



Our Interview with Vitaliy Katsenelson

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Vitaliy Katsenelson, CFA, is Director of Research at Investment Management Associates, Inc., a Denver-based money management firm and a professor of finance at the University of Colorado. Vitaliy is also the author of the highly acclaimed book, *Active Value Investing: Making Money in Range Bound Markets* (Wiley, 2007), which is available via the link above. His web site is [Vitaliy's Contrarian Edge](#).



We spoke with Vitaliy on October 15, 2008.

Let's talk first about the level of valuation for the overall market today. You advocate looking at valuations using trailing one- and ten-year averages. How does the market look relative to these yardsticks?

I have advocated for a long time to look at P/Es computed based on both one year and ten year trailing earnings, as one year trailing earnings are easily skewed by economic cyclicalities. Over last couple of years, S&P 500 earnings were skewed dramatically by all time high corporate profit margins, which made the stock market appear cheaper than it really was.

Today, both P/Es tell a similar story – corporate profit margins are contracting and the S&P's earnings are being revised down from approximately 80 to around 54. To date, most of the carnage in profit margins was caused by losses in the financial sector, but the industrial, energy, and materials sectors (I call them “stuff” stocks) are starting to take over the profit margin compression torch as we speak. These stocks did well during the last five years due to global expansion, but now face serious challenges.

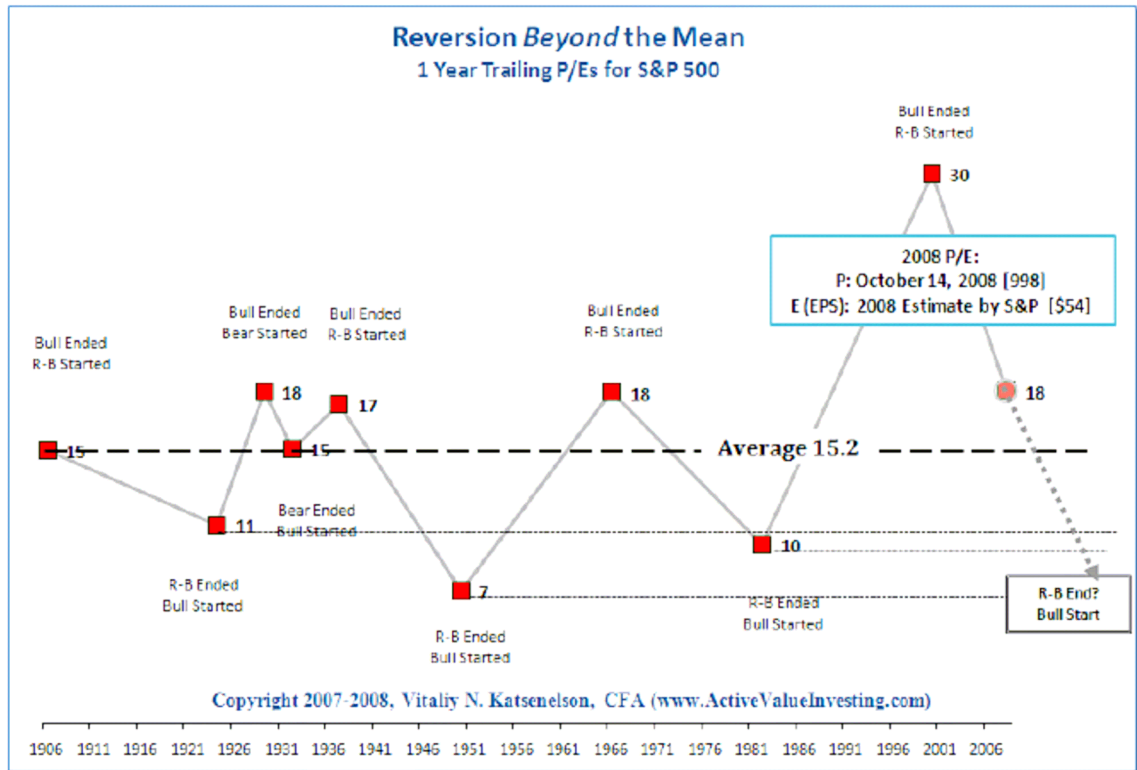
I have updated the P/E charts that appear in my book. Since trailing 2007 earnings no longer represent the economic reality of today's environment, I used the S&P 500 earnings estimates for 2008 to show where we stand today. Since we are very close to year end, these estimates should be reasonably accurate.

