

Seeking Consensus

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In many situations, seeking a consensus of opinion on a decision is a worthwhile cause. It suggests an accumulation of a group's best judgment. If we have a consensus, we can be confident, since most are in agreement.

For investors, consensus opinion is extremely valuable in a different way. Academic theory proposes that everything that is known about the economy, an industry or specific stocks is immediately and efficiently incorporated into asset prices. In other words, the consensus opinion about the future for the economy, industries and companies is already embedded in today's stock and bond prices. If we can discern the consensus outlook as it relates to certain investment categories, we gain an important edge in formulating investment strategy that differs from the consensus.

As I've noted in prior papers (Risk & Return: 2008 Update, October 2008), over the long term, stock returns are a function of earnings, dividends and valuations. Stock valuations are very much a function of investor consensus on the future. If the future evolves as the consensus expects, valuation is proper and we would expect prices to change only as earnings change. However, we know that valuations move in a broad range over time. Thus, stock prices can vary a lot more than suggested by earnings changes. The all-important valuation factor changes dramatically when the future evolves differently than expected by the consensus. For this reason, when a hot growth company reports quarterly earnings that miss consensus estimates by a penny, its stock price might drop by 10% or more. It is also why Citigroup's CEO can note in March 2009 that the bank made money from operations in January and February, and then its stock price can rise by more than 25% in two days. Obviously, understanding where the consensus is wrong can lead to great opportunity.

Formulating Contrary Opinion

Consensus opinion usually develops after an observable trend is in place for awhile. We know that most forecasts are primarily extrapolations of prevailing trends. Thus, consensus opinions on the future usually fail to factor in change. Therein lies our opportunity. Rigorous analysis and understanding of the direction and probability of change may allow us to create a plausible scenario that differs from consensus. If so, we can profit from an investment strategy that goes contrary to the consensus.

Thus, the important first step is knowing the consensus opinion. This is true for earnings expectations. It is also true for economic outlook, industry-wide expectations, asset category preferences and many more factors. When a strong consensus opinion develops, savvy investors study closely for contrary opportunities.

Current Consensus – the Big Picture

As we search for the current consensus opinions, I am guided by the wise words of the veteran market strategist, John Mendelson at Potomac Research, who says, "Watch what people do, not what they say." John eschews surveys of bullish / bearish opinion and pays attention only to where the money is flowing. Words are cheap and can be misleading. Looking at real transactions like put & call option purchases and mutual fund purchases & redemptions gives a clear view of sentiment. Here are a few "big picture" consensus views and some contrary thoughts for consideration:

1. The U.S. is a Mess!

While this sentiment doesn't have a direct cash flow link, we observe the headlines and talking head rhetoric and we see that investor flows of funds in 2009 seems to support that this consensus exists. Following the 2008 panic, the "Depression Prophets" got center stage treatment from the media, and their message of economic Armageddon dominated the airwaves. The resultant

hysteria had self-fulfilling feedback loops – selling begets selling and layoffs beget layoffs. While the depression didn't arrive, the consensus view is still firmly focused on all the scary stuff that might come to get us tomorrow. The December 28, 2009 *BusinessWeek* cover captures it well: BUY, SELL, PRAY? The consensus view calls for a weak economy, poor consumer spending and high unemployment for years to come – a view known as the “New Normal.”

There is no denying that the U.S. economy is in a deep funk. After years of overleveraging, U.S. consumption had to decline relative to income and savings had to increase. That process is painful. However, a contrarian investment case could be made that the “New Normal” view of prolonged weakness does not properly address the inherent cyclicity of economic behaviors. Even if the prediction of long-term, subpar economic growth is accurate, there will still be investable up and down cycles...like the one that emerged in March 2009 for those not mesmerized by the “New Normal.”

2. Gimme Shelter ... in Bonds!

Record inflows of \$348.9 billion poured into bond mutual funds in the first 11 months of 2009.¹ Behavioral finance has proven that investors feel the pain of loss more acutely than the joy of gain; the painful memories of the fall of 2008 continues to dominate consensus thinking. The consensus pursuit of “low or no risk” has driven the action of investors, who have overwhelmingly bought into fixed income. Record inflows into bond funds and heavily oversubscribed U.S. Treasury auctions tell us that EVERYBODY wants in the bond pool! The attraction? It isn't the yields, which are relatively paltry. Rising interest rates would be a serious problem for bond prices.

Contrarian scenarios that would undo this consensus generally involve inflation. Given the slack capacity utilization in the U.S. and most other economies, the emergence of persistent inflation seems unlikely. However, some observers see significant risk to currency devaluation moves by trapped governments and similar inflationary influences. This area bears close watching.

3. Sell U.S. Stocks / Buy China and Emerging Markets / Buy Commodities

Despite a powerful bull market in U.S. equities since the March 2009 lows, mutual fund investors continue to sell U.S. equity. For the 11 months through November 2009, \$42 billion came out of U.S. equity mutual funds and ETFs combined, while \$42 billion flowed into non-U.S. equity funds and ETFs.² Driven by the consensus “New Normal” outlook for the economy, investors are looking elsewhere for investment opportunity.

The rapid economic growth and open-ended possibilities for emerging economies have been in the spotlight for several years. While they relied on U.S. demand to support their export-oriented economies in the past, the new hope is that these countries can develop their internal economies as a road to the next leg of sustainable growth.

