Market Volatility

September 2011

Following the market swings experienced in August, many investors are understandably rattled. Despite the last-minute agreement to raise the U.S. debt ceiling and avert default, one of the major credit rating agencies downgraded U.S. government debt one notch below its highest AAA rating to AA+. Most agree that the risk of U.S. default on its securities remains remote. However, the protracted negotiations around the debt ceiling, fears about the prospects for corporate profits and continued concerns regarding austerity measures and solvency in some European countries contributed to wide market fluctuations. In just a few days, the S&P 500 gave back its year-to-date gains and then some. In this month's commentary, we offer our thoughts on recent market conditions as compared to those experienced during the last period of high volatility: the financial crisis of 2008.

The market swings experienced in August elicited immediate comparisons in the financial media to the volatility experienced during the financial crisis of 2008. In fact, current equity risk premiums appear to be reflecting equal or greater risk than in December 2008. One way to see this is by examining the CBOE Volatility Index (VIX), a measure of market expectations of near-term volatility as conveyed by S&P 500 stock index option prices. Below are some observations from last month and from the height of the financial crisis in 2008.

Date	Event	VIX Level
March 17, 2008	Bear Stearns acquisition offer by J.P. Morgan	32.2
September 15, 2008	Lehman Brothers Chapter 11 filing	31.7
September 8, 2008	Fannie Mae and Freddie Mac placed into conservatorship (9/7)	22.6
September 16, 2008	Injection of capital into AIG	30.3
August 8, 2011	First trading day following S&P downgrade of U.S. government credit rating	48.0
Source: CBOE		

In 2008, it took nine months for the level of volatility to reach levels that were reached in 6 or 7 trading days in August, 2011. In our view, investors, in their quest to achieve linear returns, sold first and asked questions later, often ignoring the fundamentals of the stocks they were trading.

The VIX closed on September 9, 2011 at 38.52, the rapidity with which market volatility expectations rose in August and into September implies that the market views investment risks as the same as or greater than those during the disruptive events of 2008. However, we do not believe the fundamentals substantiate the same level of fear for several reasons:

- Corporate profits and balance sheets are stronger than in 2008
- Federal Funds borrowing rates are at historic lows, and the Fed has made clear that they will maintain low Fed Funds rates for the foreseeable future

- The banking system has significant reserves (more than $1 trillion in aggregate reserves) with aggressive write downs imbedded in current assets

All in all, equities appear to be far more conservatively positioned than in 2008, yet the equity risk premium is extremely high, in our view, relative to other asset classes, including Treasuries, investment grade corporate debt and municipal securities.

We see similarities to concerns expressed in late 2010 and earlier this year with regard to municipal securities. Many fled municipal securities fearing increased default rates. In fact, municipal bond defaults year-to-date have been lower than in 2010 (and defaults in 2010 were lower than in 2009) as municipalities seek to rectify their budget concerns. Many municipalities have slashed services to bring their budgets in line, and some are experiencing increased revenues as their tax bases recover, making default less likely for quality municipal securities.

While the S&P downgrade of U.S. government debt may have been the final trigger, solvency of the U.S. government does not appear to be the primary concern of the markets, as evidenced by the compression of yields on 10-year Treasuries following the rating change. Many factors contributed to the tumultuous markets experienced in August, including U.S. economic concerns, questions regarding the sustainability of corporate profit levels, high unemployment levels, and continued uncertainty regarding solvency of certain European countries and the potential for contagion to other economies continue to weigh on the markets.

With regard to corporate profit margins, we believe that concerns regarding sustainability are warranted. As we have discussed in the past, the net profit margins of major U.S. corporations are at or near all-time highs. The profit margin expansion witnessed over the past decade and longer has been aided by factors including decreasing corporate tax rates and rising government expenditures. The most recent increases in profit margins are largely on the back of cost controls rather than revenue increases, and may even reflect underinvestment by certain companies in their businesses. For companies whose margins have expanded as a result of underinvestment, we do not view these profit margin levels as sustainable.

However, while many companies may have built up cash reserves and shied away from taking risks in the current environment, some management teams have bucked this trend. Owner-operators are generally focused on long-term returns on capital as opposed to near-term performance. In times of economic uncertainty, we believe owner-operators are positioned to take advantage of the investment opportunities that arise, often at fire-sale prices. These companies continue to operate as they always have, producing strong operating results and repurchasing shares. Yet, in our opinion, many of these businesses are currently available at steep discounts. We view this as an opportunity to invest at attractive valuations, and in the fullness of time we are confident that attractive returns on assets will be realized irrespective of periodic volatility.

We acknowledge that the current markets have risks, but believe that with thorough analysis and a willingness to invest over an extended horizon, it is possible to allocate capital to investments which are likely to reward the patient investor.