



*FERGUSON ASSET MANAGEMENT, INC.*

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*Investment Counseling & Asset Management for Individuals & Institutions*

## **The Second Market Commentary**

**January and February 2009**

The purpose of this commentary is to tell you what our investment strategy is as we go forward into, what on the surface appears to be, an economic maelstrom.

We know that 2008 was the third worst year for our domestic stock market in the past 108 years, and nearly as bad for the world's total stock markets. There is much doom and gloom, but also some unbridled optimism in the investment world. This commentary does not attempt to agree or disagree with any of these soothsayers. We make no forecasts. We are expressing our collective thoughts, and here is our game plan for this market. First, some background.

Our latest figures show unemployment at 7.2%, and expectations are that this will head higher. In 1957-58 unemployment hit 9.5%. In 1982, the longest period of employment contraction (17 months) since the depression, the number reached 10.8%. Typically, unemployment rates do not decline before a recession ends. They have not been reliable predictors of a recovery.

### **The Past**

"Employment changes in the housing, construction and auto manufacturing industries are generally thought to be key indicators of the general health and pace of the economy because of their strong ties to other industries. With the tightness in the financial markets there are sizeable cutbacks in industries related to home building-such as lumber, furniture, stone, clay and glass, and appliances." "The auto industry has lost one-third of total jobs. Housing starts have declined from 1.8 million in the third quarter to 1 million by the second quarter."

Does the above paragraph sound familiar? It should if you were out of college in the summer of 1980 and monitoring such data. The paragraph refers to the period of third quarter 1979 through second quarter 1980.\* What happened then was the market went mostly sideways in 1979, rallied nearly 30% from March 1980 to March 1981, but in 1982 the market tested the 1980 lows and then tripled over the next 5 years.

I mentioned earlier that 2008 was the third worst year for our domestic stock markets since 1900. The worst year was 1931 with a drop exceeding 40%. The following year, 1932, the U.S. large

stock returns were also negative, but by less than 10%, and then up over 50% in 1933, down about 8% in 1934, and up over 40% in 1935. (The Dow bottomed during the third quarter of 1932) Back in 1907, the next worst domestic stock market year, the markets were off over 30% and rallied over 30% the following year.

Is this an investable pattern? No, it is not, but it does reveal that serious market declines have been followed by serious market recoveries. Will this 13-month old recession exceed the 17-month recession of 1982? We do not know, but we are comfortably certain in proclaiming that doom and gloom will continue to dominate the headlines of the declining readership base of our daily newspapers for some time to come.

The government tells us that banks are one of the top industries with financial troubles. Wells Fargo is not in trouble, and neither is our local Eagle Bank. Think of your bank. Is it faltering? Most banks are not, but many of their share prices are being hard hit. A large number of these institutions have received funds from the current government bailout, cheap money that we will probably pay for with higher interest rates not too far in the future. Of course, some banks are in trouble and they will be taken over by the government and their assets sold or written off. This may present us with opportunities.

Over 580 financial institutions went out of business in 1988-1989. Remember the Resolution Trust bailout? We, for a number of our clients, made some great returns by participating in the fire sale of assets by the FDIC. Many assets were sold for pennies on the dollar, just as it is happening again, right now by our Treasury.

\* Monthly Labor Review. August 1981

## **The Present**

### **Tarp**

Speaking of our Treasury, how are they doing, we might ask. They have so far funneled about 300-350 billion dollars into the "rescue" package known as TARP. This acronym stands for Troubled Asset Relief Program and is designed to purchase assets and equity from financial institutions. However, many institutions that have received TARP funds did not have much in the way of troubled assets. In fact, the criteria of TARP participation are so unclear that participation appears to be arbitrary, apart from the \$200 billion we "invested" with the eight largest beneficiaries. They included Citigroup, Bank of America, General Motors, and the doing well, thank you, Wells Fargo.

