June 2011

Dear Investor,

U.S. stock prices trended modestly lower in May, with the S&P 500 ending the month down a little over 1%. We have seen an additional decline so far in June, which has been enough to trim the market's year-to-date gain from close to 10% down to a few percent. The MSCI World Ex-USA Index ended with a decline in May as well, and the more recent decline in June has pushed the index slightly into negative territory for the year.

Commodities and commodities stocks also fell in May, with the price of oil falling 5% and the CRB Commodities Index falling 5.5%. Most of this decline occurred early in the month, and since then the price of oil has traded sideways at around $100/bl. Persistently high prices for oil and other commodities have been aided by excessively accommodative monetary policy and strong demand from speculators. While the recent stabilization may continue for a short time, if the larger trend in oil and other commodities has indeed turned lower we should see additional declines through the summer.

Gold continued its recent trend of outperforming other commodities by falling only 1.8% in May (versus a 5.5% decline in the CRB index), and it has also been rising relative to stocks. While it is still very early in this new trend, this recent outperformance of gold may be a signal that the 2-year-old consolidation of the ratio of stocks to gold is at an end. We have been expecting stocks to begin declining versus gold again sometime in the near future, and we'll just have to wait and see if the recent outperformance by gold continues in the months ahead.

Along with stocks and commodities, Treasury bond yields also have fallen over the past few months. The yield on the 10-year Treasury note is now near 3%, from a high of 3.7% earlier this year. However, nothing in this recent market action has made long-term Treasuries more attractive on a fundamental basis. Determining whether or not yields will fall over the next few months is not as important to us as assessing the risk inherent in holding long-term Treasuries as we move into another period of extreme policy uncertainty. At present, the risks appear to far outweigh the potential gains, and this is not the type of odds we strive for.

We have talked a lot about larger macro themes in recent letters, and there has not been much change on the macro front. This month we'll provide a brief update on the stock market and our investment approach.

Equity Indexes	May	2011	Market Indexes	May	2011
S&P 500 Index	-1.1%	+7.8%	HFRX Global Hedge Fund Index	-1.4%	-0.5%
MSCI World (ex USA) Index	-4.9%	+3.1%	US Dollar Index	+2.2%	-5.5%
Amex Oil Index	-5.0%	+9.8%	CRB Commodities Index	-5.5%	+5.2%
Gold and Silver Index	-6.0%	-7.9%	Gold (Continuous Contract)	-1.8%	+8.1%

*   *   *

The stock market and many economically sensitive commodities have now declined from highs made at various times earlier this year. In the case of stocks, the S&P 500 has declined around 9% from a peak in April. Copper, meanwhile, has declined around 12% from its peak in February.

