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President

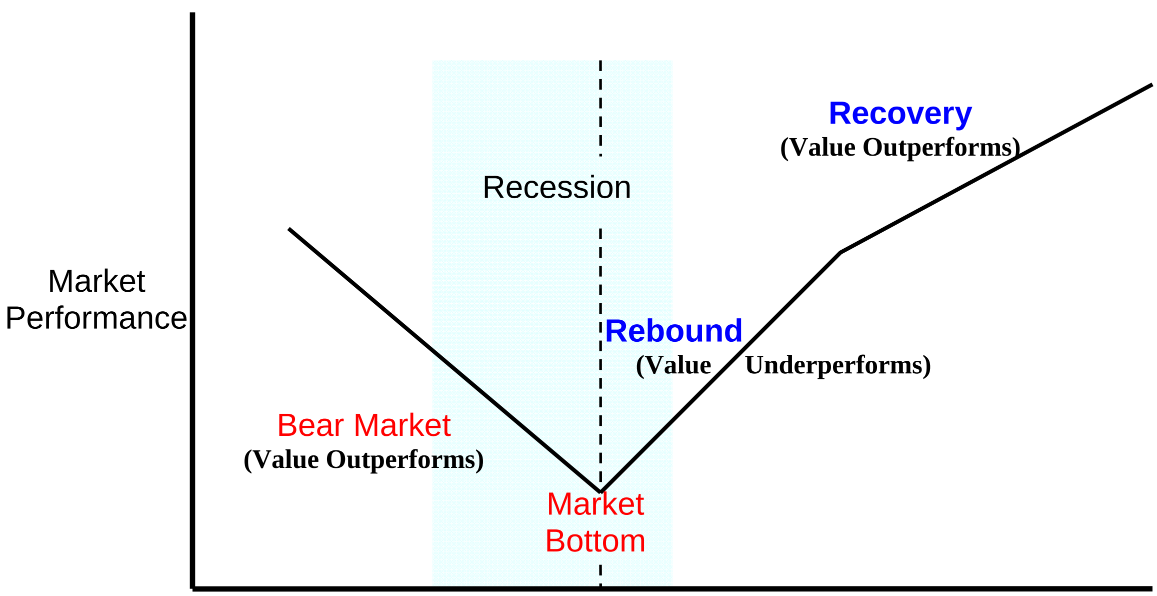
The Recovery Phase

April 26, 2011

We believe the recent strength in the most conservative high dividend stocks may finally be signaling the end of the highly speculative **REBOUND** phase of the market and the beginning of a more rational **RECOVERY** phase.

The chart below illustrates how a classic market cycle tends to play out: After a recession ends and the market hits a low, a frantic rebound period follows. Analyzed in recent market letters, this is the phase we have just been experiencing, dominated by short covering and trading around the same stocks. **Usually, within a year, the period of speculative excess ends and a recovery phase driven by fundamentals begins.**

Classic Stock Market Cycle



Source: SCCM, 04/15/11

The End of the Rebound Phase-HFT Speculation

The excesses we have seen are typical of stocks coming off a bear market low, but what is not typical is how long it has lasted – two full years. Historically, the rebound is over within a year, but it's been different this time, thanks to the emergence of High Frequency Trading (HFT), which has extended the period of speculation in the market well beyond what is normal.

HFT has been Wall Street's 800-pound gorilla which the financial press has largely ignored these last two years. Barron's recently pointed out that HFT represented an amazing 75% of NYSE daily volume.

To gauge the impact of HFT, we did a study covering the second half of last year. The findings showed that computer-driven activity produced a gain among the most speculative, highest beta stocks that was an amazing 300% greater than for the lowest beta stocks. **The market result, as you can see in the chart below, was that the stocks traded by HFT speculators have been pushed to valuation levels reminiscent of the tech bubble of 2000.** Meanwhile, the out of favor low P/E stocks are selling near the valuation lows of 2000**.**

S&P 500 P/E Quintiles*

	Quintile 5 (Highest P/E)	Quintile 1 (Lowest P/E)
March 2000	**46.2x**	**9.5x**
March 2010	**32.9x**	**9.9x**

