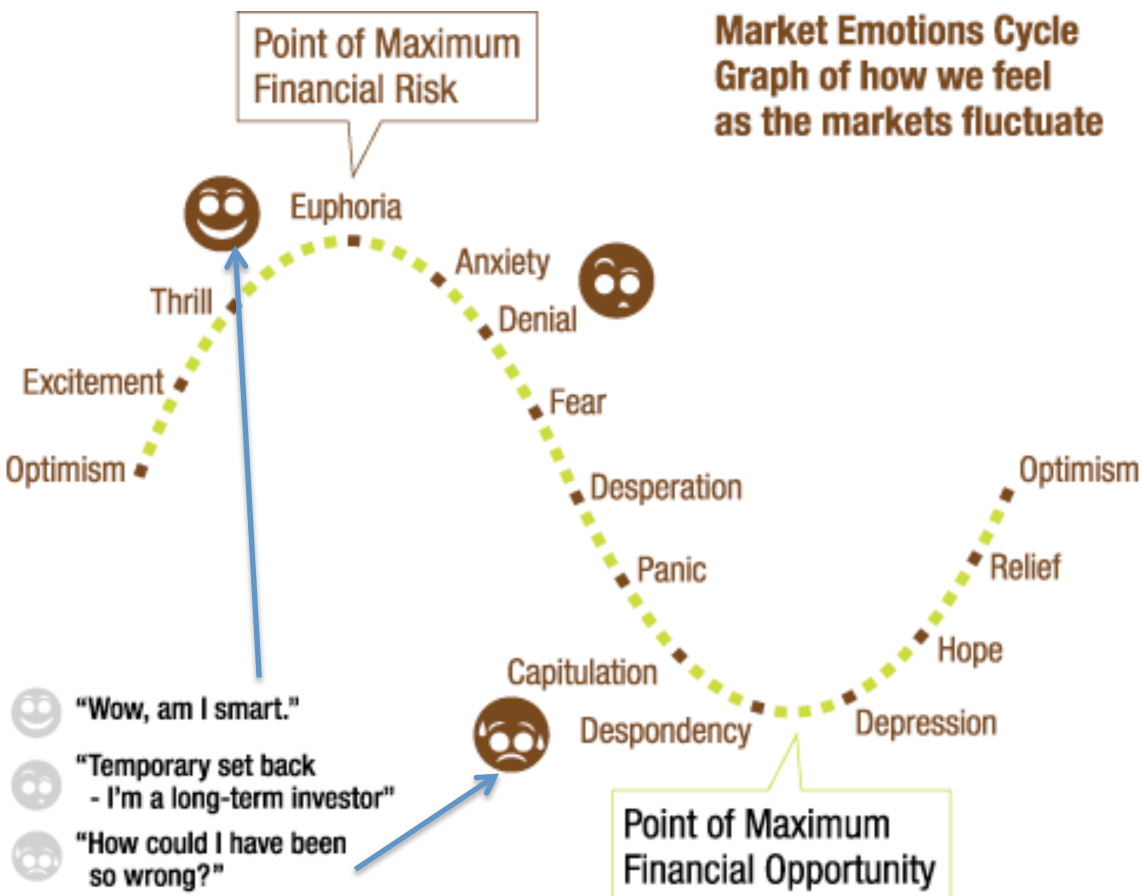
The Starboard Side Report

The week ending March 15, 2013

We don't spent much time in this report discussing investor psychology, but it is an important part of our in-house management discipline. We have all heard the saying "buy low and sell high", but the psychology of fear and greed makes this very hard for most investors to execute in practice. The market emotions cycle runs counter to prudent risk management at exactly the wrong times. This is summed up nicely in the below graphic:



The "point of maximum financial risk" lines up exactly with the feeling of euphoric emotions. Conversely, the "point of maximum financial opportunity" coincides with the point when emotions are the most panicked and depressed. This is why so many investors get sucked in at the top of market cycles and capitulate at the bottom. The contrarian investor is the one who has control of his or her emotions. The more euphoric investors become, the more cautious a contrarian strategy becomes and vice versa.