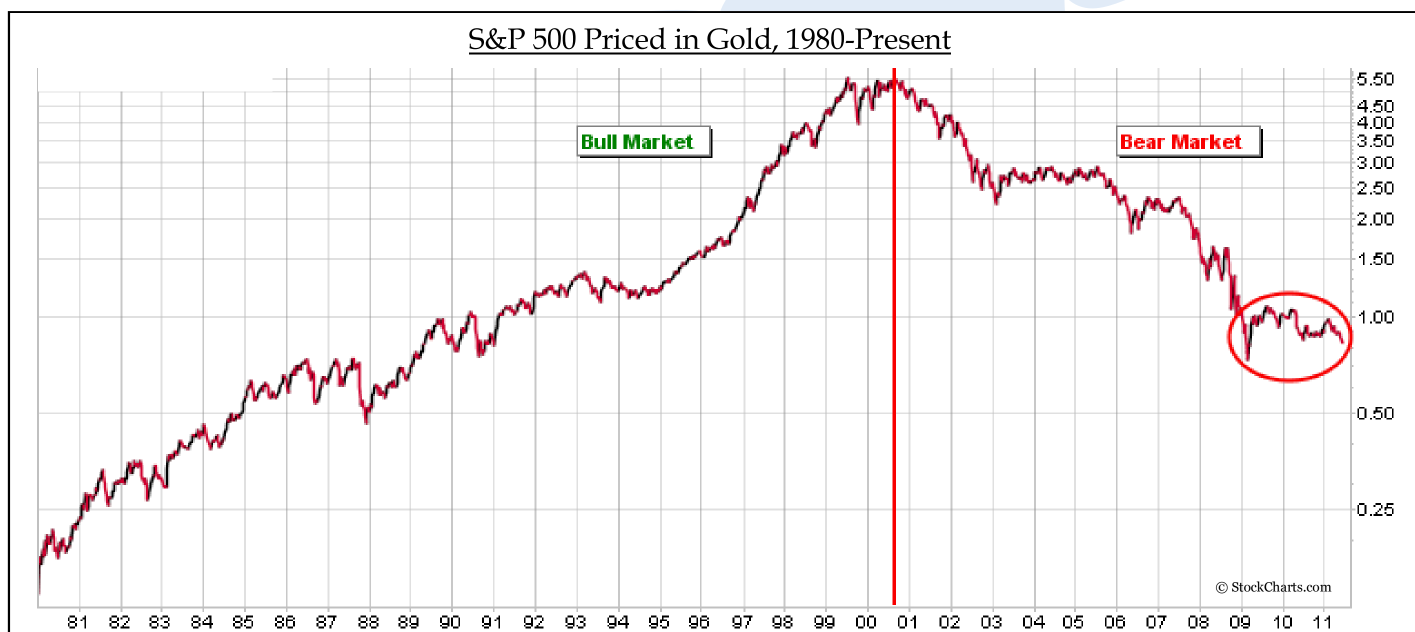
These declines have been modest so far, and they have been accompanied by some economic data that suggest there has been a slowdown in the economy. Recent manufacturing surveys have indicated the manufacturing sector has stopped expanding over the past few months, after 9 months of growth. In addition, the most recent monthly employment report showed that the rate of growth in the number of jobs has been anemic at best—the rate of job growth remains below the gains needed just to keep up with population growth.

These signs may or may not be significant as far as the economic outlook for the rest of the year. They could be early signs of another recession, or they could just be signs of short-term economic weakness that will dissipate before long. However, these data points are consistent with an overall economic backdrop that we have known about for some time: the recession in 2008–2009 was not a normal cyclical recession, and the recovery is not a robust post-WWII-like recovery.

The same thing can be said of the stock market's recovery. Like the economy, the market has recovered from the depth of its recessionary lows. However, despite the gains, it has not been a normal, robust recovery as is usually seen in a long-term bull market.

There are many ways we can see evidence of this weak recovery, but the easiest way is to look at the stock market adjusted by inflation or adjusted by gold. The chart below show one of those two adjustments. The top chart shows the S&P 500 denominated in gold through the long bull market of the 1980s and 1990s and the bear market that began in 2000.

The initial rebound from the low in 2009 was built on the foundation of inexpensive valuations based on the long-term earnings power of the market. Indeed, the initial gains in the market were also registered relative to gold. Since late 2009, however, the market's gain has been of a very different nature.



If the dollar was not constantly changing in value, we would be able to see the true change in stock prices just by looking at historical prices. But since the Federal Reserve is always de-valuing the dollar (i.e., seeking a positive inflation rate), it sometimes is difficult to see the true nature of price changes without filtering out the dollar.

If we were able to see the history of stock prices only in dollars, the sideways trading range of the S&P 500 over the past 11 years would appear rather benign. However, as we have discussed a number of times, this period has been anything but benign for stockholders. Although the S&P 500 is currently only 18% below its high price in 2000, if we use adjust for inflation using the Consumer Price Index (CPI) the S&P 500 is down 34% since 2000. And if we adjust the price of the S&P 500 with the price of gold, which is something we can invest in (unlike the CPI), the S&P 500 is down 85% from its high in 1999.

