

# Active Value Investing: Making Money in This Sideways Market

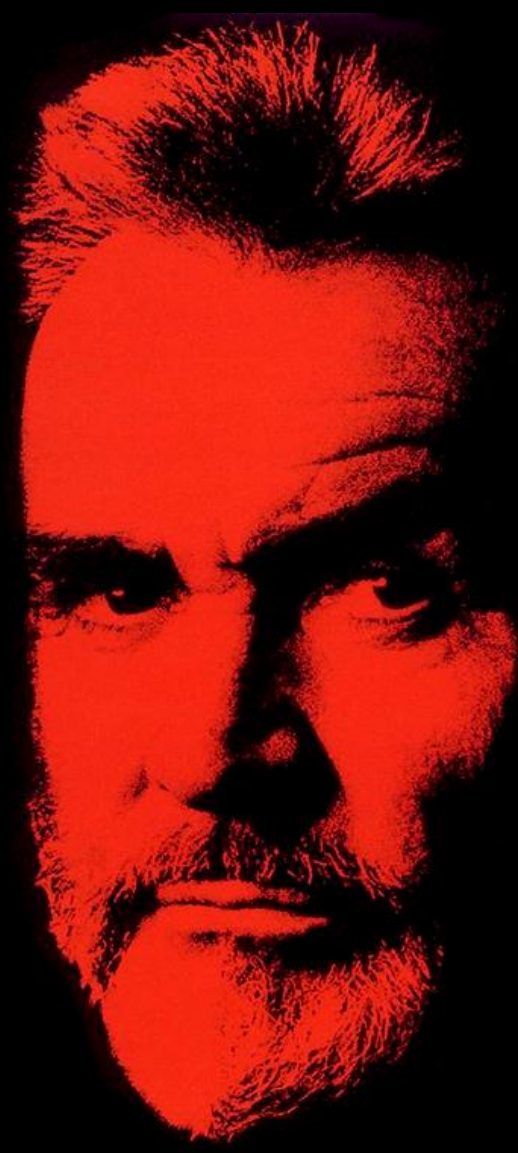
CFA Society of Atlanta  
December 2012



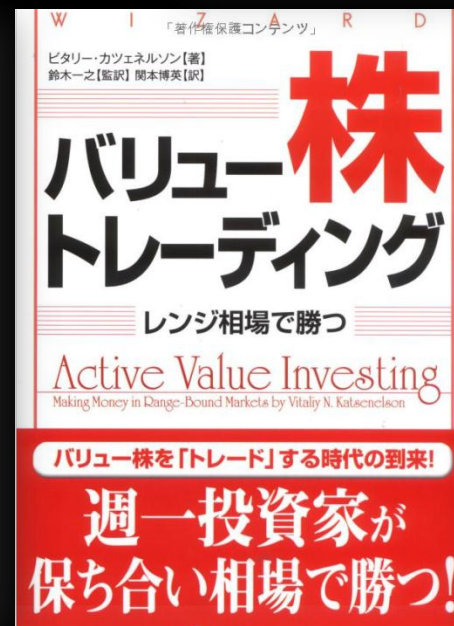
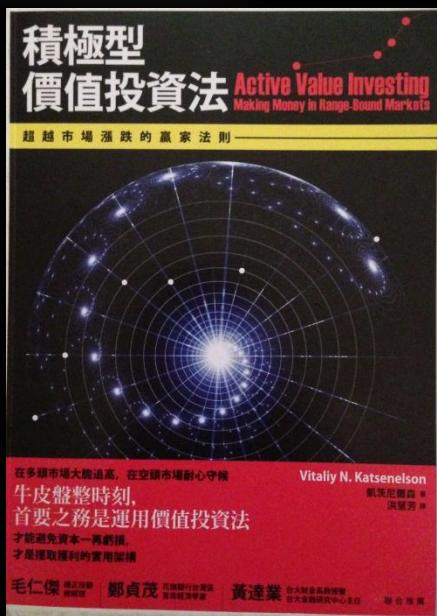
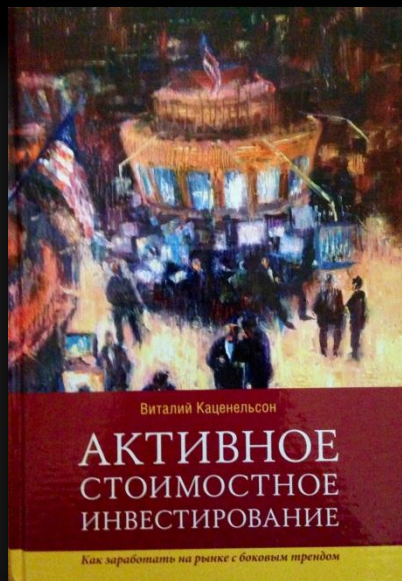
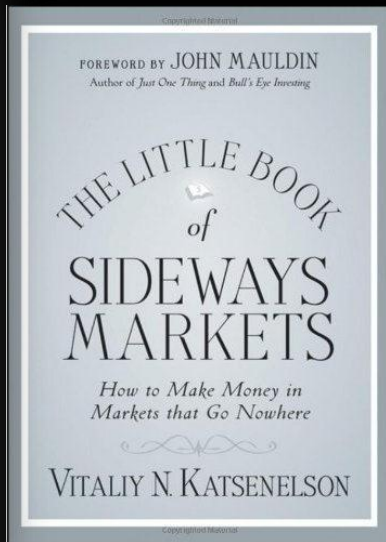
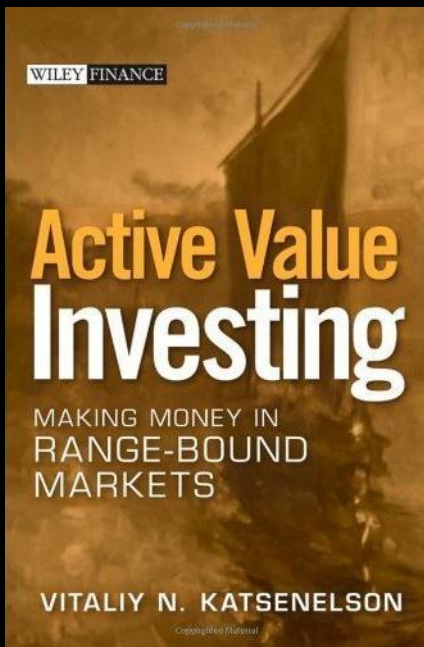
Vitaliy N. Katsenelson, CFA  
Chief Investment Officer

Investment Management Associates, Inc.





**THE  
HUNT  
FOR  
RED  
OCTOBER**



**We are used to thinking about secular (longer than 5 years) markets in binary terms:**

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There is another type of long-term market: *Cowardly Lion* or Sideways

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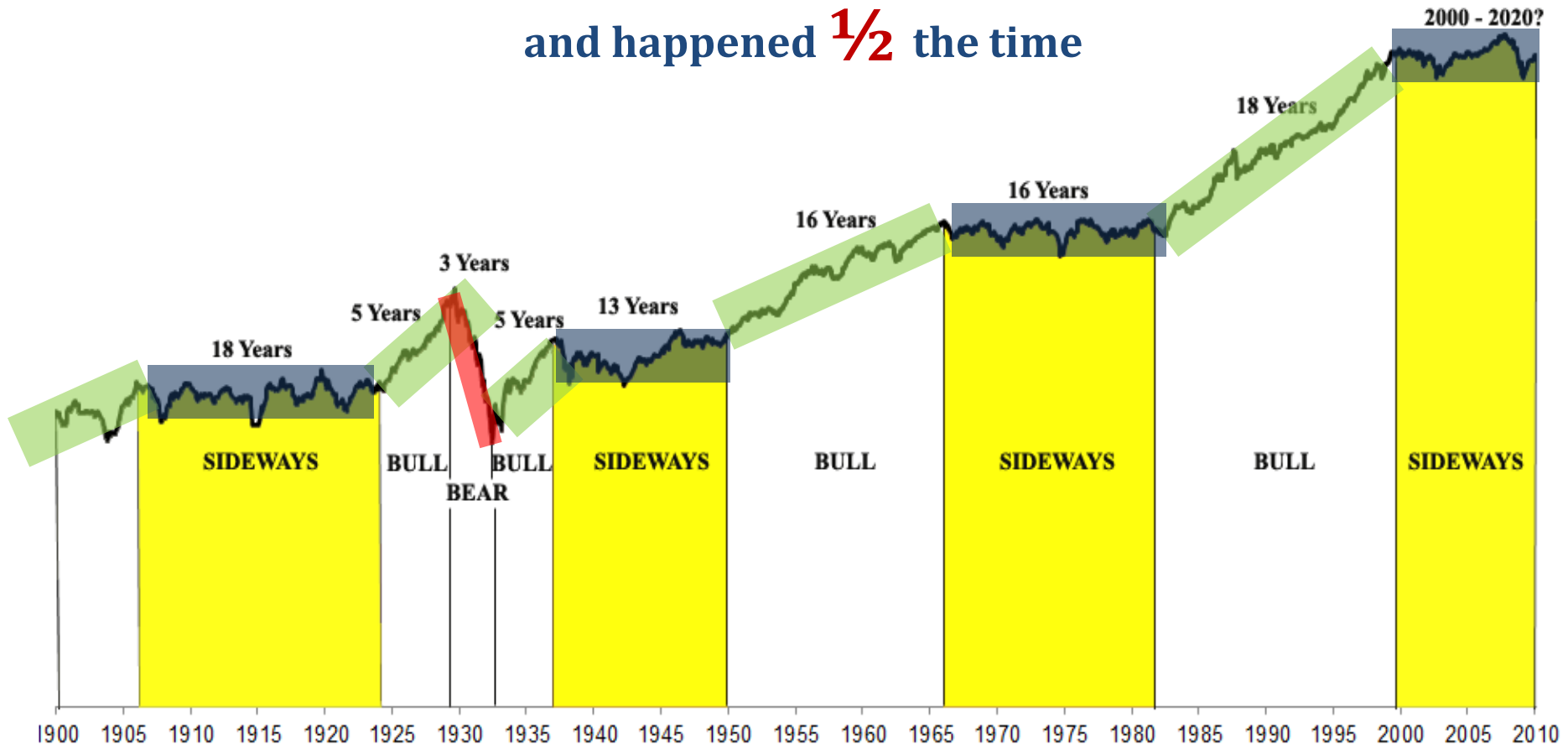


“Bursts of occasional bravery lead to stock appreciation, but are ultimately overrun by fear that leads to a subsequent descent.”

– *Active Value Investing: Making Money in Range-Bound Markets*

# Dow Jones Industrial Average 100+ Years

The “bear” markets were actually sideways markets  
and happened  $\frac{1}{2}$  the time



# Dow Jones Industrial Average 2000 - 2012

So far, recently, markets have gone sideways ... hell of a ride, but still sideways



# Stock Market Math

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**Stock (Market) Return**

**=**

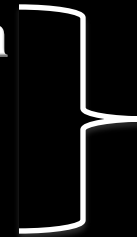
**Earnings Growth**

**+**

**$\Delta P/E$**

**+**

**Dividend Yield**



**$\Delta$  Price**

# Returns One Decade at a Time

Decade	Nominal GDP	Real GDP	S&P 500 EPS	Stock Only Return
1930 - 1940	-1.4%	0.5%	-5.0%	-5.3%
1940 - 1950	11.2%	5.9%	7.7%	2.9%
1950 - 1960	6.3%	3.8%	5.4%	13.6%
1960 - 1970	6.6%	4.5%	5.6%	4.4%
1970 - 1980	9.7%	3.2%	7.9%	1.7%
1980 - 1990	8.3%	3.1%	5.5%	12.5%
1990 - 2000	5.6%	3.0%	7.1%	15.1%
<b>1930 - 2000</b>	<b>6.7%</b>	<b>3.5%</b>	<b>5.2%</b>	<b>6.5%</b>

Several observations:

- Real GDP growth has been very consistent over the years.
- In the short run, no relation between rate of earnings growth and stock returns (as long as earnings growth was positive).

