Eidelman Virant
CAPITAL

Quarterly Letter **September 2010**

Dear Clients & Friends,

The 3rd quarter ended with the best performing September since 1939, recording a monthly gain of 7.8%. This one month gain quickly swung the 2010 negative return on the S&P 500 back into positive territory for the year. Key data lifting the markets were upward revisions in GDP, a 3% uptick in housing prices over last year, booming industrial production, and falling mortgage rates. On August 20th, the National Bureau of Economic Research (NBER) officially announced that the "recession was over."

On top of positive economic news, merger & acquisition activity increased to its highest quarterly level in three years, with companies such as Potash, McAfee, and 3Par being offered buyouts at significant premiums. However, despite this positive news, many people are still skeptical of the economy and stock market. The most common question we are getting today is: "Do you actually expect the market to go up from here?" Our answer is a resounding "Yes."

While most of our quarterly letters are dedicated to specific ideas using our value-oriented investment approach, this letter will be different. A common concern we're hearing is: "we are confident in your value approach, but we are just concerned about the market overall." While we believe that our diversified portfolios can perform well in all kind of markets, we also understand the pervasive concerns about the economy and stock market.

There are certainly many reasons to be worried including huge government deficits, stubbornly high unemployment, and slowing economic growth, but most people are not aware of the positives. Weighing all the factors, we believe there are convincing reasons to be invested in stocks to attain the best long-term investment returns. This entire letter will be devoted to making that case.

In the next section "Top 5 Reasons to Invest in Stocks Right Now," we'll explain how low relative stock valuations, pessimistic sentiment, accommodative Federal Reserve policy, the upcoming mid-term elections, and the stabilization of key economic data items (housing prices, and bank reserve ratios) indicate that stocks should perform very well in the future.

Sincerely,

Tom Eidelman, CFA
Vice President

TOP 5 REASONS TO BUY STOCKS NOW

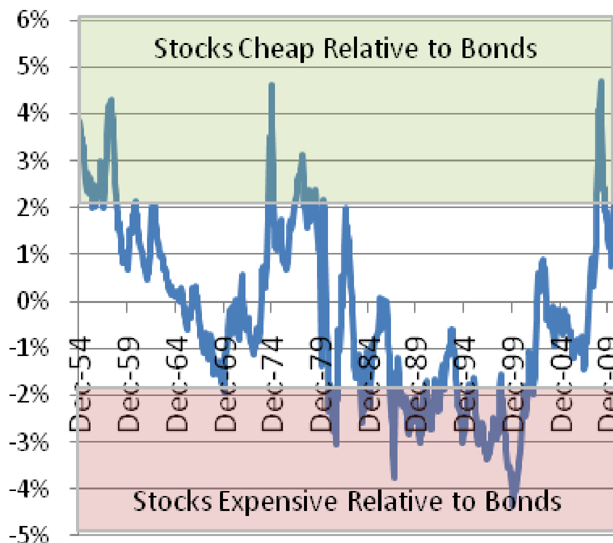
BY TOM EIDELMAN

On August 13th, I read an article in the Wall Street Journal entitled *"Is a Crash Coming? Ten Reasons to Be Cautious."* Not only did I disagree with the author's pessimistic arguments, but I thought he got it backwards. Our studies show that nine out of his ten points were reasons to be optimistic! With skepticism pervasive, his article inspired me to write about the top reasons to be bullish.

Reason #1:
Stocks are Undervalued Relative to Bonds

It should be no surprise that our number one reason to be optimistic is because stocks are relatively undervalued. One of the best ways to value stocks is to measure their earnings yields (E/P) compared to the yield on bonds. On this measure, stocks are currently trading near their cheapest levels since 1978 (Chart A).

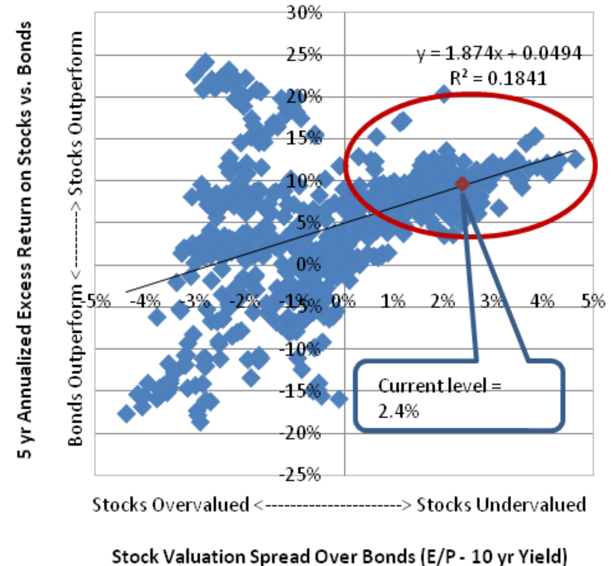
Chart A: Stock Yields Cheap Relative to Treasuries



Note: Earnings yield on stocks (E/P) using Shiller's trailing 10 year avg earnings over current price on S&P 500 versus the yield on 10-year U.S. Treasury Bond.

