



Tom Au: We Speak Again to Someone Who Foresaw the Collapse in 2008

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Tom Au is Chief Economist with the Wentworth China Fund, a NY-based investment advisor, and author of *A Modern Approach to Graham and Dodd Investing*. He also writes for TheStreet.com, the Prudent Bear, and other investment newsletters. Mr. Au graduated cum laude, with a B.A. in Economics and History, from Yale University, and an M.B.A. in Finance from New York University. He is a Chartered Financial Analyst (CFA).

We spoke with Tom Au on January 13, 2009. Our previous [interview](#) with him was on April 3 2008.

At the end of last year, you forecast a 50% correction in the market. You were a lot more accurate than most, so we'd like to know where you stand for 2009.

I first made that forecast in October of 2007, when the Dow was at 13,000 and the market was overvalued by a factor of two-to-one. I believed then, as I do now, that a fair valuation is around 6,600. We are still overvalued.

The good news is that this is an estimate, and the margin of error is plus-or-minus 50 percent. The fair value is between 3,300 and 9,900 and we are within that band. In October of 2007, as well as at the beginning of last year, we were not within that band.

The market is no longer crazily overvalued like it was a year ago.

The market will go down in 2009 for two reasons. First, we are still above the mid-point of the band. Second, post-election years are typically down. More to the point, there has been a change of party within the presidency, as was the case in 2001. New policies will take time before they have an effect. This argues strongly for a bear market.



What other insights does your valuation model offer?

Dividends are under pressure. In theory, this should increase book value and make stocks more attractive for value-oriented investors. The so-called investment value model we use for valuation is book value plus ten-times dividends. With dividend cuts looming, this raises questions about stock values.

We are in the second stage of the market downturn. The first stage was the correction which brought the market closer to its fair value. In a typical correction situation like this, the market goes to a level that is 15% over fair value. The second stage is the earnings collapse, like we just saw with Alcoa. [Ed. Note: Last week Alcoa announced a series of layoffs and programs to reduce spending. Yesterday, it announced a \$1.19 billion loss for the fourth quarter of 2008.]

There will be further corrections – not due to overvaluation, but rather due to earnings disappointments.

Is this a great time to be a Graham and Dodd value-oriented investor?

This is a stock picker's market, as long as you can find companies with earnings that can hold up in this recession. We are not looking for a further value correction. If companies maintain their earnings, we expect that P/E ratios will stay about the same. The other safety measure that's applicable is Graham and Dodd-type balance sheet investing.

There is a large difference between this year and last year. Last year, there was no safe haven. Only a few companies, like Wal-Mart, Johnson and Johnson, and Baxter, offered decent returns. This year, the thing to do is to buy cheap stocks.

Right now the market is on the high side of normal. This is like the difference between being obese and merely overweight. There are Graham and Dodd stocks with very attractive valuations, but you have to look hard for them. I can't say what we are buying now, but I will tell you some of stocks we have sold recently. For example, we sold a number of retailing stocks, like Insight Enterprises and Dillard's Stores, and we sold Avnet and Agilisys in the tech area.

We look for companies with net-net working capital (NNWC) that is close to market value. The NNWC is current assets less all liabilities, while working capital is current assets minus current liabilities. Graham and



Dodd will allow a valuation of 100% of NNWC but will apply a discount to the long term assets that make up book value.

Where are you in the inflation versus deflation debate? Are there positions in your portfolio that are designed specifically to hedge against either of these scenarios?

We are worried about deflation first and inflation later. We are on a knife's edge. We own a number of gold stocks plus a bear fund to hedge our inflation fears. Of the two scenarios, deflation is the greater fear. The Fed has been pumping money into the system to increase money supply. But the velocity of money is slowing because of de-leveraging, the collapse of many hedge funds, and overall consolidation in the financial industry. These all slow the velocity of money, and that is not good news. That is why deflation is the concern for this year.

Inflation will happen once the velocity of money improves.

Do you foresee any risk of hyper-inflation or a significant decline in the dollar?

There is no risk of hyperinflation, but there is a risk of a decline in the dollar. Hyperinflation could occur only if the dollar ceased to be the reserve currency. The world's central banks will stabilize the US inflation rate. But after such a stabilization program, the dollar will have to fall vis-a-vis foreign currencies.

Gold and some silver are our primary hedges. Silver has not kept up with the rate of inflation, but both are probably cheap right now. We own both gold and silver stocks. Some would say I am not being cautious enough about inflation.

In our last interview on April 3, 2008, you said that the worst is still ahead in terms of troubles in the housing market – another forecast that was very accurate. How much further does the housing market have to go before it levels off? Will lower mortgage rates bring buyers back into the market?

The main issue is that, at the 2006 peak, housing affordability was half of what it should be. Houses were costing six times income, versus a historical level of three times income. That has to correct. One small positive trend is that the Fed is leaning on banks to renegotiate the terms of mortgages. That shares the pain between homebuyers and the banks and will stabilize the housing market. The bad news is it will stabilize



home prices above the true price. It will take a decade for supply and demand to get back into balance.

The economy can recover without housing. The problem with the economy was that it was built on an artificial housing market. The government wanted a housing bubble (but not necessarily liar loans) as a way to maintain aggregate demand. We need to build a stronger foundation for our economy, part of which is infrastructure. One of the bad consequences of the housing bubble was it diverted money from these more important projects. We also need to rebuild our manufacturing base, not just in terms of plants and machinery, but in terms of the technology, like computer-aided design, that supports manufacturing. Once we start investing and build our export base, we will have a more balanced economy. I would like to see a trade-led economy instead of a consumption-oriented housing-led economy.

**What are your thoughts about the non-US markets, specifically China?
Can China still grow at 5%, which would be a modest rate for them based
on recent history?**

China can grow faster than 5 or 6 percent. Since 1980, China had been growing at 9 percent. But 3 percent was true growth and 6 percent was just to catch up with the rest of the world. China is trying to do in 50 years what the US did in 150 years. If China goes to 6 percent growth, it is like zero growth in US terms.

I expect that China will grow less than 9 percent for one to two years while US demand slows.

The most attractive markets are in the southern hemisphere: Brazil, South Africa, Australia, and New Zealand. The fairly simple reason is that these markets are less dependent on the US and European economies than any northern hemisphere countries. Australia has a self-contained economy, with a lot of dependence on agriculture. Brazil, South Africa and New Zealand are similarly insulated from the rest of world. But they are attractive only on the curve.



What is your overall asset allocation now, and under what circumstances would you significantly adjust it?

Our overall asset allocation is one-third gold and gold-related stocks and the Prudent Bear fund, one-third Graham and Dodd stocks, and one-third cash. We don't use TIPS for our cash, but probably should.

The main thing is to expect a rough year in 2009 and into 2010, with a rebound 12 to 18 months from now. We are almost halfway through the tunnel and through the darkest parts. It is not going to be fun but I see greater opportunities ahead. When we see the turn, we will increase the stock position at the expense of the other two.

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