# Returns During Sideways and Bull Markets

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Market	Nominal GDP	Real GDP	S&P 500 EPS	Stock Only Return
Bull Markets	4.8%	3.7%	5.0%	12.6%
Sideways Markets	9.3%	4.0%	7.0%	2.2%

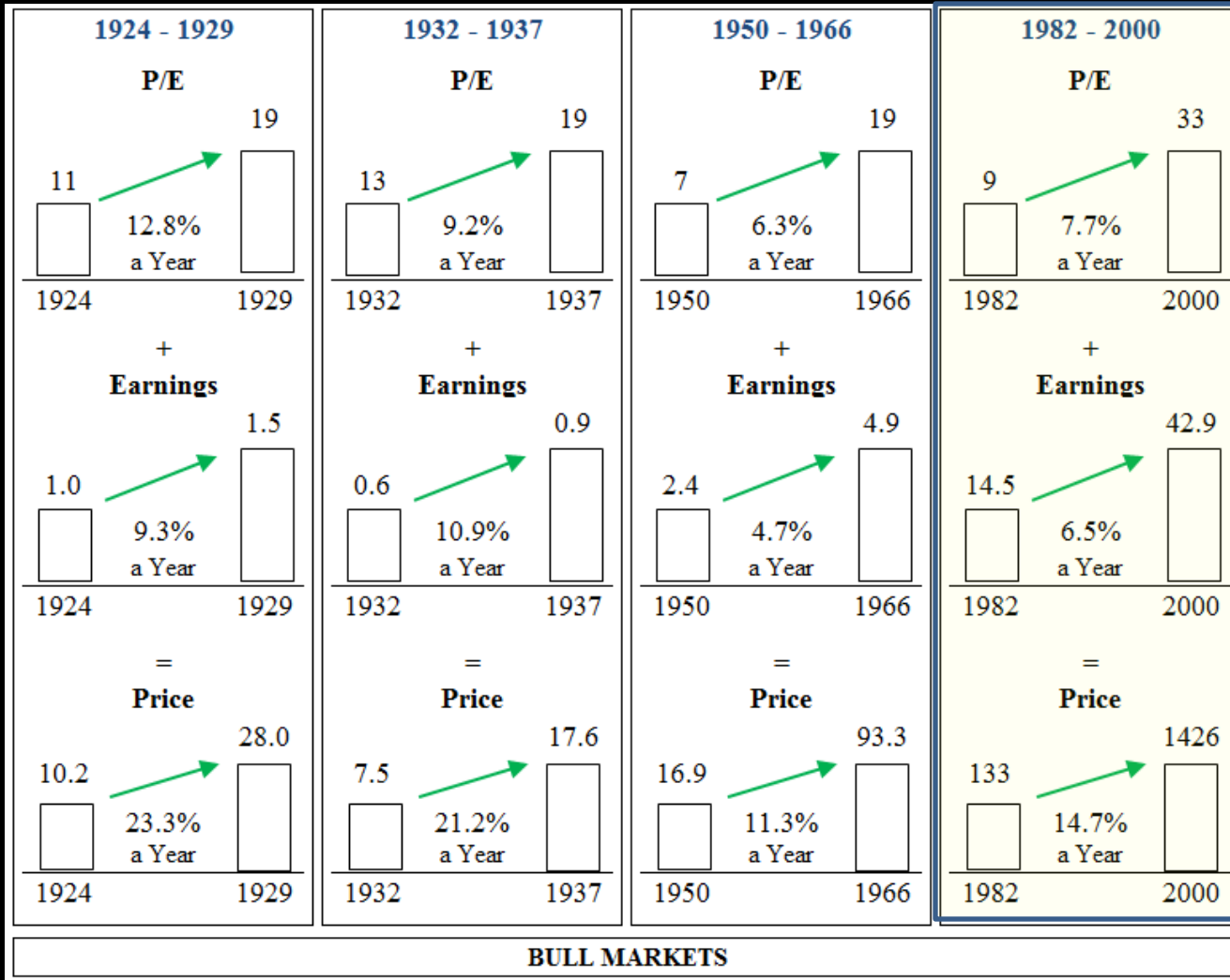
Several observations:

- Real GDP growth was almost identical during both sideways and bull markets.
- Nominal earnings growth and nominal GDP growth were higher during sideways markets . The 1966-1982 market was characterized by a highly inflationary environment.

**Earnings Growth**

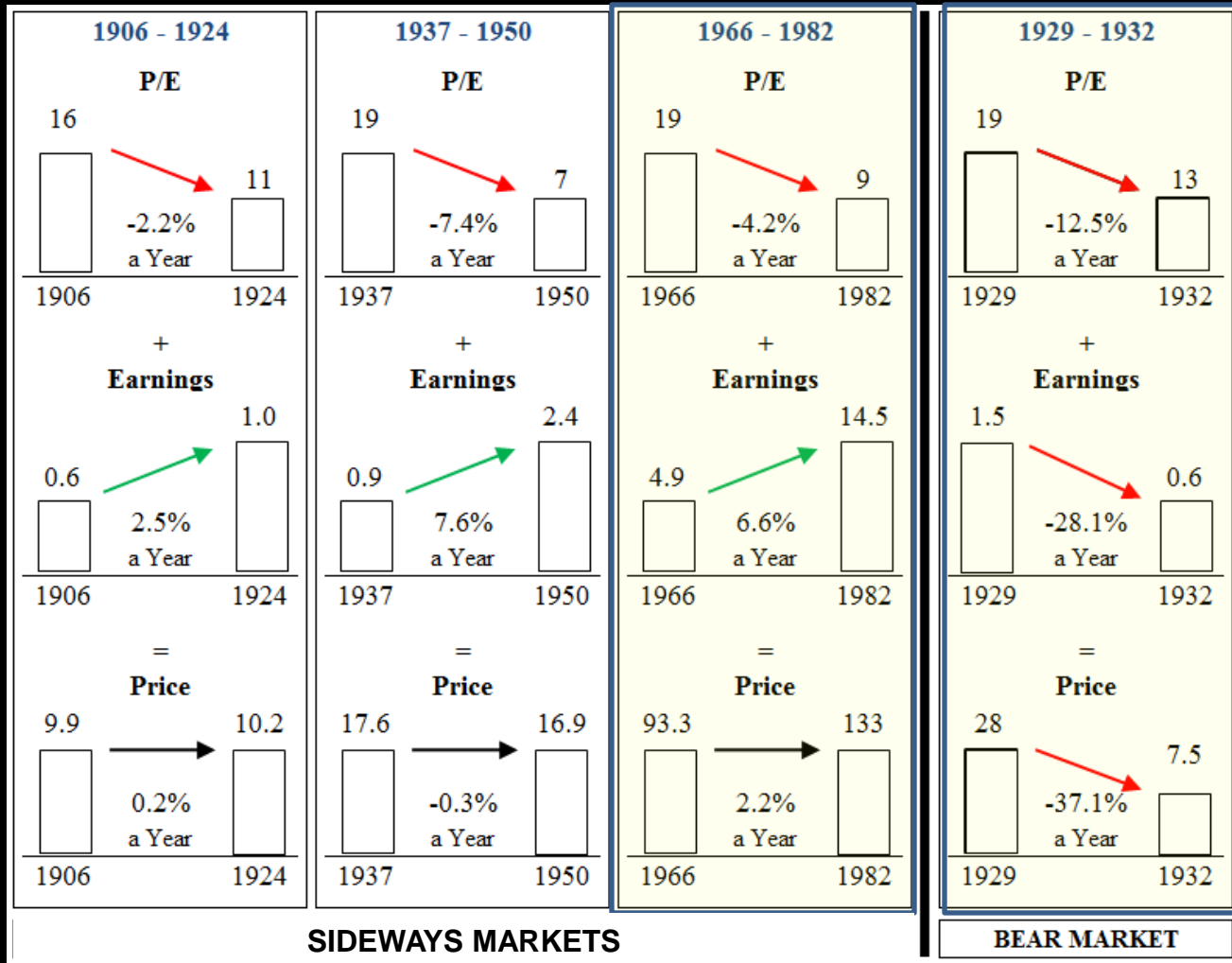
$\Delta P/E$

# Sources of Return: Secular Bull Markets



**Bull Markets: P/E Expansion + Earnings Growth = Super Returns**

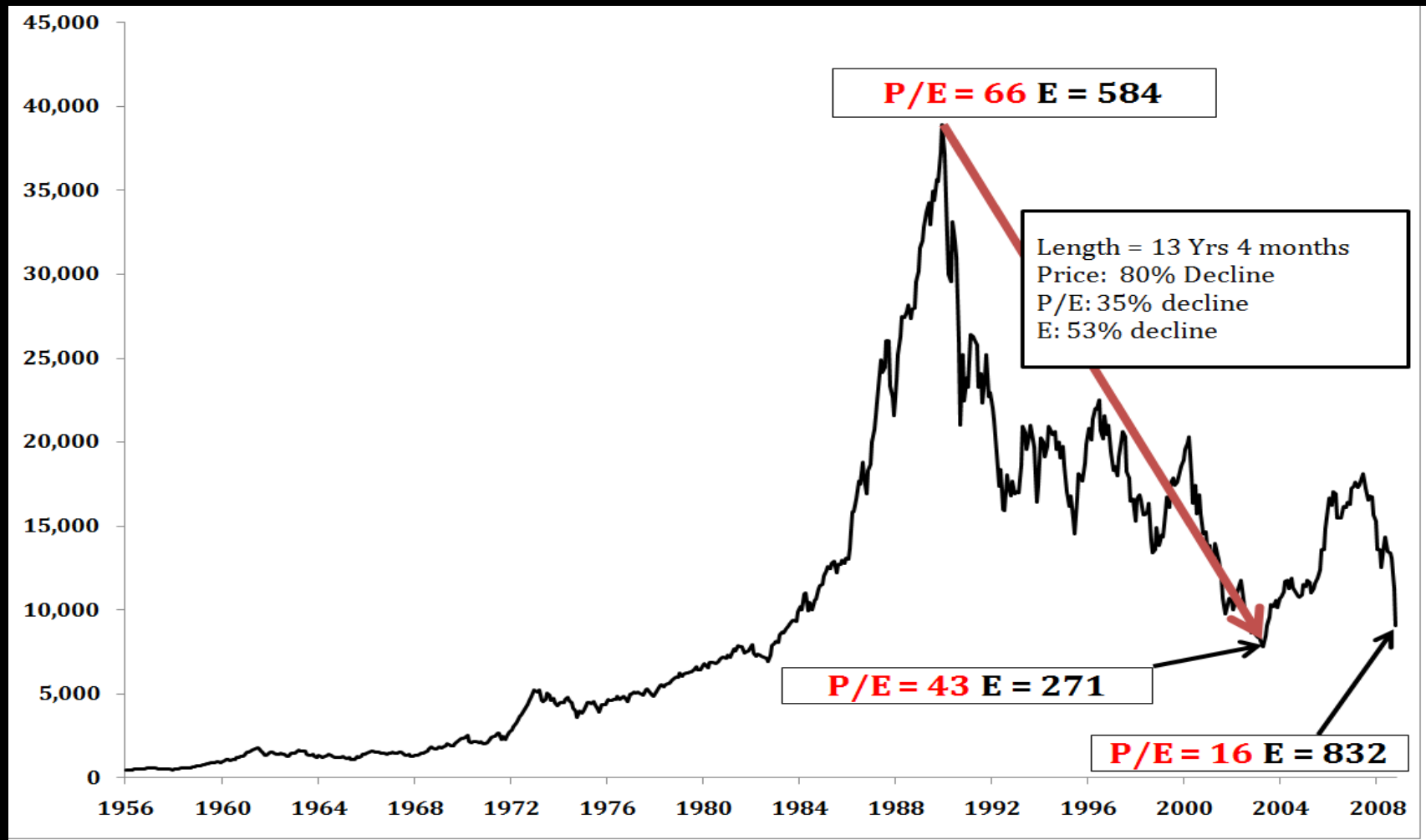
# Sources of Return: Secular Sideways and Bear Markets (S&P 500)



Sideways Markets: P/E **Contraction** + Earnings **Growth** = Low Returns  
 Bear Markets: P/E **Contraction** + Earnings **Decline** = Negative Returns