As dramatic as those losses may seem, in previous cycles the stock market eventually went on to lose much more than the current CPI- and gold-adjusted losses before another bull market emerged. In other words, if the past is any guide, we are only partway through the current bear market (our guess is that we would be in the 5th or 6th inning if this bear market were a baseball game).

The price of the S&P 500 in dollars has risen dramatically from its low 2 years ago. However, during the same time, the price of the S&P 500 in gold has barely budged and remains near its lows (red circle on the previous chart). This is a classic example of a cyclical rally within a long-term bear market—prices have risen in dollars, but not in gold.

In fact, it is quite easy to distinguish a true bull market from a bear market by just looking at stocks priced in gold. Throughout the 1970s, the S&P 500 declined against gold, and the new bull market in stocks only began in the early 1980s after stocks began to rise against gold from a very low level. During the 1980s and 1990s, the S&P 500 increased dramatically against gold until 1999–2000. Since then, stocks have been again falling against gold—and the rally in stock prices over the past 2 years hasn't made a dent in that trend.

Whether we look at the market from a long-term valuation perspective (as we have discussed in recent letters) or a real-price perspective, it appears quite clear we are still in the middle of a long-term bear market. It is in this context that we begin to assess the opportunities and risks in the market today.

During a long-term bull market, investors are free to focus almost entirely on finding the investments that will *maximize their returns*. That's because, with market valuations trending higher from a low base, there is inherently far less risk of a significant loss of capital due to market forces outside company-specific issues. However, during a long-term bear market, investors must focus much more on *capital preservation*. This is because, regardless of what is going on within a specific company, the entire market is in the process of decreasing the value it gives to nearly all stocks. This means that even if we invest in a great business that continues to grow significantly, there is a risk that real, inflation-adjusted returns will be negative anyway.

This has certainly been the case for a number of "blue chip" stocks over the past 11 years. While there are many examples in all corners of the market, we'll highlight one familiar company: Wal-Mart.

Wal-Mart's stock (NYSE: WMT) has traded between $36 and $62 for all of the past 12 years, and currently trades near $52—a price it first reached in late 1999. In that year, 12 years ago, WMT had $37 per share in sales, $1.28 per share in earnings (for a P/E of 39), and a book value of $5.80 per share. WMT stock also paid out $0.19 in dividends in 1999, for a yield of ~0.4%.

If we fast forward to the end of 2010, Wal-Mart's business had grown significantly. Sales increased 224% to $120 per share, earnings increased 218% to $4.07 per share (for a P/E of 13), and book value increased 236% to $19.49 per share. WMT also paid out $1.21 in dividends in 2010, for a yield of 2.3%.

By all measures, Wal-Mart's business has grown by a wide margin since 1999. If we'd had a crystal ball back then and were able to see Wal-Mart's financial results for 2010 and all the growth that had occurred through the intervening 11 years, most investors would have been happy to sit tight and hold WMT shares. Yet, investors who did exactly that have been handed an inflation-adjusted loss of around 10% (including dividends) for doing so.

The reason for that loss is simple: the valuation given to WMT by the market has decreased more than the real growth of the business and inflation. This shows that even if we had invested in a good company that produced solid results over the course of the last decade, it still wouldn't have been enough to overcome the drag of declining valuations during a long-term bear market.

Of course, some large cap stocks have performed better than WMT since 1999, and others have performed far worse. However, since 1999 there has been a struggle throughout the market against declining valuations, and that has made it extremely difficult for buy-and-hold investors to reap a positive real return (or a positive return of any kind). This is the case in every long-term bear market.

The most important thing for an investor to do is to match the investment approach with the market environment. There is nothing wrong with a long-term buy-and-hold approach, as long as the particular market one is buying into is in a long-term bullish trend. But in a long-term bear market, those seeking real gains have to shift their strategy.

Over the past 11 years, investors in precious metals and other real assets have done well, as gold and oil have risen dramatically over the past 11 years. These have been the few areas in which investors could maintain a buy-and-hold approach and enjoy positive real returns, because these assets have been in their own long-term bull markets.

