Eidelman Virant
CAPITAL

Quarterly Letter September 2011

Dear Clients & Friends,

The S&P 500 and Russell 2000 indices declined 13.9% and 21.9% respectively in the 3rd quarter, the most since 2008. These losses were driven by macroeconomic news from Europe, China, and the U.S. Continued political wrangling over Greece's budget issues fostered concern of a Lehman Bros-like domino effect in Europe. In China, a manufacturing index recorded its third consecutive month of contraction, renewing fears of a "hard landing" as the government maintained efforts to curb inflation and demand for exports weakened. Here in the U.S., Standard & Poor's downgraded the U.S. government's top Triple-A credit rating for the first time in history and falling economic metrics such as consumer confidence renewed concerns of a "double-dip" recession.

The key question now on everyone's mind is, "How will all these problems impact stock prices in the near and long-term? No one can answer that question with certainty, but history suggests that low valuations and negative sentiment imply favorable odds for good returns going forward. One of the most convincing arguments to own stocks today is the current spread between stock and bond yields. Since 1954, when equity earnings yields (E/P) rose this far above the 10-year Treasury yield, the S&P 500 Index subsequently outperformed 10-year Treasury bonds by an average of 11% per year over the subsequent five-year period.

David and I recently had the opportunity to attend a presentation by and speak with Dr. Jeremy Siegel, commentator and author of one of my favorite investment books of all time: "Stocks for the Long Run." In the next section of this letter, I'll outline Dr. Siegel's timeless lessons and why he thinks equities currently represent an outstanding investment opportunity.

Dr. Siegel's argument for owning equities is so convincing that one may ask "Why wouldn't everyone have a significant allocation to stocks?" Nearly everyone invested in the market over the last quarter knows the painful answer to this question: short-term losses. However, if equities didn't experience short-term volatility, stock prices would be higher and thus long-term returns would be lower. In other words, short-term risk is what creates long-term opportunity.

In the final section entitled "Q&A," I'll dive a little deeper into common questions we are asked regarding the cloudy macroeconomic picture and the best course of action going forward. Overall, we remain confident that a carefully picked portfolio of value-oriented investments gives us the best chance to minimize losses during such market volatility and capture gains when the market rebounds.

If you have any questions, please don't hesitate to give me a call.

Sincerely,

Tom Eidelman, CFA
Vice President

STOCKS FOR THE LONG RUN

BY TOM EIDELMAN

On September 22nd, David and I had the opportunity to attend a presentation and speak with Dr. Jeremy Seigel, commentator and author of "Stocks for the Long Run." In his presentation, Seigel made a compelling case for why stocks have been and will continue to be the best avenue for growing and protecting wealth in the long run. I would summarize his case as follows:

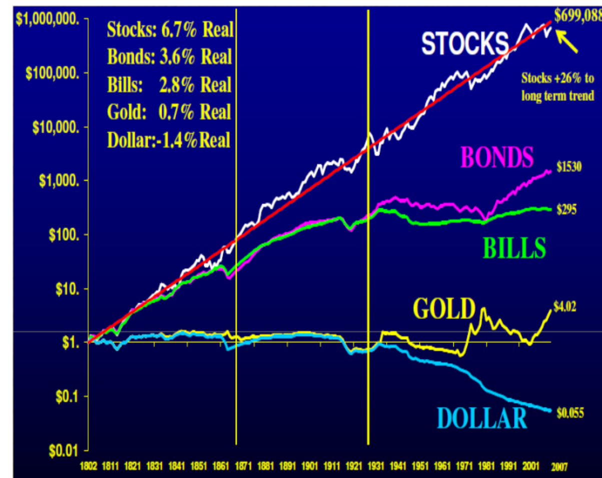
- Stocks have been the best performing asset class for over 200 years.
- This long-term outperformance has occurred across different countries and decades, encompassing varying macroeconomic conditions.
- U.S. stock returns depend on world productivity growth; which should continue to increase with ease of communication & globalization.
- Stocks are currently undervalued relative to bonds and historical averages, implying good future returns.

Stocks Outperformed

From 1802-2010, stocks have dramatically outperformed bonds, bills, gold, and cash (See Chart A). On an inflation-adjusted basis, $1 invested in stocks would be worth $699,000 versus just $1,530 for bonds, the next best asset class listed. This works out to an inflation-adjusted return of 6.7% for stocks versus 3.6%, 2.8%, and 0.7% for bonds, T-bills, and gold over two centuries. Perhaps more relevant has been the performance since World War II (1940), in which stocks returned an after-inflation 6.6% annually vs. 1.8% and 1.3% for bonds and gold respectively.