The key to not getting wrapped up in the wicked roller coaster ride of investor psychology is to practice prudent risk management. That means the willingness to go against the grain and hold cash when the emotions cycle pictured above is cresting and spend cash when the emotions cycle is bottoming. This is how only the most patient and disciplined investors are able to take stocks off panicked investor's hands at fire sale prices. In our first two charts below, we highlight two asset markets in very different stages of the emotions cycle. The S&P 500 is once again back to the euphoric stage. Talk now centers on the birth of a "new" bull market fours years and 135% above the old cycle low in 2009. This is ridiculous when you factor in current valuations (as we do later in this report). Investors are *hoping* that the third time will be the charm for the US market. The second chart below is the NYSE Gold Miners Index. It has recently entered the panic/despondency/depression stage of the investment psychology cycle.

S&P 500 Index (1997 – Present)

NYSE Gold Miners Index (1997 – Present)

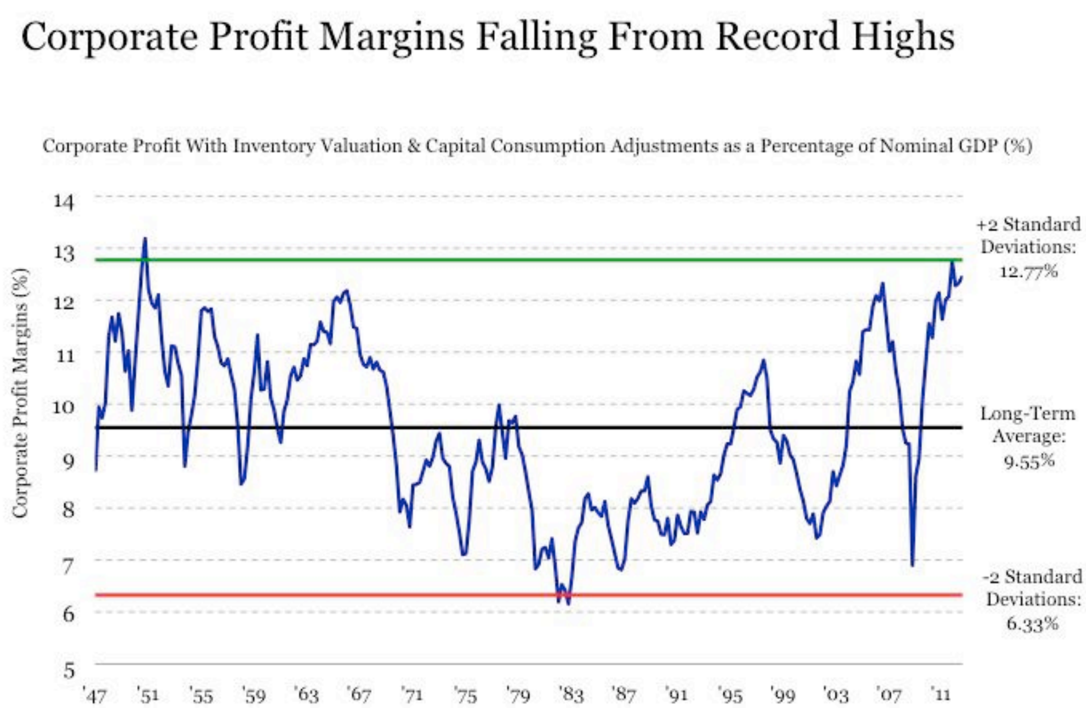
This time next year, we suspect that the roles may be reversed and precious metals may be back to euphoria and the S&P 500 back in panic mode. When the whole world was seemingly falling apart in late 2008, that was the time to commit ones life savings to the stock market, not when stocks are trading near the peak of a secular bear market trading range. Throughout history, being fully invested at similar price and valuation levels was a recipe for financial disaster. As frustrating as it can be to be "missing out" near the end of a bull run, it would be ten times more frustrating to lose 50% of ones net-worth in a bear market or market crash. A 20% loss only takes a 25% gain to get back to even. *However, the compounding nature of losses is such that a 50% loss needs a 100% gain just to get back to even.* One of the keys to successful investing (especially in these long structural bear markets like the one we've been in since 2000) is to *avoid the big losses at all cost*. Being early is much better that being the last one unable to find a chair when the music stops. We continue to believe (consistent with the market emotions cycle) that the S&P 500 is in the process of making a major top and that the precious metals market is in the process of making a major bottom. Our accounts remained positioned accordingly.