The chart below was prepared on October 14 (based on an S&P valuation of 998), and it shows that, based on one year trailing/estimated P/Es, we are still at an above average valuation. The P/E is 18, and historically bull markets



have started at valuations between 7 and 11. The average P/E has been 15.2. Unfortunately, we still have a way to go.

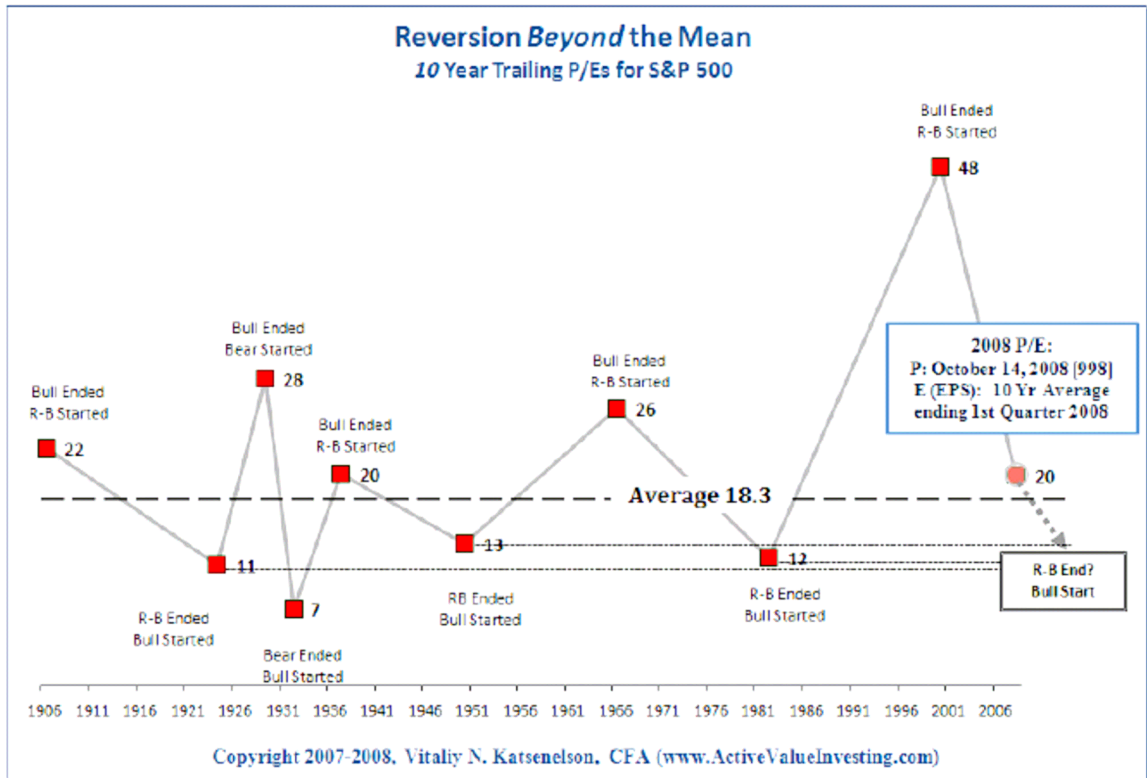
**Bull Markets Start at Below Average and End At Above Average Valuations.
Range-Bound Markets Start and Above Average and End at Below Average Valuations.**



The same story plays out when you look at trailing 10 year earnings:



Bull Markets Start at Below Average and End At Above Average Valuations.
 Range-Bound Markets Start and Above Average and End at Below Average Valuations.



Here, we can see that P/E levels are at approximately 20, but bull markets start at levels between 7 and 13, and the average P/E was 18.3.

