O'Shaughnessy
ASSET MANAGEMENT

What Numbers Can Tell Us About Where the Market Is Going

MARKET COMMENTARY BY JIM O'SHAUGHNESSY: JUNE 24, 2009

Anatomy of the Market Recovery

The market has rebounded with impressive force since our last commentary in mid-March. In the last 85 years, there have only been a handful of times that the market has gained more than 35% in just 68 days, and in each instance the market was recovering from landmark bottoms—those in 1933, 1938, 1975 and 1982.[1] The S&P 500's recent 35% bounce has been very impressive indeed. However, like the man who has his head in an oven and his feet in a bucket of ice but insists that on average he is fine, the market's average return does not tell the full story. There have been huge spreads between the best and worst performing stocks since March 9th: the best 20% of our All Stocks Universe is up 134% while the worst 20% of those stocks are up just 5.7%.

The rebound has been largely driven by companies which the market had priced for extinction. Companies like Citigroup (up 212%), Bank of America (up 243%), Las Vegas Sands (up 486%) and a host of others were down more than 85% through early March as investors had serious doubts about the viability of these companies. Now that the market has realized that we are not heading for another Great Depression, these stocks have been re-priced quickly and sharply. Before the rally, these were the stocks with the worst trailing momentum and extremely depressed valuation levels.

At OSAM, we are committed to the disciplined implementation of time-tested strategies. These strategies rely heavily on value (cheap prices) and momentum (strong recent price movement). History shows that these metrics are the best ways to identify those stocks that are most likely to outperform the market in the future. Our emphasis on these key characteristics allows us to profit from the behavior of other investors, who routinely misprice stocks.

The key to our success is patience and discipline because over the short-term, our process does not always work. Our research shows several periods since 1950 when value and/or momentum underperform. Indeed, in the last two years, we have experienced prolonged periods where both value and momentum appear to be "broken." The temptation to abandon a strategy always peaks at the worst possible time, because following periods of painful underperformance, value and momentum tend to significantly outperform. A large part of why these strategies work so well is that it takes courage and discipline to hold onto a group of stocks that no one else wants to own, especially in the midst of a tumultuous market.

During the current market recovery, value has done extremely well while momentum has done very poorly—curiously for the same reason. This rally has been led by those stocks most beaten down during the crash, which left them with weak momentum but strong price-to-sales and other measures of value. Several of our strategies place a particular emphasis on either value or momentum, and the performance of those strategies in the recovery tells the story well.

Value oriented strategies have outperformed by wide margins, and momentum (growth) oriented strategies have suffered extreme underperformance.

(Performance for the period 3/9/2009–6/16/2009) **Strategies that Emphasize Value**	Strategy Total Return	Benchmark* Total Return	Excess Return
Enhanced Dividend	60.3%	44.4%	15.9%
Small Cap Value 50	70.2%	49.9%	20.3%
Market Leaders Value	75.1%	41.4%	33.7%
Strategies that Emphasize Momentum			
Small Cap Growth Taxable	21.6%	49.8%	-28.2%
SMID Growth	20.7%	46.5%	-25.8%
Market Leaders Growth	21.6%	35.4%	-13.8%

The above performance reflects the total return of the holdings of a cross section of portfolios invested in each strategy for the time period specified. No transaction activity has been accounted for in the calculation of the returns. Additionally, the performance information is not a full reflection of the strategy composite (although every portfolio is also a member of its strategy composite). This is done for illustration purposes to provide performance information from the market bottom of March 9, 2009. Composite performance is only calculated on a full month basis, and as such, is not available for intra month periods.

* The benchmarks used are as follows: ED (MSCI ACWI), SCV50 (R2000V), MLV (R1000V), SCGT (R2000G), SMIDG (R2500G), MLG (R1000G).

[1] Based on daily returns of the Dow Jones Industrial Average, 1926–present.

Past performance is no guarantee of future results. Please see important information at the end of this presentation.

Is Momentum Broken?

More often than not in equity investing, the trend is your friend. But since March 9th the opposite has been true: previous losers have outperformed previous winners by a staggering 135% (best 10% minus worst 10% of our All Stocks Universe). In fact, the worse a stock's return was in the six months leading up to the March 9th bottom, the better it has been in the recovery—with a remarkable degree of consistency: the correlation between trailing six-month return and return during the recovery is -0.70.[2] As the table below shows, stocks with strong relative six-month momentum leading up to the March 9th bottom had performed remarkably well given the market crash, but their performance since has been uninspired. Conversely, stocks which had done terribly have more than doubled, on average.