On January 5, 2009 a new index was created (symbol NDAQ). The NASDAQ listed options on an index tracking stocks that have received at least 1 billion dollars of TARP money. This gives individuals the opportunity to buy or sell options, betting either with or against the government bailout. Through the end of January 2009, in just twenty trading days, the index is down over 35%. Are you watching, Mr. Geithner?

Not everyone is a bear, not everyone is a bull!

Arguably, today's most famous economic forecaster of gloom, known as Dr. Doom, is NYU professor, economist, speaker, and consultant, Dr. Nouriel Roubini (Yale PhD. Economics). Dr. Roubini correctly forecast today's sub-prime housing, banking, and economic crisis in 2006-2007. He believes we are at the beginning of a global depression. You can read the headlines from his consulting firm at [www.rgemonitor.com](http://www.rgemonitor.com). Word is that the current Dr. Doom is still totally invested in index funds, but I cannot confirm that. (Remember Dr. Henry Kaufman of Salomon Brothers, who was known as Dr. Doom in the late 80's and early 90's?)

What Dr. Roubini does not do is forecast the direction of the stock market. He is an economist, not a portfolio manager or market forecaster. Those who fall into the latter categories are comprised of both major bulls and major bears. I will give you an update from just a few of the hundreds, perhaps thousands of forecasters on both sides.

### **Bears**

The Elliott Wave Theory has been around since the 1930's when an accountant named Elliott determined what he believed to be a pattern in stock market price behavior. He felt that these patterns were predictable, and termed them waves. Therefore, we now have Elliott Wave forecasters and newsletter writers, with some predicting another 500-800 points down before the next intermediate rally within a longer-term bear market. Other bearish market forecasters point out that this January's market decline of 9% was the largest January decline on record, and they also point out that as January goes, so goes (the simple majority of the time) the year.

### **Bulls**

In the bullish camp are such names as money managers John Rogers, founder of Ariel Investments, and Ken Fisher, a regular columnist for Forbes magazine. Also bullish is the universally subscribed to The Value Line Investment Survey. Mr. Rogers, a bear last year, now says he is "very bullish." In the current issue of Forbes, Fisher comments, "Bear markets have been typically followed by bull markets in a V-shaped pattern. The steeper and bigger the decline, the sharper and bigger is the subsequent bull move. What I am pretty sure of is this: When the market rebounds, a lot of gains will take place in a very short span, and people who are cautious will miss most of these gains." Fisher concludes, "If you wait until the economic recovery is here, you'll miss most of the action of Wall Street."

The Value Line Investment Survey provides the following statistics. The price-earnings ratio of the S&P 500 sits at 11, the lowest of the current market cycle that began in October 2002. The dividend yields of 3.5% are the highest of the cycle. Both of these statistics are constructive numbers. They also estimate that the appreciation potential within 3 to 5 years of the 1700 stocks they follow is 155%, one of the highest published potentials I can recall.

We hope no one goes overboard on these bullish forecasts because Value Line increased their stock allocation by 5% (up to 85%) in October 2008. This was a bad timing move. Still, the performance record of their top ranked stocks out performed the S&P 500 by nearly double for the period 1965-2008. Not too shabby!

### **What do we do now?**

If history is any indication, we know that eventually the economy and the markets will recover.

We do not know whether this will be in months or years. Most of us were surprised by the failure of such businesses as Bear Stearns, Merrill Lynch, and AIG.

Are there more negative surprises on the horizon? Not expectations, such as continued rising unemployment, but genuine surprises, such as more major business failures. What about positive surprises, such as the recent one-month improvement in home sales? Surprises are just one of the criteria we are watching in considering your portfolio rebalancing. The portfolio allocation we have for your account is designed specifically for you and is under constant review. We consider many factors in this allocation, including your age, health, and time horizon, tolerance for risk, and current and near future withdrawal requirements.

