



What the Model is Telling Us

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Introduction

Fear and greed, so we are often told, are the highly contagious emotions that rule the stock market in the short-run, often sending stock prices to exuberant highs and pitiful lows with scant regard to rational thought and underlying fundamentals. Recently, we have witnessed a particularly violent form of this in only a few volatile months. Such periods can be the bane of quantitative models. However, these periods often give rise to extraordinary opportunities for disciplined money managers, who remain faithful to their valuation models, while patiently waiting for underlying company fundamentals to overthrow emotion as long-term values are realized. After all, the numbers don't lie.

The VIX Index gets its 15 Minutes

From the high in October of 2007 to the low on March of 2009, the S&P 500 lost more than half of its value, the biggest drawdown since 1932. Again, widespread fear gripped the market. In the following three months, the index rose almost 40%, the biggest three-month shift since, not surprisingly, 1933. In the melee, bulls and bears shook the market to and fro, creating near-unprecedented levels of volatility.

In a more normal environment, daily price fluctuations of the S&P 500 of over 2% are a rarity, occurring on average about once a month. In the past year, however, daily price swings of over 2% have averaged twice per week. As a result, investor attention turned to volatility, and financial news services began regularly reporting the level of the CBOE's Market Volatility Index (VIX).

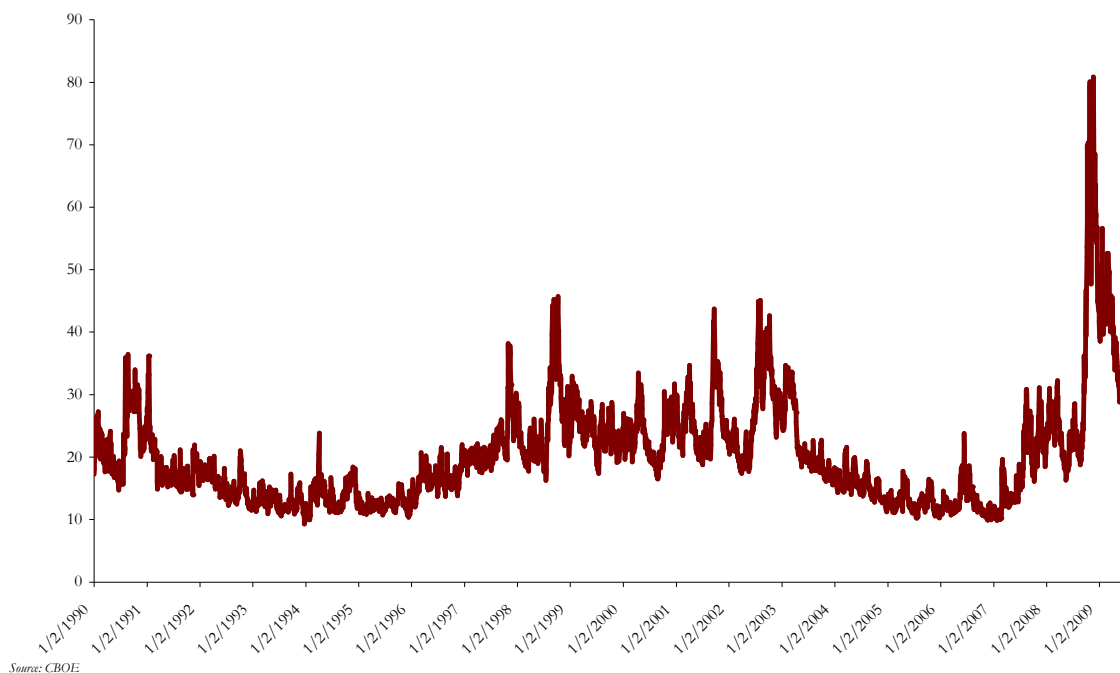
While the index is variously touted as a measure of fear, and sometimes even a cause of volatility, it is important to understand that the index is, in fact, designed to be a forward-looking measure of volatility that investors expect to see. The VIX is implied from 30-day put and call options on the S&P 500. Therefore, any interpretation of volatility based on the VIX should refer to anticipated moves down *or* up. That the index has worked well as a gauge for fear (expected down moves) is more a function of the fact that the S&P 500 futures market has been dominated by investors buying puts. In this regard, the index spiking during the recent turmoil was, in fact, indicative of fear. Investors, who were perhaps long equities, were seeking near-term portfolio insurance in the form of 30-day puts. In other words, one might reasonably conclude that based on the VIX and more importantly its underlying drivers, fearful investors were not willing to wait for long-term values to be realized. As the market rebounds, the VIX plummets. Unsurprisingly, investors become less consumed with the idea of portfolio insurance as emotion gives way to reason.



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VIX INDEX DAILY PRICES



The Fair Value Model

Cornerstone's proprietary Fair Value Model (hereafter 'the model') comprises 800 stocks. At the trough of the market, 760 of these stocks were undervalued on our valuation measure based on long-term fundamentals. Many other in-house measures of valuation (discount to fair value, implied growth, risk premium, etc.) were also at all-time highs, or lows in the case of implied growth. Indeed, the model architect, a man whose investment experience spans over four decades, declared that he had never seen anything like this before.

