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Balanced View

WEEKLY COMMENTARY | AUGUST 9 2007

A class $9.85 | **F class** $9.86 | **X class** $9.83

Fruit Flies

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The nature versus nurture debate is one of the most enduring in the field of human experience. Are people hardwired with certain inborn ideas and traits that enduringly underpin their approach to the world? Or does experience fully contribute to human behavior?

More recently this debate was again pushed to the forefront with the breaking of the human genome with the discovery that we humans are the proud owners of a paltry 30,000 genes, barely twice the number of a fruit fly. The seesaw struggle between our genes (nature) and the environment (nurture) had swung sharply in favor of nurture. In the words of Craig Venter, president of Celera Genomics, one of the two teams that cracked the human genome in the winter of 2001: "We simply do not have enough genes for this idea of biological determinism to be right".

As deep believers in the concept of balance, our sympathies lay with the opinion that most of us swing like a pendulum between the two states. However, recent market turbulence has us second guessing; maybe investors are fruit flies.

Like fruit flies it seems that investors are too easily controlled by the whim of the moment. A scant few weeks ago investor sentiment was that of elation. The issues that have rocked global markets are nothing new: too many new houses, too much credit and a lackadaisical attitude towards risk from so-called "hedge" managers who do a lot of things but hedge.

This is the end of the liquidity driven market, but with every end there is a beginning. Welcome to a market based on fundamentals.

We don't know if or when the Fed will cut rates, we don't know if or when the housing market will recover and we don't known how many more poor "hedge" fund managers will blow up.

What we do know is that we are capable of extracting the most out of our 30,000 genes to transcend our brother fruit flies. Amid the market turmoil we stick to our investment discipline. With all that the chaos valuation is our anchor.

Contrary to the fear of the masses we think the S&P 500 represents good value.

As those familiar with us already know, we determine "good value" by considering the present Price Earnings Ratio of the S&P 500, or in other words what it costs to buy the dollar value of earnings of all 500 companies combined. We have developed a valuation model that considers three key factors:

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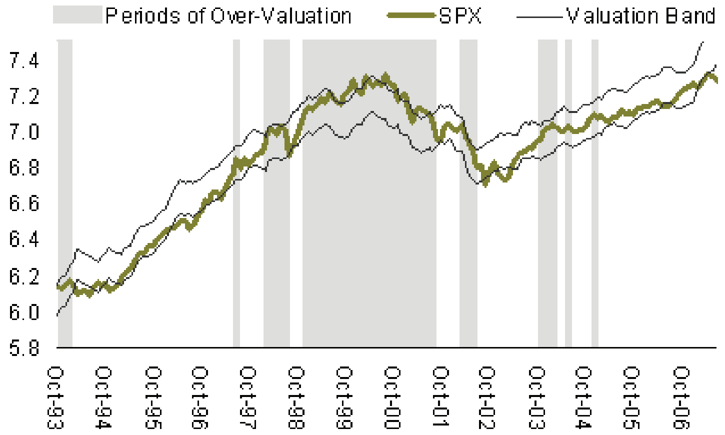
Intrinsic valuation of the S&P 500



1. **Momentum of earnings;**
2. **Implied market volatility; and**
3. **Moving direction of interest rates (yield curve).**

Our model shows strong relationship between the Price Earnings Ratio and these three factors. We use this tool to give us a disciplined way to determine the good value of the S&P 500 versus the level where it trades.

Today our valuation tool indicates that the S&P 500 is extremely undervalued after the sell off of last two weeks. Actually it's so oversold that it's already outside of the low end of its valuation band. Historically, the index has performed well from these levels.

People are scared. The VIX index above 25, a level we haven't seen since the end of the bear market in 2002; the short ratio is at a historical high and markets around the world have plunged.

Unlike fruit flies, investors have a choice. When the chips are down valuations due to easy money always prove to be a trap. Investment should be based on merit not return. Profiting with the crowd always ends with losing with the crowd. Use this as a reminder to review your portfolio and with each investment ask this simple question: was this purchase made on a whim or anchored by valuation?

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