

Newsletter

“Paralysis By Analysis; Or Patience, A Virtue”

We started our [August 2009](#) newsletter with the following passage: *“A common model used to deduct the valuation of major indexes is to project future earnings potential of the companies in the respective index and multiply it with a historical average price to earnings (P/E) multiple. Currently, the S&P 500, a popular broad based index used in the US, is trading at 987. Earnings for fiscal year 2009 for the 500 companies in the index are estimated at \$55-56. In other words, if we divide the index value with the earnings estimate, we will derive a P/E multiple of approximately 17. Historically, the index has traded at an average P/E multiple of 15-16. Encouraged by second quarter 2009 earnings, most analysts increased their earnings estimates of the S&P 500 companies for 2010 by almost 34% to \$75-76. If we use the historic P/E multiple stated above, we can deduct a fair value of S&P 500 index in the range of approximately 1125-1200. It can be inferred from this simple model that the S&P 500 can gain another 14% in value if the economy is infact in a turnaround phase and earnings continue to grow.”*

We have mentioned a number of times since late 2009, that the earnings projections in the US and globally will determine the market direction. We still believe that this variable is the most crucial aspects impacting investor sentiment and hence market direction.

Following are various issues which have kept market pundits busy valuing domestic and global economic growth:

1. [European banking and debt crisis.](#)
2. [US financial regulation.](#)
3. [Double dip recession in the US.](#)
4. [The impact on Chinese GDP growth if the European Union's economy slows down significantly.](#)

It can be clearly observed in Chart 1, that despite a 14-15% gain since August 2009, the markets have traded in a range for most of 2010.

Chart 1



We reiterate the importance of global and domestic earnings in driving markets and believe that the world is at a pivotal point with emergence of over 500-600 million consumers which shall drive growth over the next two decades. This new consumer class comes from the the burgeoning middle class in countries like China, India, Brazil and other emerging countries continue to experience growth in disposable income. The per capita consumption in these areas is currently less than one tenth that of their US counterpart consumer and in some instances even less. The potential for increased consumption in basic commodities and consumer products will continue to explode in our view and boost capital markets all over the world.

Despite increasing frequency of headlines from various media sources emphasizing the uber growth in emerging markets, the average investor has not recognized the importance of this phenomenon. Instead, the short term reactionary behaviour of investors is satiated by the spicy snippets of news on aspects that are believed to have long lasting impact on the market.

We truly believe that the advent of technology in the form of telecommunication, cable and the internet has impacted investor sentiment for the negative. Too much information and in our view has brought about "Paralysis By Analysis". In other words, investors do not see or believe in a systematic approach to investing in the market which has created a distasteful experience, especially as the ownership of investment products has risen over the last two decades. We would like to divert our reader's attention back to the fundamentals where earnings ultimately drive the markets.

Earnings Growth and S&P 500 valuation based on historical Price Earnings multiple

S&P 500 Earnings (2008)	\$49.51
S&P 500 Earnings 2011 (Estimate)	\$80.00

	82 Year Average	50 Year Average	25 Year Average
Average P/E	16.00	17.00	21.00
Projected S&P 500 Valuation	1,280.00	1,360.00	1,680.00

1. Our model uses the average Price to Earnings multiple, usually used to value the market indexes.
2. Price to Earnings Ratio data derived from www.ndr.com and <http://cgamadvisor.com/wp-content/uploads/2009/06/CGAM-Newsletter-December-20091.pdf>. This data is used for the last 82, 50 and 25 years for illustrating the range of the S&P 500 index valuation.
3. The US economic recovery and the perceived financial infrastructure reconstruction has led to heightened expectations in regard to US corporate earnings.
4. Most analysts and economists have started to raise the US corporate earnings expectations and expect approximately \$80 in earnings for the S&P 500 companies in fiscal year 2011.

It can be observed that based on investor sentiment, which translates into different P/E multiple, we have different values of the S&P 500 exhibited in the table above. In other words, at a reasonable P/E ratio of approximately 16-17, we can expect the S&P 500 to appreciate by 14-21% respectively for the next 12 months with \$80 in corporate earnings.

Instead of being paralysed by too much analysis, we recommend that investors embrace patience as a virtue for long term handsome economic fruition.

Table 1 illustrates the change in U.S. broad based equity indexes since the beginning of the year 2009. This is followed by the performance of the recommendations CGAM has provided via the monthly Newsletters for the same time frame.

Broad Based US Indexes	Dec 31st, 2008	30-Jul-10	Gain/Loss (%)
Dow Jones Industrial Average	8,776.00	10,466.00	19.26%
NASDAQ COMPOSITE	1,577.00	2,255.00	42.99%
S&P 500 INDEX	903.00	1,102.00	22.04%
RUSSELL 2000 INDEX	499.51	651.00	30.33%
Average Return			28.65%
CGAM Recommendations Since December 31 st , 2008	Security Price at Recommendation Date (\$)	July 2nd, 2010	Gain/Loss (%)
UltraShort 7-10 Year Treasury ProShares	52.66	42.38	-19.52%
Blackrock Corporate High Yield Fund Inc (Sell Recommendation Oct 2009)	4.08	6.98	71.08%
Eaton Vance California Municipal Income Trust (Sell Recommendations July 2009)	7.99	13.32	66.71%
Western Asset Managed Municipals Fund Inc	9.40	13.14	39.79%
Boulder Growth & Income Fund Inc	4.47	5.87	31.32%
Ultra Financials ProShares (1:10 Split; April 15th, 2010)	32.80	58.4	78.05%
CGM Focus	25.56	28.22	10.41%
Bank of America Corp	6.82	14.36	110.56%
Caterpillar Inc	27.96	70.43	151.90%
Corning Inc	14.62	18.91	29.34%
Manitowoc Co Inc	5.95	11.3	89.92%
E TRADE Financial Corp	14.40	15.08	4.72%
Blue Nile Inc	45.90	51.12	-11.37%
Wendys/Arbys Group Ord Shs Class A	4.00	4.28	7.00%
Foster Wheeler Ltd	23.10	23.94	3.64%
Akamai Technologies Inc (Sell Recommendation on May 2010)	16.44	38.49	134.12%
Immersion Corp	4.30	5.88	36.74%
United States Natural Gas	11.74	7.96	-32.20%
Progressive Corp	16.00	19.75	23.44%
Banco Santander ADR Rep 1 Ord Shs	16.11	13.66	-15.21%
Corning Inc	16.68	18.91	13.37%
AT&T Inc	26.94	26.63	-1.15%
Citigroup Inc	3.32	4.15	25.00%
Activision Blizzard Inc	11.39	11.48	0.79%
PowerShares DB Gold Double Short ETN	14.13	11.69	-17.27%
Goldman Sachs Group Inc (Sell Recommendation on May 2010)	156.35	152.78	-2.28%
Chimera Investment Corp	4.00	3.86	-3.50%
Banco Santander ADR Rep 1 Ord Shs	12.34	13.66	10.70%
ProShares UltraShort S&P500	35.54	31.33	-11.85%
Microsoft Corp	\$23.27	26.01	11.77%
AT&T Inc	\$24.29	26.63	9.63%
Bank of America Corp	\$13.84	14.36	3.76%
Chevron Corp	\$67.31	78.8	17.07%
Pfizer Inc	\$14.14	16.36	15.70%
Citigroup Inc	\$3.79	4.15	9.50%
Merck & Co Inc	\$34.22	34.94	2.10%
			24.83%¹

¹ Note: Total return for CGAM are not annualized and do not consist of dividends and interest.

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