	Decile by Trailing 6-Month Return (As of 3/9/2009)	Average Return	
		10/9/2008–3/9/2009	3/9/2009–6/16/2009
Best Momentum →	1	3.2%	15.7%
	2	-21.2%	21.4%
	3	-29.7%	28.2%
	4	-36.4%	36.5%
	5	-42.2%	39.5%
	6	-47.9%	50.6%
	7	-53.4%	60.8%
	8	-59.5%	62.5%
	9	-66.7%	84.5%
Worst Momentum →	10	-79.5%	145.3%

Historically, there have been several other periods in which low momentum stocks outperformed high momentum stocks. In general, these periods are aligned with recessionary inflection points where stock leadership changes dramatically. These periods are unpredictable, but not unexpected. Importantly, following the worst periods for momentum investing, the strategy has returned to form and beaten the market by an average of roughly 7% annually.[3]

There is nothing in the recent short-term inversion of momentum that indicates this will not be a profitable strategy in the future. As is so often the case in investing, the best time to follow a strategy is usually when it is the hardest to do so. Ben Graham stressed that investors should be greedy when others are fearful. This principle applies to our strategies as well. The best time to invest (or stay invested) in a strategy is when others are fearful that it is broken.

Value Returns to Form

Historically, value has been a great tool for finding out of favor companies trading at deep relative discounts to their sales, earnings or cash flow. As a group, these companies outperform the market in the long run, albeit with occasional periods of underperformance. Value had been out of favor since mid-2007, before rebounding sharply in 2009. The rally since March 9th has been particularly kind to deep value companies. Like the low momentum stocks I just discussed, deep value stocks were those with very bleak outlooks and which were, in many cases, priced for extinction. The top 10% of stocks based on price-to-sales has outperformed the worst 10% by 79% during the rally. We are encouraged by the reversal in value stocks and expect cheap stocks to continue to outperform.

In a time when the market is characterized by uncertainty, one thing which is sure to endure is the fallible nature of human decision making. Both value and momentum have undergone significant inversions since 2007, but because the efficacy of both is rooted in human behavior, we expect them to endure as the best ways to systematically buy stocks.

	Decile by Price-to-Sales (As of 3/9/2009)	Average Return	
		10/9/2008–3/9/2009	3/9/2009–6/16/2009
Best Price-to-Sales →	1	-65.2%	112.0%
	2	-54.6%	70.15
	3	-53.2%	65.6%
	4	-45.7%	55.0%
	5	-46.3%	53.2%
	6	-42.2%	45.6%
	7	-37.9%	38.5%
	8	-35.4%	36.3%
	9	-32.2%	36.5%
Worst Price-to-Sales →	10	-21.9%	32.1%

[2] Spearman correlation based on OSAM's All Stocks Universe.

[3] Based on 10 worst rolling 12-month periods for Decile 1 of 6-month price momentum and the subsequent 12-month return.