Psychology is just one part of the investment tool kit. Fundamental and technical analysis also plays a big role in helping us determine how to allocate cash properly. We want to buy stocks when fundamental valuations are cheap and technical barometers indicate oversold metrics. On the flip side, when valuations are high and charts are overbought, we want to be raising cash or looking at alternative asset classes. Technical analysis can also be used to determine long-term relative strength (i.e. what areas of the market are the strongest). But, we will leave that out of this discussion for the time being and just focus on the contrarian aspect of technical analysis to determine big picture extremes. The three-legged stool of big picture analysis then becomes psychology, fundamental analysis and technical analysis. The Holy Grail that we are seeking is a market that has a good set-up in all three of these areas.

Let's keep with the two assets we discussed above and look at fundamental and technical picture to help confirm that we are at opposite extremes.

<u>S&P 500 Fundamentals</u>

I'm sure you have all seen the investment house pundits coming out in the financial media jumping on the market bandwagon and talking about how cheap the market is. Actually, when you drill down and look at the numbers, it becomes apparent that the S&P 500 is actually at one of its most expensive levels in history. The Price-to-Earnings ratio (P/E Ratio) is the most common value metric for the stock market. This is simply the amount that investors are willing to pay for one dollar of earnings. The long-term historical average P/E of the market is 15 times earnings. Below 10 times earnings is considered cheap and above 20 times is expensive. The current P/E of the market is 17.57 times earnings. On the surface, not cheap, but not really considered expensive. However, the P/E equation is made up of two variables; the price of the market in the numerator and the earnings in the denominator. Price is simply the closing price of the market whereas the earnings side of the equation is the total earnings of the S&P 500 over the most recent trailing twelve-month period. Earnings are what drive stock prices and this is where the analyst must focus to truly determine if the market is over or undervalued. Below is a look at *the* key component of earnings, corporate profit margins. The profit margin is simply how much of each sales dollar is falling to the bottom line. As you can see, this ebbs and flows with the business cycle and is an extremely mean reverting statistic that has stayed within an orderly band over the past seventy years since WWII ended. Right now we are clearly at peak profit margins of 12.77% (meaning $12.77 in profits for every $100 of revenue). This is at the upper boundary with 9.55% being the long-term average and 6.33% being the trough level.



Source: Gerring Wealth Management, National Income & Product Accounts – Bureau of Economic Analysis

Why is this important? The fact that profit margins are at an all-time high means that the market's "E" in the P/E equation is actually very expensive based on normalized margins. Current corporate profit margins are 25% above the long-term average and 45% above the trough of the historic band show above. Let's look at the how this plays out in out P/E equation that we discuss above.