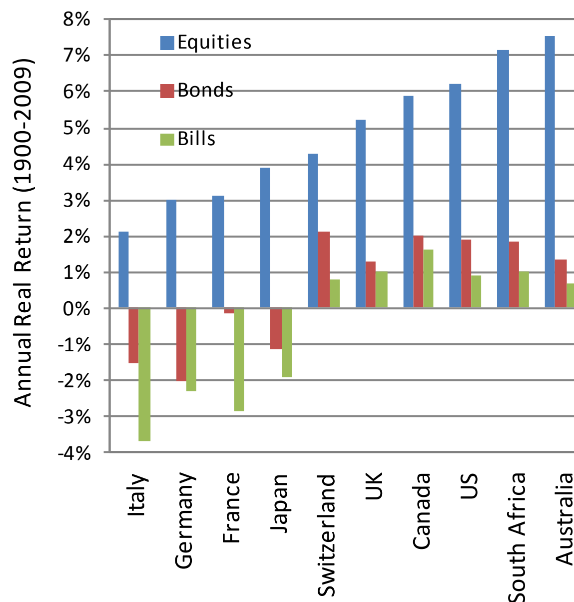
Such spectacular stock market performance was not limited to the U.S. alone. Since 1900, stocks have outperformed in nearly every developed country and have clearly been the way to build wealth over the long run (See Chart B).

Chart A: Stocks Outperformed Dramatically (1802-2010)



Source: Stocks for the Long Run

Chart B: Stocks Outperformed Worldwide (1900-2009)



Source: Stocks for the Long Run

The Odds of Stock Outperformance

Since 1871, stocks have beaten bonds 71%, 81%, and 95% of the time over 5, 10, and 20 year holding periods. There has yet to be a 30-year period where stocks did not outperform bonds (See Chart C).

Chart C: Percentage of Periods Stocks Outperformed Bonds & T-Bills (1871-2008)

Holding Period	Stocks Outperform Bonds	Stocks Outperform T-Bills
1 Year	59.4%	64.5%
2 Year	65.2%	69.6%
5 Year	71.0%	74.6%
10 year	81.2%	84.8%
20 Year	94.9%	99.3%
30 Year	100.0%	100.0%

Source: Stocks for the Long Run

Although the dominance of stocks over bonds in the long run is clear, it is important to note that over 1-year periods, stocks still underperform bonds or bills about 40% of the time. As we have seen in 2008 and 2011, such underperformance can be dramatic. The severity of losses, combined with a reasonable probability of short-term underperformance, is why it can be so hard for investors to stay the course in a down market.

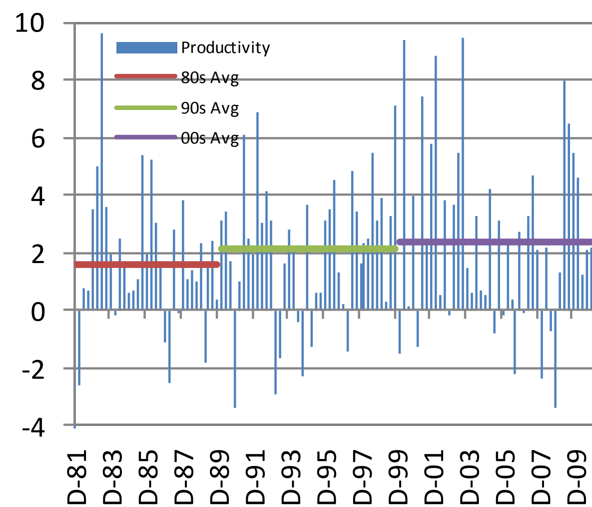
Productivity Matters

Many investors are concerned that future returns won't return to historical levels when faced with a more mature, sluggish, and over-indebted economy. Siegel doesn't believe it.

While attaining his PhD in economics at MIT under famed economist Paul Samuelson, Siegel determined the most important indicator of economic health to be productivity. Productivity is output per man-hour (producing more with less) and is what really increases the standard of living.

Dr. Siegel believes that productivity will not only continue its historical growth rate, but may actually be accelerating as you can see by comparing each decade's average productivity rate (See Chart D). Siegel postulates that global collaboration will result in even larger productivity gains as information sharing via the internet and mobile communications facilitate new discoveries and inventions.