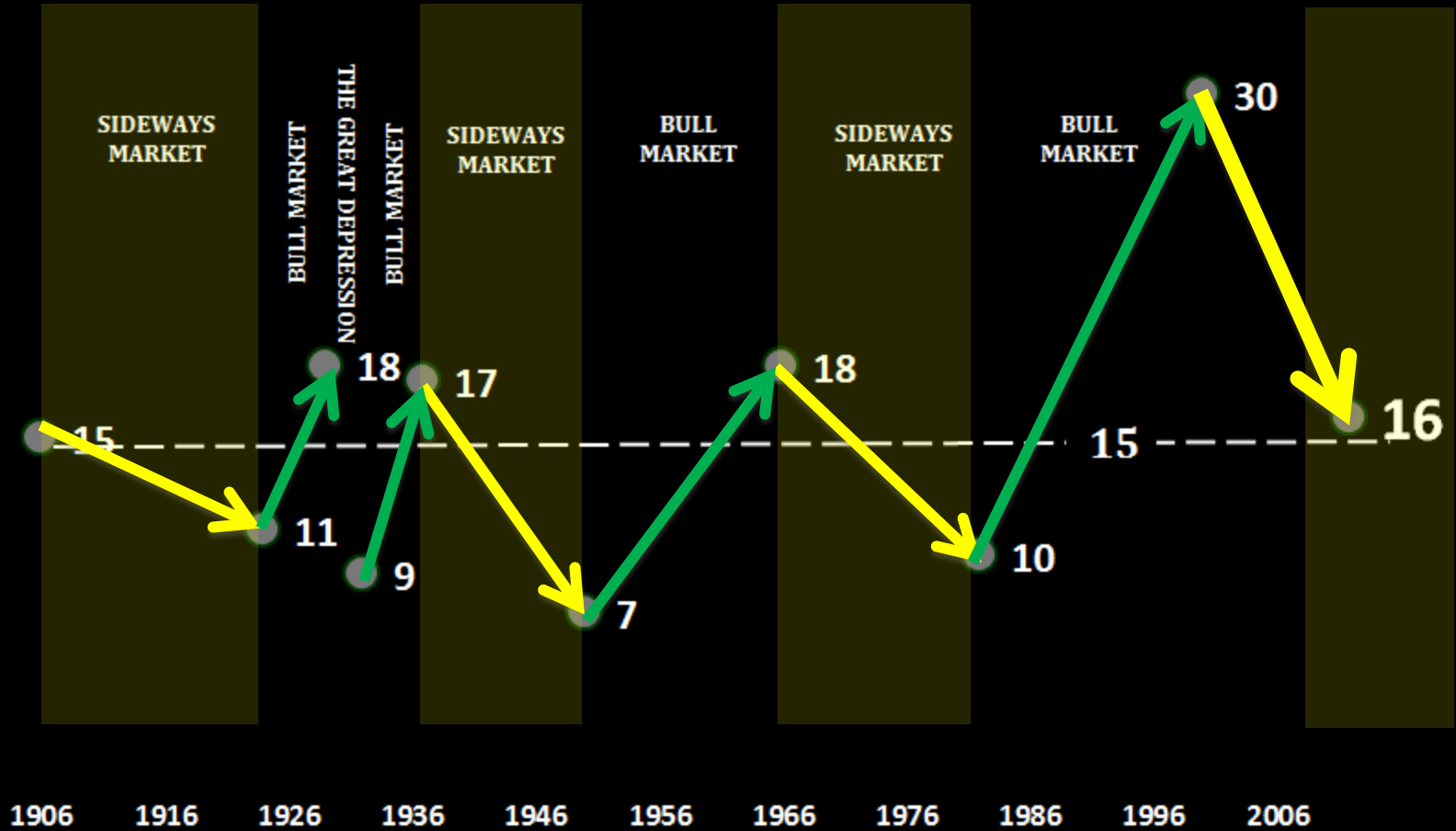
$\Delta P/E$

# “By the Book” Bear Market – Japan

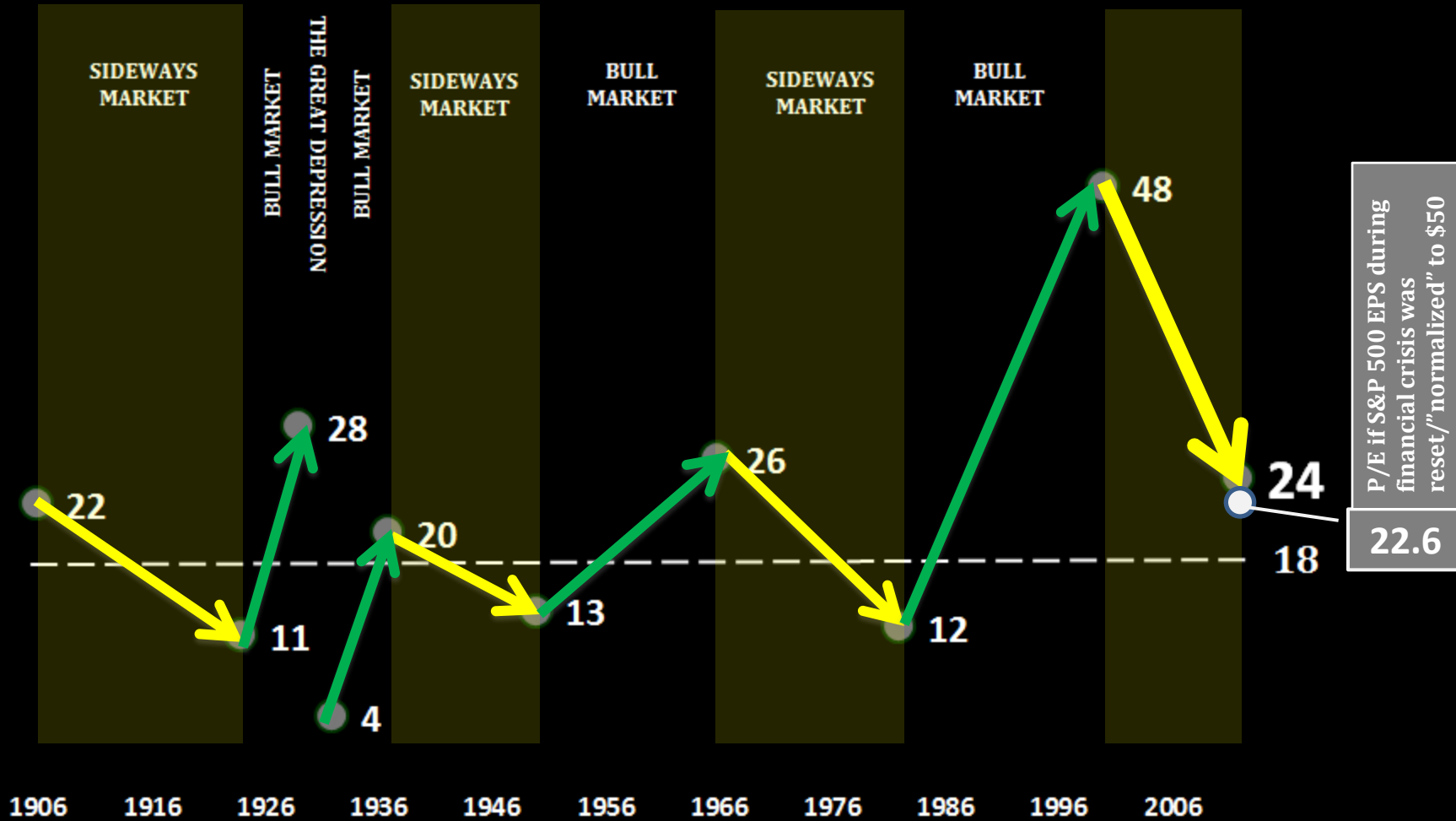


SECULAR BEAR MARKETS REQUIRE: HIGH VALUATION + DECLINING EARNINGS FOR A LONG PERIOD OF TIME

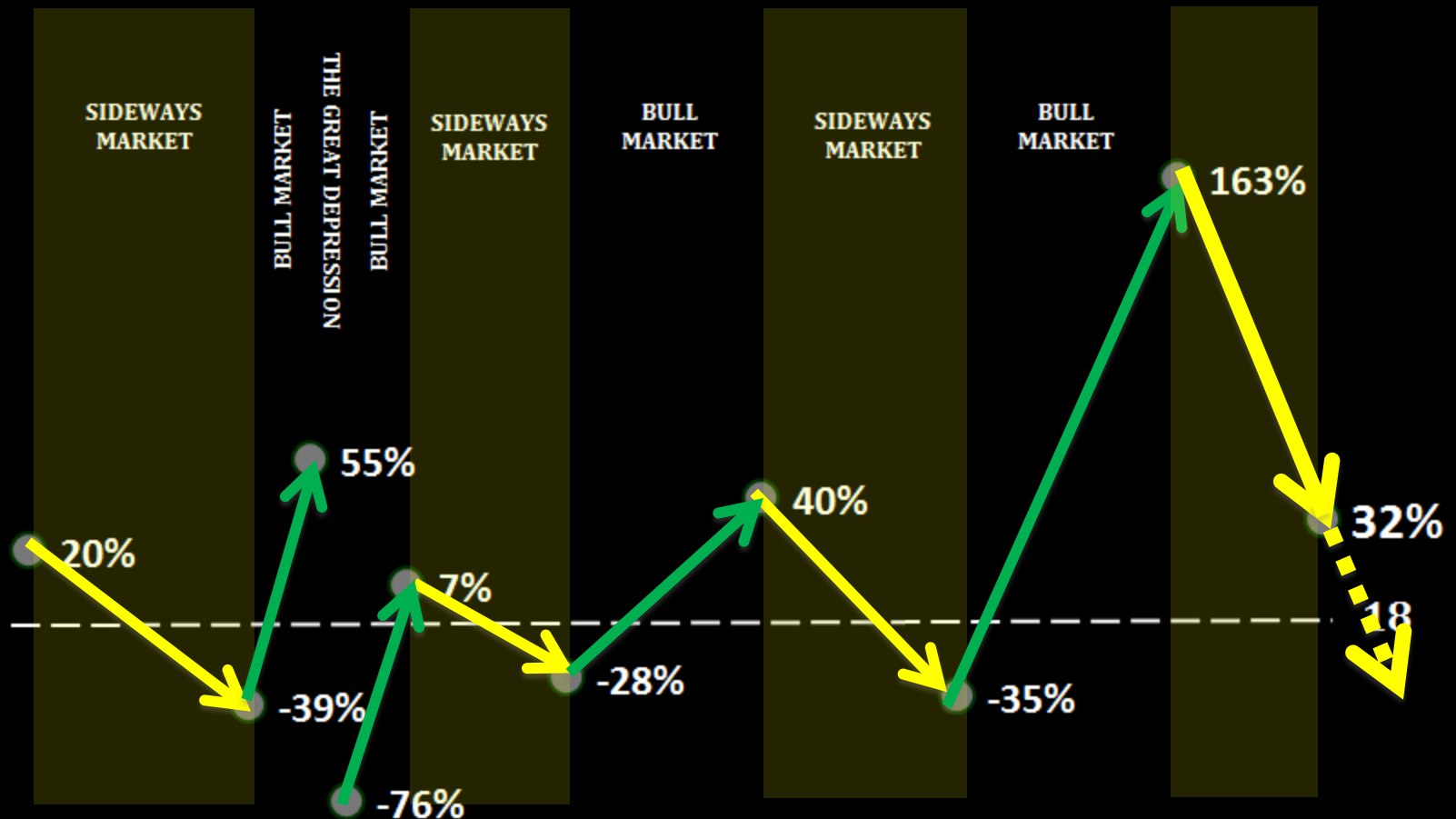
# Mean Reversion Beyond the Mean [1-year P/E, S&P 500]



# Mean Reversion Beyond the Mean [10-year P/E, S&P 500]



# Mean Reversion Beyond the Mean [10-year P/E, S&P 500]



S&P 500 = 1,411  
October 2012

# Let's Look at True Earnings Power

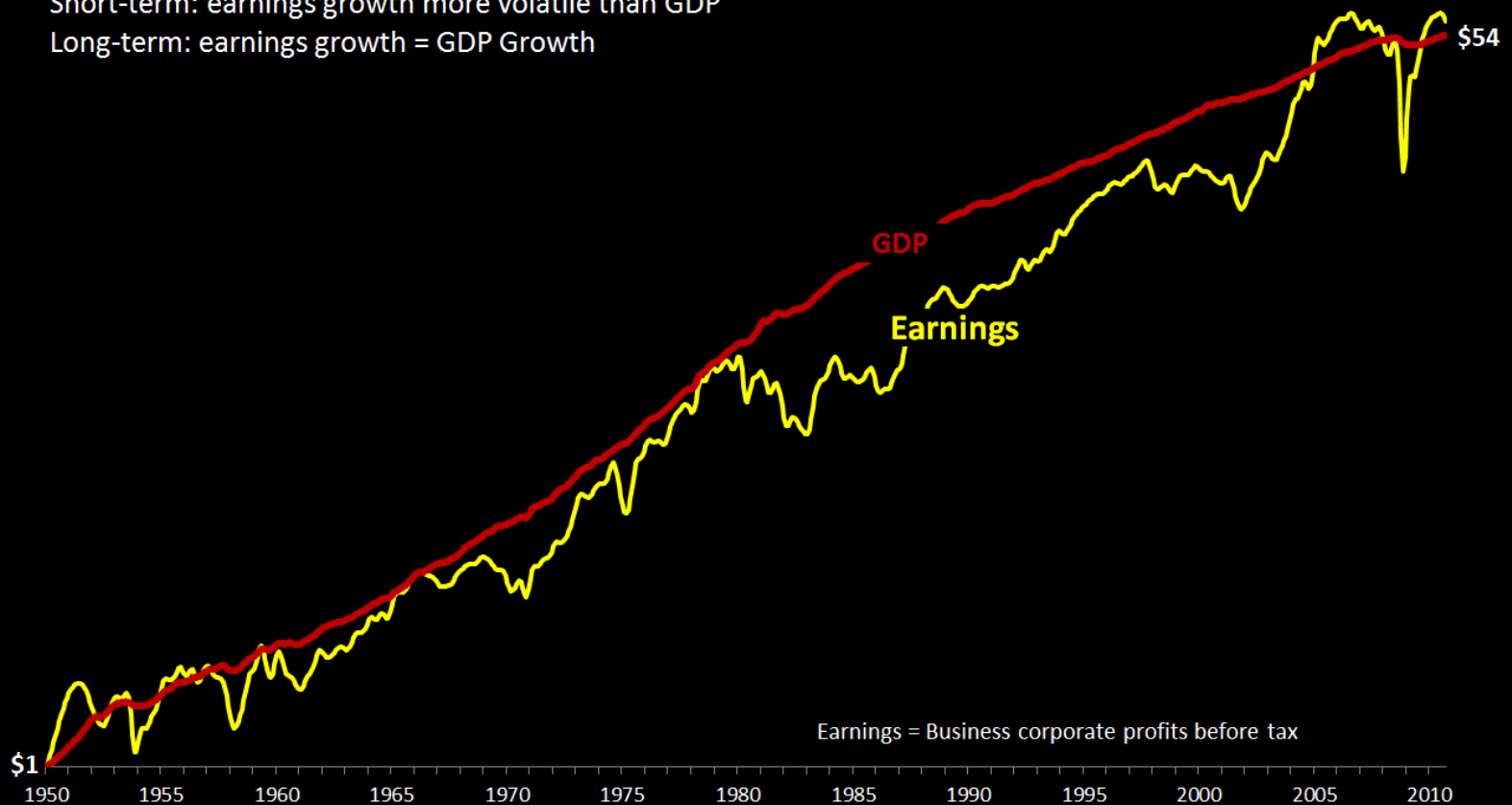
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**Earnings = Sales x Profit Margins**