However, in order to achieve positive returns over the past 11 years in the broader stock market, investors have had to change their approach from buy-and-hold investing to buy-and-then-sell trading. It has been important to buy stocks when the market had declined and was ready to turn up, but it has been even more important to sell when the market had risen far from its low and was showing signs of technical weakness.

In a long-term bear market, reaching for the last gains of a rally (when risk is highest) isn't nearly as attractive as building up cash in order to take greater advantage of low prices after the next market sell-off

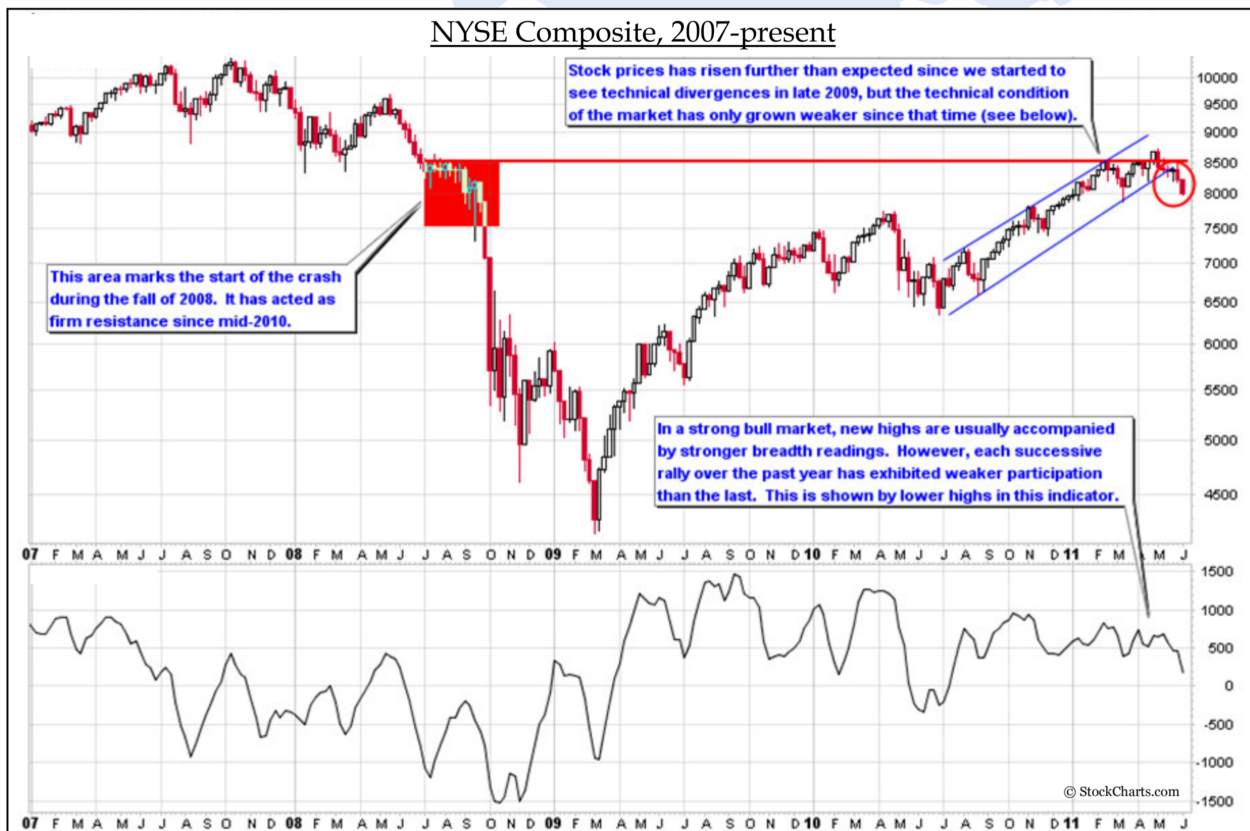
(when risk is lowest). This buy-and-then-sell approach isn't designed to be comparable to the short-term return of the stock market; in fact, there will be long stretches of time when this approach underperforms the market. Instead, it is geared toward creating a positive real return *over the course of the bear market*, when traditional long-term investing, as illustrated by the Wal-Mart example above, is on average a losing approach.

