March 2, 2009

CAZ Investments

The Buying Opportunity of Our Generation, Part II

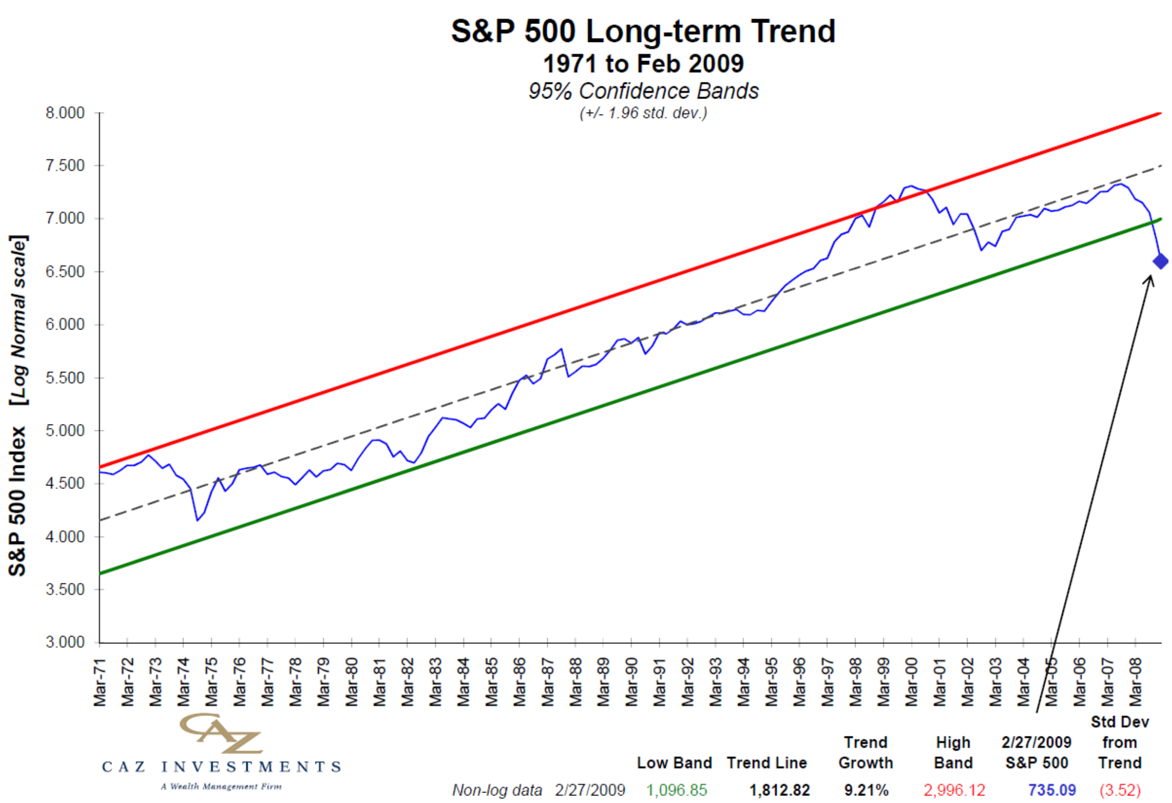
We have been saying for the last few months that we expected the November lows to be tested again, and possibly would break those levels. That test has now occurred and the market failed to hold the November lows in the Dow, S&P 500 and the Russell 2000. The NASDAQ and the Mid Cap Index are still holding, at this point.

What does this mean? Unfortunately, it means that psychology will be damaged as those who were “hoping” the lows would hold now have nothing to hold onto. This usually leads to a sharp follow through decline that in many cases is purely technically driven. We certainly felt that today. Sometimes that drop is a pre-cursor of more declines to come and sometimes it is what is known as a “bear trap”, which is essentially a wash out of the last few remaining hold outs. The hard part about this business called investing is that you never know for sure which one it is until after the fact!

Have we thrown in the towel? Should we change our strategy? The answer to those questions is an emphatic no. We are as bullish as we have been in 7 years and we are growing more convicted every day as the market continues to sell off.

