Market/Economic Outlook: January 2012

Insight from the perspective of our Chief Investment Officer

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By
Fred Martin, CFA

DISCIPLINED GROWTH INVESTORS

The Way Wealth Is Built

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We think the year of 2011 will be remembered as an historic year. There were three nearly simultaneous collapses of political/economic governing models. The three models were:

1) The European social-democrat contract
2) The Arabic strongman/despot regime
3) The American Keynesian economic model

Each of these three governing/economic systems has been deteriorating over a lengthy period of time. Their simultaneous occurrence roiled the capital markets throughout the year. In the face of this turmoil, U.S. companies focused successfully on managing their respective enterprises. The U.S. stock market ended 2011 largely unchanged.

While we are tempted to conclude that the turmoil in 2011 will continue into 2012, we believe the odds favor a more benign market climate. The reason is practical: These three models of major importance have already failed. There is arguably only one more to fail—the Chinese central command model. If nearly everyone knows the three have failed and at least partially adjusted their portfolios to the new reality, the only shocks to the system should be aftershocks.

Our analysis is not meant to suggest that the political world will not continue to be chaotic. As of now there are no clear "new" models to replace the old ones. Europe's current leaders are largely in denial; their voting populace is perhaps even less motivated than the political leadership for change. The Arab strongman model is still disintegrating. Iraq, Tunisia, Egypt, Libya, and Yemen have changed governments; Syria (and Iran?) are teetering. More regimes may fall. It is not clear whether the new governments in the Arab world will be Islamist regimes, democracies, or some hybrid mixture. In both Europe and the Middle East, progress is likely to be uneven and slow.

During 2011 it became increasingly clear that the long-running American experiment with Keynesian economics was utterly out of answers. Increased government spending did not yield improved economic conditions, but huge budget deficits, more debt, high unemployment, and sluggish growth. The increase in the U.S. indebtedness is overriding the stimulus effects of massive budget deficits. A dramatic increase in regulatory activity and a loophole-riddled tax code have also put a damper on U.S. business activity.

To make matters even worse, revenues (taxes) paid to the federal government seem to be going down a black hole. Almost no federal government enterprise, save the military, seems to be working. The Postal Service is flirting with bankruptcy, the Social Security system is actuarially insolvent, our national energy policy has been misfocused for decades, and the U.S. educational effort seems to be slowly declining in spite (or because) of the federal government's role in setting national policies or providing student loans. There are far too many cabinet departments; one would hard-pressed to name all them, let alone describe what they do. The two most prominent government-sponsored enterprises, Fannie Mae and Freddie Mac, are still zombies, and U.S. housing remains in a depression.

It cannot surprise anyone that voters are extremely unhappy with their elected officials.

The United States has a national election in November. While it is clear that U.S. voters are more committed to change than the existing crop of officeholders (with a few exceptions), the election may not provide much more than a glimpse into the future framework of the new relationship between the citizenry and the federal government. We would caution our readers to avoid reading too much into the election. We believe U.S. voters will ultimately insist on a smaller and more effective federal government. Progress is likely to be measured in decades, not years.

> **"Over the next decade, the return from big cap stocks of 7-8% should dwarf the 2% or less return from 10-year Treasury notes.**

A plethora of problems

In the meantime, the failure of Keynesian economics has put U.S. monetary authorities (FOMC) in a difficult position. The FOMC has twin tasks: full employment and price stability. The FOMC has been trying to single-handedly revive the economy by following an easy-money policy. This has produced several unintended consequences: The economy is not reviving quickly, the threat of destructive inflation has increased, and the interest-rate environment has become grossly distorted.

This distortion in the interest-rate environment may become the major story of 2012. Problems are already cropping up in the capital markets. The money-market fund industry has suffered a game-changing decline in fee revenues. According to Barron's weekly newspaper, annual fees for the money-market funds have declined from $13 billion to $5 billion per year in the last three years. Many money market funds are earning no yield before fees, and the industry is consolidating rapidly. Money market fund assets are fleeing into regulated bank deposits. The banks do not want the deposits because they have nowhere to invest the money at a reasonable interest spread.