# Earnings Growth vs. GDP Growth 1950-2012

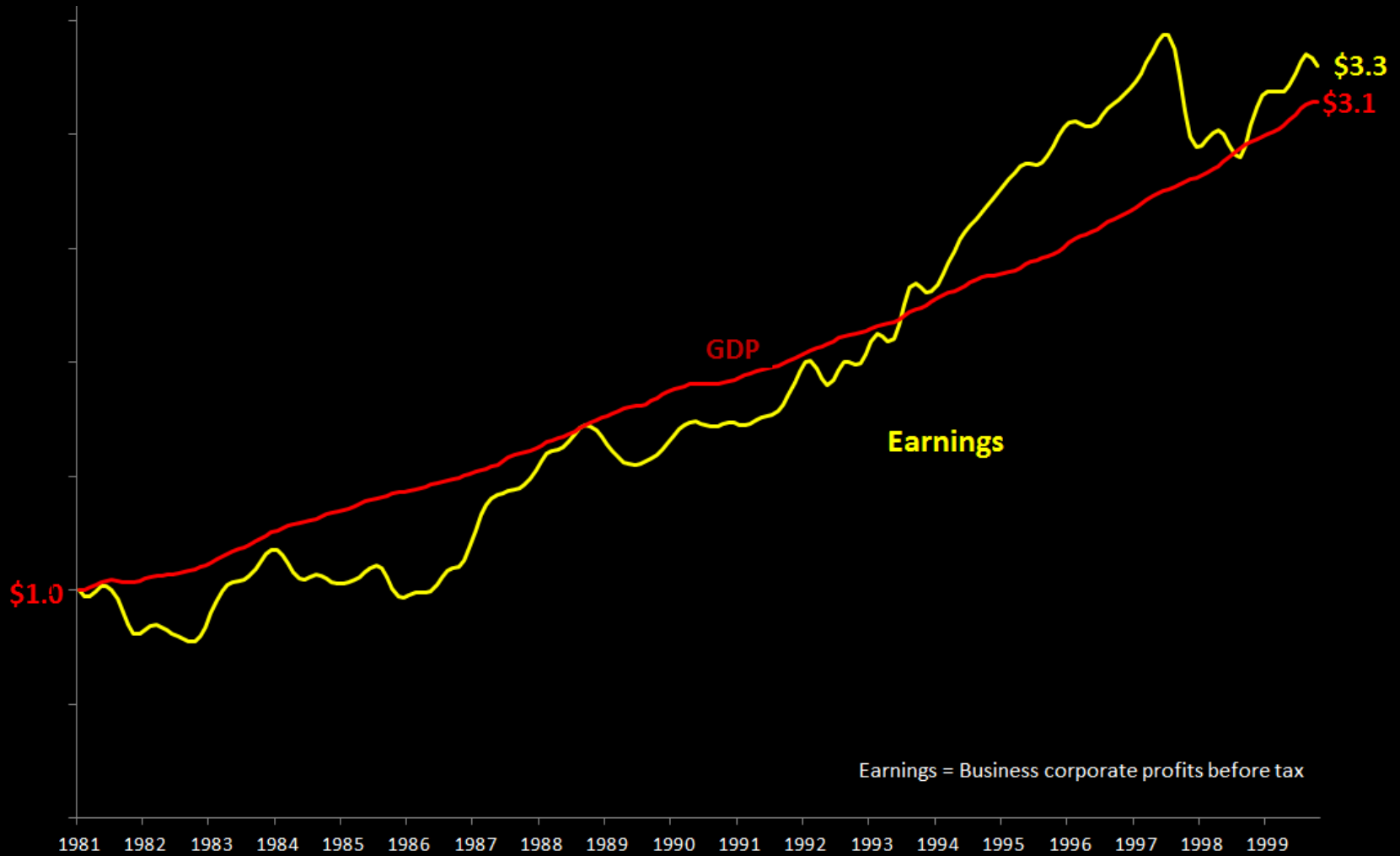
## Earnings Growth Vs. GDP Growth

Short-term: earnings growth more volatile than GDP  
Long-term: earnings growth = GDP Growth

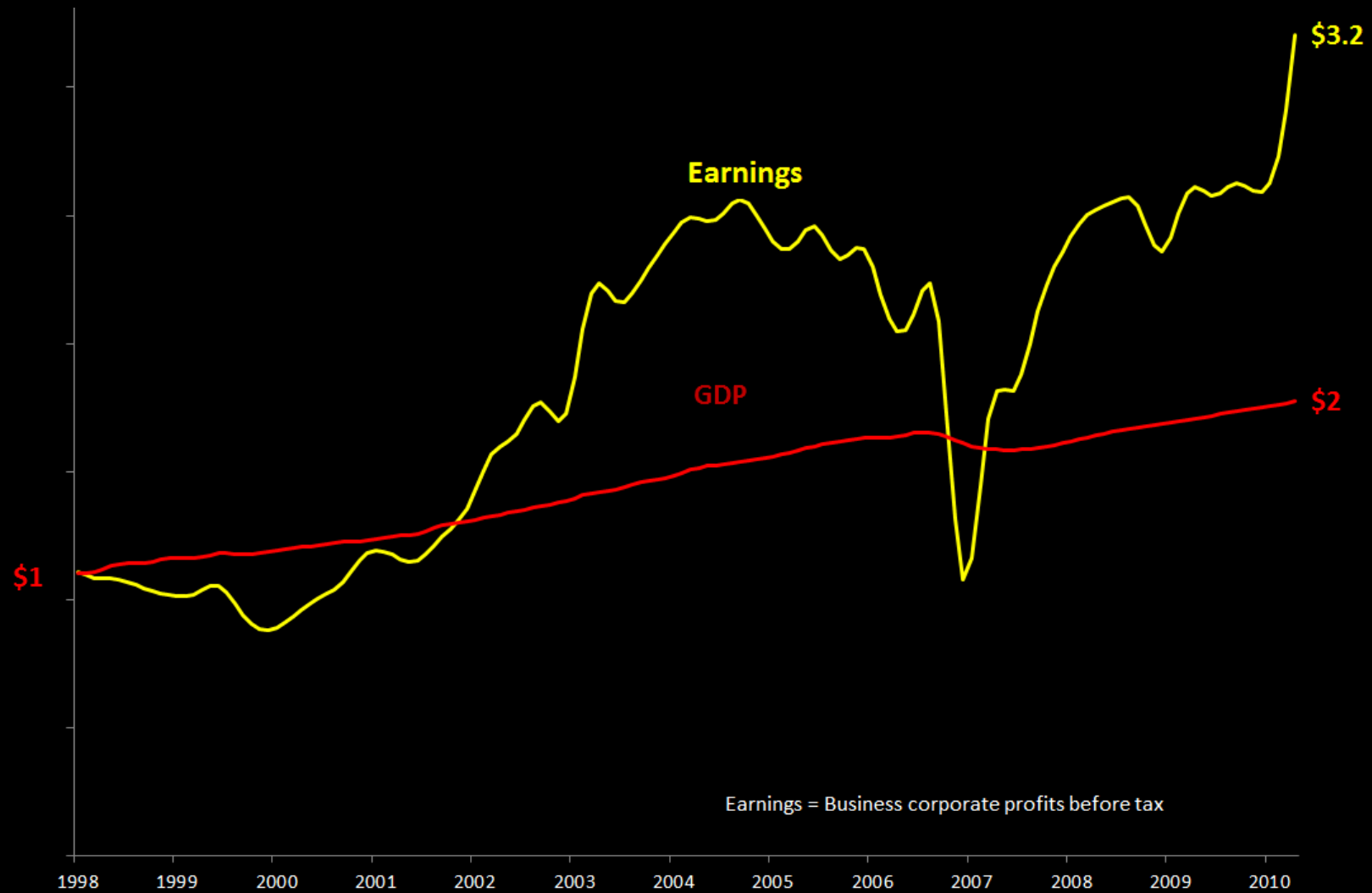


Earnings = Business corporate profits before tax

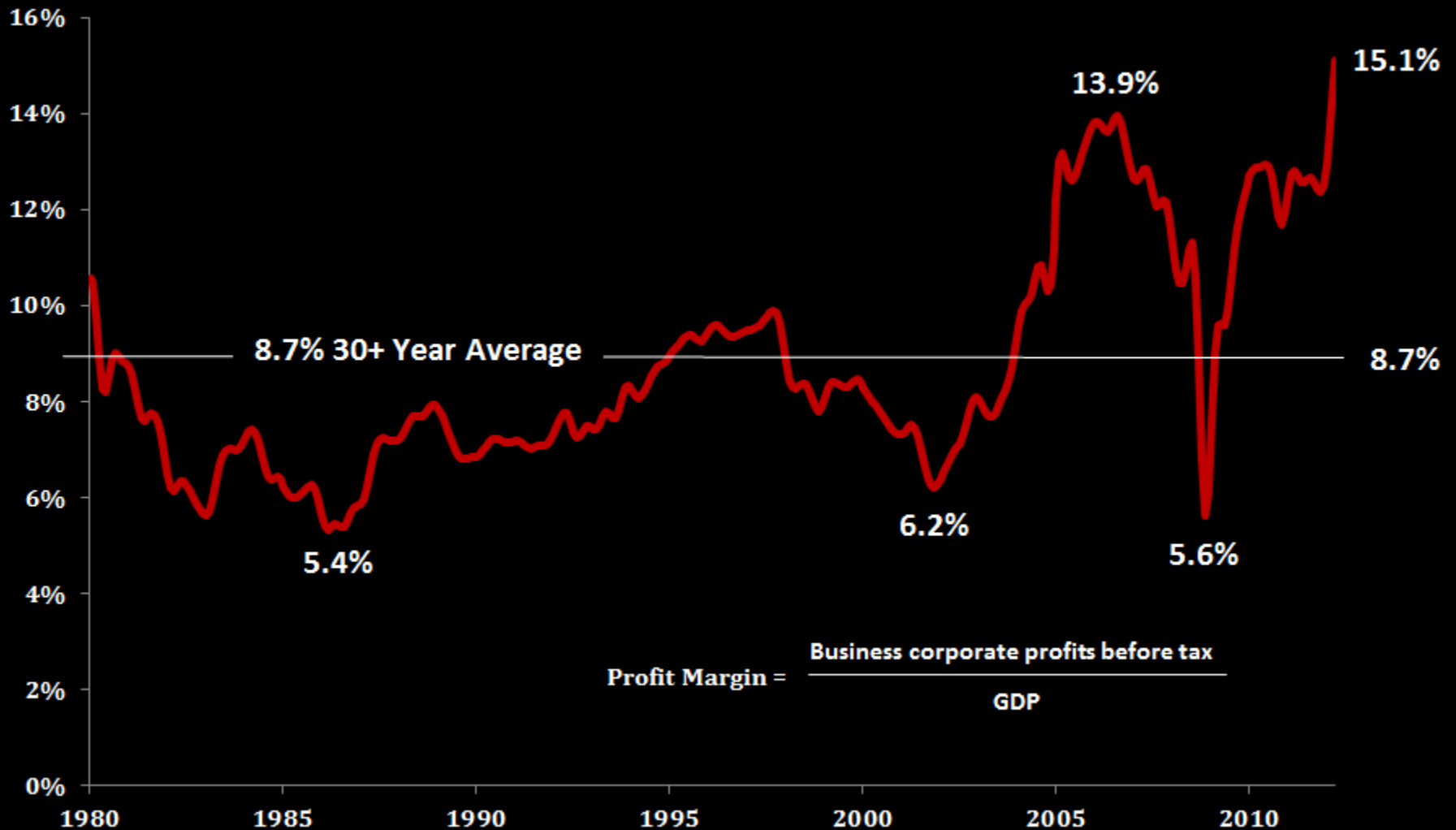
# Earnings Growth vs. GDP Growth 1980-2000



# Earnings Growth vs. GDP Growth 1998-2012



# U.S. Corporate Profit Margins 1980-2012



# Profit Margins, a New Paradigm?

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1. **Who said that margins have to mean revert, why can't they remain high?**
2. **What about the billions of dollars US companies poured into technology – wasn't it supposed to make them more efficient and bring higher profit margins?**
3. **Shouldn't globalization allow US companies to increase margins?**
4. **Shouldn't average profit margin be higher now, as the American economy has transitioned from an industrial (low-margin) to a service (higher-margin) economy?**

