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Greetings,

On many occasions over the years, Warren Buffet has said "you can either make 5% smooth or 15% bumpy". With today's historically low interest rates (which are unlikely to go up soon), I think Mr. Buffet will have to change his expression to 3 ½% (more on that later) smooth because unless you want to go out more than 10 years in taxable bonds, you won't make much more than that in the fixed income market. While I am not certain as to whether we will make 15% this year, I am certain that we are having an extremely bumpy ride. The second quarter of this year was the worst second quarter for the S&P 500 since 2002. In my last investment letter, I wrote that the worst was over and the market will stabilize soon. It turns out that I was rather conservative in my assessment. July was an outstanding month as corporate profits turned out to be better than expected. There was a mild pull back in August and September turned out to be the best September in 70 years.

Just three months ago it was all doom and gloom, at least for most people. The S&P 500 was down nearly 8% and it appeared to many people that it would be a challenge just to make money this year, never mind a respectable absolute return. Actually quite a few things happened. One thing that didn't happen is that there was no improvement in the economy. The economy stunk three months ago and it is not any better now. What has changed is the perception of the economy and more importantly (since the stock market is forward looking), the outlook going forward. Three months ago, fears were rampant that there would be "European contagion". European contagion from what I gathered was the belief that the problems in Greece and the other smaller European countries with poor economies would spread to all of Europe and then to the U.S. economy, possibly causing a recession here. That has not happened. The reality is that the problems with Greece, Portugal, Ireland and Spain have not spread to the larger, stronger economies of Germany and the United Kingdom. In addition, the results of the stress tests of the European banks weren't as bad as was expected.

As mentioned, the domestic economy has not improved. On occasion, someone I know will ask me how can the stock market possibly be going up when the economy is so bad ?Basically, there are three reasons;

1) The stock market should never have gone down as much as it did last quarter.
2) Based on what stock prices were three months ago, the market was pricing in a double dip recession. Other than Mario Rubini (better known as Dr. Doom) who is a well known economics professor at Columbian University and Paul Krugman (someone who I believe has never written or said anything positive about the economy or the stock market) who is a Nobel Prize winning journalist, all objective economists and stock market observers seem to agree that another recession is extremely unlikely. Even the ever pessimistic Goldman Sachs is beginning to tone things down recently as far as another recession.

3) Based on the fact that valuations of the stock market were at a 22 year low, it was not necessary for the stock market to hear any good news to move it up. All the market needed was economic news that was not as bad as expected because the expectations were so dire. The people in the market were relieved that the recent economic data was not nearly as bad as what was expected

Despite the poor economy, corporate profits last quarter continued to excel. Ultimately, corporate profits move the market. During times of uncertainty, the price that people will pay (better known as the PE ratio, PE being price to earnings) for corporate profits will shrink. This is called multiple compression. As long as the earnings, cash flows and revenues continue to increase (as they are), then the prices of the companies will also increase.

A concern for many of the talking heads has been the quality of earnings. There has been concern that earnings will only rise because of cost cutting. That concern proved to be invalid as revenues not only grew, they exceeded expectations. Unlike consumers who are hurting, corporate America is flush with cash. Many companies are now increasing their stock buybacks, increasing its dividends and some companies are now using their excess cash to purchase other companies at rich premiums. How this is beneficial to us is that the acquisition lifts the valuations of all the companies in the sector of the company that is being taken over.

A concern for me, more in the short term than the long term is the fact that there is virtually no new cash being put into the stock market. Over the past year and a half, I have heard more times than I can remember about all the cash "on the sidelines". This is all well and good and certainly bullish for the stock market. The problem is that all the cash on the sidelines (both with the retail investor and corporate America) won't do us a bit of good unless it is eventually put into the stock market. Since the bull market began a year and a half ago, all the cash that has come off the sidelines has gone into bond funds or individual bonds. That just goes to show that the vast majority of individual (retail) investors are still like a deer in the headlights with no confidence in the financial system. While attending a luncheon hosted by the Longleaf Partners fund two weeks ago; I asked the lead fund manager about the lack of confidence in the system and that no matter how cheap the stocks are that the fund is holding, the prices of these companies will stay cheap unless new money flows into the market. His response to my question was uninspiring to put it mildly.

A long time ago, when talking about how cheap stocks were, Ron Muhlenkamp (a long time mutual fund manager of mine) said "if stocks get too cheap, then the companies will buy themselves". I wasn't certain as to exactly what he meant at the time but now I do. Corporate America has been hoarding cash recently. They have been producing hundreds of billions of dollars in free cash flow but not doing anything with it other than hoard it. Since cash has a zero return (or near zero if it is kept in money funds), this has been frustrating to shareholders, including myself. One of the reasons, at least recently, that companies are reluctant to do anything with their cash is the political situation. When Congress and the current administration in the White House continuously blast business and then continue to pass policies that are harmful to all business, both large, medium and small, that simply does not inspire companies to invest their cash. Recently, many large companies have announced that they are using their cash to increase stock buybacks and make all cash acquisitions. This is happening because despite the fact that the retail investor refuses to buy cheap stocks, the CEO's are glad to take advantage of the great opportunity that the market is providing them. The CEO's are also gaining more confidence because they see the return of gridlock in Washington. Like it or not; it is probable that the Republicans will have a majority in the House of Representatives come November. While it is unlikely that the Republicans will win the Senate, the majority for the Democrats will be so slim that it is unlikely that very much will happen in Washington over the next two years. The stock market just loves gridlock in Washington. I believe the anticipation of gridlock has been one of the reasons why the stock market has been doing so well lately. There was gridlock in Washington from 1995-2000 and I firmly believe that one of the reasons why the stock market did so well back then was because of gridlock in Washington. The stock market doesn't like it when one party has too much power. What little was done on the legislative front from 1995-2000 was bi partisan and some of it was actually good, at least in my view.

I don't think it is written in stone that a significant amount of all this cash on the sidelines will go into equities. I firmly believe that there is a given percentage (I am not sure exactly how much of a percentage) of people who are just so scared off that they won't put cash into the stock market no matter how putrid the yields are in fixed income. However, I still think that there are plenty of people out there who after another quarter or two of positive gains in the stock market will put some cash to work. One of the many things that I have learned as a professional investor over the last 16 years is that fear turns to greed very quickly. When some people see their friends and relatives making 1% a month in equities (or even say ¾ of 1% for those who prefer to be on the cautious side), when they are earning a paltry 1% per year (which is actually a negative return after taxes and inflation) in a taxable money market account, I think that they will put some of that cash to work in the stock market. The last that I checked (which was a couple of hours ago) a one year CD is yielding 1 ½% per year and if you want to commit your assets to a CD for 5 years, then you will earn a 2 ¾% annual return, before taxes that is. Believe it or not, the yield on the ten year Treasury note isn't even that high at 2.45%. Some people like to chat about how scary the stock market is. I personally think it is scary how so many people are perfectly willing to lend money to the United States government with its $ 10+ trillion dollars in debt (and growing rapidly) for ten years at a yield just under 2 ½%. What so many of these people either don't understand or if they do, prefer to dismiss is that they better not need the principal before it matures because when interest rates go up, they will suffer a nice loss on the sale of that supposedly safe investment. Much of the cash that is being invested now is going into long term tax free bonds or tax free bond funds. Right now, they are doing very well and are receiving a relatively strong 4 ½-5% tax free yield. Again, anyone purchasing those bonds or bond funds had better be prepared to hold them for a very long time otherwise they will also be looking at big losses down the road.

I gave you much to chew on. If you have any questions or anything that you would like to discuss, please by all means either send me an email or give me a phone call.