The Starboard Side Report

The week ending December 6, 2013

Continuing a theme we started in our last report, we wanted to focus on some areas where we see attractive *relative* opportunities over the next few years. Again, we expect to move cash into these areas only after the global markets have a meaningful correction (which is long overdue).

While we hold to our analysis that the US market is the most overvalued in the world, this does not mean that there won't be select opportunities to make money in the US over the next decade. In many ways, the next cyclical bear market downturn may turn out to be the mirror image of the 2000 market top. As we entered the turn of the millennium in 2000, the US market on the whole was extremely overvalued (much like today). However, under the surface it was apparent that the overvaluation was being driven by a select number of large capitalization stocks. The majority small capitalization stocks (excluding technology stocks) were relatively much cheaper and offered investors better long-term value than large company shares. Right now we have the opposite situation, a 13-year run of outperformance has left the small caps massively overvalued while the largest blue chip stocks are not nearly as expensive. After a normal 20-30% correction, many of the 100 largest stocks in the US market should represent an attractive situation for the long-term investor. One of the great things about charts is that they can often help tell a story. In this case, they will help show the power of having valuation parameters in order help best position capital over the long term.

On the page below, we chose two charts to measure the small and large segments of the market. First, we show the S&P 600 Index, a popular benchmark used to measure the small company slice of the market. Next, we have a long-term chart of the S&P 100, a popular benchmark that consists of the largest 100 stocks in the entire US market.

The first thing that you will notice is that since March of 2000 (date is marked by the yellow arrows between the charts), the S&P 600 is up close to 200%, whereas the S&P 100 only just clawed its way back to those lofty year 2000 levels (a 0% gain over 13 years!). Another key takeaway is that it took 3 years before the momentum was fully bled out of the S&P 100 and for the value of the small caps to be recognized by the market (we highlighted this period in gray). You will notice in the chart of the S&P 100 Index that it declined 55% in the 2000-2002 bear market versus a max decline of only 35% for the S&P 600. Even though they were relatively cheaper in early 2000, there were still plenty of opportunities to buy small cap stocks over this bear market period due to the extreme large-cap overvaluation and the volatility created by that situation. In fact, over the 13 plus years and 200% gain highlighted in this first chart, the S&P 600 Small Cap Index had five corrections of over 20%. Patience, discipline and buying after the big dips were the most rewarding strategy due to the overvaluation that existed at the 2000 top.

S&P 600 Small Cap Index (1995 – Present)

S&P 100 Mega Cap Index (1995 – Present)

In early 2000, if your thesis was that small caps were going outperform large stocks over the next decade due to relative valuation, then patience was a better strategy than just rushing to buy at the top of the market cycle. Therefore, if we are to invest capital in the relatively better valued blue chip segment of the US market over the near future, it should only be after a sharp correction.

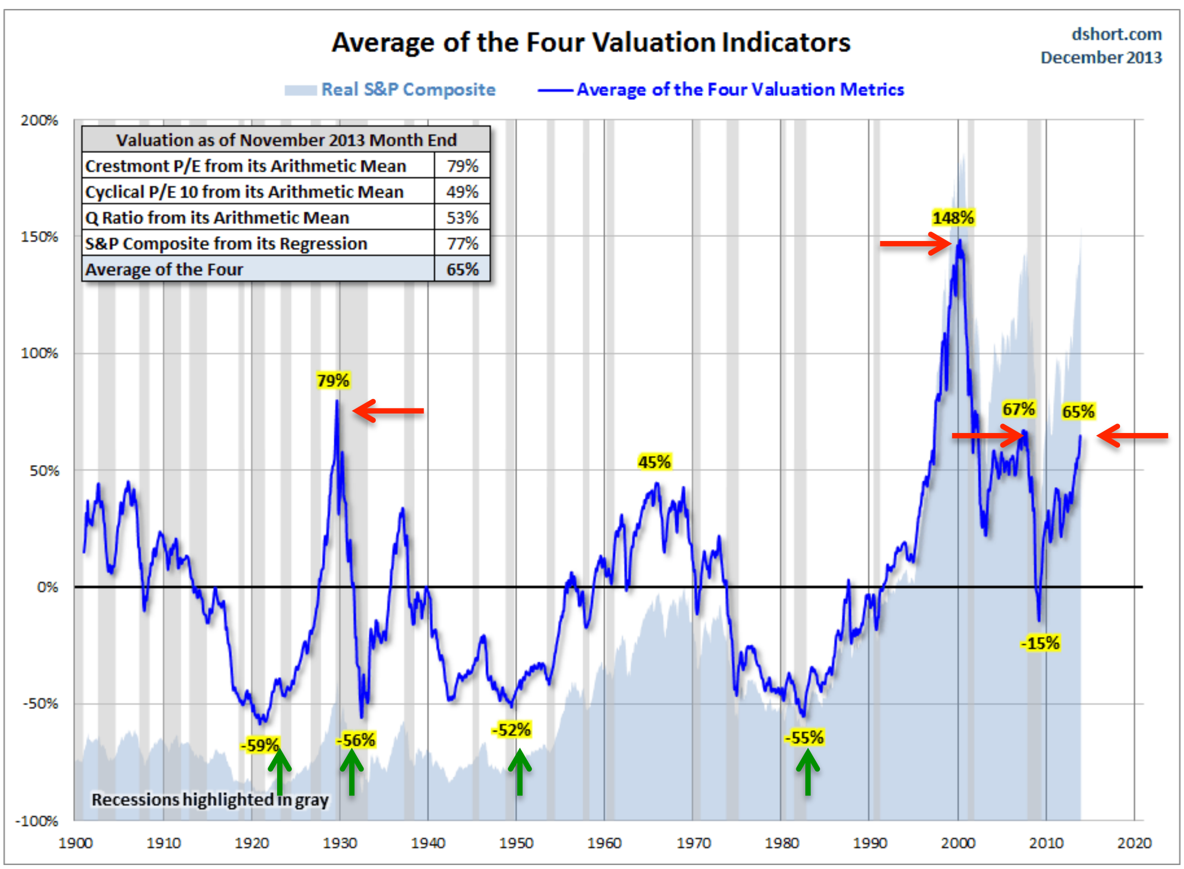
Whereas the S&P 100 is running into resistance and pulling back at its 2000 peak, the NYSE Composite Index is starting to show signs of rolling over from its 2007 peak. The NYSE Composite is a very broad stock index that includes every single stock listed on the New York