A "tired rally" is what we have seen over the past year and a half, since the S&P 500 first reached 1100 and the NYSE Composite rose above 7000 in late 2009. Since then, stock prices have oscillated up and down while trending modestly higher; the NYSE Composite is currently ~14% higher than it was in late 2009.

We have kept our exposure to stocks low since late 2009, because the potential return of the market did not appear to compensate for the high risk. But as it has turned out, with the aid of the Federal Reserve, stock prices have been able to stay aloft far longer than appeared likely at the end of 2009.

However, while major market indices have been able to stay high, this hasn't changed the "facts on the ground" much. The chart below of the NYSE Composite highlights several of these facts. First, the rally from the 2009 low remains below the resistance from start of the crash in the fall of 2008, which means that the broader market is, so far, still only in a post-crash rebound. Second, each successive rally over the past year has continued to be weaker, from a breadth perspective, than the one before it—this is the opposite of what we typically see in a sustainable bull market. And third, the market has seen strong periods of distribution over the past couple of months, indicating stocks are being unloaded onto the market. These are the opposite conditions compared to the strong accumulation seen in late 2008 and early 2009.

When coupled with unattractive long-term valuations, the above are indications that the market gains made over the past year and a half are vulnerable to being taken back. This does not mean they will be taken back for certain, but it does mean that buyers at these prices are at significant risk of loss from a market decline. Such a decline may come sooner or it may come later (or it may not come at all), but there are ample reasons to remain cautious at these prices under the current technical conditions.



The main reason behind our emphasis on different approaches for investing in long-term bull and bear markets is because investing in the current market environment with a bull-market approach is bound to deliver losses, and most investors will only realize this when it is too late.

However, there are ways to approach investing in stocks during these times that have a far better chance to deliver positive real returns over the course of the bear market. It involves buying stocks only when the market has a high potential return relative to the risk, and selling when the market has a low potential return relative to the risk—and then waiting for the next buying opportunity. While these periods can be identified by focusing on valuations, market sentiment, and technical indicators, it is ultimately patience and the willingness to stand apart from the crowd that will enable their successful navigation.

This has been our general approach to stocks since Sitka Pacific was founded in 2005, but our approach will change as this bear market runs its course. The end of a bear market is never marked by a single moment in time when prices and valuations reach their low in all corners of the market. Some areas of the market will inevitably reach their low points before others, and as that happens we will progressively be able to start thinking more long term with various holdings.

In fact, some areas of the market may have already reached valuations that suggest a long-term buy-and-hold approach is justified. For instance, some large cap technology stocks are now trading at prices that offer investors a P/E ratio below 10. These companies are rich with cash, carry little debt, and some now have a dividend yield higher than the yield on 10-year Treasury notes. As the darlings of the technology bubble, and the subsequent bust, most investors today have a negative experience with these stocks and have given up on them – which has helped create the compelling valuations we see today.

If we look ahead at what our economy and currency will likely face over the next 10 years, these stocks would appear to offer a safer place to hold capital than long-term Treasury notes and bonds. However, at this point there is no reason to rush into these stocks, or any others for that matter. Just as the market has remained overvalued for most of the past 15 years, it will likely spend a number of years undervalued as well (which will come with its own challenges). But in all likelihood we will see more and more areas of the market become significantly undervalued in the years ahead, both inside and outside the U.S., and there will plenty of opportunities to buy great companies at great prices.

In the meantime, gold remains in a firmly established bull market, and this will likely remain the only asset class we will be able to confidently *invest* in for some time. When the combination of events occurs that brings stocks to a level of long-term value relative to gold on a long-term basis, it will be time to shift our focus away from the precious metals. We will then focus more of our attention (and capital) on stocks as a source of long-term returns.

As always, if you have any questions about your account or issues discussed in this letter, feel free to contact us.

Sincerely,
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