Overall, relative to historical valuations, stocks are still trading at above average levels. We are not at end of the range-bound market which began in January of 2000. [For a discussion of Vitaliy's definition of a range-bound market, see our previous [interview](#) with him earlier this year.]

Although I hate to be the bearer of bad news about the stock market as a whole, the bad news applies only to investors that are taking a very passive approach – buying a broad market index fund or defaulting to a traditional buy and never sell approach. Money still is to be made in the stock market, but it will require a more active – as well as disciplined - approach. Being in stocks is not good enough - not anymore. You want to be in the right stocks. Stock selection is paramount.



What do you see as the likely scenario for the economy?

First, a Great Depression of the 1930s is not in the cards. The world will not suddenly lose its color and turn black and white (the colors that come to mind when we think about 1929 Great Depression, as there were not color cinemas then). No, we won't have food lines, our kids will not start playing with bricks and sticks instead of toys and they will not be wearing handed down clothes several sizes their senior. Their collection of toys rotting in the attic may shrink and - I have to warn you - you may still see kids wearing torn jeans with holes that are too big for them. But don't blame the economy, blame the latest fad. Our economy is stronger, more diversified, and far more developed than in the 1930s. It is unlikely our government will repeat the mistakes it made then. We also have a system of social nets, such as unemployment insurance (which will probably be extended, like it was in 2001 and 2002) and welfare.

I see three possible scenarios for the economy: (1) a Great Recession (2); a (semi-normal) recession; and (3) a quick recession leading to growth.

Our problems today stem from two sources (here I am oversimplifying a bit): an abundance of bad debt and a loss of trust in the financial system. Banks don't trust their current or potential customers; investors and depositors don't trust banks; and banks don't trust each other. The government is trying to restore this circle of trust. Two months ago, socializing the financial system would have seemed preposterous. Now there is no way around this, at least temporarily. The Fed and Treasury are trying to restore trust by shoring up banks' balance sheets and by stamping government guarantees on otherwise risky loans, and they will likely succeed.

The next step is dealing with the bad debt. Some of it will be socialized (paid for by the taxpayers). Some of the bailout programs will cost money, and some won't. Warren Buffett says the government will make money on the CDO auction program, but I think this will depend on the price the government will pay for this debt.

The possibility of a Great Recession (which would be a steep decline in GDP growth and a sharp rise in unemployment, lasting a long time) is higher than in the past. The only reason a Great Depression would happen is if the "circle of trust: not restored.

The bottom line is, if the Fed is successful at restoring the circle of trust, a Great Recession is avoided.



We are very likely to be in a semi-normal recession. How long and deep will the recession be? We really don't have a good benchmark to forecast the level of unemployment, nor the level of growth or decline in GDP, nor the duration of the recession. This is a consumer-driven recession and the consumer is two thirds of the economy. The last recession of 2001 was led by corporate slowdown; the 1991 recession was a consumer recession, but it was very different from current one. Housing prices did not decline nationwide; the consumer was not as leveraged and the global economy was in different shape. And yes, we are in a recession, no matter if it fits into traditional definitions. Growth is down and unemployment is up. The definition of a recession doesn't matter.