Chart D: US Labor Productivity Growth



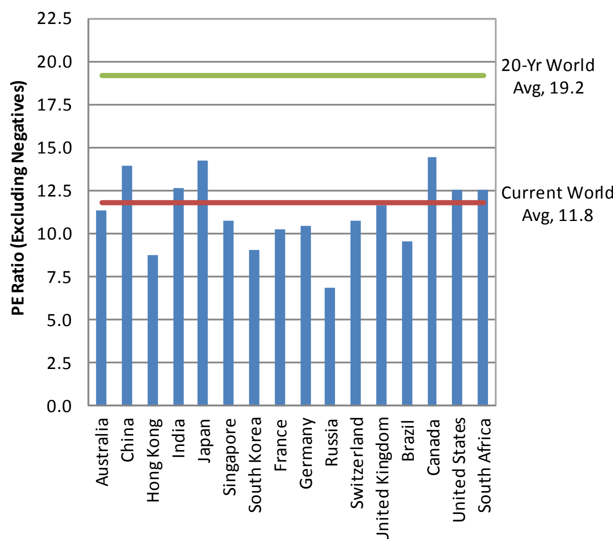
Source: Factset

Valuations Cheap in the US & Worldwide

Another key determinate of whether stocks will continue their long-term performance is current valuations. If stocks are overvalued, then their future returns would likely be lower than in the past. Conversely, low valuations would imply good future returns. Where do valuations stand today?

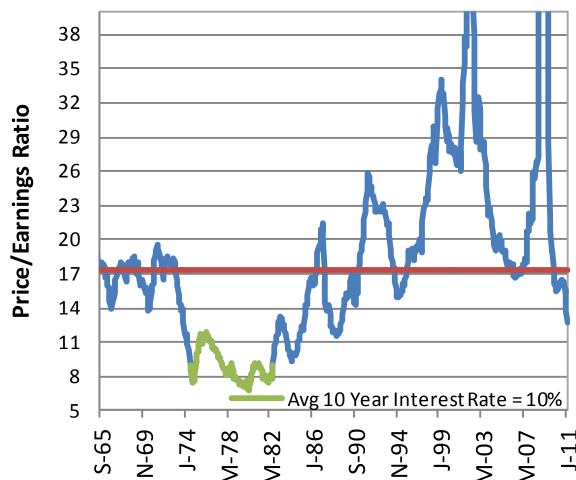
World and U.S. valuations (as measured by P/E ratio) are approximately 38% & 27% below their historical averages respectively (See Charts E & F on next page).

Chart E: World Valuations < Historical Avg.



Source: Factset

Chart F: US Valuations Below Average



Source: Factset

Many people look at Chart F and say "Couldn't P/E ratios go back down to single digits like they did in the seventies?" Siegel doesn't think so.

Siegel believes the only reasons stock valuations got so low in the 70s and early 80s is because bonds offered an attractive alternative. Why invest in stocks when bonds offered guaranteed double digit returns?

In 1981, any investor could have yanked their money out of the stock market and gotten a guaranteed 10-year treasury return of up to 15%. Don't you think that's pretty good competition for stocks? The 8-year period highlighted in green on Chart F shows that while P/E ratios were in single digits, the 10-year treasury bond averaged 10%.

Siegel thinks the only way stocks will experience another prolonged period of P/E ratios in the single digits is if we also have another extended period of double digit interest rates. As a reminder, the current 10-year treasury bonds just hit an all-time low of 1.8%, the lowest level since the 1940s. Stocks appear extraordinarily valued relative to bonds in the eyes of Professor Siegel.

Investor Behavior Causes Poor Returns

Despite great historical market returns, studies show that typical investors actually earn much less. Dalbar Inc, a company which studies investor behavior and analyzes investor market returns, reported that while the S&P 500 Index averaged 9.14% for the twenty years ending 12/31/2010, the average equity fund investor earned a market return of only 3.83%. How is that possible? People pour money into equity mutual funds when they are going up and pull money out when the market goes down. In other words, emotional reactions cause them to buy high and sell low.

Conclusion

We agree with Siegel's compelling case for stocks. When times get tough, and investor fear sends stocks tumbling, it's important to review the facts and see the big picture. With stocks as attractively valued as they are today, equities should continue to be a great way to grow wealth in the long run.

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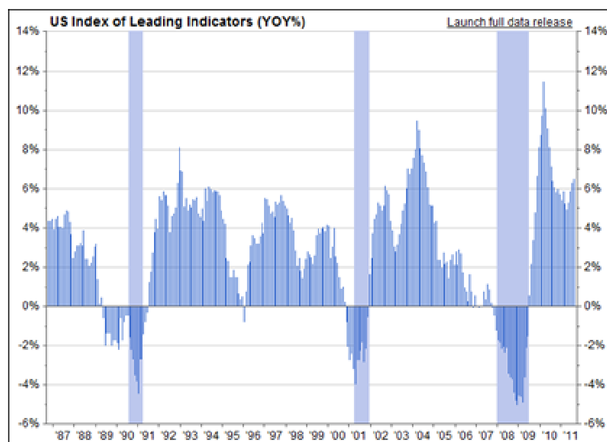
QUESTION & ANSWER (Q&A)
WITH TOM EIDELMAN

Question: Do you think the U.S. will experience a "Double-Dip" Recession?

There is certainly a diversity of opinions on this question. St. Louis based Macroeconomic Advisors just increased their 2011 GDP forecast from 1.7% to 2.1% and believe that the U.S. will avoid recession. Supporting this case is a strong 6.5% year-over-year increase in the US index of leading economic indicators and record corporate profits (See Chart G).