The long-term investor is suffering under this interest-rate environment. For years, the prudent investor had been able to hedge against the risk of major macroeconomic events by investing in bonds. Since 1981 bonds have not only provided investors with a hedge, but have also yielded excellent absolute and relative returns. This is called "having your cake and eating it, too." As of the date of this piece, 10-year U.S. Treasury notes yield-to-maturity is 1.9%. Notwithstanding the obvious credit deterioration of the U.S. Treasury, this yield-to-maturity strikes us as puny. There is no margin of safety for investors in these securities, especially if inflation rears its ugly head.

The low interest rate environment is likely to cause other problems. The assumed returns for pension funds must be reduced if the particular fund has a significant exposure to fixed income securities. The hedge fund business to some extent relies on a reasonable interest rate environment to earn its rich management fees.

The clear winner

The U.S. stock market is clear winner in this environment. Price-earnings ratios for the S&P 500 are below average at around 12.5x. P/E multiples should increase to historically normal levels of 18x, providing the basis for a return in excess of earnings growth. Most investors have misunderstood the relationship between P/E ratios and systemic risk. While P/E ratios are clearly related to earnings growth and interest rates, there is little evidence that they should be adjusted up or down for rising or falling systemic risk. With future earnings growth likely to be only slightly below historic norms and below-normal interest rates, P/E ratios can go back to normal levels. With earnings growth of 4-5%, big cap stocks should yield a return of 7-8% for investors, depending upon how quickly P/E ratios return to normal levels.

We want to reinforce the point that investors incorrectly raise and lower P/E ratios based on perceived economic stability. After a long period of economic growth from 1981 until the late 1990s, investors raised P/E ratios to unsustainably high levels. After two severe bear markets in 2000-2002 and 2008-2009, investors decided to reduce P/E ratios. Both calculations were wrong.

Over the next decade, the return from big cap stocks of 7-8% should dwarf the 2% or less return from 10-year Treasury notes. Our common stock portfolios are positioned to achieve returns in excess of big cap stocks and far in excess of bonds. We build our portfolios one stock at a time. In every case we develop a seven-year forecast of revenues, earnings, and cash flow for that particular company. Our forecasts are conservative—which means our companies have excellent odds of achieving their revenue and earnings forecasts. This should provide the basis for excellent long-term returns for our clients' portfolios.

We have based our forecasts on a sluggish worldwide economy. That affects our clients' portfolios, but not in the way you might think. The key to our portfolio companies is less related to the economy and more to the conditions in their own targeted markets. Economic uncertainty causes larger companies to focus on their core businesses, often leaving large market opportunities for the savvy mid-sized or smaller company. Economic uncertainty also virtually stops the flow of new IPOs. Our companies face less competition from well-capitalized startup companies than anytime in the last 20 years. Their odds of achieving superior growth are higher than normal.

A final observation

One final observation about our portfolio holdings: Virtually every one of our companies reduced labor expense after the 2008-2009 financial crisis. They have not reduced spending on research and development. New product development is one of the keys to long-term success for our holdings. We are pleased that our corporate managements have maintained their commitments.

Forecast returns are based on Disciplined Growth Investors' assumptions and internal research. Forecast performance does not guarantee future results.

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About Disciplined Growth Investors

Disciplined Growth Investors is a Minneapolis-based investment management firm specializing in prudently exploiting investment opportunities in publicly held small cap and mid cap growth companies. Founded in 1997, the firm remains employee owned and completely independent.

About the Author

Fred Martin is Disciplined Growth Investors' founder and Chief Investment Officer. Fred has been managing portfolios since 1976 and is the primary architect of the investment philosophy employed by the firm.