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Market Overview

The first quarter saw the continued deterioration of the broad economy, and the stock market followed suit. Stocks were, at one point, down 25% from year-end 2008. They finished down only 11% after a March rally. Validating our belief that continued carnage is to be expected in the commercial property market, REITs fell 32% in Q1.

The muni and corporate bond markets stabilized nicely in Q1 and our overweight to those sectors has provided a nice counterbalance to continued stress in stocks. In the article below, we discuss our methodology for valuing stocks, and summarize our outlook. We still do not know whether we're at a bottom or a top. We can get the valuation right, but the timing is tough. If you, like us, are serious about our long-term commitment

when owning stocks, today's prices are attractive enough. We are still underweight stocks because the risk is still very high in the near term.

Unemployment hit 8.5% in Q1. The last time we had a market low coinciding with unemployment this high was 1982-83. As you might know, stocks went on a rocket ride upwards starting right about then. The difference between then and now is that stocks were about 50% below fair value then, and only about 10% below fair value now. In other words, there was HUGE room to the upside in 1982-83 and only limited room now. Accordingly, we do not expect stocks to go to the moon any time soon.

We still like bonds, and we are starting to look at culture opportunities in commercial real estate.

What is a Stock Price?

Our writings and communications about the market and our portfolio strategies have talked about valuation over and over. It's our favorite broken record theme, and it's worth a more detailed digression now and then.

The most common questions we field these days from clients and friends is, "Is this the bottom? Is it time to get back in?" Or, "Is the bottom going to fall out? Should we sell everything and put it under a mattress?"

We always try to respond calmly and rationally and provide our take on the situation. But, you should know that we ask ourselves those same questions nearly every day. And the answers are grounded in valuation. Are stocks cheap, expensive, or about right?

If I can leave you with one lesson that sticks from this quarter's letter, it is this: *Stock prices are quoted in the wrong units.* Stocks trade by the share: The price you see in the paper or on your brokerage

statement is the price for one share of the company. But, just what is that, exactly?

For some companies, a share is one of a billion. For others, it's one of many billion. For still others, it's one of mere millions. Stocks change hands by the share, because that is the legal structure the company has chosen. But to say you own a share of the company doesn't say anything about what you really own. It especially doesn't provide you any information to compare among the many companies in which you might consider investing. A share of one company is \$14; a share in another is \$46. What does that tell us? Nothing.

We know even less if we are trying to compare prices from different eras. If Company A is priced at \$20 per share today, and was \$8 per share 15 years ago, what does that tell us? Nothing — today's price might be too high or too low. There is no way to really know based on share price alone

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What is a Stock Price? *(continued)*

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since surely the company's business and profits have changed over time.

I like to use analogies from the bond market, since most people see the picture more readily.

Imagine I showed you two bonds, both priced at 98% of the maturity value, or "98," as we say. Both bonds have a \$10,000 principal amount, both are AA rated and both mature in five years. Which one do you want?

If that is all the information you have, it's impossible to say.

Before you answer, you have to know the coupon rate on the bond. If one bond carries a stated interest rate of 6%, and the other a rate of 8%, your decision is pretty clear, I would assume. You like the 8% bond better. In bond trader parlance, it's the "cheaper" bond. When bond traders say, "cheaper," they mean "it's worth more to the investor because it pays more cash back to the investor for a given purchase price."

For this reason, bonds don't trade by price quotes alone—they trade by *yield* quotations. For the price you pay, how much cash is going to flow back your way over time?

That \$10,000 bond is probably part of a much larger issue of perhaps a billion dollars. If the original total issue was in \$1,000 increments, you are buying ten "shares" of the bond. The shares are \$980 each.

Now again — what does that share price tell you?

Nothing!

The price-per-share of a bond, or of a stock, is only meaningful when compared to what you get in exchange over time. The full bond issue of a billion dollars, at 8%, pays out \$80 million per year in interest. You get 0.001% of that interest for your ten shares, or \$800 per year.

When buying a bond, what you get in exchange is

fixed and well-established. You get annual interest payments of a set amount, and you get the stated principal back at maturity. Your bond is a claim to those future cash flows.

When buying stock, what you get is a claim to a given share of the future earnings of the company. If you own 0.001% of the company's shares, you own (or at least have a claim to) 0.001% of the company's earnings. Even if you can't show up at headquarters and request a check for your earnings share, you can at least sell your shares to somebody else who would like to own that claim.

- ◆ Bonds are a claim on future principal and interest.
- ◆ Stocks are a claim on future corporate earnings.
- ◆ Bonds are quoted in the market in a sensible and easy-to-understand manner.
- ◆ Stocks are quoted in an archaic and *ad hoc* manner.

