



Tom Au: A Bearish Forecast for the US Market in the Wake of the Sub-Prime Crisis

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We spoke with Tom Au on April 3, 2008.

As an introduction for our readers, can you describe the investment principles in your book and, in particular, how they diverge from traditional Graham & Dodd investing? What is “modern” about your approach?

The foundation originally laid by Graham and Dodd, in 1930, was to look at equities as a bond plus a call option. These principles were popularized by Bill Gross of PIMCO, who spooked the market in 2002 when he proclaimed that the Dow was worth only 5,000. What he meant was the bond value was 5,000 and the excess was a call option on the new economy. At the time, I agreed, although I said the comparable valuation on the Dow was only 4,000.

In the 20th century, the trend line for equity valuation was inflation plus dividends plus 0.6% in real returns. Bill Gross implied that US blue chips were like TIPS, providing no real return over inflation over periods of 35 years or more.

Today, most US investors treat equities as options, which explains the high levels of volatility in the market. Bonds are inherently less volatile.

The Graham and Dodd philosophy does not apply to small caps, which are valued more like private equity and venture capital. For mid and large caps, they devised a test that shows that low P/E and P/B ratios are attractive. In addition, they prefer a dividend yield greater than the yield of the 10 year Treasury. The majority of US equities don't meet this test. Today, in the S&P 500, there are perhaps 50 stocks meeting this criterion - mostly utilities and REITs. Prices for a lot of the pharmaceuticals have lowered to the point where their yields meet this criterion. In this case, investors are being reward for extra risk they incur, vis-à-vis bonds.



Traditional Graham and Dodd valuation calls for all three criteria to be met – low P/E, low P/B, and high dividend yields. My approach requires just one of these criteria, and I advocate allowances that can be made if either of the other two is not met. I also utilize a proprietary investment valuation metric, which looks at book value plus ten times dividends, and this combines all criteria. Plus, the modern version uses more cash flow analysis because cash flow statements are available now, but they weren't in Graham and Dodd's time.

For wealth managers that serve HNW and UHNW clients, what would you say are the key insights your book offers in terms of investment strategy?

People need to be realistic about U.S. stock market returns over the next ten or so years. The fact that they've averaged 10%-11% over the 20th century is a bit misleading. Instead, we've had 35-year long cycles, incorporating 17-18 years of 18%-20% average annual returns along with 17-18 years of 2%-4% average returns. We're now in that bad cycle from 2000-2017 or so. In essence, we borrowed returns during the good times from 1983 to 2000.

The HNW have more to lose, but my advice applies to everyone. We are in for 10 more rough years. My advice is to be proactive, and to look to foreign markets, commodities, or - if you have a really trusted hedge fund manager – try an alternative investment strategy

A buy and hold strategy that worked well over most of the recent past will work poorly in this environment. People don't realize that we have long stretches of good and bad markets, but we do.

You've gone on record, at the end of last year, as predicting a 50% correction in the markets. What are the key economic and market factors behind your forecast?

U.S. stocks are too far above their trend lines, a fact that the "new economy" ideology made us forget by pretending to give us a "free lunch." The new economy has been discredited recently by the sub-prime crisis and other problems. The bubble burst and stocks will return to their trend line. The Dow is still way ahead of my proprietary investment value calculation. And, from 1932-1992, the difference was never more than 50% either way. So the overvaluation has been a post-Persian Gulf War, "1990s" phenomenon. This is illustrated in the following table of the actual value of the Dow versus my calculation of investment value:



Year	Value of the Dow	Investment Value
2000	11,000	3,000
2002	7,500	5,000*
2007	13,000	6,600

* Bill Gross' estimate.

Stocks got ahead of their long term trend line from 1982 to 1999, and now need to “catch up” by “catching down.” Stocks could go nowhere over next 9-10 years, but this is less likely. More likely is a major dip that creates a bottom like we last saw at the depth of the Depression in 1932 or in 1974.

I foresee three scenarios, each with a distinct probability:

- 60% - stocks make a major dip to catch down to earnings
- 30% - sideways movement for the next 10 years
- 10% - meaningful up movement

If there is a big dip, then there can be a big upside, but don't mistake a 10% dip for a big dip.

My forecasts apply only to the US market. China, India, Brazil and other small countries with different economic cycles and stock market behaviors are different, both in direction and magnitude.

European markets will behave like the US markets, but with greater volatility. I believe we are in a recession and the economic slowdown will be felt in Europe.

Now that we are at the start of the second quarter, how do you feel about that prediction? Is there anything in the first quarter market results that surprised you?

One thing I did not get, and could not get, was the timing of the market correction. I thought it would be more of a Q1 2009 event after the Presidential election. If anything, the secular trend is weaker than I thought. So we are well on our way to a major decline punctuated, however, by 1930s type rallies by those who refuse to believe how bad things will get.