# Services Are Higher, But...



If Services Margins 11.5% **2x** Margins of Goods 5.8%

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1980

% services

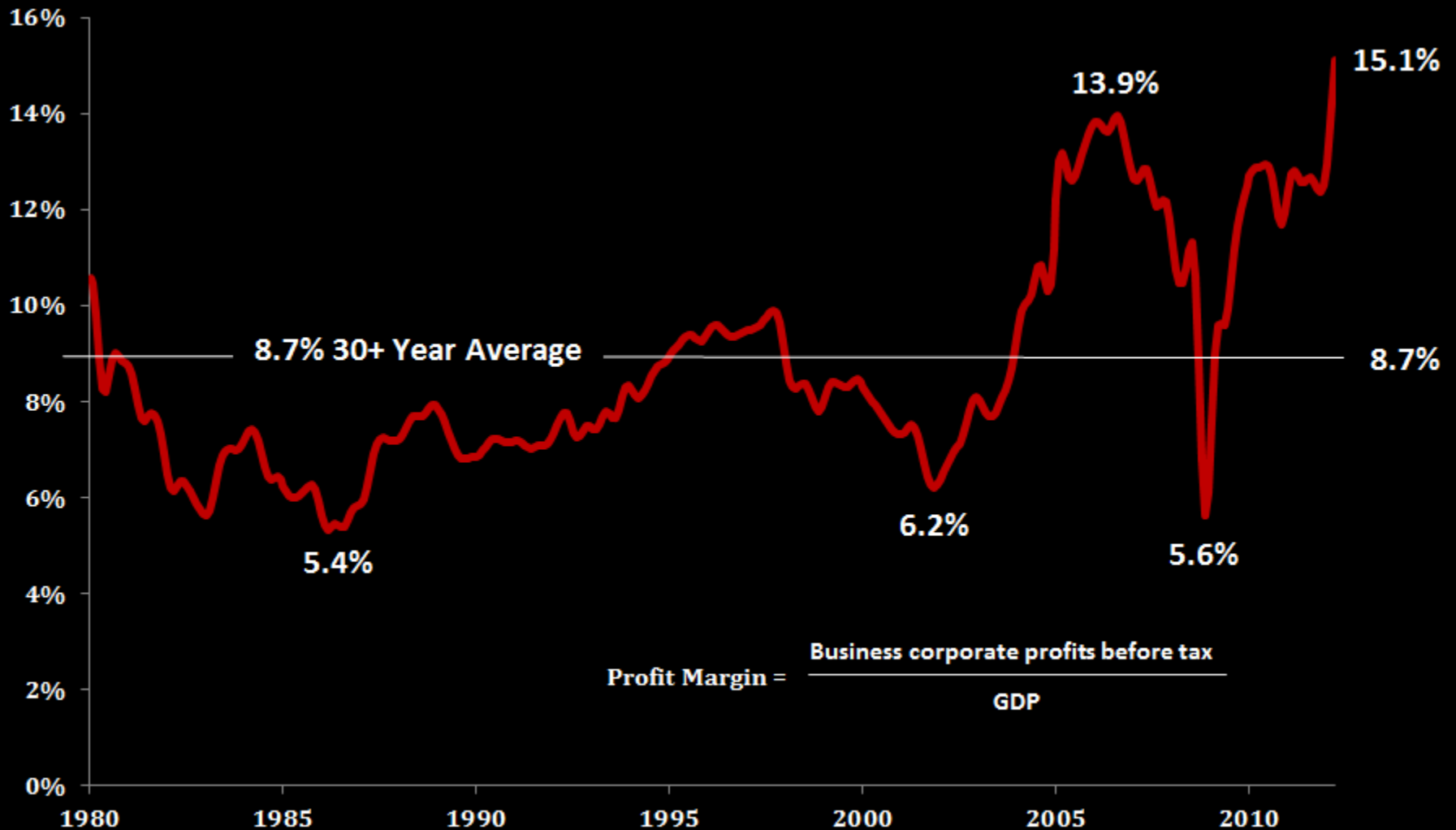
% goods



$$(51\% \times 11.5\%) + (49\% \times 5.8\%) = 8.7\%$$

margins

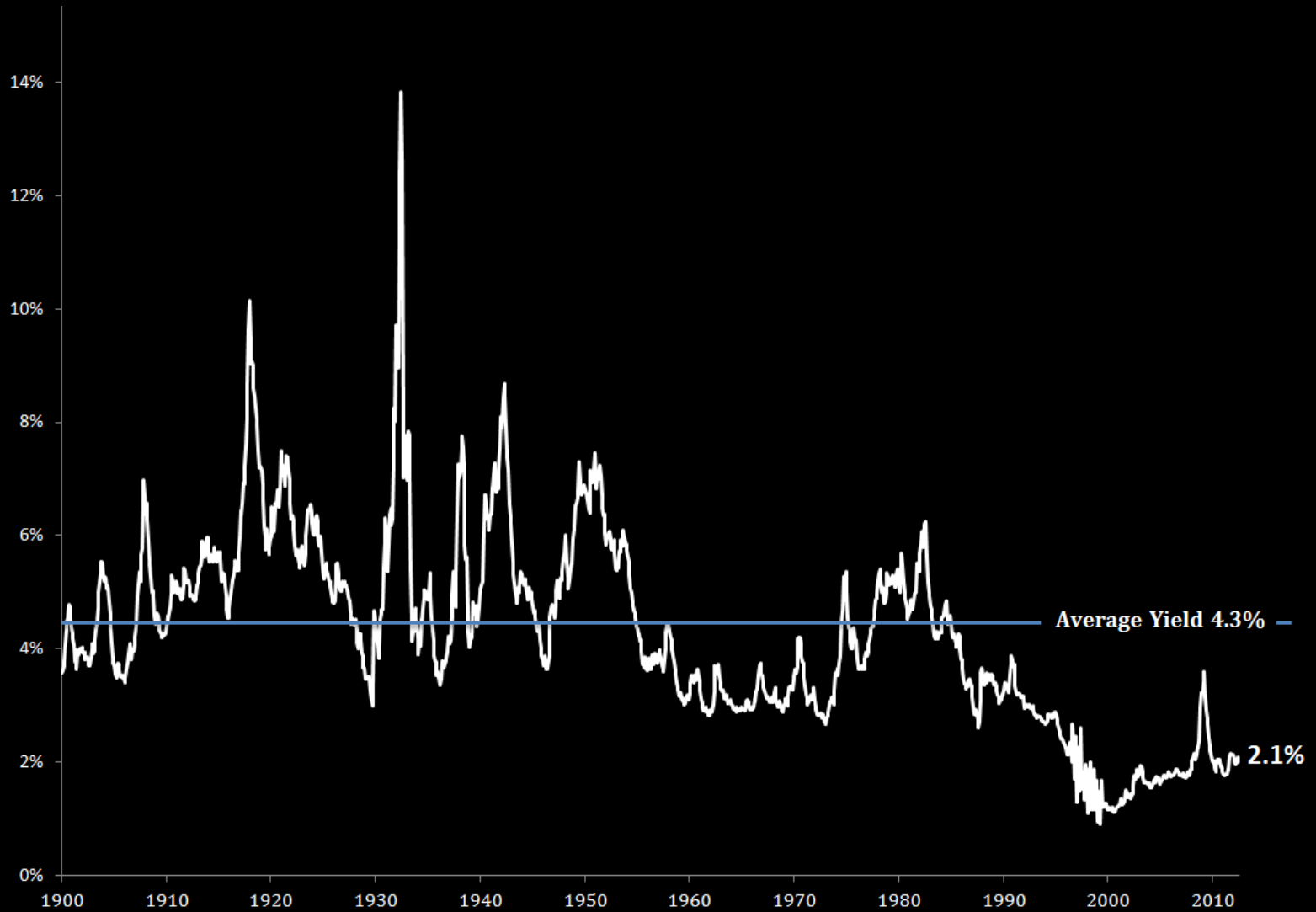
# U.S. Corporate Profit Margins 1980-2012



# The Effects of Psychology on Market Cycles



# Dividend Yield



# Expect Sideways Markets to Continue

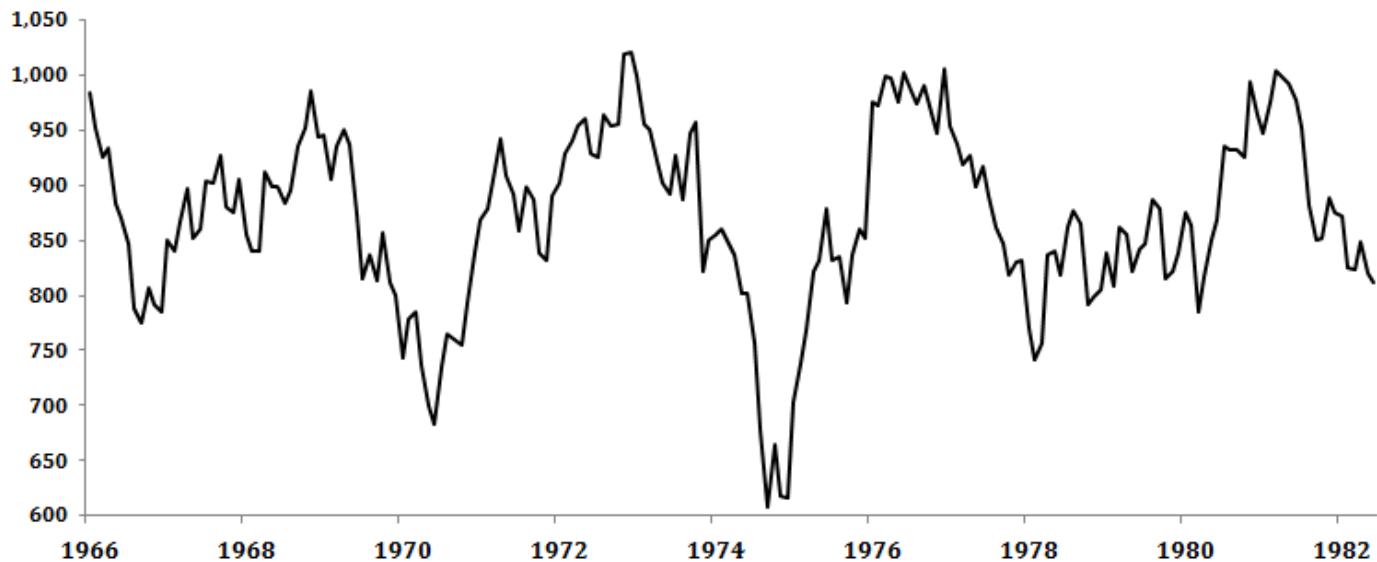
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## Earnings Growth – slow

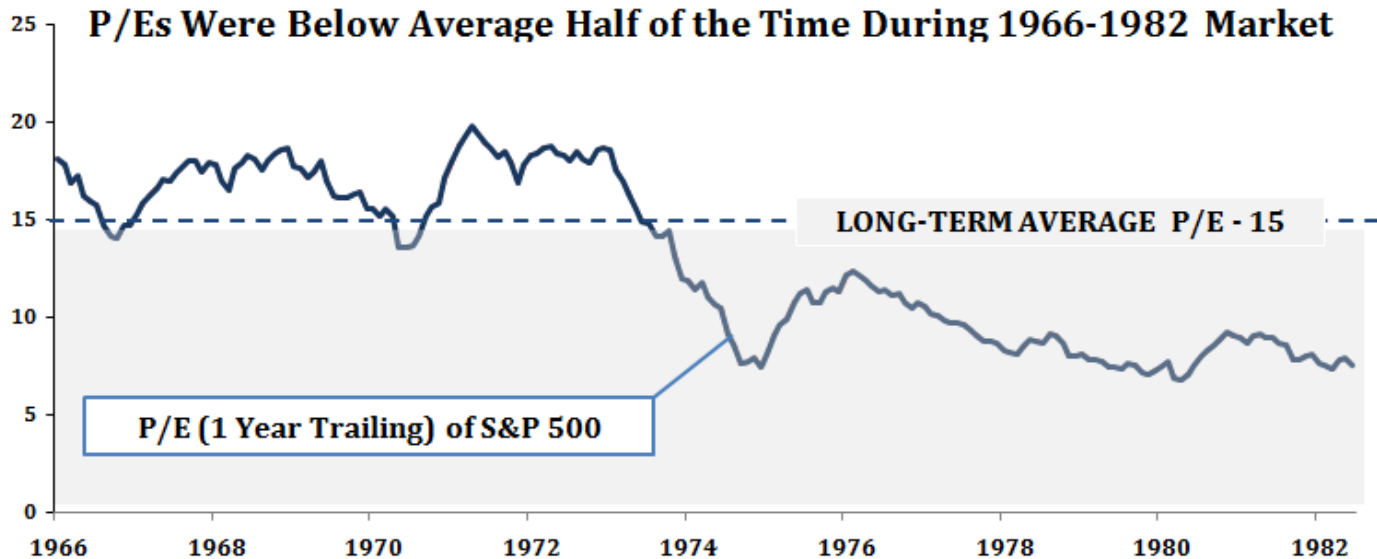
1. Global debt pile – higher taxes, austerities (also known as fiscal cliffs), higher interest rates
2. High profit margins
3. China – overcapacity; Japan – debt bomb

\* Inflation/deflation. High inflation will get us to the other side faster, final P/E will be lower (good + bad). Deflation will reduce nominal earnings growth and will result in lower final P/E (double bad).

