



# AL FRANK MARKET MONITOR

July 15, 2010

## Rolling with the Punches

The opening credits were still rolling and Tom Cruise had just bumped into Cameron Diaz coming up the escalator at the Wichita airport. We were two minutes into *Knight and Day* at our sold-out local cineplex (yes, the flick has played poorly at the box office, but it was opening night) when blue alarms started flashing and the public address system began blaring, “There has been an emergency reported. Please calmly move to the exits.” Happily, there was no fire and no other apparent emergency, making it relatively easy for several thousand moviegoers to stream out of the 21-theater complex without incident. Twenty-five minutes later, an all-clear was given. We were able to go back in and enjoy the show, though we had to again sit through the same six pre-views—can’t wait for the sing-along release of *Grease*.

“A day of worry is  
more exhausting than  
a day of work.”  
—John Lubbock

Not exactly the same situation, but we know that many equity investors stampede for the exits when they smell trouble and that they generally have little interest in returning to the theater until long after the scare has ended. We saw this play out once again when mutual fund investors stayed out of U.S. equities for most of the rally

off of the March 2009 lows, only to finally regain their courage in mid-April 2010, right before the major market averages began the current 15%+ correction.

Illustrating the lack of success most have in trying to time the markets, research firm Dalbar Inc. reports in its *2010 Quantitative Analysis of Investor Behavior Report* that over the past 20 years, equity mutual fund investors have managed an average annualized rate of return of just 3.2%, compared to an 8.1% annual return for the S&P 500. Believe it or not, it’s the same story with fixed income, as bond fund investors had a 1.0% average return over the same time period, compared to a 7.0% return for the Aggregate Bond Index. Why is this the case? Dalbar explains, “Investors are impatient...and irrational.”

Of course, no matter how many times folks hear that stocks historically have returned 9% to 11% per annum over the past 85 years or that periods of great uncertainty have more often than not provided excellent opportunities for those with a long-term orientation to pick up great com-

panies at terrific prices, we understand that it is difficult for even the patient and the rational to remain sanguine about stocks, especially when the headlines offer little in the way of optimism. Whether it is the ongoing disaster in the Gulf, dissatisfaction with Washington, European sovereign debt woes or slower growth in China, there are plenty of very real issues about which to be concerned. Throw in the dismal employment picture, ugly housing numbers and waning consumer confidence and it’s probably no surprise that double-dip recession fears are on the rise.

No doubt, the weakness could continue, especially as the fear/greed pendulum has swung mightily in both directions over the past couple of years, but we can’t forget that the consensus of economists and the Federal Reserve is still for modest economic growth in the U.S. of 2% to 3% over the second half of 2010. True, those forecasts may prove to be too high, but nominal Gross Domestic Product (GDP) hit an all-time high in the first quarter of 2010 with real (inflation-adjusted) GDP likely to hit a record before year end.

Obviously, a 9.5% unemployment rate is a major headwind, but those who have jobs are helping to keep Corporate America’s coffers filled, while expected slow growth in the developed world and decent growth in the emerging countries should benefit many of the multinational companies in which we are invested. Though analysts are often overly rosy in their projections, the bottom-up EPS estimates posted by Standard & Poor’s on July 15 for its market-proxy S&P 500 index of \$81.86 for 2010 and \$94.92 for 2011 do not seem that far-fetched, especially as there are also productivity and market-share gains to be had. A forward P/E ratio on the S&P of 13 when the yield on the 10-year Treasury is below 3%, very little inflation and corporate balance sheets flush with cash, make us think that it won’t be too long before investors are again enjoying the equity show.

### On second quarter earnings

Speaking of earnings, the few companies that have announced Q2 results thus far have turned in pretty good metrics, even if the market failed to show much enthusiasm. As *Barron’s* mentioned this weekend, 75% of companies have beaten profit expectations while 82% topped revenue forecasts. Of course, management commentary and guidance for the balance of the year and beyond is what investors were waiting to hear and so far we think it’s been generally favorable, albeit with plenty of caveats.

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For example, two shipping companies, important barometers of economic activity, posted excellent numbers. Trucking heavyweight J.B. Hunt said, "Demand for transportation services has increased fairly dramatically as we have emerged from a multi-year freight recession... Across all segments demand was solid throughout the quarter with no evidence of renewed weakness." Railroad giant CSX commented, "We touch many parts of the economy and we think it's (the economic recovery) going to continue into the second half of this year."

There was also good news from the tech sector. Microchip king Intel proclaimed, "Strong demand from corporate customers for our most advanced microprocessors helped Intel achieve the best quarter in the company's 42-year history...The PC and server segments are healthy and the demand for leading-edge technology will continue to increase for the foreseeable future."

Of course, given that the market pummeled its stock, a report from toy-maker Mattel was not well received. Still, the accompanying commentary was not exactly negative. Mattel CEO Robert A. Eckert said, "What a difference a year makes. Last year at this time, Mattel, along with many other consumer goods companies and retailers, was lamenting how much further the economy was going to decline. And while reports remain mixed on whether or not we're out of the woods, I can tell you that I'm very pleased with the company's performance for the quarter."

Only just tipped our toes into the pond of reports, however, and even as we pen this note, market reaction even to remarkably upbeat reports has turned decidedly more cautious, reflected both in selling pressure and standard surveys of sentiment. One of two widely-watched emotion gauges (the other being the Conference Board's Consumer Confidence Index), the University of Michigan indicator tumbled to 66.5 for July from 76 in June. While we know what people actually do is far more important than how they say they are feeling, there is little doubt that the oppressive unemployment rate, the weak housing environment and the struggles of the equity markets do not provide a lot of reason for optimism.

And, yet, history shows that weak Michigan numbers such as what we are seeing today generally have coincided with favorable times for long-term oriented investors to be adding to equity holdings. This is not to suggest that folks shouldn't be feeling concerned about their own prospects, but if economic growth—yes growth—is still being projected by the majority of forecasters. The latest survey by *The Wall Street Journal* found 64% of the 55 economists polled thought the economy would get better over the next 12 months and 9% said it would get worse with the balance saying it would stay about the same. True, most are revising lower their projections, but on average they expect the economy to grow at 2.5% or so through the second quarter of 2011.

All context and consequence considered, we remain confident in the selections we've included in our portfolios, biased as they are to what we find to be undervalued location/vocation diverse larger-cap dividend yielders that we're holding for their long-term appreciation potential. ■

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