Stock Exchange. Therefore, it excludes many of the most speculative stocks that are driving the Nasdaq into the stratosphere.

NYSE Composite Index (2005 – Present)

In isolation, pulling back at the exact level that marked the primary high in July of 2007 may not seem a big deal, but when we combine it with the following valuation chart it takes on much greater significance.

S&P 500 Historical Valuation Study (1900 – Present)



Doug Short compiled this aggregate valuation chart going back through 113 years of market history. It is an average of four common valuation measurement tools: two cover corporate earnings, one covers corporate balance sheets and fourth is the market's deviation from its long-term trend. On average, these metrics show the market as 65% above its long-term mean valuation (black horizontal line is the long-term mean). 1929, 1999/2000, 2007 are the only other times in US market history that the stock market has been stretched this far above its underlying fundamentals (the red arrows indicate these points in time). In each instance, the market fell *dramatically* once the upside momentum finally died out. Please notice how far valuations are above where secular bear markets have troughed in the past (the green arrows on the bottom indicate where long term bull markets are born). If you are banking on more gains from these levels, then you are dangerously betting that another bubble such as 1929 or 1999 will occur in the very near future ***and*** that you will be able to get out before everyone else. That is not an easy thing to do. In the first two months after the 1929 peak the Dow crashed 47%, while the Nasdaq crashed 40% in the two months after its 2000 peak. When the down cycles were all said and done, the Dow lost 90% and the Nasdaq lost 80%. We should not be rooting for another bubble!

In summary, we feel that the top of this cycle is approaching the froth observed at important inflection points in US stock market history. The higher we go from here the more spectacular the fall. Contrary to popular belief, the US Federal Reserve has not outlawed stock market cycles. Trees do not grow to the sky and US stock markets don't only go up. We see the next bear market for US stocks as being the mirror image to the 2000 correction in that the small and mid-capitalization companies will bear the brunt of the selling pressure and the volatility caused by their decline should provide a good opportunity to add more attractively valued blue chips. The final chart below shows how dramatically the small stocks have outperformed their larger peers since 2000. The next decade should show a stabilization of this downtrend and then a mean reversion higher as the largest stocks in the market come back into favor and the excessive valuation of small stocks finally comes home to roost. In the long-term, valuation is the ultimate arbiter of price.

S&P 100 Index Relative Performance vs. S&P 600 Small Cap Index (1999 – Present)

In next week's installment of these relative value ideas, we will look at the oil service sector and why it may be poised to start another bull market up cycle.

Nothing on this Weekly Report should be interpreted to state or imply that past results are an indication of future performance. There are no warranties, expressed or implied, as to accuracy, completeness or results obtained from any information posted on this or any "linked" web-site. Any reference to specific securities is not considered a recommendation. Every investment strategy has the potential for profit or loss.

Please note: It is the Client's responsibility to notify us of any changes that would influence their financial needs.