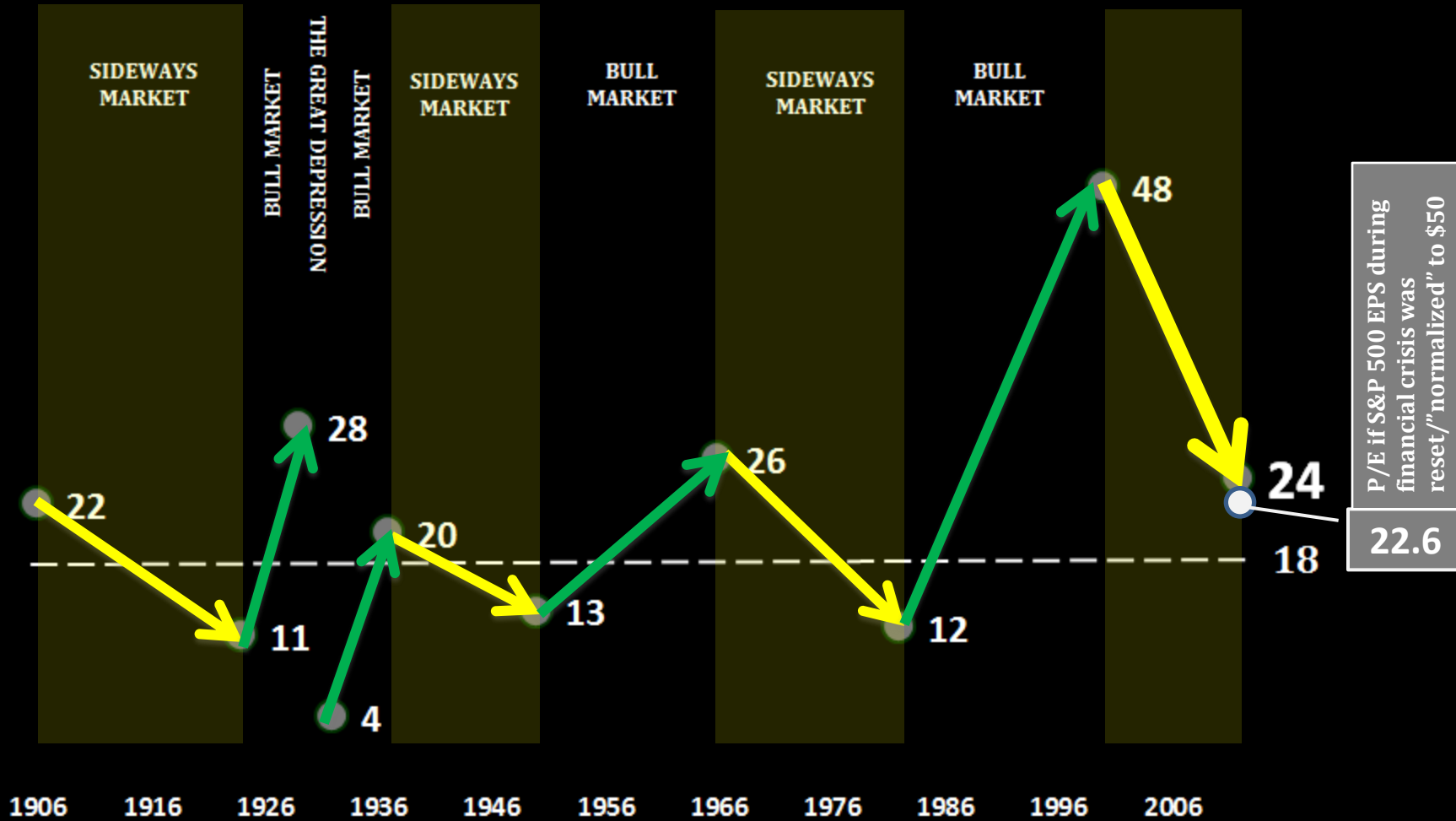
### Dow Jones Industrial Average 1966-1982 Range-Bound Market