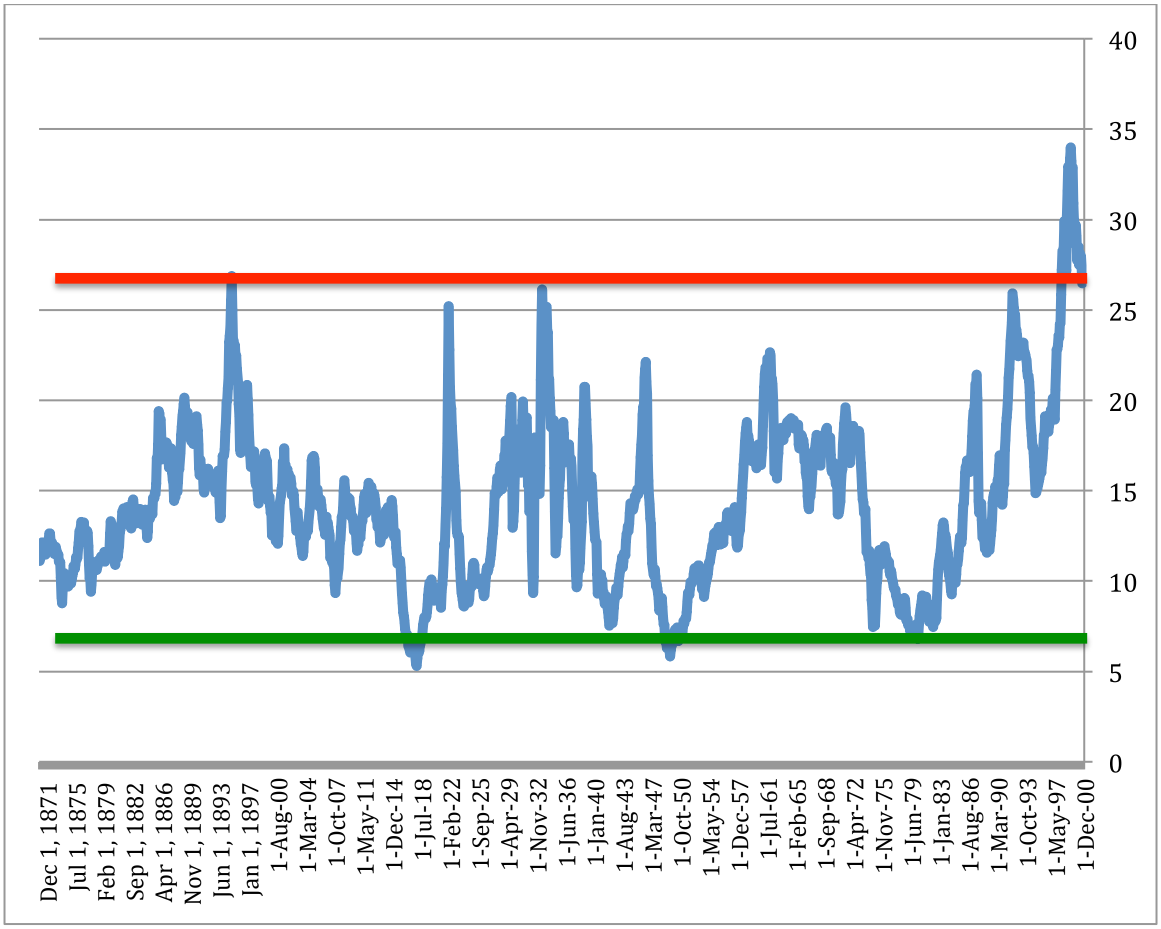
S&P 500 Price	S&P 500 Earnings	S&P 500 P/E Ratio	Profit Margin Scenario
1563	89.07	17.55	Current Peak Margins
1563	66.8	23.40	At Average Margins
1563	48.83	32.01	At Trough Margins

Source: Robert Shiller via multpl.com

The table above shows the current market price of the S&P 500 (1563) at three different margin levels. The yellow row on top is where we stand now. The 17.5 P/E ratio is calculated by taking the S&P 500 1563 and dividing it by the last twelve months earnings per share of the entire S&P 500 of 89.07. 1563/89.07 gets us to the 17.57 times earnings. Now the problem comes in when we look at where the earnings would/should be at the long-term average profit margin (9.55%) and the level that has been the historic trough (roughly 7%). As you can see in rows two and three above, the market now becomes extremely expensive if we normalize margins/earnings (i.e. the denominator of the P/E equation). Instead of a P/E ratio of 17.55, we now get a P/E ratio of 23.40 at average profit margins and 32.01 at trough profit margins.

Let's take this one step further. The chart below shows the historic trailing P/E ratio of the market between 1871 and the year 2000 (over 129 years of market history). We are showing this to help illustrate the very well defined range that existed over 129 years of market history and how the extreme stock bubble in the late 1990's blew out the overvalued meter to 35 times earnings. We are using 2000 as our cut-off point to illustrate how disconnected from the rest of history the markets have become since the late 1990's. Furthermore, this historic P/E ratio chart can help show how expensive the market is at the normalized profit margin level (again a 23.40 P/E). Much closer to the red line that has traditionally signaled the start of bear markets than the green line that marks the start of long-term bull markets. A contraction in profit margins to the trough level (at the market's current price) would bring the market P/E ratio back 32.01 times earnings (just below its 2000 bubble peak).