Closely related to the emerging market story is the commodity consensus. As evidenced by the \$28 billion in net inflows into commodity and commodity stock-based ETFs, many folks are piling into this strategy.² Energy bulls often pose the question, “If the Chinese consumed half as much oil per capita as the average American, what would happen to the price of oil?” Similar thoughts about metals, fertilizer, meats and other basic commodities underpin a positive consensus on commodity prices in the future.

This consensus seems to have lots of support. However, those who are selling their U.S. holdings and plunging into emerging markets may be underestimating the impact of cyclicity and the relatively high correlation between these markets. This can be especially troublesome during downturns, when overheated, relatively illiquid emerging markets often drop like a rock. In the recent bear market, the peak to trough declines for stock markets in Brazil, Russia, India and China were materially higher than the S&P 500's 57% decline. Are the investors in these markets fully prepared for this volatility? With the torrent of money chasing these stocks, do they still represent good value?

4. All That Glitters

According to GFMS, a leading precious metals consultancy, global investment demand for gold doubled to 1,820 tonnes during 2009. The consensus view embraces gold not only as a store of value, but also a safe haven with upside. We are bombarded with full-page newspaper ads selling gold and TV advertisements offering to buy our old gold jewelry. Gold certainly has regained its luster in the eye of the investor.

Gold prices have a significant “notional” component: most gold is not consumed, so the price is not based on cost of production or usage. Demand for gold can vary significantly from year to year based on fickle investor attitudes. Therefore, the pricing of gold defies fundamental analysis; its value is unrelated to function.

The lack of a fundamental case for gold has never stopped people from buying. You didn't hear much about gold when it was slouching along around \$250 per ounce back in 1999. The price had fallen by 65% from its peak two decades earlier. Fast forward ten

years to 2009 and the price breaks through \$1000 per ounce, up 400% in 10 years. Now gold has the spotlight. Where will gold ultimately peak in price? Impossible to say. However, it is far from unloved and undiscovered. When was the last time that you saw newspaper and TV advertisements offering to buy and melt down Grandma's old locket? Back in 1980 when gold spiked to \$800 per ounce, a high that was not seen again for three decades. The signs of "frothiness" abound.

5. 'Buy and Hold' is Dead

The cover of the November 10, 2008 *BusinessWeek* asked the question, "Are Stocks Really Best for the Long Run?" The magazine was taking a shot at Wharton professor Jeremy Siegel's book, *Stocks for the Long Run*, which was extremely popular during the height of the 1990s bull market run. Near the bottom of the market in 2008, *BusinessWeek* wrote, "Many American investors feel they've been played for fools." Following the worst decade on record for equities, it is not surprising that the consensus has eschewed stocks as the centerpiece of their investment strategy. We hear repeatedly that "long only" equity exposure is too risky; we can only find comfort in long-short hedged portfolios. Last summer, I nearly choked on my coffee while listening to the presentation of a new strategy by a major investment consulting firm – they called it "De-risking the portfolio." Their idea was that after the stock market goes up, you would reduce your equity exposure, then after the market goes back down, you increase the equity exposure. This strategy has also been called "Buy low, sell high" or "Market timing"...and it sounded just as good in theory last summer as it has throughout time. Unfortunately, market timing remains just as impossible to implement. But if everyone from mutual fund investors to *BusinessWeek* to prominent, ivy-covered investment consulting firms doesn't like the idea of holding equities, we have a consensus! While we see countless magazine covers and headlines highlighting that 2000-2009 was the "Lost Decade" for equities, I don't see many asking the question, "When would you prefer to invest in equities – after the best decade for returns or after the worst?" I'll take the latter!

Conclusion

From among these well established consensus views, there will be some significant surprises in the future. While operating with the consensus is comfortable, staying with the crowd ultimately brings investors to despair. Departing from the mainstream opinion and adopting an informed, contrarian view are important parts of the value investing formula. Unfortunately, it is a lot easier to identify consensus views (by looking at cash flows) than it is to identify how the consensus will be wrong in the future. However, it is important to know when your investment positioning is with the consensus and when it is not. If too much of your portfolio reflects consensus thinking, warning alarms should ring!

Contrarian Checklist

What prevailing conditions would be expected to exist prior to the start of a long-term secular bull market similar to the ones we saw in the 1949-1968 and 1982-1999 periods? Here are some elements that a contrarian would look for before such a journey was launched.

- A very deep economic downturn (2008-2009 Recession)
- Seemingly overwhelming structural problems in the economy
- Low levels of consumer confidence & business confidence, political turmoil
- A long period of poor market returns
- Low levels of investor confidence and net outflows from the market
- Low valuations for equities (Yes, at the market bottom, but not at present)

The one thing you won't see in the press is that the difficult conditions we now face are exactly what you would expect to have prior to the beginning of a secular bull market. However, the contrarian's checklist would suggest that many of these conditions exist. Most observers cite the last secular bull market as starting in 1982. However, the definitive low during the preceding secular bear market was in 1974. The S&P 500 provided annualized returns of 15.26%³ from the 1974 bottom to the end of 1981, assuming reinvestment of dividends, before the market broke out to the next 17-year secular bull. Following the 2009 bottom, are we now in a circumstance similar to that which followed the 1974 bottom?

“The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not an infant, but a giant.”
- Arthur Cecil Pigou (1877-1959)

¹Mutual fund flow data from Investment Company Institute

²Commodities: A Solution in Search of a Strategy, Goldman Sachs – Sharmin Mossavar-Rahmani, Chief Investment Officer, Private Wealth Management, January 2010 p.4

³Source: Bloomberg

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