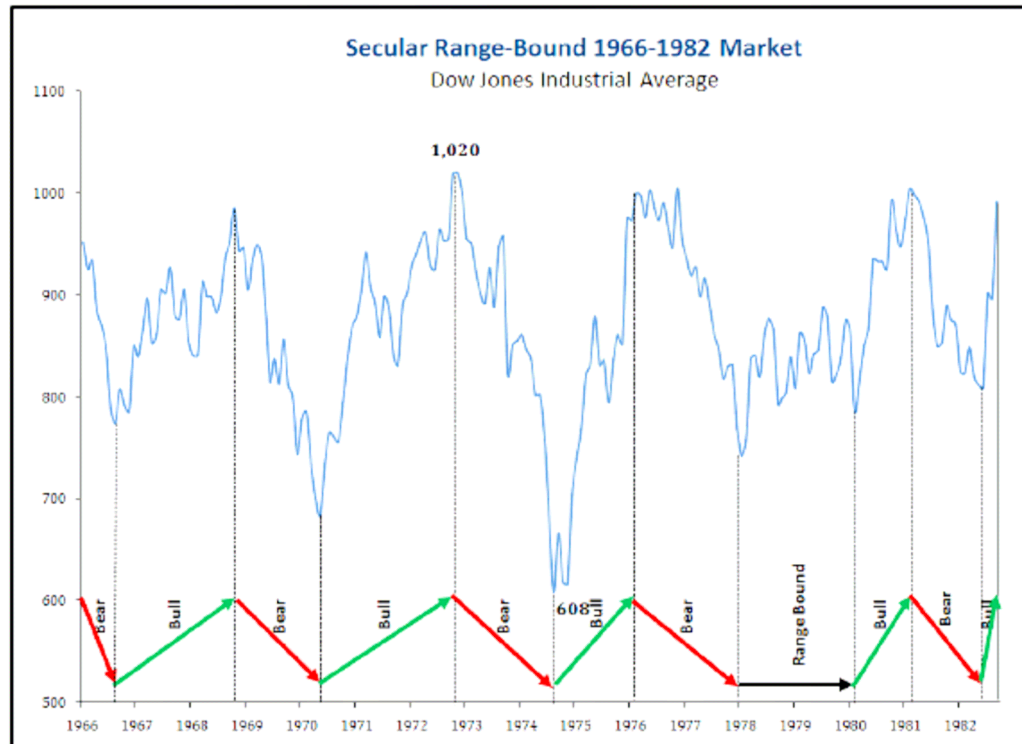
A possibility of the third scenario – a quick and shallow recession leading to growth – is not high but it is there. For this scenario to play out the bulk of losses in financial sector need to be behind us.

Given your forecast for a semi-normal recession, what are the implications for the direction of the market?

Historically, secular bear markets developed when you had a combination of high valuations and a prolonged recession. The first condition is met – today's valuations are not cheap. If the second condition is met (a very deep and long term recession), then all bets are off, and we will end up like Japan in its Lost Decade.

If the economy is just experiencing a cyclical downturn, one that is possibly more severe than similar downturns in the past, then we are likely to be in a relatively short-lived cyclically driven bear market. The last 1966-1982 secular range bound market had 11 shorter term market cycles inside of it (5 cyclical (short-term) bull markets, 5 cyclical bear markets and 1 range-bound market). See the chart below.

Secular Range-bound Markets Is Comprised Of Many Cyclical Markets



5 Bull + 5 Bear + 1 Range-Bound

Despite all that, I would not try to time the market, as it is a very difficult market and will likely turn before the economy, as the market is a discounting mechanism. If you own stocks that will survive the worst case scenario, you will come out stronger in the end.

One school of thought says the economic slowdown will result in deflation, to go along with the deflation we have seen in asset prices. The other school says that inflation is the inevitable result of printing money to fund bailout programs, health care, and other initiatives. What is your thinking on deflation versus inflation?

The Fed and the Treasury know they have limited tools to fight deflation and this is why they always want to err on the side of inflation. Once the economy slips into deflation, the cycle is difficult to stop. As prices drop, consumers and corporations postpone spending as they expect prices to drop further and are concerned about the future. The savings rate goes up, which normally would be a good thing, but it causes the velocity of money to drop, and the money supply shrinks. Unemployment goes up, the economy slows down



even more, corporate and consumer spending declines further – the vicious cycle keeps repeating.

The Fed and the Treasury know this quite well, Bernanke is an expert on the Great Depression; to fight this they are using every weapon in their arsenal and are inventing new ones every day. Ben and Hank declared global war on deflation and they'll likely succeed even if it will cause inflation to go up in the long-run, once credit stabilizes.

The immediate concern is deflation. We should not be concerned about inflation at least for awhile. It is very hard to have inflation when the banks won't lend money and their capital base is shrinking. Also, it is unlikely that the \$700 billion plan will be inflationary, as the Fed is swapping government for corporate debt.