We should look at the stock market not through the lens of the daily prices thrown out of the trading floor, but through the lens of our claim on future earnings.

It is better to look at stock prices not as "price-per-share," but rather as "price-per-dollar-of-earnings." What am I paying for a claim to one dollar of earnings? Since the number of shares issued by companies will vary widely, this method allows us to compare apples to apples.

If I showed you two similarly situated companies with similar growth prospects, and one was priced at \$12 per dollar of earnings and the other was priced at \$18, which one would you want to own? You would want the cheaper of the two, all else equal.

In the real world, companies are never quite so identical. Their prospects differ and a company that seems cheap today might be on the way down due to declining earnings.

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What is a Stock Price? *(continued)*

(Continued from page 2)

At Creekside, we look at the price to control a dollar of earnings across the whole market (or at least the S&P500). If the 500 companies in the index are earning \$50 per share, and the index is at 1000, then we are paying \$20 per dollar of earnings.

I really believe that, if the daily market index quotes were made in these terms, we would see less volatility and fewer extremes of highs and lows.

Ah...but astute readers have already asked the question: How do you know what future earnings will be? When looking at a bond, we know exactly what the earnings (*ie*, interest) will be. The stock market is unpredictable and earnings are constantly swinging up and down.

True enough, but we would point out that when earnings are adjusted for inflation and averaged out over ten years, they swing up and down far less than you might think. Despite millions of person-hours dedicated to the task, the efforts of research analysts to estimate future earnings company-by-company have proved a dismal failure. As is often the case in life, a simpler technique is often the best. And the best way that we have found for predicting the next 10 years of inflation-adjusted earnings is to look to the past ten years of the same. We call this inflation-adjusted-past-ten-years figure “normalized earnings,” or NE10 for short.

Corporate America sails along like a battleship, if you stand back a little and look at multi-year cycles. Earnings are remarkable smooth, because GDP growth is remarkably smooth. Sure, there are scary bumps along the way, but 100+ years of experience tells us that those 500 companies will get a consistent share of a consistent GDP growth line.

We, then, look at the stock market in terms of the price we are asked to pay today for one dollar of the past ten years of inflation-adjusted earnings.

As the market (S&P500) was peaking in October 2007, we were asked to pay \$27 (in today's dollars) for one dollar of NE10. At the bubble peak back in 2000, we were asked to pay \$43.

So, despite the fact that the two peaks were similar

in terms of the price quoted in the paper (around 1500) *stock prices were actually 36% lower in October 2007 than in mid-2000.*

Again, it is not the price per share that matters — *it is the price per dollar of NE10.*

Still, it was our view in October 2007 that \$27 was too much to pay. The inverse of price-per-dollar-of-earnings is called “earnings yield.” If you pay \$10 for a dollar of earnings, you are earning a 10% yield (\$1 divided by \$10).

At \$27, were being asked to accept an earnings yield of only 3.7%. Sure, that yield will grow over time (as earnings grow), but inflation-adjusted earnings per share of the S&P500 have only grown at an annual rate of about 1.5% over repeated business cycles. That brings the total expected return to only 5.2%. We could have done better (after taxes) by owning municipal bonds at the time!

At this writing (April 3, 2009), the S&P500 is priced at about \$15 per dollar of NE10.

And therein lies our outlook: We think that \$15 is within the range of reasonableness to pay for stocks. It's slightly below the average of \$16 over the past 100 years, and below the average of \$18 in the postwar period. Can stocks go lower? Certainly, and we have no way of knowing whether they will. All we can know is that the price we are asked to pay today is fair for what we receive in exchange. In the fullness of time, we think that we will be rewarded for keeping our stocks at these prices.

The economy surely faces great challenges as the debt write-down continues apace. Still, GDP has always, and, in our view, will always, return to its long-term trend line that is defined by population growth and productivity growth. The core group of large public companies will capture a predictable share of that GDP, and will deliver to us a predictable stream of earnings.

We are wise to think of stock prices strictly in terms of that earnings stream.

Best Regards,

Rick Ashburn, Chief Investment Officer

“Despite similar prices listed in the paper, stock prices were actually 36% lower in October 2007 than in mid-2000.”

“In the fullness of time, we think that we will be rewarded for keeping our stocks at these prices.”

Asset Class Overview *What we're doing right now.*

The value ranges stated below are on a scale of 1-5, with 1 being cheap and 5 being expensive.

Domestic Stocks. Value range: 2.5. In our valuation methodology, stock valuations are slightly cheap, for the first time since 1990-91. Returns over 7-year periods following valuations like we see right now have been satisfying more than 95% of the time. Due to fundamental economic risks, we remain *underweight* domestic stocks by 30-40%, depending on client risk objective.

