Thought for the Week: Monday, May 14th, 2012

Groundhog Day in May?

Many academically-inclined investment professionals decry the use of clichés as superficial or uneducated. In their opinion, the world is highly complex and cannot be approximated via a series of glib one-liners.

This may be a fair opinion; however, it's uncanny how certain clichés have a habit of working. For example: "Sell in May and Go Away" has "worked like a charm" (there's another cliché) for the last two years and is showing signs of producing a hat trick.

The chart below shows the S&P 500 with the last three Mays marked by red arrows:

Should we Stay Invested?

We have been investing with caution over the last few months and recently carefully considered whether to "Sell in May." Although we have maintained more cash and low risk investments than our longer term outlook suggests, our current view is to stay invested and ride out this temporary correction.

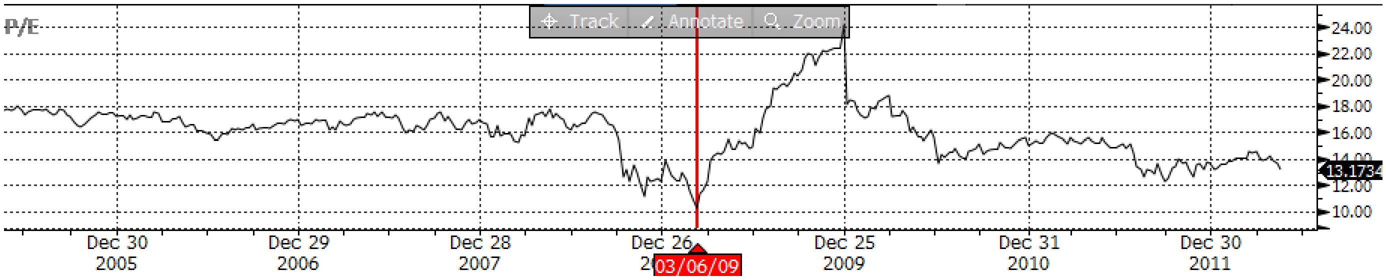
Why do we currently feel this is Temporary?

1. **Valuations**

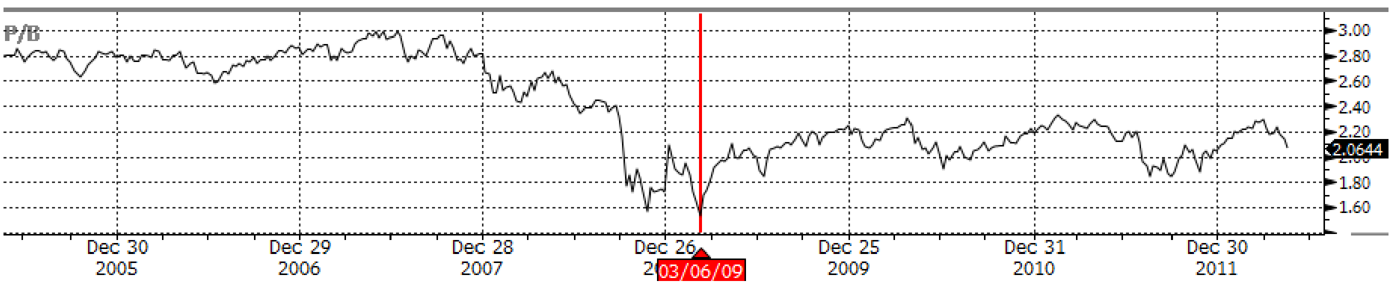
   Equity valuations are reasonable to low, judged by historical standards. The charts below show three different measures of equity valuation using the S&P 500.

   P/E is the standard Price to Earnings valuation. The current ratio of 13.17 is not at the lows seen in March 2008, but it's not too far away. This tells us that earnings have been growing quicker than share prices, on average. P/E looks backwards to past earnings and, therefore, the current low level reflects the fact that investors are forecasting lower future earnings.

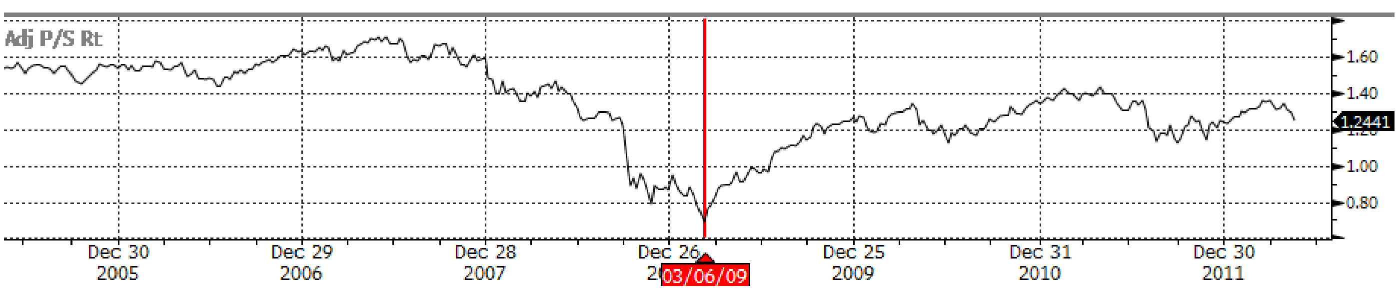
Still, the chart shows stocks are not overvalued at the moment, based on past earnings.



P/B measures current equity prices against the Book Value (net asset value) of the same companies. Once again, the increase in stock prices has not kept pace with increasing company valuations. This is a more robust measure as book values do not tend to fluctuate as much as earnings.



P/S measures current equity prices against the Sales of the same companies. Once again, the increase in stock prices has not kept pace with increasing company sales; however, this measure shows less value than the first two.



2. Growth Potential

Investors and the media have been talking down the prospects for U.S. corporations; the same entities that comprise the S&P 500.

At the same time, Quarter 1, 2012 S&P 500 corporate Sales rose 5.90% and Earnings rose 6.79%. So while Nero and his European buddies play the fiddle during the burning of their countries, our own corporations continue to generate attractive growth.

Finally, many companies are growing market share in non-traditional markets including: Brazil, Australia, Singapore, Israel, South Africa, Turkey and Canada.

The world is growing and we feel the U.S. based companies we invest in will benefit from this growth.

We call these companies the “Big Uglies.”