



Q&A – Street Price

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In tough times, as middle-market deal makers struggle to evaluate a company's book value and asset holdings, we thought it a good idea to ask a portfolio professional his thoughts. **Gregg Fisher**, CFA, CFP and President & Chief Investment Officer at **Gerstein Fisher** lent his expert insights.

M.A.: Conventional wisdom says that the economy will not improve until 2010 or late 2009 at the earliest. What does this mean for asset holdings and what does it mean for overall economic growth?

G.F.: The fundamental view of asset price cycles is that as the economy goes through the phases of expansion and contraction; these shifts affect the near- and medium-term attractiveness of different asset classes as well as that of different sectors within one asset class (say, stocks in different industries). Therefore, one can regard such data points as money supply, inflation, demand for commodities, the ISM (Institute for Supply Management) index, etc. as indicators of the state of the economy. At the trough of a cycle, the investor should expect to see low commodity prices, low inflation and a low ISM reading. This picture will gradually change to the opposite at the peak of the cycle, where the economy is nearing its production limits. According to our analysis, tracking business cycles peak-to-trough going back to 1948, both GDP and S&P 500 market performance increase most in the 1-year and 5-year periods following downturns in the business cycle. In the 1-year period following the worst business cycle downturns, GDP historically has grown at a rate of 9.58% on average and the S&P 500 has gained 20.91% on average. In the 5-year period following these downturns, GDP has risen at an average rate of 7.69%, and the S&P 500 has climbed by 13.24%.

M.A.: What should deal makers know about market results?

G.F.: It has been shown that investing when the market is "overvalued" (when the residual is high) leads to subpar results, and investing when the market is "undervalued" (low residual) yields superior ones. Interestingly, the market is more likely to become overly optimistic than overly pessimistic. Moreover, practice shows that good current fundamentals (recent strong

growth, for example), especially in combination with favorable non-fundamental factors, is a recipe for an eventual huge mispricing of risk.

M.A.: Deal makers should know driving structural forces that impact investing. What are these?

G.F.: Structural factors arise from the fact that although the basic premises of the efficient markets theory are correct, in practice there exist so-called limits to arbitrage, which allow only one opinion of market direction to temporarily dominate. One example of this is a momentum-driven bull market, where it is virtually impossible to maintain an open short position in a stock. In such cases, even if the professional investor believes that the stock is overvalued, a failure to predict when exactly it will go down is financially devastating. As John Maynard Keynes once said, "the market can stay irrational longer than you can stay solvent". A clear example of another structural factor at work is the recent (whether successful or not) ban on short-selling financial stocks, made with an obvious intention to artificially skew prices upward.

Investment manager incentive structures represent yet another structural obstacle to the functioning of a fundamentals-based market. For instance, when faced with a 70% probability that a potential investment will go up (implying a 30% probability of a loss), an institutional portfolio manager is very likely to go ahead and take a long position, as missing out on the upside would have severe compensation – and even career – consequences.

Similarly, an enhanced index manager is likely to choose a "better safe than sorry" route, and to make a clearly suboptimal investment decision rather than risking an increase in the portfolio's tracking error. The costs involved in perfectly tracking an index may result in the manager actually underperforming that index – all because managers are evaluated based on their ability to adhere to a tracking error target. To give a broader example, structural reasons ultimately stood behind the current financial crisis – as it would be suboptimal from an incentives standpoint for a bank executive not to follow risky strategies when everyone around was using them.

An extreme, but also very common and recent example, of a structural factor at work, is the still ongoing deleveraging of investment portfolios where the portfolio managers were forced to sell their best, most liquid assets to meet margin calls. Counterintuitive to many, another structural factor is the fact that immediate availability of information to an unlimited number of investors can totally reverse the effect fundamentals “should” have on returns.

M.A.: Can you give us an example of how emotions control investing strategies?

G.F.: Sure. If one invests, while being optimistic about the market, is it a good idea to add even more money at the point of thrill? Probably not. However, that is what most people are likely to do. Similarly, being depressed about recent underperformance will lead most naïve investors to pull out of the market just when opportunity is actually highest. Historically, however, investors have tended to follow their emotional hunches by changing their asset allocations at precisely the wrong times.

For example, in 1987, sentiment was low and cash levels were high (near 35%) – right when the S&P was poised to take off on a 10+ year run. In other words, most investors were out of stocks for emotional reasons just when the growth potential was at its highest. Comparing the timing of the second cash allocation peak with the optimal configuration shown at left, we can see that although the timing was close to optimal, the majority of investors did actually miss the lowest point – they would have achieved higher returns if they had started buying when the sentiment index stood at an unusually low level of 20%. In other words, emotions may deceive us, and, if unchecked, sentiment will overshoot the fundamentals, hurting returns.

M.A.: Thank you.

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