* Average P/E using FY1 IBES estimates

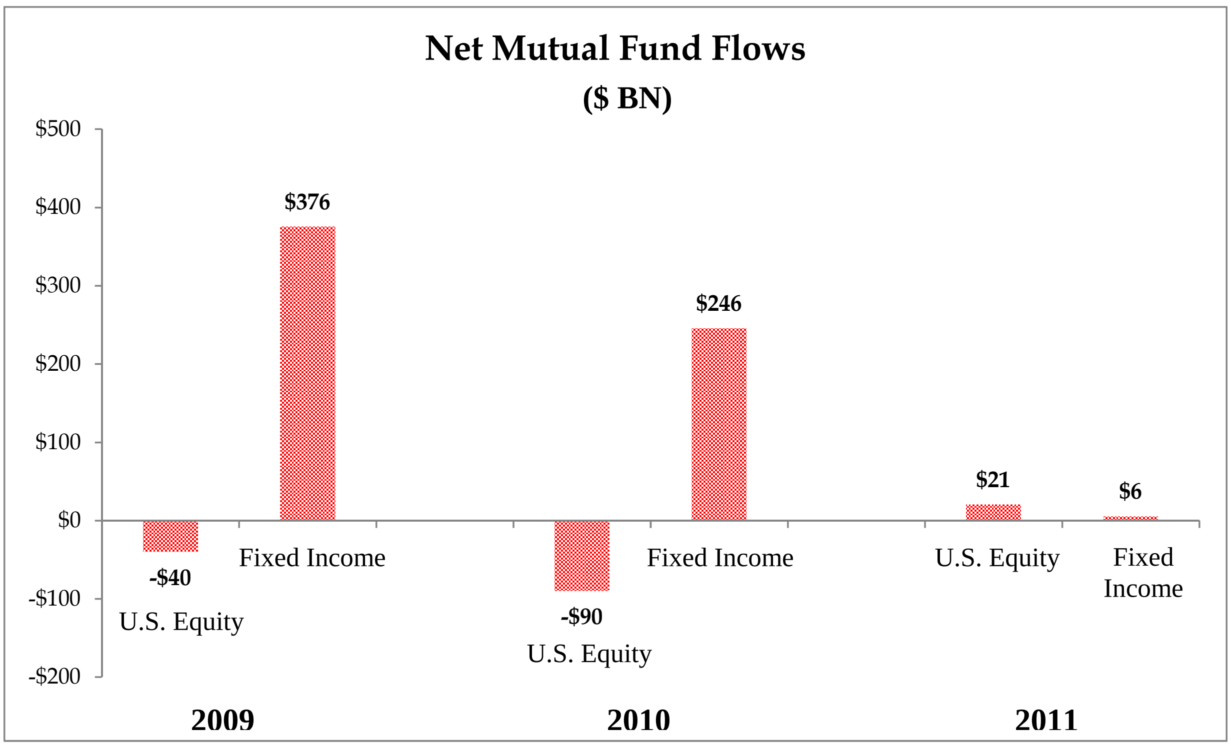
The good news for value investors is that recent articles in the Financial Times and Wall Street Journal have reported that HFT is no longer making money for its practitioners.

Mutual Fund Flows

A shift in mutual fund flows also indicates a return to value stocks. During the last two years, when the market was dominated by speculative trading activity, many conservative investors, nervous about the volatility of stocks, parked money in fixed income as a safe haven. But recently, many have begun to worry about inflation and higher interest rates. **And as these investors come back into the market, it is probably safe to assume that they will buy reasonably priced stocks with growing earnings and dividends rather than put their money in momentum trading.**

The table below shows the dramatic swing in fund flows.

Major Asset Class Shift Beginning



Source: Strategas, April 2011

<u>Next: The Recovery Phase</u>

After a 100% move in the S&P, should we be worried that we've missed the move in stocks? If we are entering a new phase of the market driven by fundamentals, there's no need for the worry, as you can see in the table below.

Here we look at all the recessions and their associated market lows in the last 50 years. We find that in every case the recession officially ends three to seven months after the market low. From the beginning of the calendar year that follows the end of the recession (nine to nineteen months following the bear market low), we track performance for the lowest P/E stocks (those in the bottom quintile of the S&P 500, rebalanced annually) for the next 5-year period. **The findings show surprisingly strong performance for value in every period, despite some extraordinarily difficult years within each period.** They also show that the highest P/E growth stocks performed only half as well.

Recession Period	Market Low	Months Between Market Low and Recession End	Recession End	Months From End of Recession to Beginning of Next Calendar	5-yr Period Starting the Calendar Year After Recession End	Annualized Performance Low P/E Value	Annualized Performance High P/E Growth
1969-70	06/70	7	01/71	12	1972-76	**+17.8%**	**+2.4%**
1973-74	11/74	6	05/75	7	1976-80	**+24.7%**	**+15.3%**
1981-83	09/82	3	12/82	12	1984-88	**+18.2%**	**+9.8%**
1990-91	10/90	3	01/91	12	1992-96	**+17.9%**	**+12.5%**
2001-02	10/01	3	01/02	12	2003-07	**+17.3%**	**+16.3%**
2007-08	03/09	3	06/09	6	2010-14	**-**	**-**
					Average:	**+19.2%**	**+11.3%**

Source: S&P 500/SCCM, 12/31/10

Conclusion

The best period for value tends to occur during the **RECOVERY** phase of the market when earnings and valuations are more important than speculative plays on momentum.

- Jim Cullen

Period	S&P 500 Bottom 20% by P/E	Period	S&P 500 Bottom 20% by P/E
1968-1972	**9.7%**	1987-1991	**10.5%**
1969-1973	**0.0%**	1988-1992	**15.4%**
1970-1974	**1.1%**	1989-1993	**14.5%**
1971-1975	**12.4%**	1990-1994	**10.1%**
1972-1976	**17.8%**	1991-1995	**23.2%**
1973-1977	**17.0%**	1992-1996	**17.9%**
1974-1978	**24.7%**	1993-1997	**22.0%**
1975-1979	**34.3%**	1994-1998	**17.8%**
1976-1980	**24.7%**	1995-1999	**18.2%**
1977-1981	**18.2%**	1996-2000	**13.9%**
1978-1982	**22.2%**	1997-2001	**13.3%**
1979-1983	**24.5%**	1998-2002	**4.7%**
1980-1984	**26.1%**	1999-2003	**12.1%**
1981-1985	**26.5%**	2000-2004	**16.0%**
1982-1986	**27.6%**	2001-2005	**15.4%**
1983-1987	**18.9%**	2002-2006	**16.0%**
1984-1988	**18.2%**	2003-2007	**17.3%**
1985-1989	**16.3%**	2004-2008	**-2.3%**
1986-1990	**6.1%**	2005-2009	**4.3%**
		2006-2010	**4.5%**

Source: S&P 500/SCCM, 12/31/10

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