### P/Es Were Below Average Half of the Time During 1966-1982 Market

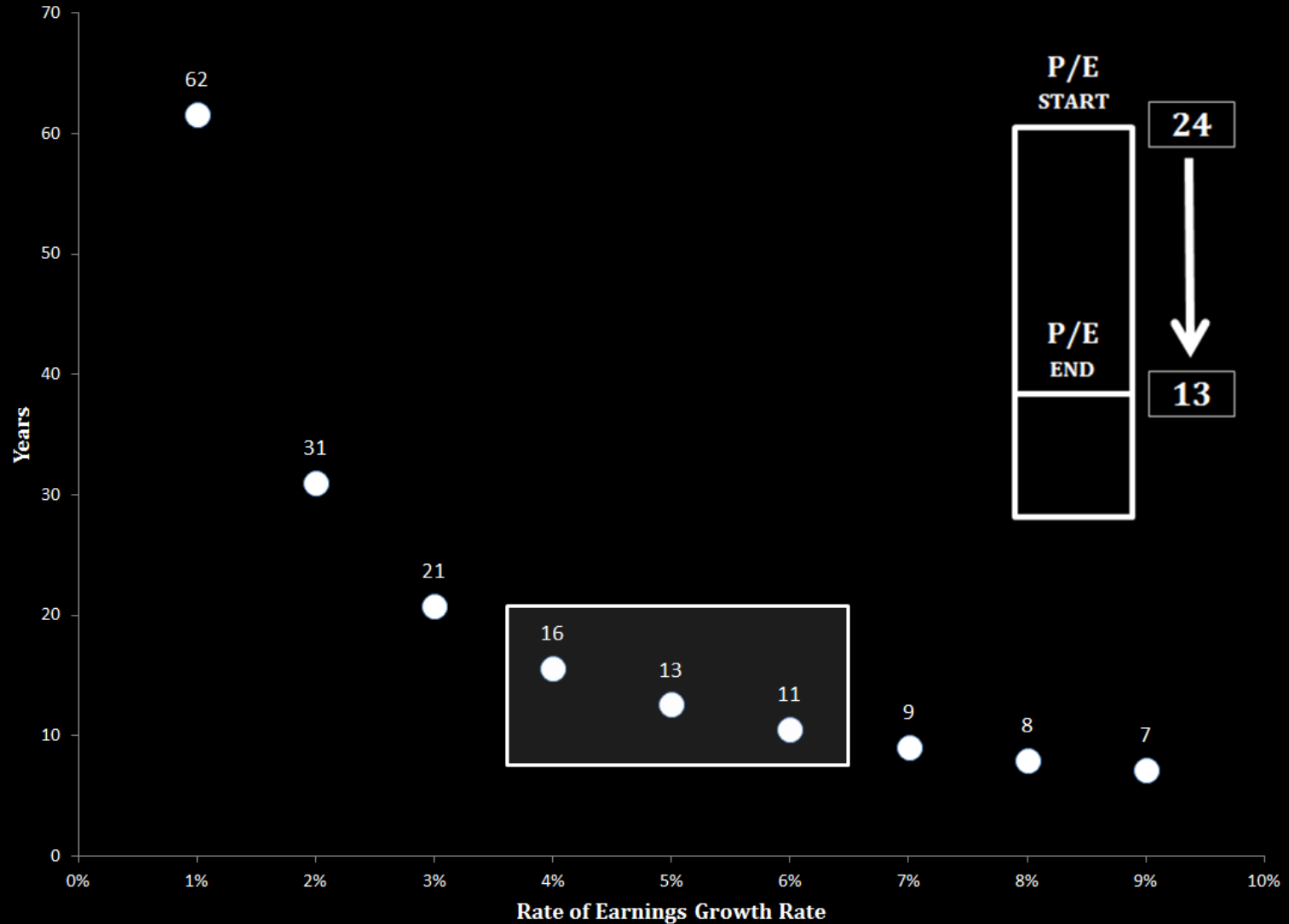


# Mean Reversion Beyond the Mean [10-year P/E, S&P 500]

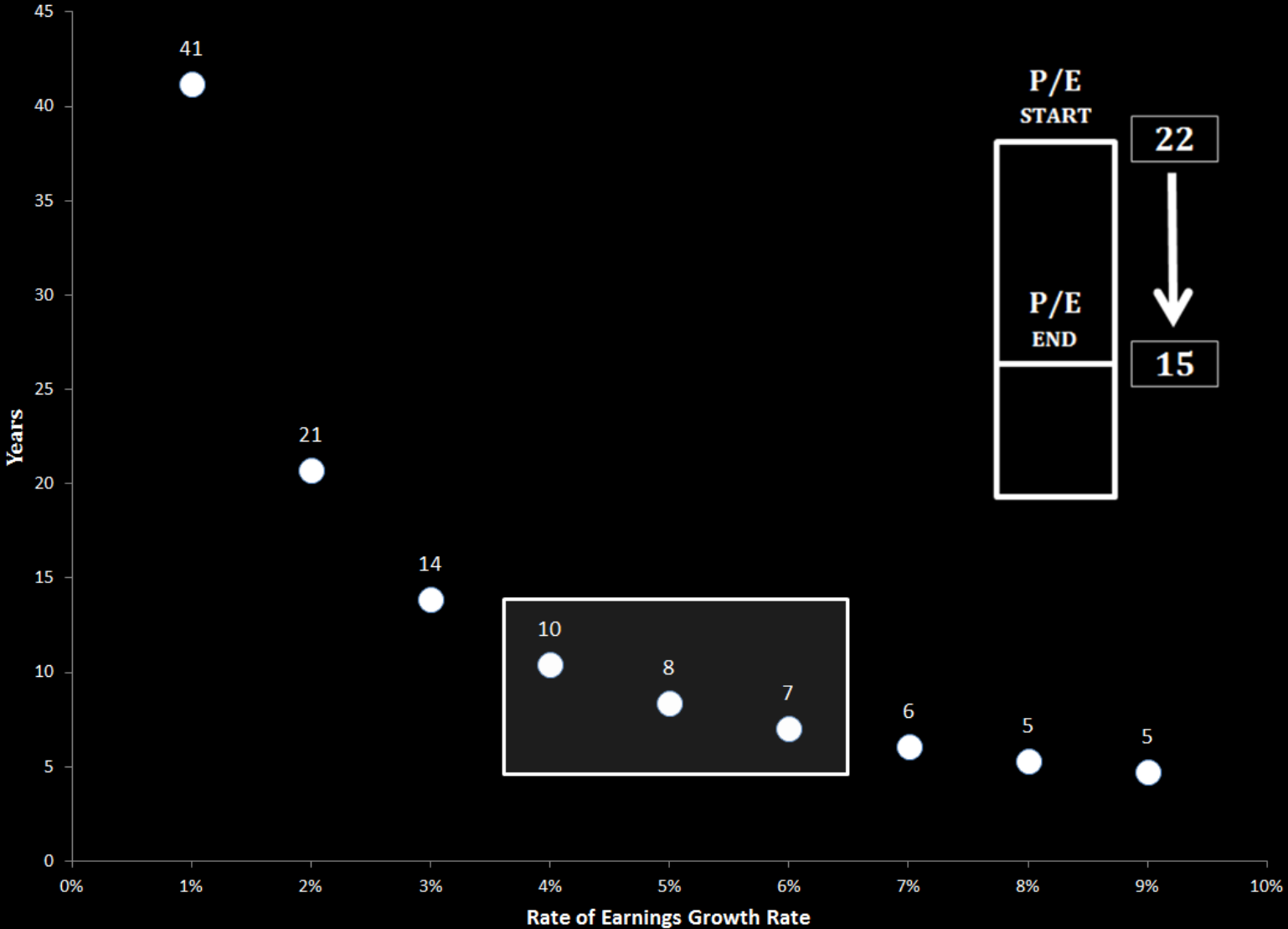


S&P 500 = 1,411  
October 2012

# Current Sideways Market Will Continue Precisely...11-16 Years?



# Or ...7-10 Years?

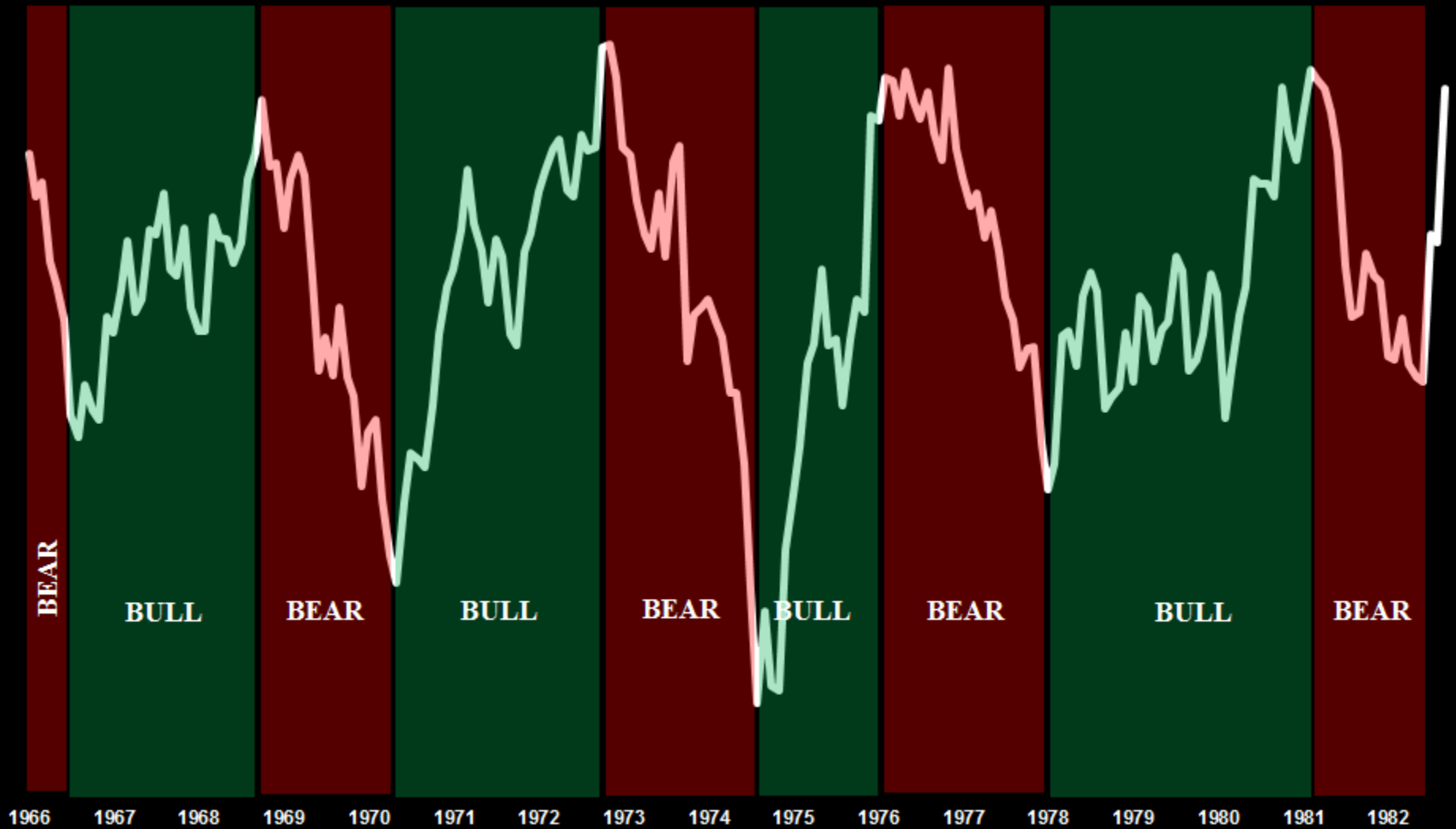


## Brief Summary of Strategy and Analysis for Today's Environment

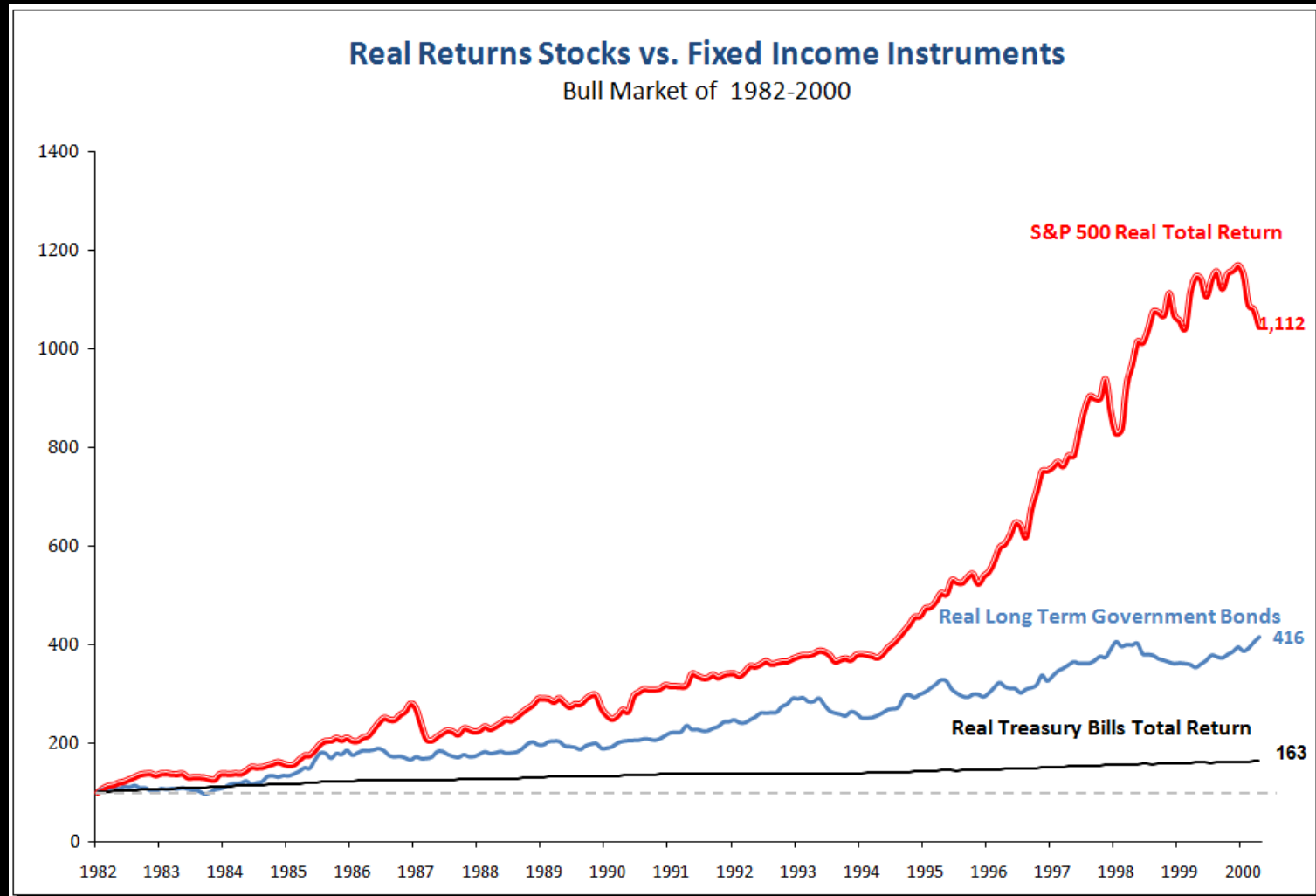
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- ❑ **Be a buy and sell investor.** Buy and hold is in a coma (see next chart) . Time (price) stocks through a strict buy and sell process. Buy when undervalued, sell when fairly valued.
- ❑ **Time stocks, not the market:** Market timing is very difficult. In the short run emotions are in the driver's seat.
- ❑ Don't buy for the sake of being invested. Don't lose money by making marginal decisions. **In the absence of good stocks to buy, be in cash.** The opportunity cost of cash is not as high as in a secular bull market.
- ❑ **Increase your margin of safety:** Fewer (better) stocks will be in your portfolio.
- ❑ Favor dividend-paying stocks. Dividends were 95% of the return in previous sideways markets. (Warning: dividends are part of the analytical equation, not the equation.)
- ❑ Look overseas -- increases return without increasing risk.

# Secular Range-Bound Market Is Comprised of Many Cyclical Markets

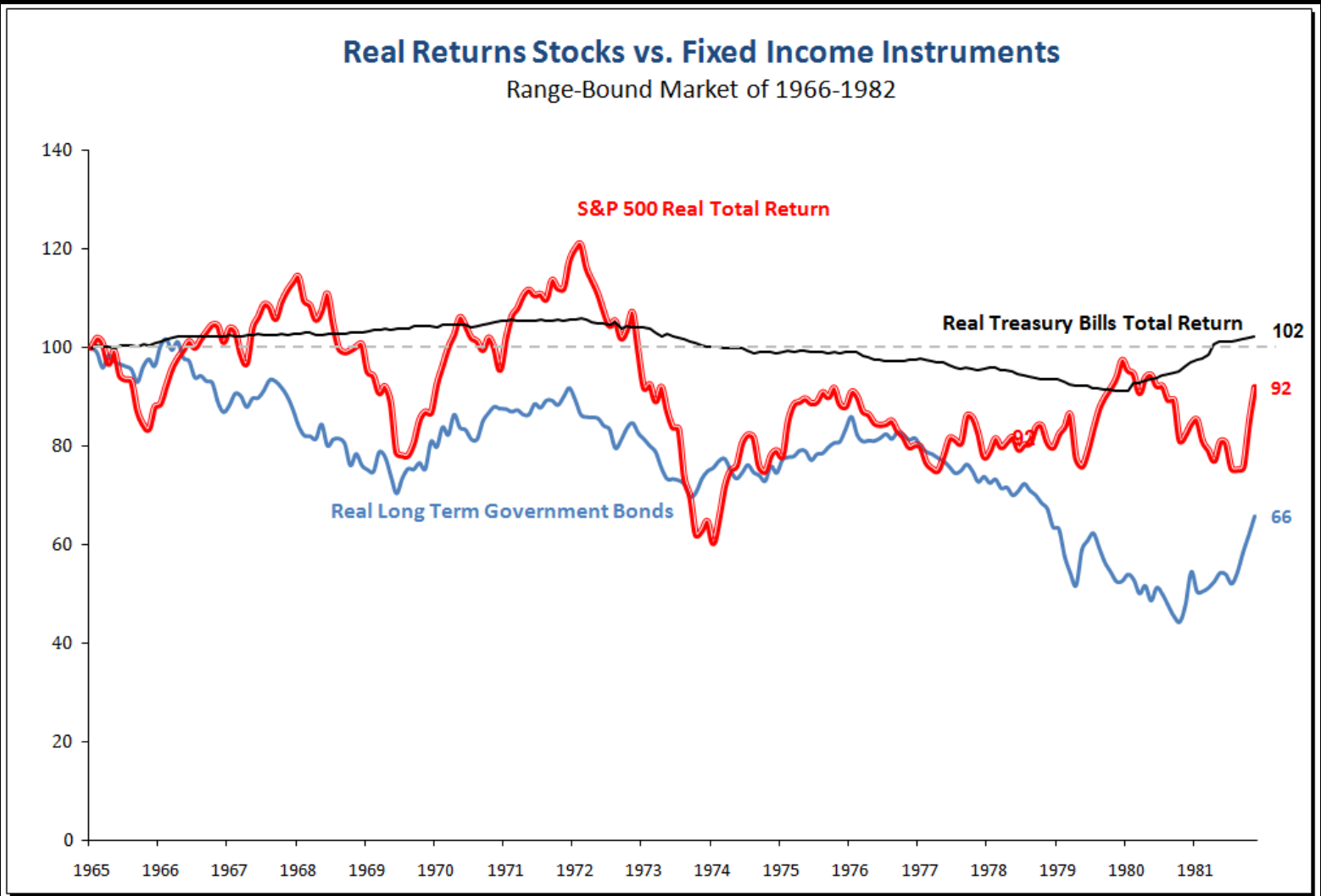


# Bull Markets: Stocks Do Outperform Bonds, Hands Down



**Throw money at stocks, and you'll do much better than in bonds or cash. In general, the fewer decisions you make the better off you are (buy and forget).**

# Sideways Markets: Stocks' Dominance Is Not Significant



**Asset allocation is not as important as stock selection.**

## **Conclusion: Stock Selection Matters A Lot!**

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**Investing as you did during a secular bull market will NOT work.**