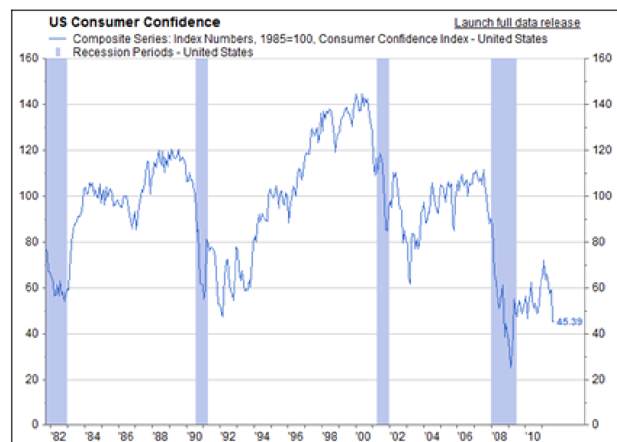
Conversely, Economic Cycle Research Institute (ESRI) notified their clients last week that the U.S. economy is indeed "tipping into a new recession" and "there's nothing that policy makers can do to head it off." They point to falling U.S. consumer sentiment and asset prices (See Chart H). If we had to give odds on it, we would put it at 50/50.

Chart G: Leading Indicators Growing



Source: Factset

Chart H: Consumer Confidence Falling



Source: Factset

Will continued bad economic news negatively impact stocks in the near and long-term?

We believe the most likely economic scenario to be a modest recovery or shallow recession and that stocks may have already priced in much of the bad macroeconomic news already. According to a recent article and data from Bloomberg, U.S. equity valuations have already pushed the S&P 500 Index 25% below the average level from the last nine recessions since 1957. In other words, the market may already be reflecting recession prices.

Another hopeful piece of historical data came from Standard and Poor's, who noted that awful third-quarters have historically preceded positive fourth-quarters. S&P's Stovall says, "out of 66 third-quarters since 1945, there have been 10 that declined 10% or more, including this year's. Of the previous 9 third-quarter wipe outs, the S&P 500 turned positive in Q4 8 out of 9 times by an average of 7.2%. That's an .888 batting average that we get a 4th quarter pop of some degree."

(continued on next page)

How serious are the problems in Europe and what will be the effects on the market?

The reason the market has reacted so negatively towards news emanating out of Europe is that nobody really knows what's going to happen. Greece (and to a lesser extent other countries) has accumulated debt loads to the point that paying it back is virtually impossible given the size of their economy. Typically, such a country would default (like Argentina in 2002) and work out a solution with their bond holders like paying them half the money now and the rest in payments later like a credit collection company. What makes this different is that 17 countries in Europe are tied to the same euro currency, hold a lot of each other's debt, and worry that default of one country may cause a domino effect or "contagion" where bank losses and fear causes the next country default. With the 2008 financial crisis so fresh in people's memories, many investors are fleeing stocks for the perceived safety of cash and bonds.

The good news is policy makers are hurrying to nip this in the bud. Their solution is the European Financial Stability Fund (EFSF), a TARP-like program with 440B euros to safeguard financial stability within the Eurozone by loaning to sovereign states and banks.

I'm further comforted by the fact that Germany and France seem to have the economic capacity to absorb losses from the less healthy euro countries. France and Germany have a combined 4.5 trillion euro economy and a relatively modest 55% net debt/GDP ratio. Even if Greece, Portugal, and Ireland all defaulted (600 billion Euros), a hypothetical fully financed France/Germany bailout would increase their net debt/GDP to 68%; which is still below that of the U.S. (75%) and Japan (128%).

More realistic, however, is a concerted effort and cost sharing between the IMF (which includes money from the U.S.), the European Central Bank (ECB), and the European Financial Stability Fund (EFSF). Most experts believe the final solution will "ring fence" the better economies like Italy, recapitalize the banks, and implement good old fashioned belt tightening. Let's hope the policy makers make sound and quick decisions. Once this big uncertainty is behind us, the markets may not look back.

What is the best course of action going forward?

We continue to believe the best way to grow wealth in the long run is by selecting a diversified group of individually picked securities that meet our strict criteria. As I outlined in the previous section, macroeconomic fears have created an opportunity for diligent long-term investors.

Three points that further support the case for better future market returns are: 1) Investor sentiment measures (as measured by the Conference Board, AAII, & Investor's Intelligence) are at very low levels, 2) Valuations (as measured on an absolute basis or relative to bonds) are well below average, and 3) On a micro level, we are seeing some great individual values in the market. While we don't know what will happen for sure, we believe the odds favor holding a strong allocation to value-oriented equities for the long run.

Disclosures:

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