In our 1st Q letter we will expound on our reasons for being bullish, but suffice it to say for this correspondence that this is the time for people to be aggressively allocating money to stocks and risk assets. The returns earned from these levels will be very dramatic. Fortunes will literally be made from these levels. In an email correspondence like this, there is simply not enough room to go into a lot of detail. But, as they say, a picture tells a thousand words. We actually have 4 pictures for you to review attached to this email.

The first is an updated regression chart that shows how dramatically this market has overshot to the downside, based on statistical data that goes back nearly 4 decades!



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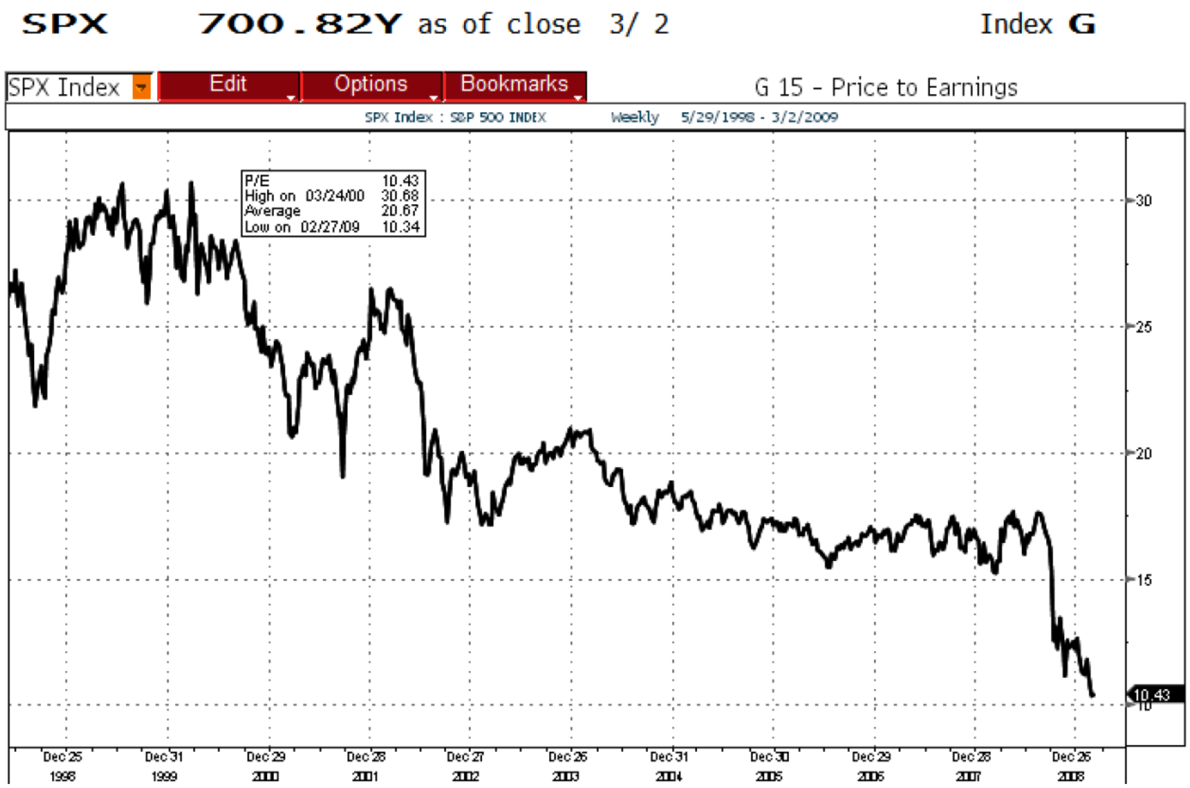
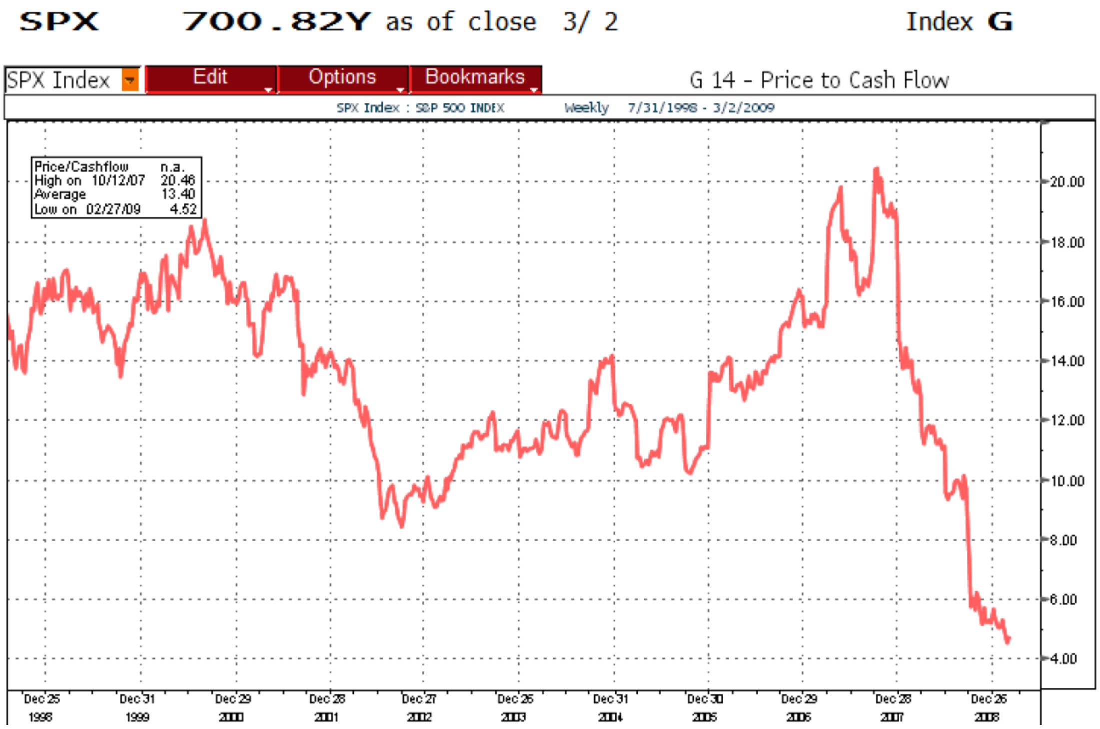
The next three charts show the valuation levels of the S&P 500. As you can see, whether looking at Price to Earnings, Price to Cash Flow, or Price to Book Value, these valuations are extreme. Additionally, current valuations are trading at roughly HALF the average value we have seen in the past.