The model was also telling us that volatile, or economically sensitive stocks, were more undervalued than stable, or less economically sensitive stocks. In volatile times this discrepancy is perfectly understandable, as investors shun the former in favor of the latter, the perceived safe-havens. However, the extent to which investors turned their collective backs on the more volatile, cyclical stocks created compelling long-term opportunities as had been identified by the model.

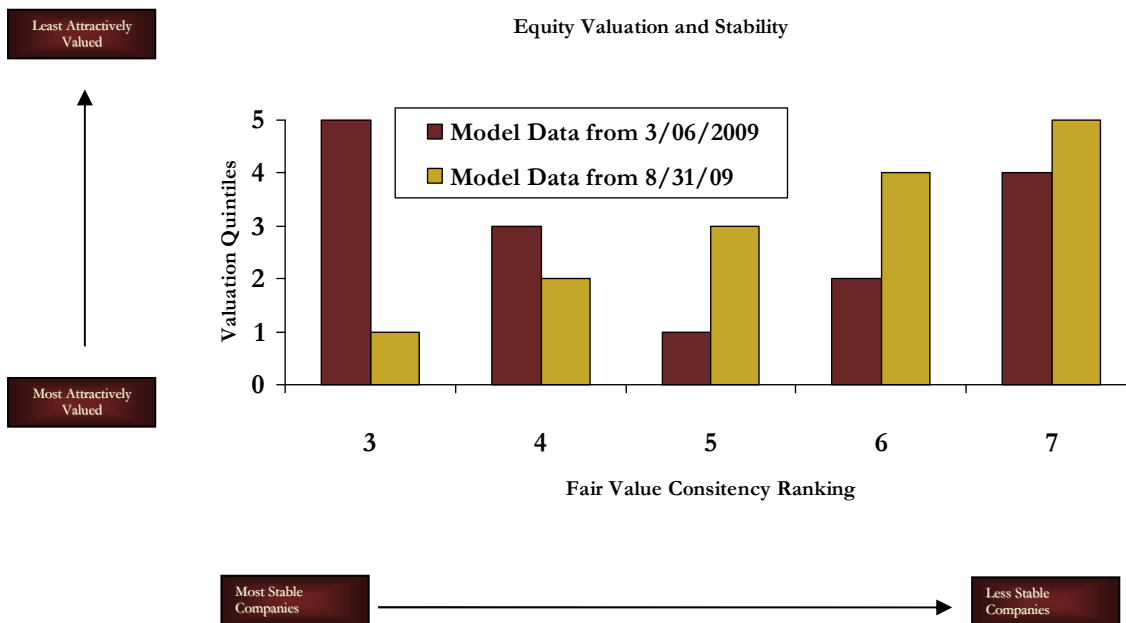
The model is not emotional and does not forecast; it was simply telling us that investors were extrapolating increasingly dire scenarios based on ever-worsening macro data points as the new norm. Based on what the model was telling us, one had simply* to believe that the situation was either not as bad as many perceived, or would at least not persist *ad infinitum*. In fact, the next earnings season proved both contentions to be true. Of the companies that reported, 80% beat their low expectations, and the market reacted accordingly. The herd shifted direction abruptly and dramatically, with everyone wanting a piece of the action.

* There was absolutely nothing 'simple' about this. The emotional pain of doing something when everyone else is doing the exact opposite is felt in exactly the same part of the brain as physical pain and has been likened to having one's arm broken on a regular basis! On a similar note, Keynes once noted, "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally".



Stocks that were left for dead only three months earlier saw their values double, triple or even more. Just as portfolio insurance is being shunned, so too are the so-called safe-havens as fear abates.

Today, most companies in the model are still undervalued based on their long-term fundamentals; however, the make-up of the most undervalued names has shifted. Many of those stable safe havens have become the forgotten stocks and now offer the most compelling opportunities in the model. A prime example is Wal-Mart. This industry-leading behemoth has grown revenues and earnings consistently year in and year out with very little fluctuation in even the rate of growth. Returns are also incredibly consistent regardless of the economic environment, yet the stock is still comfortably in negative territory over the last twelve month and year-to-date periods. The stock has underperformed the S&P 500 by almost 50% since the low on March 9th. In the midst of a massive bull market rally, it is hard to argue the appeal of a boringly consistent operator such as Wal-Mart, except to say that therein lies the appeal. The circular logic of this statement might not be a difficult concept to grasp; it is, however, a very difficult concept to act upon. Knowing something to be true isn't always enough to change behavior, and thank goodness for that!



Source: Cornerstone Investment Partners Fair Value Model

Concluding Remarks

An emotion-driven stock market can be a tough time for those focused on long-term fundamentals and valuation. In such times, following the herd is not only the easiest course of action, but it may also be, in the very short-term at least, the correct course of action. Longer-term, however, it is very difficult to consistently outperform the market using this strategy. A disciplined investment team, guided by a well-designed model, must put emotions aside and go where the valuations tell them. Results prove that this strategy works over the long-term regardless of the cycle. The numbers really don't lie.