I thought we could escape a major correction because of the election year, which tends to be kinder to the markets. The weakness in the market says there will be a change in leadership (i.e., the Democrats will win the Presidency). The nasty correction we have seen is a down payment on the larger 50% correction. Look for ups and downs because it is an election year. We will see a rally when the Democrats nominate their candidate. After the election things will head south.

Where are we now with respect to the sub-prime crisis? Is the worst behind us?

The sub-prime problems are just beginning. It took a decade to create, which is to say it will take about that long to resolve. What's interesting is the fact that the courts are getting involved to force lenders to jump through hoops before they dispossess home owners. Trial lawyers in this field of litigation are in for a bonanza.

The Fed is doing the right things with Bear Stearns and this will lessen the damage but not fix the situation. The problem is already baked into the cake. Who will suffer? Banks, brokers, hedge funds who were trading CDOs, homeowners and borrowers, or taxpayers – the question is who will pay the price.

The largest number of ARMs adjusted in the first quarter of 2008 and we haven't seen the fallout from these yet. This will be felt over the rest of 2008, and will cause more finger pointing regarding who was deceived on the terms of the loans. Hedge funds will say the originators gave them implicit guarantees, and that will be adjudicated in the courts. This is more good news if you are a trial lawyer.

Most advisors believe (or would certainly like to believe) the sub-prime crisis is not much different from previous crises the market has successfully weathered. What is your view – is this time different?

The sub-prime crisis is worse than most because it was artificially and deliberately created for bankers to earn fees. Lenders created a bunch of shaky products for sale to consumers on one end, and for resale to so-called investors on the other end. In this regard, the sub-prime is different from a one-time problem such as a tsunami or even the 1970s oil crisis.

In 1920 we over-farmed and created a dust bowl. Now we have over-farmed the housing market to squeeze as much as we could out of that sector of the financial system.



Another important aspect of the sub-prime crisis is the moral hazard issue. The Fed has protected hedge funds, banks, and others from the consequences of overleveraging. If we had more failures earlier on, we would have had fewer and smaller failures later on, like Bear Stearns.

In previous bailout situations, like LTCM, rates were kept artificially low. There was a stable relationship between Treasury and inter-bank lending rates, but that has broken down. Spreads are much higher, which means lowering Treasury rates doesn't do a lot of good.

What monetary, fiscal, or regulatory policies do you believe will be most effective in stimulating the economy?

For a bunch of cultural and economic reasons the economy was in overdrive in the last couple of decades. Baby boomers created a boom in technology and leverage. Starting with Woodstock we have done things in a big way. We have created an economy that others have found hard to sustain.

The recent actions by the Fed are leading to over-stimulation. There is no quick or easy fix. The long term fix is to raise the savings rate, which hurts the economy in the short term. The period of greatest national prosperity in American history was right after World War II, because we had a 20% annualized savings rate for three and a half years following the war. I hope we won't need another world war to re-start the engine of prosperity.

We need to get the savings rate back into positive territory - greater than 10%. What would be helpful is Jimmy Carter's "moral equivalent of war." Carter's idea was implemented by Paul Volcker, by controlling inflation through interest rates. That laid the groundwork for the boom of the 1980s. None of the three Presidential candidates have the strength to wage that battle to increase the savings rate. It would essentially require increasing interest rates, which would cut consumption but would increase savings.

At the beginning of the year, your portfolio was 1/3 gold, 1/3 cash, and 1/3 Graham and Dodd stocks. Can you explain the rationale behind that structure, and whether your allocations have changed since then?

Gold is more expensive now than at that time. It is at the high end of my \$800-\$900 an ounce range for 2008, so I've traded down my positions. A few stocks have gotten cheaper recently. I've added Schering Plough to a pharmaceutical position consisting of Pfizer, Johnson & Johnson, and



GlaxoSmith Kline, some of which happen to be Warren Buffett choices as well.

Given my forecast for a halving of the Dow, I do not like US equities, except for high-yielding stocks like Pfizer. I still have a lot of cash, and I am waiting for opportunities in stocks like Schering Plough.

The pharmaceuticals are still a relatively safe and stable sector. They are no longer a growth sector, which is why their valuations have come down. Those I've cited are selling at 60% of the market multiple. I see pharmaceuticals becoming the new utilities. They now yield more than real utilities. Investors are being paid dividends in excess of those of the real utilities but with growth prospects.

Is there any additional advice you would offer for advisors with long term horizons? Is now the time to make adjustments to their asset allocations?

We are in a rather soggy market, and will be for the next 10 years, with downward and not upward pressure. Advisors will not lose much by holding Treasuries, gold, and developed foreign bonds (European or Canadian). Because the US markets are so unappealing, you need to be creative in asset classes, like commodities or foreign stocks.

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