

## MARKETS UNDER PRESSURE

In these sorry days many investors wonder how it is possible that they own so many lousy stocks, which keep sinking deeper and deeper, and how long it is going to take until all their fortune is lost.

In the seventies, stock markets were in a similarly desperate state. My boss at the time approached the problem by separating our universe into two categories: the “wonderful companies” (les belles affaires) and the “lousy companies” (les cochonneries). Purchases were selected from the first list, whereas sales were drawn from the second. That was the solution. The only drawback: we realized, after a few years had passed, that the lousy companies had performed quite well, but not the wonderful enterprises, which were lagging behind.

How could this happen? At the point of departure, the selection was clear: good performers with an attractive outlook got on the first list, poor performers with a clouded future on the second. In reality the list proved to be backward looking and more a description of previous developments rather than a predictor of future events. In reality reversion to mean played its role. Favored sectors and companies with fantastic products continued to do well and to enjoy high valuations for a while but soon circumstances changed, their competitive advantages disappeared while other sectors and companies advanced and profited. Our two lists had to be rewritten.

Problem sectors and companies, which today face dire prospects, get only minimal valuations in stock markets. Most people avoid them; nobody wants to show them in his portfolio, in particular if holdings have to be published. Clients and superiors will ask a fund manager why he or she is investing in those losers when everybody knows that their outlook is bleak. The easiest path is the one of least resistance, bow to the pressure and fill the portfolio with popular stocks while shunning losers. However, as tables turn, looking ahead past the next few months the sectors and companies with the potential to produce the biggest gains are today's losers, although this may still be out of sight.

Today, energy and raw material stocks look attractive and promising. Sales and profits are reaching new highs, new investments abound and the outlook is rosy. On the other hand, there is only negative news in the press, on the radio and TV concerning financial and to a lesser degree, pharmaceutical companies. Stocks are hammered down without mercy and the outlook is dismal, with further losses almost certain. But within a few years the situation will look quite different. The low prices of today, that cause us so much pain, will appear as a unique chance to get in at a bargain level. Today's ridiculed buyers may be tomorrow's smart investors. But it is hard to envision this in the middle of all the gloom and doom.

Maybe you ask now: how do you know that valuations in these sectors are really low? You can see it when large parts of a firm or whole companies are being bought and sold. Tesco for example is buying half of TPS (Tesco Personal Finance), which is owned by Royal Bank of Scotland. It pays 13 times the profit of TPS. Royal Bank of Scotland is available at only 4 times. Another example: Zurich Financial Services pays 15 times the profit for a Spanish insurance company, but you can buy its own stock for less than half at 7 times the earnings. It may be that you don't like the term “within a few years”, but if values double in five years it amounts to a 14.8% annual return; after ten years it is still 7.17%. It pays to be patient and persevering!

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