

## Bucking the Trend

Any serious stock market investor should be well apprised of hard and fast market rules and incorporate them into their process.

For starters, there is the January effect. Stocks tend to rise in January, after a generally weak December. However, in 2010 the Dow actually fell 3.5% in January, after rising in the 2009 December “Santa Claus rally.” Perhaps we should incorporate the Santa Claus rally factor in the future and ignore the January effect?

January 2010’s decline causes concern for the rest of 2010, because “as goes January, so goes the year.” However, in 2009, the S&P 500 fell a hefty 8.4% in January and then went on to finish the year up more than 26%. Maybe January isn’t such a reliable indicator of annual success?

Perhaps the *most* reliable indicator is the Super Bowl Effect. When a team from the old NFL (before integration of the NFL and AFL in 1967) wins the Super Bowl, the market rises for the year a whopping 75% of the time. Given that the New Orleans Saints have their roots in the old NFL, 2010 is looking good!

OK, so a manager of others’ money would be derelict in actually pretending like the winner of the Super Bowl has anything to do with the stock market. But is there anything we can learn from the dismal 2007-2008 stock market performance?

Of course, some say. The credit crash illustrated the importance of paying

attention to the macroeconomic forecast, and to indicators like market sentiment. In fact, a firm in San Francisco follows market sentiment closely. When it dips below certain levels, indicating souring investor outlooks, they get out of the market altogether and go to cash. When it rises back above specified levels, they get back in. By employing this top-down methodology, this firm saw a far smaller decline than the market in 2008.

But 2008 was a pretty rare year. In fact, it was the worst year for the stock market since 1931. So would this strategy make sense over the long term?

One scenario in which such a strategy fares poorly is in an extended sideways market. During such a market, indices stay within a tight range and sentiment swings from favorable to unfavorable frequently. This happened from 1975-1982, and could happen going forward. We make no predictions of course...

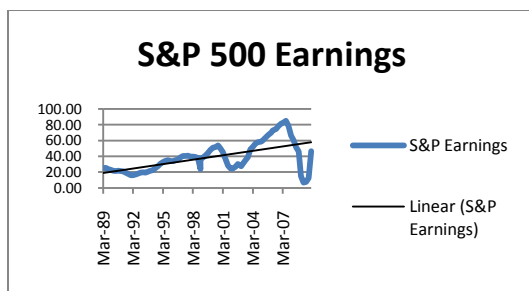
A sideways market is favorable for both value and yield based strategies. While the overall indices may go nowhere for an extended period, action does happen *within* the indices. Undervalued securities rise while overvalued fall. Mean reversion is the only truly reliable trend, and it passes the biggest test that the Super Bowl and January indicators fail: common sense.

If anything, the credit mess reiterates the merits of value investing, and the benefits of eschewing risk.

**Equities**

Stocks closed out 2009 with their best year since 2003, bottoming at bombed-out levels in March and rallying significantly through year-end. Stock prices act as discounting mechanisms, with markets typically anticipating changes in economic conditions many months in advance. Employment, on the other hand, is a lagging indicator, typically rising after the economy has begun slumping and remaining stubbornly high in the early stages of recovery. Of course, this tendency is lost on politicians.

The debate rages as to whether stocks are over, under or fairly valued. Robert Shiller, Yale Economics professor extraordinaire and author of *Irrational Exuberance*, notes that stocks appear pricey relative to average earnings of the last decade. The S&P 500, at 1,100, is at 18 times estimated 2010 earnings and 19 times the historical trend line (see “Linear” below). However, these remain comparable valuation levels to the early recovery in 1991.

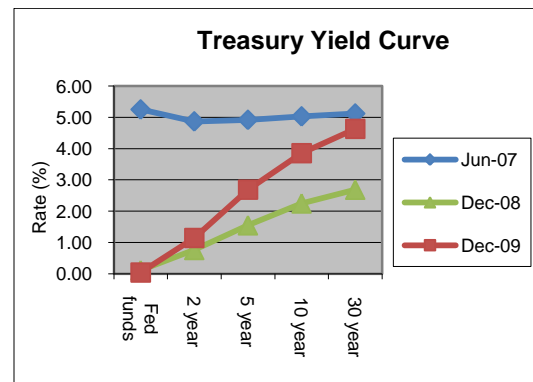


Overall, stock market valuation isn't at March 2000 extreme highs or March 2009 extreme lows. We continue to find a good selection of equities available at

bargain prices. The valuation of our holdings remains well below historical average, and we've continued to raise quality and safety as markets have rebounded.

**Bonds**

As investors re-embraced risk during 2009, they dumped the risk-free. The Treasury “bond bubble” that had formed during the depths of the credit crisis abated during the year. Riskier bonds rallied as market conditions improved. Long-term U.S. Treasuries sold off 8% in the 4<sup>th</sup> quarter, and 20+ year maturities lost 20% during 2009. The overall U.S. bond market returned 5.93% during the year. With the rise in long-term treasury rates, the yield curve became steeper, or more “normal.”



The U.S. 2009 budget deficit came to 12.3% of GDP. Interest on the national debt actually declined in 2009 despite a 2.5 trillion increase in debt, due to lower interest rates. The Federal government has thus yet to see a fiscal impact on the growing national debt. But ultimately the bond market will be less sanguine about our circumstances, and hard choices will have to be made. As risk taking returns to the market and the day of rising Fed Fund rates draws closer, 3.8% 10-year

treasuries are becoming a less savory fare. The cost of the last two year's debt binge will ultimately rise.

CIT sped through a quick prepackaged bankruptcy in the 4<sup>th</sup> quarter, reducing and restructuring debt. We held a position in the unsecured notes, and received secured notes and new common shares post-bankruptcy. The new notes and shares we received are presently worth about 89% of the par amount of the original notes. We think the shares have more upside as they are selling at a steep discount to estimated book value.

### **Stock Briefs**

**Vodafone** is a UK based telecom company with operations on six continents. They own 45% of Verizon Wireless and have seen strong growth via its operations in emerging markets. VOD's dividend yield at our purchase price was in excess of 6%, which provides a income stream while we wait for the stock price to rise from its present discount.

**Mirant** is an independent producer and seller of electricity, with operations in the Mid-Atlantic, Northeast and San Francisco Bay area. Mirant is extremely cheap relative to both replacement value and fundamentals and retains a strong balance sheet after the 2007 sale of their international assets. Earnings are volatile due to required accounting policies, but Mirant hedges their commodity exposure, resulting in stable cash flows.

**Valero** cut their dividend 75% due to the challenging refining environment and

took an impairment on some assets held for sale. We have modestly trimmed our appraisal value. However, the stock remains attractive, and our original entry price allowed for a fair amount of bad news.

While stock splits are not normally worthy of mention, **Berkshire Hathaway's** recent 50 for 1 split of their B-shares, much to Warren Buffett's chagrin, was unusual and merits mention. The split happened entirely so Berkshire could more smoothly complete their acquisition of Burlington Northern, the railroad concern. Prior to the split, Berkshire's shares were priced at 35 times Burlington Northern's (BNI), meaning that BNI shareholders would have received significant fractional shares through the acquisition, which would have been cashed out. The split thus allowed BNI shareholders to retain more shares.

Harper Asset Management, LLC is an investment advisory firm, providing clients with investment management and financial advisory services since 2001. If you are concerned about your assets' capacity to support you, please let us help you evaluate your position.

Brian Harper  
206-632.2354

[bharper@harperasset.com](mailto:bharper@harperasset.com)

Jim Harper  
404-317-1225

[jcharper@harperasset.com](mailto:jcharper@harperasset.com)