Are things ugly out there? Of course, and that is why the market is at this level. That is what creates opportunity. For those that have less equity exposure than their target allocation, they need to be putting capital to work NOW. Could it go lower? Of course, but one thing we feel is abundantly clear, we are LOT closer to the low than we are to the high. People will look back 10 years from now and ask themselves, “Why didn’t I put more capital to work at 700 on the S&P 500?” And they will regret giving into the emotion of the day instead of investing with valuation as the driver. One thing is a certainty in an uncertain world, stocks will always reflect underlying business values. Sometimes, like 1999 they overshoot values dramatically on the upside. Other times, like now, they are overshooting values dramatically on the downside. Think about it, in 1999 the Price to Cash Flow of the S&P 500 reached more than 20X. Today, the Price to Cash Flow is 4.5X! That is a 77% decline in valuations!

Many people have heard me say that there have only been a few “no-brainer” situations that I have seen in my career. The first was that the financials were an incredible buying opportunity in 1991. The second was that the tech bubble would burst in 1999. The third was the buying opportunity in stocks in 2002. The fourth was that the housing bubble would burst. The fifth is undoubtedly today. Stocks will go considerably higher from $700 on the S&P 500 that we closed at today.

The hardest part about “no-brainers” is that they usually fly in the face of everything you hear and, more importantly, what you feel. Great investment returns come from thinking clearly when everyone else is losing their head. That is where we are today. Focus on the valuations. As sure as the sun will come up in the East tomorrow, the S&P 500 will trade at 9X cash flow at some point in the future. The only question is whether or not we will maximize the opportunity from that increase in value.

Please let us know if you have any questions. If you are not sure that your asset allocation is where it should be, let us discuss it with you. There are tremendous opportunities to take advantage of the dislocations in the markets. Allow us to help you capitalize on those situations.

All our best to you and your family.

The team at CAZ Investments