But the rest is uncertain. It is very likely that bad debt will need to be socialized to avoid the Great Recession. In other words taxpayers will carry the burden of losses in the financial system and of the stimulus packages that will be announced very soon. This will bring higher taxation and higher interest rates in the future, which will dampen the growth rate of the economy after the financial crisis passes. A likely price for today's government intervention is slower economic growth in the future.

In any scenario it will be hard to avoid higher unemployment in the US as, up until today, the US economy was geared for growth. Increased unemployment will add another level of stress to the issue of bad debt on the government's books. In the semi-normal recession scenario, unemployment will be at more acceptable ranges, much lower than in case of the Great Recession. (Of course, "acceptable" is a very subjective word and it is only "acceptable" if you are not the one losing the job. Paraphrasing Ronald Reagan – a recession is when your neighbor loses a job, depression when you lose a job.)

What is your forecast for other world economies?

In looking at the external consequences of a global recession, I prefer to divide the world into four broad categories of countries: the US, Europe (and other developed countries), emerging markets, and commodity exporting nations (Russia and the Mideast).

As I mentioned before, the US will fare the best on a relative scale, because we are diversified. Despite the socialism which has transpired through the various bailout initiatives, we are still a capitalistic economy. Our capitalistic DNA will be only slightly (and hopefully only temporarily) diluted with socialism.



Europe is in a very interesting situation, one which will test the stability of the European Union (EU) and the long-term survivability of the euro. The EU consists of countries with strikingly different histories. Some have experienced runaway inflation and, for this reason, countries like Germany are very cautious about increasing monetary supply. To fight today's financial crisis some countries will want to increase the money supply, and this will pit countries against one another. This also makes me less bullish on the euro.

Russia and the Middle East benefited from high commodity prices. If you look at Russia, for instance, the return on capital in oil- and commodity-related industries was much higher than in any other industry. This siphoned capital from other industries, which caused investments in these industries to decline. To make things worse, the rise of commodity exports drove up the Russian currency, making non-commodity industries even less competitive in the world market. Once you take high commodity prices away, Russia is worse off than it was before. On top of this, when Russia did well, it acceded to pressures to increase social programs. (In case of Middle East, they embarked on ambitious construction projects, like building a brand new city with a zero carbon footprint in the United Arab Emirates). Russia has created a stabilization fund (a super savings account), but I am not sure how long this fund will last. Russia is strong on a balance sheet basis, but that is a reflection of the past. The future, as reflected in its future income statements, looks horrible. To some degree it is almost a mirror image of the US – our balance sheet is weaker but our earnings power is strong.

The Middle East is a very similar story to Russia - with a twist. It benefited from oil prices and spent a lot on infrastructure, like building out new cities. My concern is that terrorism came mostly from the Middle East, and I am unsure what will happen when poverty levels go up in these countries.

You've written quite a bit about China and you have not been bullish on their economy. Can you walk us through your thesis and, now that commodity prices have backed off along with valuations in the Chinese markets, are you rethinking whether China is attractive?

In the emerging markets, the story begins with China, whose plight I compare to Starbucks. Starbucks grew fast for a long time and got very big. But in the late stages of that growth, the quality of growth declined. Instead of opening two stores a day they opened five stores a day. In the later stages of growth, management could not keep with such a high growth rate - management decision quality deteriorated. They opened stores on the wrong side of the street, hired the wrong people, and paid too much for leases.



They realized their mistakes and went back and closed some stores. The lesson is that when you grow fast, the quality of growth at the late stage is not good.

Starbucks is providing us an insight of what is going on in China, but on a much greater scale. China is moving toward capitalism, but they are not there yet. It has grown at 10% for 10 years and, thus, the quality of growth has very likely suffered. For instance, they built the biggest shopping mall in the world, yet it is empty. There is a huge amount of bad debt in the Chinese economy. It is very difficult to see where bad management decisions will show up, but some are surfacing. They only show up when growth slows down, both in China and the rest of the world. Last month, for the first time in 26 years, Japan became a net importer. This was because the US and European demand declined. It foretells the fate of China, whose exports will dry up very fast.