What will happen if Rogers and Fisher are right? What if this is the time to be "very bullish?" One indicator we watch is the 200-day moving average of stock, index, and fund prices. This indicator averages the closing price of the last 200 days, and is a reliable measure of the long-term trend. In general, we do not buy or advocate buying anything that is making new lows, as cheap is relative. We do not agree with Fisher that all bottoms turn like a "V" zooming up, leaving one in the dust if they were not already invested before the turn.

Not all surprises are negative. In the real estate slumps of the seventies, eighties, and nineties (there is a pattern here), the markets recovered due to one or both of two reasons: price and/or time.

In the seventies, prices generally came down to what we buyers perceived as bargain levels. An example is the Ocean City, Maryland vacation condominium market. There were periods of months without a single sale in a dozen high rises. Most properties were deeded over to the banks in lieu of foreclosure. In turn, they hired property liquidation specialists who priced the properties to move, often at 20-40% discounts. When that happened, it was not unusual for a project to sell out in a few weeks. The same thing happened in Alexandria, Virginia, Chicago, and California.

Time was the major influencing factor in the real estate recovery of the nineties. The over supply was gradually whittled away. The tide turned from a buyer's market to an equalizing supply/demand market and, of course, eventually to the seller's market, which forces higher and higher prices. This starts the boom and bust real estate cycle all over again.

Other positive surprises we might find include unemployment reaching a plateau around 8-8.5%, the economic stimulus actually helping the economy, government foregoing pork instead of loading lard as usual, earnings improvements from leading core businesses, a pickup in manufacturing, and a milder than usual remainder of the winter. We do not rely on these happening, but they would be deemed positive by investors.

We remain committed to the passively managed investing approach of Dimensional Funds and the use of Exchange Traded Funds (ETF's) such as Vanguard and Russell indices. Long-term performance analysis reveals that this approach has had returns superior to actively managed mutual funds and individual stock selection.

In light of the above information, we have constructed a list of core industry securities that are household names and industry stalwarts. They have declined over 50 percent from their highs (2004-2008). I wonder if these beaten down core companies will rebound more than the market averages. For answering this question, we will be monitoring the direction and returns of these core companies in comparison to returns in the overall market. This is an academic exercise. We will keep you apprised of the model behavior over the next 12 months.

### The test list

Industry	Name	Recent \$ Price	1-5 year high	P/E ratio	Yield
Bank	Wells Fargo	19	39	9.5	7
Comm. Equipment	Cisco	15	32	11	na
Spec. glass	Corning	10	29	3	2
Drug	Pfizer	14.50	37	12	8.8
Metals	Alcoa	7.80	47	nm	8.7
Construction Equipment	Caterpillar	31	85	5.5	5.4
Chemical	DuPont	24	54	10.5	7
Retail	Home Depot	21.50	43	12	4.2
Financial	American Express	16.80	65	7.5	4.3
Diversified	General Electric	12.50	41	7	10

Seven of the above securities are components of the Dow Jones 30 Industrial Average.

### Offer to send you a copy of our ADV II

The SEC requires us annually to offer to send each client a copy of our ADV II. This is a disclosure about Ferguson Asset Management's services, fees, and investment strategies. Please call, fax, or send us an e-mail if you would like us to send the ADV II to you.

### Conclusion and Summary

The current market uncertainty is not unique.

Banks and real estate have had ongoing problems for two centuries.

Government may or may not be the answer.

Markets recover.

Markets overreact both on the upside and on the downside.

The four most dangerous words in the investment community are:  
"This time it's different." (Sir John Templeton quotes this from an address.)

We have a game plan that may or may not include rebalancing your specific account.

We will be speaking with you about your portfolio in the very near future.

We live in interesting times.

### **Year-End Reports**

Your year-end gains and losses, dividend and interest income, and expense reports are included in this package. If we are not already doing so, we will be pleased to forward a copy to your accountant. If you have any questions about these reports please give us a call or send us an e-mail. We will do our best to address your questions in a most timely manner.

From the group here we wish you good health.

John Ferguson, Derek Johnson, Dawn Doebler, Zach Ferguson, Duran Field.