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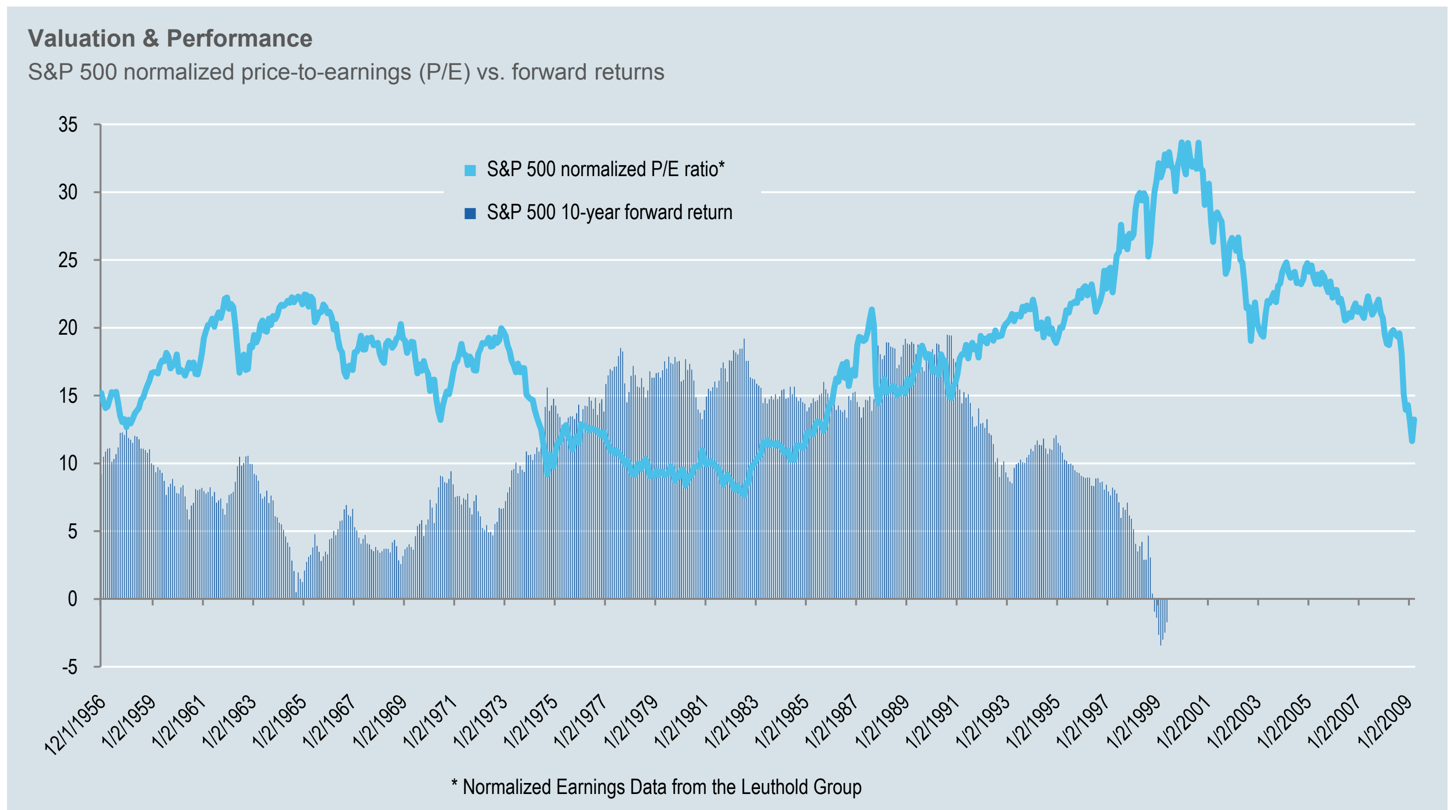
Equities in General Remain Attractive

While many of the once-in-a-lifetime bargains are gone, stocks still look attractively valued. As shown in the chart below, the current normalized price-to-earnings (P/E) of the S&P 500[4] has historically been a very strong predictor of returns in the following decade. Typically when normalized P/Es are low, returns in the next decade are high and when normalized P/Es are high, returns in the next decade are low. In March, the normalized P/E of the S&P 500 dropped to its lowest level since 1982, suggesting a phenomenal buying opportunity. After the rebound, normalized P/E remains significantly below its long-term median. The market will likely remain cheap as earnings recover from the massive losses of 2008. In addition, 15% of the index is still trading below liquidation value.

In a previous commentary we analyzed the 20-year trends in the equity market and noted that we are in the midst of what is shaping up to be one of the worst 20-year periods ever. In March, we noted that to simply match the 20-year rate of return during the Great Depression, stocks need to compound at a real 8% through 2019. Post-rally, that number now stands at roughly 6.5% after inflation. We continue to believe that few other assets classes can possibly match a post-inflation return comparable with this worst-case scenario for stocks for the next decade.

If you were not able to use our March commentary to get clients back into equities, use the current low valuations to at least get them to rebalance their portfolios to target allocations. Rebalancing across and within asset classes is a critical component to a successful portfolio, and many investors have failed to do so since September 2008, leaving their allocations out of whack. Despite the strong bounce back since March, we continue to believe that over the next three, five and ten years, equities will be the best performing asset class and that investors need to take the opportunity the market has given them.

This commentary was co-authored by Patrick O'Shaughnessy, research analyst and member of the OSAM research team.



[4] The Leuthold Group defines normalized earnings as 5 years of earnings, adding trailing 18 quarters and 2 forecasted quarters.

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