Historically, when equities were this discounted to bonds, stocks outperformed by an average of 10% annually over the subsequent 5 years (Chart B). In fact, there has been no rolling five year period over the past 50 years when stocks didn't outperform bonds when the valuation spread was as significant as it is today.

Chart B: Stocks Outperform with Favorable Spread



Note: When stocks were cheap relative to bonds (based on earnings yield minus 10-year Treasury spread), stocks outperformed bonds over an annualized 5-year period. Data from 1954-2010.

JNJ Bonds vs. Stock: A Case Study

One way to think about the value disparity between bonds and stocks is to use a specific example. Healthcare spending is growing steadily throughout the world and Johnson & Johnson (JNJ), a leading diversified healthcare company, is dominantly positioned to take advantage. 70% of JNJ's products are #1 or #2 in their industry with patent protection and a strong product pipeline.

AAA-rated JNJ recently issued 10-year bonds at 3%. Conversely, JNJ's common stock, which has grown earnings at 13% compounded over the past 20 years, now sports an earnings yield of 7.6%. This earnings yield represents the yield JNJ could distribute if its annual earnings were paid out as a dividend. Would you rather have a fixed 3% interest rate or an earnings yield of 7.6% which should grow at a healthy rate?

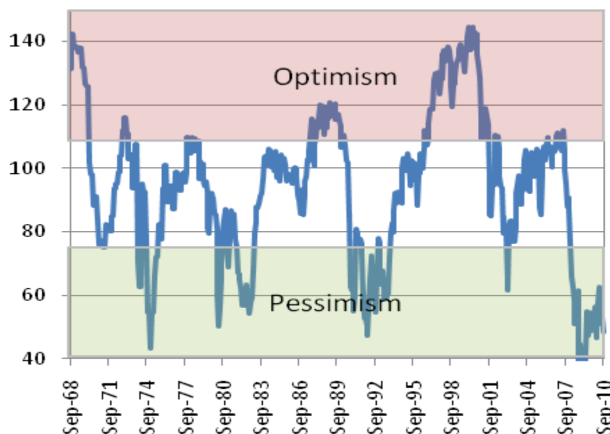
To us, the JNJ common stock presents the better value. We see total return potential for JNJ exceeding 10% per year based on their 3.5% dividend plus 5-10% growth. In addition, there could be a potential 20% kicker if their valuation increases from their currently undervalued level of 13x earnings toward their historical average around 16x.

Reason #2:
Sentiment is Pessimistic (Yes, that's good)

Second to valuations, we think investor sentiment is the next most important factor. Investor optimism and pessimism are contrarian indicators. For instance, when people are most pessimistic, they have often already sold their stocks at rock bottom prices believing there is little hope left for a rebound. It is often at the point of maximum pessimism when stocks reach their lows.

Two measures of investor sentiment are the Investor's Intelligence poll and the Conference Board Consumer Confidence Index (CCI). While the Investor's Intelligence poll just rebounded from pessimistic levels to an average level, the CCI is still decidedly pessimistic.

Chart C: Consumer Confidence Near All-Time Lows



Data: Conference Board

The chart below shows the historical market returns following periods of differing confidence levels. The current pessimistic CCI reading of 45 has positive implications for future returns. Market returns have averaged 12% subsequent to readings as pessimistic as they are today (See Chart D below).

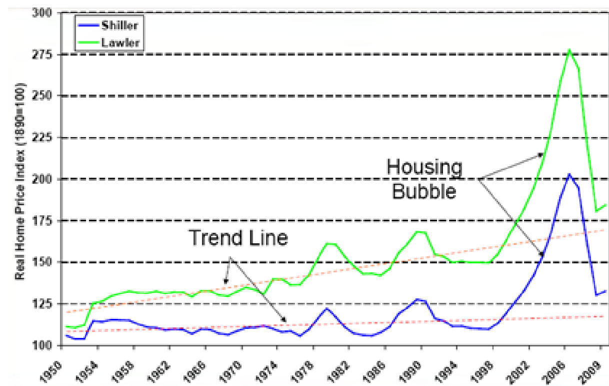
Chart D: CCI vs. S&P 500 Annual Returns (1968-2010)

Sentiment	CCI	Ann Return %
Optimistic	> 110	3.8%
Positive	100-110	8.2%
Neutral	90-100	7.7%
Cautious	75-90	6.5%
Pessimistic	< 75	12.2%

Reason #3
The Root Cause of the Crisis is Behind Us

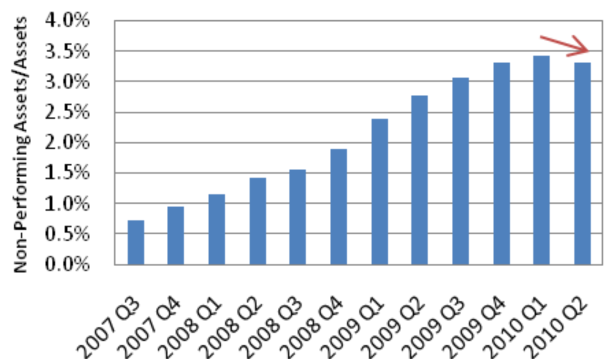
The market collapse of 2008 centered around over-leveraged bank balance sheets whose assets were tied to overvalued real estate. This situation has improved dramatically. After falling 28% from the peak, the Case-Shiller housing index is now back in line with historical trends and has actually perked up 7%.