Foreign Stocks. Value range: 2. The fundamentals point to attractive values. Currency factors are perhaps moving in our favor, and we are neutrally-weighted in foreign stocks. Within the category, we are not making a special alloca-

tion to emerging markets at this time.

High-Grade Bonds. Value range: 5. Government bonds are expensive — meaning low yields. We are not buying treasury bonds. High Grade *corporate* bonds offer very attractive yields and are a 2 on the scale. We have meaningful exposure to high-grade corporate and mortgage bonds.

Municipal Bonds. Value range: 1.5. Muni bonds remain cheap right now due to overblown fears about municipal defaults. We know how to pick the wheat from the chaff and have been buying over the past four months.

High-Yield Bonds. Value range: 2.0. On the basis of yield relative to higher-quality bonds, high-yield (“junk”) bonds are attractive. After

holding off for nearly 3 years, we added a significant position in high yield bonds in Q4 2008.

REITs. Value range: 3. REITs have gone from wildly over-valued to the middle of the range. There is still far too much uncertainty in order to justify a purchase at this time. We're not buying now, but we're starting to keep an eye on them. We see broad indications that commercial real estate is in a very tough position.

Foreign Bonds. Value range: 3. We are essentially neutral on foreign bonds from a pure valuation perspective — meaning yield and income potential. We added a dedicated foreign bond position in the first quarter as a hedge against a deterioration in the dollar.

Rick Ashburn & Andy Hempeck

Swapping With Uncle Sam

With all of the acronyms being thrown around these days, it is very difficult to keep them all straight. We all feel like we have been thrown under the TARP at this point. Unfortunately, there is no money underneath the TARP for most investors.

Has the market stabilized at this point?

Probably not; two big components still need additional data to convince us that the worst is behind us. One is Residential Home prices. The psychological damage going on in the residential housing market is hard to quantify, but it is acting as a huge hangover for most individuals. There is not a sign on top of your house flashing the price everyday like the stock market.

(Although www.zillow.com is getting close. They send out uplifting emails to me every few months letting me know my home is down another 10% per their algorithm.) When we see about three months stabilization in “owners’ equivalent rent” of primary residence, and mortgage approval rates increasing, we might get more excited. For now we will remain

cautious. The latest estimate for the value of the housing market is approximately \$16 trillion, which is down 30% from 2005 estimates.

The second area of concern relates to another acronym which has been thrown around a lot in the last year. The CDS market, a.k.a., The Credit Default Swap market. This acronym is the one that brought down AIG. Less than a year ago there were estimates being thrown around that this market had a notional value of \$70 trillion.

More recently this market has been estimated at \$27 trillion. Mr. Obama and Mr. Geithner are attempting to coordinate a clearing house for the CDS market, which needs to happen. Once we have transparency into the CDS market and can eliminate the moral hazards involved we will have a gone a long way to getting the market back on track. As of last year you had the equivalent of a free-for-all in the debt default insurance industry. In an analogy, ten of us could have bought a fire insurance policy on our neighbor’s house. Even though we like our neighbor and think he is a standup guy, our ten policies for his \$1 million

dollar house become kind of tempting and all of sudden his house goes up in flames. The fire department (ie, SEC, Fed, Treasury) can’t prove arson, so we all get paid \$1 million each — for the loss of *one* \$1 million house!

Hmm..something doesn’t seem right with this scenario. Granted this is an extreme example, but we are talking about trillions of so called “insurance” in this market. I like the free market, but this needs to be corrected.

Let’s get these two minor parts of our economy stabilized and then we can get back to business in that other market called the stock market, which is worth approximately \$15 trillion. For perspective the United States GDP is approximately \$14 trillion. You can see why we are still concerned about the two markets above. There will not be a bell at the bottom, but a few more moves on the chess board and some great opportunities might arise.

Andy Hempeck

2009 First-Quarter Index Returns

Large-Cap U.S. Stocks	-11.0%	REITs	-32.1%	Wherever possible, we use the returns on Vanguard Index Funds as the benchmark figures for various asset classes.
Small-Cap U.S. Stocks	-13.5%	High-Yield Bonds	4.65%	Readers wishing to review the actual performance record of a composite of our client portfolios should call or email us at info@creeksidepartners.com
Foreign Stocks (Developed)	-15.8%	High-Grade Bonds	0.35%	
Emerging Market Stocks	0.1%	High-Grade Corporate Bonds	-0.22%	
		Inflation	0.24%	
		<i>(year-over-year Feb. 28)</i>		