The Upside of Down Markets

or how in recessions the equity markets throw out the baby with the bath water!

by IMCZ Member John Henry Smith

Experts believe that the toxic mix of collateralized debt obligations, such as asset-backed securities and credit default swaps that allowed massive off-balance sheet leveraging of junk quality mortgages is responsible for the deep, wrenching financial crisis of global proportions unlike any we've seen since 1930s.

As a consequence of this deepening recession, the stock market began to rapidly cannibalize itself in a vicious maelstrom of deleveraging caused by the abrupt cessation of inter-bank lending. Consequently, the 10,000 hedge funds with more than $1.7 trillion in assets saw their credit lines being slashed or cash demands made upon them to cover margin calls as stock prices plummeted. This illiquidity further exacerbated equity market stability, when in September alone a $31 billion tsunami of redemptions forced many hedge funds to dump up to 20% of their holdings, irrespective of quality, causing a further decline in net asset values to meet their obligations (see The Hedge Fund Scorecard below). And this process of "throwing the baby out with the bath water" is likely to continue when quarterly redemptions falling due on 30 November 2008 are expected to set off another fire-sale of assets that will again fuel the downward price spiral.

Hedge Fund Scorecard			
Fund	**Strategy**	**Assets[1]**	**Returns[2]**
Winners			
Clive Fund	Commodities	$2.4	+34%
Bluetrend Fund	Financial futures	$5.7	+31%
Paulson Credit	Distressed	$5.0	+18%
Brevan Howard	Macro-strategy	$16.0	+14%
Oceanic Hedge	Stock/commodities	$1.5	+2%
Losers			
Tosca Fund	Global stocks	$3.4	-60%
Tremblant Partners	U.S. stocks	$2.1	-36%
Third Point Offshore	Mult-strategy	$2.8	-21%
QVT Overseas	Multi-strategy	$6.0	-21%
Drake Global	Bonds	$2.6	-17%
Data: BusinessWeek of Nov 3, 08		[1]Billions	[2]Year-to-date

Despite efforts to stem the problems it is difficult for funds that are down 30% or more to raise new money and persuade investors not to rush to the exits. Charles Biderman, chief executive of TrimTabs Investment Research, estimates that 25% of hedge funds will be out of business by the end of 2009.

So where have all these interlocking 'shenanigans' of Wall Street left investors? Undoubtedly drained and highly insecure! According to Dr. John Rutledge of Rutledge Capital, a private equity firm, last summer the total market capitalization of the U.S. stock markets was calculated at $19.1 trillion. As of close November 7, 2008, it was estimated that the U.S. market cap is now only $11.5 trillion, losing a staggering $7.6 trillion, or 40%, in 14 months!

For patient investors these losses have thrown their investment dreams as far back as early 2003 in the bitter knowledge that in the economic environment of tomorrow, full recovery is likely to take much more than a mere five years since the high leveraging practices of Wall Street will be swept away by the U.S. regulators that will reflect itself in slower economic growth.

On the other hand, for those shrewd enough to get out in time, or those who are simply cash-rich, the situation opens up once-in-a-life-time investment opportunities after the carnage is done, revealing an aftermath of high quality, but significantly depressed stocks that continue to demonstrate sustainable growth prospects, but at remarkably low price-to-earnings (PE) ratios.

Verily, this is the upside of down markets; it occurs when exaggerated fear and petulance has forced broad market moves that ignore the fundamentals, track record and future prospects of sound companies. The following table shows a selection of stocks that in terms of their earnings growth forecasts belong to the babies that the market dumped.

Symbol	Industry	YTD Nov 26, 08	EPS this Qtr	EPS next Qtr
MTRX	Materials & Construction	-67%	3900%	25%
MEE	Metals & Mining	-53%	1650%	192%
CNX	Metals & Mining	-58%	325%	337%
POT	Chemicals	-57%	229%	116%
MOS	Chemicals	-69%	173%	142%
DO	Energy	-46%	60%	34%
CTV	Telecoms	-77%	55%	39%
BUCY	Manufacturing	-60%	54%	53%
FLS	Manufacturing	-49%	49%	18%
RIMM	Telecoms	-61%	42%	35%

No one knows just how far the stock market will fall, but the combined effects of the financial meltdown, a serious main street recession and the anticipated regulatory curbs on the banks' abilities to leverage 'in the same old way' will continue to take their heavy toll on stocks across the board. Yet it must not be forgotten that today stock prices are so cheap that as an investment class it has prompted Warren Buffet to say that the best time to buy stocks is when the economy tanks because it lets you buy a slice of America at a marked-down price.[2]

However, even the venerable Mr. Buffet confesses that he can't predict the short-term movements of the stock market, not knowing whether it will be higher or lower in a month or a year from now. If therefore he is unable to gauge when a future turnaround is due, surely it is better to wait until the market itself signals that the economy has started to recover. With this assurance in place informed investors can enjoy the pickings of deeply undervalued stocks such as those shown in the table when the timing is safer.

Warren Buffet believes that early investors will have the unique choice of outstanding companies with very low PEs that he believes are set to make new profit records 5, 10 and 20 years from now. He of course may be right, but when one looks at the start of the current bull market on October 7, 2002 when the SP 500 stood at 785 points and which ran out of steam on October 10, 2007 at 1565 points, we see a bull market cycle that ran not for 20 years but for 5. If, as I suppose, bull markets will probably get shorter with fewer opportunities for excessive returns, investors must learn from recessionary cycles and be prepared to either go short or exit the market in a timely manner to avoid the losses that many a beautiful market baby has suffered this year.

[1]A Goldman Sachs index that tracks the top stocks held by hedge funds dropped by 34% over the three weeks ending October 10, a period when managers were frantically selling shares.

"Buy American. I am," by Warren Buffet, published in The New York Times on October 16, 2008[2]