**Your analysis and strategy needs to be modified.**

# Thank You!

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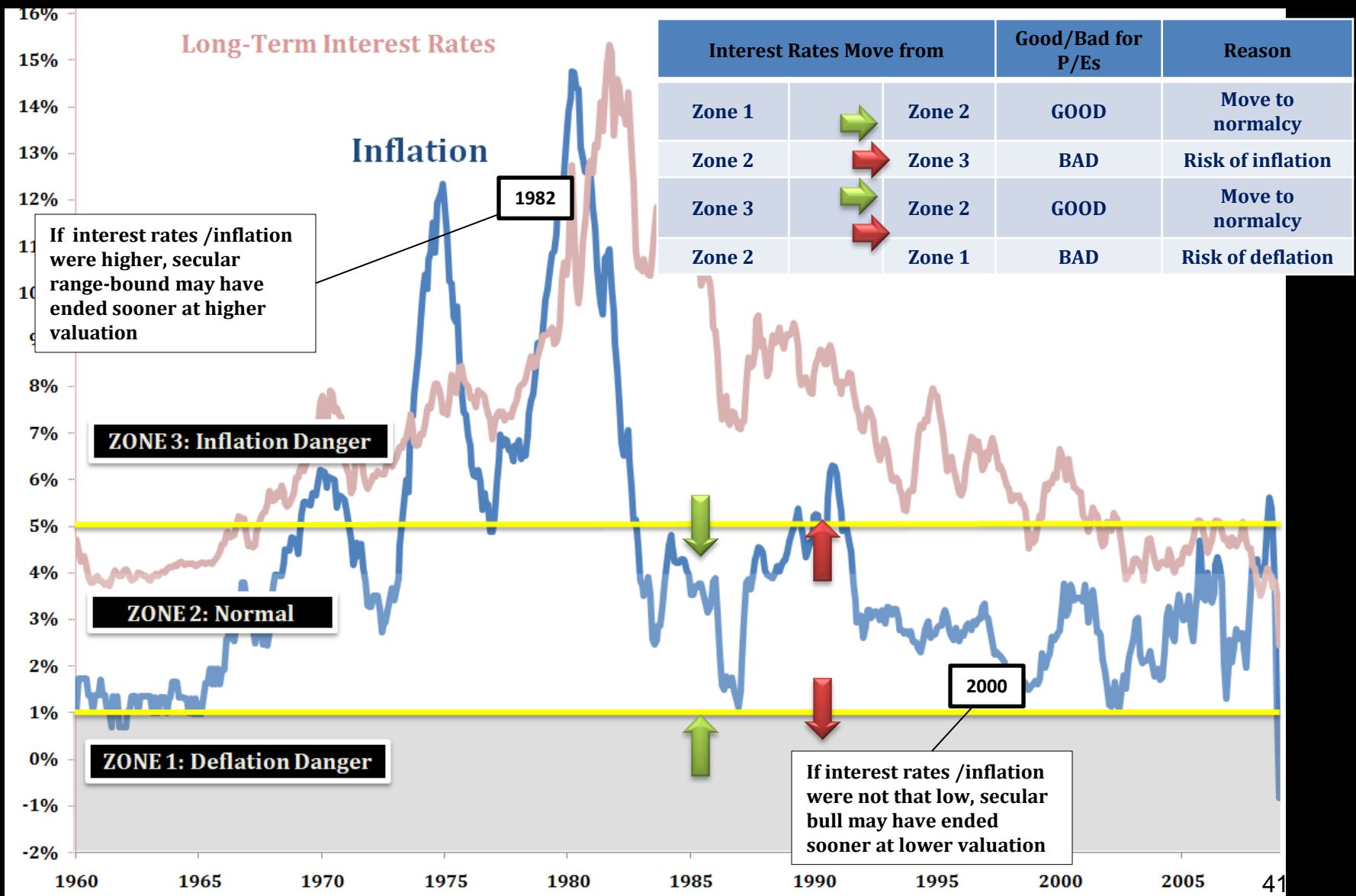
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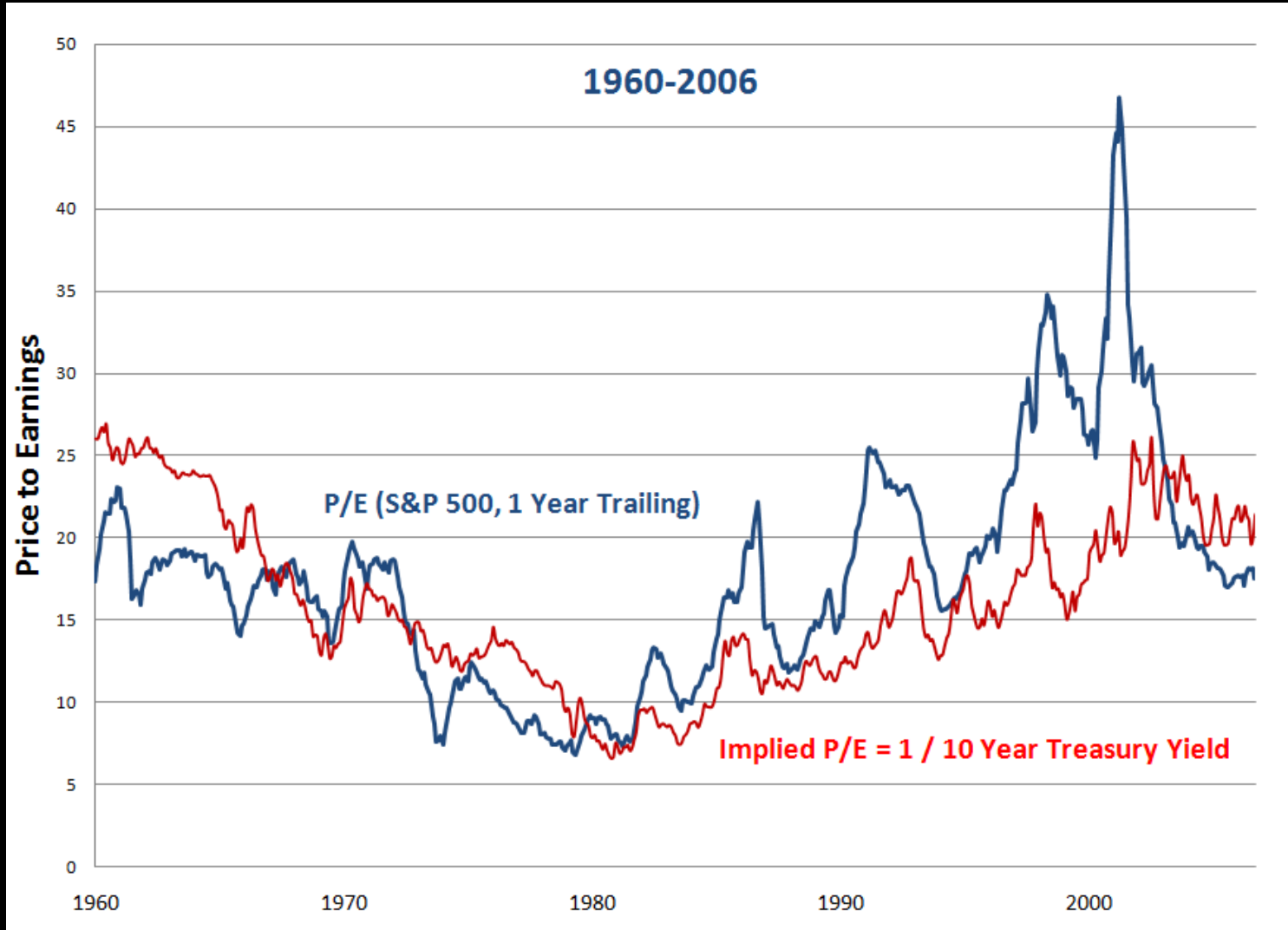
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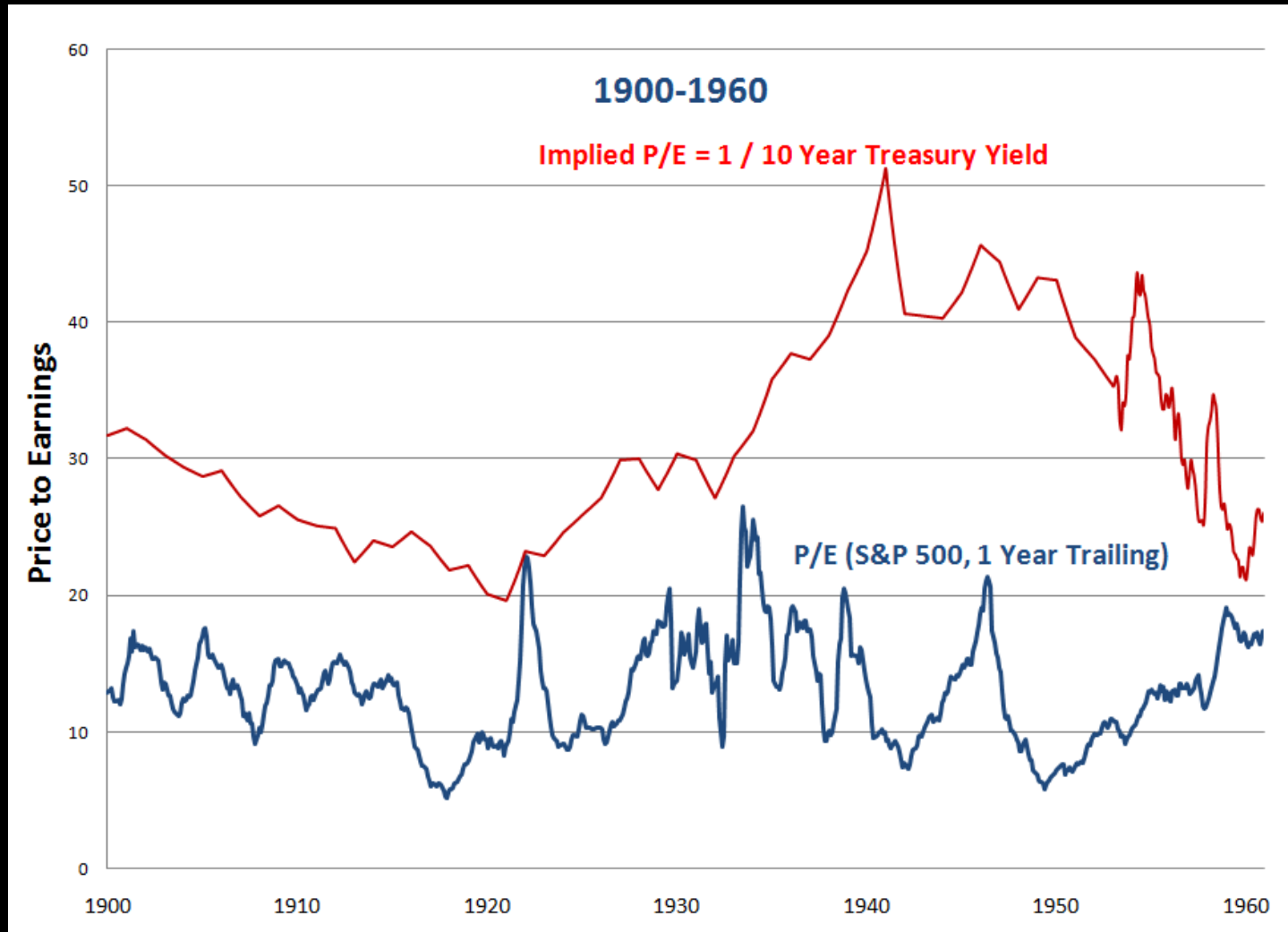
**Interest rates and inflation are very important but they take a second seat to market psychology. They ultimately determine the length and the extremes of market cycles.**



# There Is A Very Tight Relationship Between Interest Rates And P/Es During 1960-2000.



# The Relationship Between Interest Rates and P/Es Is Extremely Weak Between 1900 And 1960.



# Let's Take a Look at Dividend Math

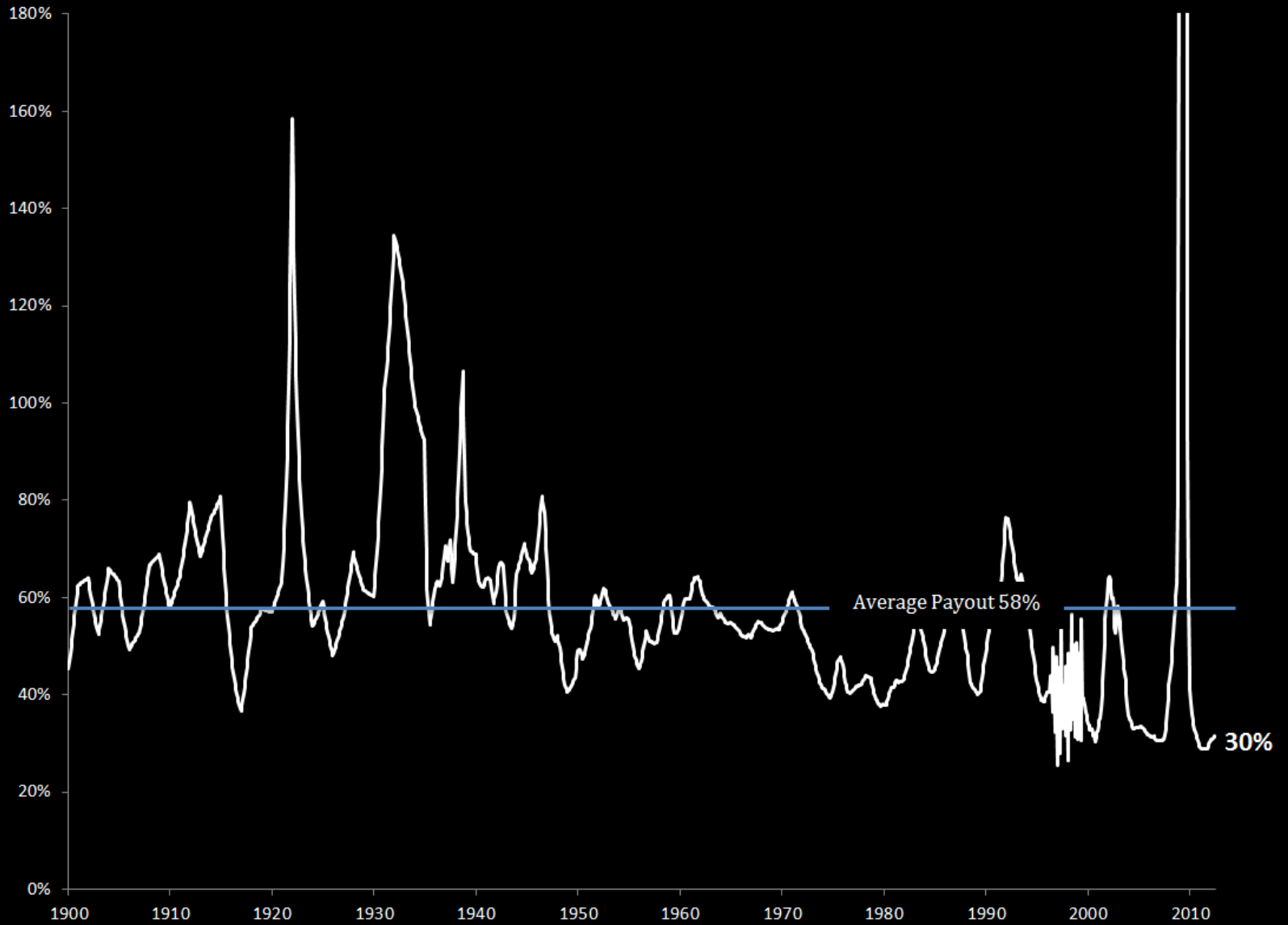
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**Dividend Yield = Earnings Yield x Dividend Payout**

**Or**

**Dividend Yield = (Earnings / Price) x (Dividend / Earnings)**

# Dividend Payout



# Earnings Yield

