

## **February 2010 Market Commentary**

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### **No middle ground?**

January 2010 started off nicely enough before running into a brick wall once earnings season started in earnest. While 2009 was characterized by a euphoric rally tied to escaping from the brink, 2010 is likely to be a "show me" year and initial earnings results, while an improvement relative to comparable quarters, are coming in below what imputed valuations suggest. This is leading to a quick rush to the doors as investors attempt to reconcile economic conditions, company specific issues, and valuations. The period from 2007-2008 is still branded in investors' minds so naturally any slight disappointment is being met with a "take the money and run" mentality; investors don't seem comfortable waiting for investment theses to play out. One consequence of the past two years is that investors have become increasingly nauseous with equity market volatility and the recent equity market choppiness is leading some investors to search for greater safety, which has in part led to higher inflows in bond funds.

### **Stretching for yield**

In essentially a zero return environment, investors are feeling squeezed between the nauseous volatility of the equity market and the near zero-yield of safer fixed income securities. Consequently, some investors may find themselves stretching for yield and unknowingly assuming a greater deal of risk relative to the return they will receive. Extend maturities and investors expose themselves to the prospect of principal risk if rates rise while if one shortens maturities they find that yields are generally unattractive.

The quest for "safe" but higher yielding assets has driven investors into corporate bonds including both investment grade and high yield bonds but investors may be taking great liberties in assuming that these are safe or offer an attractive yield relative to the principal risk. Investors should note that credit spreads have tightened dramatically since the start of 2009 as the Federal Reserve was pouring liquidity into the system. Now that the credit crisis has abated, the Fed has been reigning in a number of quantitative easing programs. While the Fed may not raise rates in the near term, removing system liquidity could eventually result in spreads between corporate bonds and Treasuries rising, adversely impacting current holders of corporate bonds.

More importantly, a number of companies still face the prospect of refinancing in 2010 and 2011, particularly the most leveraged ones tied to the leveraged buyout boom from 2005-2007. Given a tepid economic recovery and removal of Fed liquidity systems, as these companies come to market to refinance, yields could rise, particularly in the high-yield bond segment. In addition, while some of my colleagues that work in structured finance have noted a rebound in activity, the overall appetite for speculative credit may be greatly tempered given the decline of CDOs and CLOs.

Investors in corporate bonds are currently paying par or more in an environment where supportive liquidity systems are being withdrawn and previous significant buyers such as CDOs and CLOs have declined reducing overall market appetite. When combined with the impending refinancing activity of leveraged loans and high yield bonds, the cost of credit in this sector may rise burning current investors in the corporate bond space.

### **An easy alternative**

So what's an investor to do? I personally think if an investor can't stand the prospect of drawdowns given the tumultuous two year period they've experienced, then pure cash and earning 1% on that is fine rather than extending themselves for yield in securities that could crack under moderate strains in the credit market. However, I do believe dividend paying, megacap stocks can be very attractive for investors that can tolerate volatility and have a longer-term (2-3 year) view. The biggest hurdle for investors, however, is to deal with the fact that equities are highly volatile. The average annual standard deviation of the stock market is roughly 18%.

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This means in a normal distribution and an average annual return of 5%, 67% of the time returns will range from -13% to 23%. This is a massive range and once you account for 2-3 standard deviations from the mean, it's clear how volatile equities can be. Most investors have been used to the growth experienced from 1982-2000 where volatility was low and despite a rough shake out from 2000-2003, it appeared that things would be fine from 2003-2007. Unfortunately investors are not in an environment close to what led to the most powerful bull market period in history (1982-2000) and market choppiness is much worse now than it was during the raging bull market of 1982-2000.

At the start of that period the market P/E was roughly 6.0x and inflation was over 14%. Now we're facing P/Es based on normalized earnings of roughly 18.0x and investors are faced with deflation. In 1982, inflation was peaking and P/Es could expand. In today's environment, rates can't really get any lower and they will eventually rise which would punish fixed income investors. While earnings may be abnormally low due to last year's difficult period, optimistic forward estimates still indicate that equity markets are valued at about 15.0x 2010 EPS, not that exciting, particularly in an economic environment where GDP growth will be unimpressive.

Given the above paragraph, readers may wonder why megacap equities would make sense. The reason is while the broader market may be trading in the high teens in terms of EPS, many megacaps are a bargain, trading for 11.0x-13.0x EPS. In addition, a number of megacaps offer very healthy dividends. For example, Kraft Foods ("KFT") offers a compelling bargain considering its strong brands and presence. Its purchase of Cadbury plc ("CBY") will expand KFT's product offerings and global reach. More importantly, KFT offers a yield of 4.2% and an earnings yield over 7%. In addition, KFT basically bottomed out around \$21-22 per share in March 2009 so the downside relative to the current share price is really not that bad.

In comparison, an investor could be paid 4-6% in near term corporate grade bonds or 7-8% in long-term corporate grade bonds. With those bonds investors are paying par or above par so the only thing they have to look forward to is clipping the interest payments. An investor may focus on REITs but the issue there is a number of REITs are offering distributions not much better than what KFT would offers but are trading at higher valuations and facing significant headwinds in terms of occupancy and refinancing issues. With KFT and stocks like it, investors have the chance for legitimate capital appreciation as a case can be made for multiple expansion, particularly in an environment that may favor consumer staples. So an investor can experience capital appreciation along with a very attractive dividend yield. Additionally, KFT has a liquid options market and investors can manufacture additional yield through option sales.

If investors encounter an inflationary spike, KFT has the ability to pass through those increases which could protect earnings. In contrast, inflation and commensurate rate hikes would impair principal values of bonds. The same work can be applied to other megacaps such as GlaxoSmithKline plc ("GSK"), which stock is valued at 13.0x and yields 5%. Like KFT, GSK is a high quality company but has been generally passed over as investors focused on the high risk trade in 2009 and may now be trying to figure out where a reasonable place to focus on in 2010 will be.

The general theme with these megacaps is that they trade at cheap P/Es with earnings yields over 7%, pay hefty dividends (4%+), and have options markets that can be utilized to generate additional yield. Cheap P/Es present the prospect for increased valuations as it's not difficult to make the case for a global leader to be valued at 15.0x EPS rather than the 12.0x EPS some are them are currently trading at.

Investors that partner with managers that can identify these types of opportunities should do well in 2010 as the underlying businesses of these stocks are generally very strong. Nonetheless, there are still numerous opportunities in the small and mid cap arena and specific sectors but these require much more intense company-specific analysis and valuation exercises along with a stronger stomach. For example, I am focused on a number of regional banks but there are still potential landmines in this space and finding the right opportunities requires a bit more due diligence. My fund and managed accounts are also invested in Sprint ("S"). On the surface S is worst in class and embroiled in a nasty price war but once one digs beneath the surface there's a lot to be excited about with this company. However, investing in regional banks or a turnaround like S requires a lot more groundwork and investors that don't want the stock and business volatility associated with these smaller companies are much better served with increased exposure to megacaps with higher yields.

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