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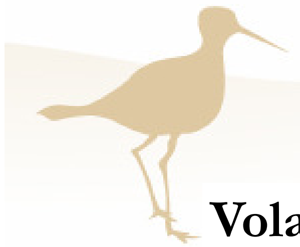
**Sandpiper Capital**

# Gleanings



## Volatility Happens

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> *"Between 2000 and 2007 there were four trading days where the S&P was down 4% or more. Since 2008, there have been twenty-one."*

### Market Returns through 06/30/2010

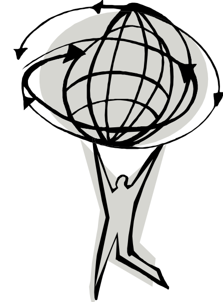
| Index | 2008 | 2009 | YTD |
|---|---|---|---|
| **S&P 500** | -36.9 | 26.5 | -6.6% |
| **ML 1-10 yr Gov't/Corp** | 4.1 | 5.7 | 4.6% |
| **EAFE (Developed Mkts)** | -43.3 | 31.8 | -13.2% |
| **Emerging Markets** | -53.2 | 78.5 | -6.2% |

The prodigious quantity of excess liquidity that fueled our economic recovery has not been withdrawn as sales and earnings revive, it just hasn't been supplemented. While we're certainly past the high water mark, the question the markets have been asking recently is when will the tide go out?

In normal (modern) economic circumstances, the central bank seeks to introduce just that amount of extra money into the banking system to lift demand sufficiently to prevent prices from going down. The debt that piles up with each successive round of easing, however, has made the degree of retrenchment in each recession that much larger, requiring greater and greater policy offsets. The extra $1.2 trillion added to the monetary base last year was a reflection of just how severe a contraction we had been experiencing. In a regulatory environment where money center banks' trading operations are permitted 50:1 leverage, the low interest rates that accompany a stimulative monetary policy make for many billions of dollars of trading profits as the rising tide lifts all boats. With traders accustomed to commensurate bonuses, a certain degree of desperation has been evident recently in the violent movements of trading capital looking for a trend, (either up or down.) Just as one example, between 2000 and 2007 there were four trading days where the S&P was down 4% or more. Since 2008, there have been twenty-one. As long as rates are low, leverage is high and regulation permissive, volatility will continue to be a fact of life.

So, how long before the Fed raises rates? Have there been sufficient trading profits to rebuild banks' equity capital? Not really. The FDIC reported that commercial banks had a $17 billion increase in non-performing loans last quarter against trading profits of $8 billion and total net income of $16 billion. (Do you think it's a coincidence that the amount of quarterly recognition of bad assets just matches the amount of realized net income?) Even assuming no increase in non-performing loans, to work the current $250 billion in bad loans and foreclosed real estate off commercial banks balance sheets will take another four years (at $16b in profits/qtr.). That's assuming rates stay low and trading profits continue to double net income.

The benefit of all this volatility is the increase in the number of entry points for value investors as the markets vacillate around a central value. With the recent market pullback, we find that the current quote on the S&P 500 puts it at a significant discount to our calculation of fair value.



Remembering that past performance is no guarantee of future success, we are reassured to see, in the chart below, that buying value has historically worked pretty well. In the three different episodes over the past twenty-three years where the S&P was selling at a similar discount to intrinsic value, (the pink line measured against the left scale); the subsequent three year total return (blue line, right scale) for buyers at those levels accrued in a range of a compound 13% to 31%. We may not yet be at the point of maximum pessimism. We do know, however, that there are many smart investors who are aware of the 7.6% current earnings yield of the S&P and who may well be persuaded to re-allocate assets from bonds to stocks now that bond yields are at historic lows, (1.75% on the five year Treasury).