S&P 500 Index Trailing Price to Earnings Ratio (1871 – 2000)



Source: Robert Shiller via multpl.com

The other important take-away from this chart is highlighted by the green line at the bottom of the range. The prior three bear markets for stocks did not end until the P/E ratio fell to an average of 6! What does that look like given today's situation? Even at current peak profit margins, the S&P 500 would be at 534.42 (65% below current levels) if investors were only willing to pay 6 times earnings as they did at prior market bottoms in 1920, 1949 and 1980 (highlighted in green on table below). At long-term average margins, the S&P 500 would have to fall to 400.8 to reach a P/E ratio of 6 (74% below current levels). Finally, at trough corporate profit margins of around 7%, the S&P 500 would need to fall to 292.98 (or 81%) to be valued at 6 times earnings (highlighted in yellow below).

S&P 500 Price	S&P 500 Earnings	S&P 500 P/E Ratio	P/E Scenario
534.42	89.07	6	Historic Bear Market Bottom P/E
400.8	66.8	6	Historic Bear Market Bottom P/E
292.98	48.83	6	Historic Bear Market Bottom P/E

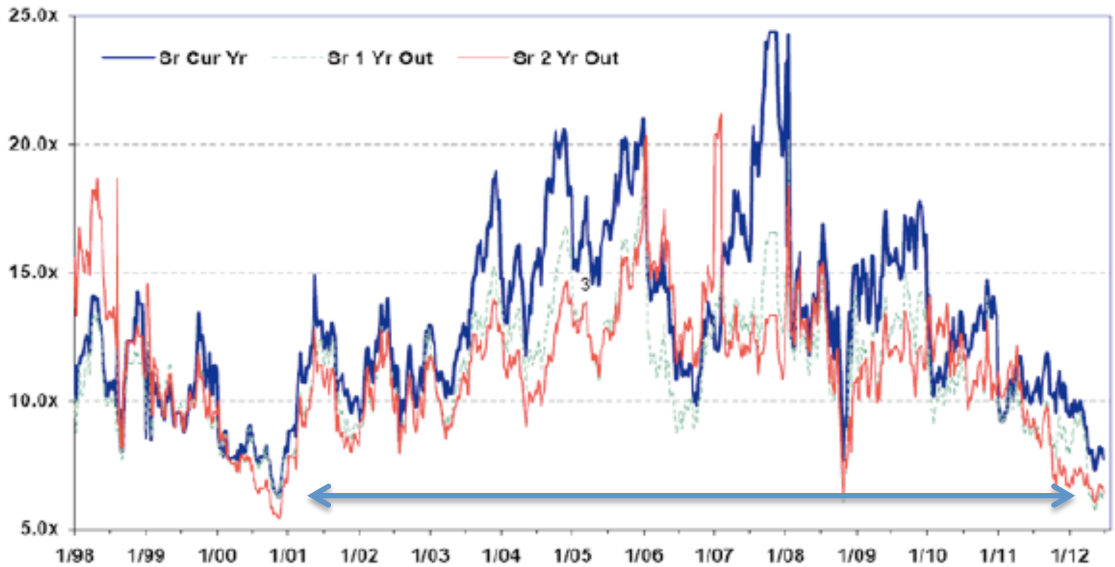
Source: Robert Shiller via multpl.com

These are certainly not predictions. Rather we are trying to dispel the pundit's claims that the market is cheap. It would be utter disaster if the companies in the S&P 500 were to revert back to trough profit margins *and* trade at a historic bear market bottom multiple of 6 times earnings. This happened in 1980 at the bottom of that bear market, so it is not like we are making this up. Record profit margins mean that there is no getting around the fact that the S&P 500 is actually at one of the most overvalued levels in history despite being thirteen years into this bear market. Investors are once again getting euphoric at exactly the wrong time.

Gold Stock Fundamentals

Much like the case with psychology, gold stocks are at the opposite end of the fundamental spectrum compared to the rest of the market. If we look below at the price to cash flow of the senior gold producers, we see that they are as cheap as they were at the start of their bull market in 2000 and at the bottom of the 2008 stock market panic.