The Chinese economy is geared for much higher growth. It is like the bus from the movie Speed, which must go at 55mph or else it will explode. When an economy grows so fast for so long, all decisions are factored into that growth. Companies build factories sized for five year growth projections. If growth slows down to 5%, China will have 25% over capacity. Remember that over last 15-25 years, the US had a lot of manufacturing taken over by China. Now, in the US and the developed markets, factories make up 18-25% of the economy, but in China it is close to 50%. A global slowdown has a much greater impact in China.

China has higher operational leverage and financial leverage. When sales growth slows down, margins and profits will collapse. As the global economy slows down to a couple of percentage points, for China it will be the equivalent of negative growth in the developed markets.

If the quality of decisions was poor, their consequences will be even greater. Overcapacity and leverage will accelerate the impact of a global recession for China.

You attended the Value Investing Congress in New York on October 6 and 7. What was the general sentiment among investors there?

It was a great and a must-attend event. What made it especially interesting this year was that most of the presentations for the conference were prepared several weeks prior, which normally would not matter, but the market tanked during that time. Presenters, including many very distinguished value investors, identified stocks that were cheap when they prepared their slides, and then when presenting these stocks were in many cases 30% cheaper.



The lesson is that even stocks valued at 50 cents on the dollar can still go to 25 cents. It is very difficult to pick the bottom. Investing is not a sprint, it is a marathon.

A lot of discussion centered on the energy sector - oil and gas companies. For this sector, I believe you have to “subnormalize” the earnings. The last 3-5 years were based on oil at around \$70/barrel. As the global economy slows down, the price of oil will change dramatically. We could see \$30 oil (before we see \$100 oil). Demand is already slowing down, and alternative energy sources and consumption patterns are changing. There are more of these changes to come. In the last five years, high oil prices encouraged investment, but it takes a while for supply to come on line. As these new sources come on line, it will depress the price of oil even further.

When you buy an oil company, you buy oil in the ground, and you pay what it is worth based on the price per barrel. Oil company valuations are based on the marginal cost of extraction. As oil prices subside, the high marginal cost players will disappear. To “subnormalize” means to look at how much will oil companies make (their earnings power) based on a long term recession (i.e. \$30 oil prices).

My crystal ball no better than anyone else’s, but I believe this is a high probability scenario and thus if you own oil or natural gas companies make sure you own low cost producers that have strong balance sheets.

What industries and sectors look attractive now?

High return *on* capital is great, but in today’s environment return *of* capital is what matters. This is not a time to be a hero. We are not making leveraged plays to make a lot of money. We are being very conservative.

The meaning of what constitutes quality is being redefined today. We are buying high quality companies with low valuations (a large “margin of safety”), a lot of cash, and low debt. A lot of ex-dotcoms - technology companies - look attractive, since it is an industry that is deeply imbedded into the corporate structure. If the economy slows down, corporations generally can’t cut back on technology usage. New projects may slow down, but a lot of technology is based on recurring revenue. That is what matters in this environment. We expect that companies like Microsoft and Oracle will be able to buy competitors at attractive valuations. They have bulletproof balance sheets.

We are very careful of consumer spending habits. We don’t like industries (like automobiles) that sell products that require consumers to borrow money. These industries have already been crippled. If you buy a cyclical company,



then you must normalize earnings and be very conservative in valuations, and make sure you are increasing required margin of safety.

Are there any foreign markets that look attractive now?

It comes down to stock selection. For example, we are concerned about Europe, but we own a British liquor company that has better fundamentals, a lower valuation and higher yield than its American counterparts. It is likely to do better in this environment. Our biggest concern is the “stuff” stocks (industrials, energy, and materials). They were responsible for a good chunk of excess in corporate profit margins. The analysts’ earnings assumptions are way too optimistic. The only question about the recession is how big it will be and how long it will last.

As I mentioned before, it is a stock picker’s environment. We don’t know how long this drama will last, and thus we are not trying to be heroes.

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