Chart E: Housing Prices Back to Trend



As a result of a stabilization in housing, combined with capital raises, bank balance sheets saw their first improvement since the credit crisis began. Non-performing assets ticked down in the second quarter for the first time since the crisis began (See Chart F).

Chart F: Bad Loans Finally Improving



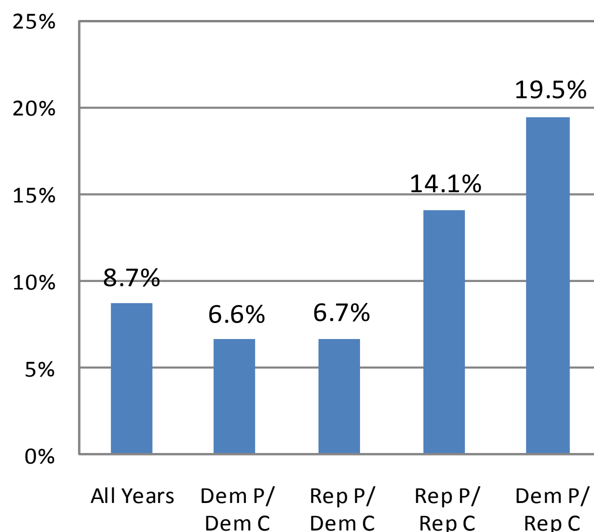
Data: BankRegData

With housing prices back to normal levels, strong bank capital levels, and improving credit trends, some of the biggest potential threats to the economy have been diffused. These two charts alone should give everyone some relief that the worst is behind us.

Reason #4:
Mid-term Elections & Presidential Cycle

A hot topic over the coming months will be mid-term elections, the potential for the Republican party to gain control of Congress, and what it means for the stock market. Personal politics aside, the stock market has historically preferred certain combinations of political control. You may be surprised to learn that the worst performing political climate for stocks has been the one we're are currently in: A Democratic president combined with a Democratic Congress. Below is a chart from the stock trader's almanac entitled: "Gridlock in Washington Best for Market." It shows that a potential Republican victory could provide the ideal combination (Democratic presidency and Republican Congress) for the best market returns (See Chart G).

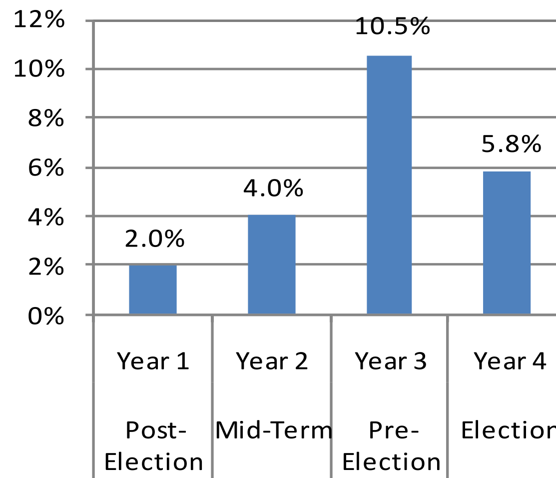
Chart G: Gridlock is Best (1949-2007)



Data: Stock Traders Almanac 2009

Presidential elections have profound impacts on the economy and the stock market. Wars, recessions, and bear markets tend to occur in the first half of the term; prosperous times and bull markets, the latter half. Why is that? Many believe in an effort to get re-elected, presidents take care of their most contentious initiatives in the first half of their term and undertake stimulative measures in the second half so the electorate is more prosperous when they enter the voting booths. For this reason, the pre-election year has been significantly better than the others going back 175 years (See Chart H). If this trend continues, the implication is that 2011 will be a very strong year.

Chart H: Presidential Cycle vs. DJIA Returns (1833-2010)



Reason #5
The Fed is Accommodative

"Don't fight the Fed" is a famous Wall Street adage that has been proven right throughout time. While interest rates are near zero already, the Fed has indicated that they are keeping rates low for "an extended period." In addition, the FOMC said it is "prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate." Some prominent hedge fund managers have pointed out that the Fed's policy creates a win-win situation. If the economy recovers, stocks go up. If the economy sputters, the fed will institute another round of quantitative easing, which would also be bullish for stocks.

Conclusion

As we've outlined above, we see a compelling case to own stocks today. Undervaluation, negative sentiment, accommodative fed policy, upcoming elections, and improving economic data lead us to remain confident that stocks are a great way to protect and grow wealth for the long run.

We are confident that our portfolios have the right combination of value and downside protection, while at the same time provide an opportunity to take advantage of the underappreciated reasons to be optimistic.

Disclosure: This newsletter is for informational purposes only and does not constitute a complete description of our investment advisory services. This newsletter is in no way a recommendation of any security or a solicitation or offer to sell investment advisory services.