Fig. 57: P/CF – Senior Producers (N.A.)



Source: BMO Capital Markets

Taking it one step further, let's look at the price of the gold mining stock index in relation to their main commodity, gold. Unlike the S&P 500, which has no room to expand margins, the gold mining sector is showing the opposite. Not only are the senior miners back to 2000 and 2008 levels in terms of price to cash flow, they are now back to those same oversold levels in terms of stock prices to the price of gold. There is enormous coiled leverage in gold stocks to any upside movement in the price of gold. The most important driver of gold-mining profits by far is the price of gold. The price of gold really doesn't have to move up dramatically for gold stocks to work from these price levels, it just need to stabilize and return to an uptrend.

NYSE Gold Miners Index Versus Gold

Gold stocks have the dual benefit of having cheap valuations and the potential for margin expansion due to being so depressed versus the price of gold. This combined with emotions being in the panicked/depressed/despondent stage makes two of the three legs of out proverbial stool in the favor of gold stocks. The opposite has been proven to be true for the S&P 500. Now let's briefly look at the third leg of the stool, technical analysis.

<u>S&P 500 and Gold Mining Index Technical Analysis</u>

The Bullish Percent Index (BPI) is a technical breadth indicator based on the number of stocks on Point & Figure buy signals within an index. It is often used as a contrarian indicator to gauge whether or not an index is overbought or oversold. A reading above 80 (i.e. 80% of the stocks in the index are on buy signals) lets us know that there is not much demand left to drive stocks higher. Conversely, a reading below 20 is often a sign that supply is close to drying up. Below, we have the Bullish Percent Charts of both the S&P 500 and the NYSE Gold Miners Index. As you can see, the S&P 500's Bullish Percent is at 84.20 versus just 3.33 for the Gold Miners. From a contrarian perspective, this means all of the sellers are just about out of gold stocks and that the S&P 500 is quickly running out of buying power. The essence of technical analysis is supply and demand; in this case, supply and demand dynamics point towards much better risk-reward in gold mining stocks versus the S&P 500.

S&P 500 Bullish Percent Index (2000 – Present)

Gold Miners Index Bullish Percent (2007 – Present)

The final technical chart below shows a direct comparison of the S&P 500 to the NYSE Gold Mining Index. Comparing two indexes directly versus one another is known as relative strength analysis.

S&P 500 Index Versus NYSE Gold Miners Index (2000 – Present)

Three things stand out in this chart. First, since late 2000, the S&P 500 has dramatically underperformed the Gold Mining Index falling from a ratio of 7.5 to a low of 0.69 in August of 2011 (a relative decline of 91%). Second, the past year and a half has seen the S&P 500 have an extremely strong countertrend rally versus the Gold Mining Index as it has gone from 0.69 back up to 1.51 (a relative gain of 118%). Lastly, this countertrend rally has created an overbought condition in this relative strength relationship that is rivaled only by the epic gold bear market bottom in October 2000. Over the next two years following that bottom, gold stocks gained 200% as the S&P 500 lost 50%. The Monthly RSI Index going above 70 defines this similar set-up in the bottom pane of the chart above.

In conclusion, all three legs of our proverbial investment stool; investor psychology, fundamental analysis and technical analysis all point to the same conclusion. The S&P 500 Index is extremely *overbullish*, *overvalued* and *overbought*. All signs that have been exhibited near major cyclical peaks in this index. On the flip side, the NYSE Gold Miners Index is extremely *hated*, *undervalued* and *oversold.* This give us confidence that avoiding major S&P 500 exposure and having a relatively large precious metals exposure is the prudent course of action for our investors. Not because we are gold bugs or haters of the US market, but simply because that is what history points to as the most likely outcome given present circumstances. Being optimistic on the future prospects of gold and gold stocks is being positive, it is just not being positive in the conventional way that Wall Street sells as the dream of stock ownership. As more sectors and country indexes eventually join precious metals in fulfilling all three legs of the stool (i.e. hated, undervalued and oversold), then we will gladly consider them for investment portfolios.

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