomson Datastream
[5] Thomson Datastream
[6] Thomson Datastream, Money market balances were used to measure cash levels in the referenced historical analysis. The formula utilized to calculate investor cash percent was as follows: money market funds/(money market funds + corporate equities)
[7] Thomson Datastream
[8] sentimenTrader
[9] Thomson Baseline, price earnings ratios based on trailing twelve months earnings
[10] Thomson Baseline
[11] Citi Investment Research
[12] Wall Street Journal
[13] Buffett, Warren New York Times 10-17-08 "Buy American. I am."
[14] Buffett, Warren New York Times 10-17-08 "Buy American. I am."

3961584 10/2024