

Investment Outlook



CONTENTS

INVESTOR BOOTCAMP

Are stocks overpriced?

Fixed income?

Real Estate?

HOLDINGS PROFILED

IRETS

Genzyme

Quintanta Maritime

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Investor Bootcamp

Pop quiz: Which stock is more expensive, Exxon Mobil at \$91 or Disney at \$35? If you answered “Disney”, give yourself a gold star. You deserve it, especially since I didn’t give you all the information you need

to answer my question. You see, a stock is considered cheap or expensive in relation to its earnings per share. Exxon Mobil trades at 13 times earnings, while Disney trades at 16 times earnings. Disney is therefore more expensive.

This valuation measure is known as the Price/Earnings or P/E ratio. Contrary to popular belief, the P/E ratio is NOT the percentage of investors wetting their pants as the market continues to crash! If you flip the ratio upside down, you get the annual earnings as a percentage of the stock price. So, Exxon Mobil at a P/E ratio of 13 has an earnings yield of 1/13 or 7.7%.

Disney at a P/E ratio of 16 has an earnings yield of 1/16 or 6.25%.

Over the last 200 years,

U.S. stocks have posted average annual real returns of 6.8%. “Real return” means the return over and above the inflation rate. This 6.8% return has been amazingly consistent over the last 200 years. If you look at the accompanying graph, you will see that stock returns vary around a straight line. Although stock returns vary sharply from year to year, the returns are steady over longer time periods.

This 6.8% earnings yield corresponds to a P/E ratio of 14.7. As of this writing, the S&P 500 has a P/E ratio of 18.1. This means that the broad stock market is today 23% above its



200 year average Price/Earnings ratio. What factors, if any, justify this premium?

Are earnings temporarily depressed? On the contrary, earnings have been growing. Is economic growth accelerating? No, gross domestic product growth has been slowing ever since 2004. Falling home prices and rising gasoline prices are a drag on the economy, and I do not see these trends reversing any time soon. The futures market is predicting a 9+% increase in gasoline prices over the next six months (so fill your tank now!).

I fear the recent "credit crunch" is just the first piece of bad news for residential real estate. Back in the refinancing boom of 2003, homeowners took out adjustable mortgages which were fixed for three or five years. These mortgages are just now beginning to reset at higher rates, putting more homeowners under pressure.

On the positive side, the falling dollar will help U.S. exports. However, exports comprise only 12% of our

economy, so this effect will be limited. All in all, the economic outlook just does not support stock prices 23% above average.

Are there factors besides the economy which support these stock prices? Some may claim that lower interest rates justify higher stock prices. If we had a crystal ball and could know that rates will stay low, I might agree. However, I am more inclined to believe that rates are headed up, if only because they are low by historical standards. Real interest rates on Treasury bonds have averaged 3.5% over the last 200 years, and 6.8% over the last 25 years. Today, real rates are at 2.65% (4.65% nominal rate minus 2.0% inflation.) The fact that the stock market is rising on interest rate cuts just shows the short term mentality of the stock traders.

Despite the foregoing, I do not suggest getting out of the stock market. Indeed, the alternatives, fixed income and real estate, look even worse than stocks. A better strategy in my view is to avoid investments in the broad domestic market (i.e. index funds) and make highly selective investments in stocks of individual companies. The

selection criteria should include modest P/E ratios, financial strength, international growth prospects and insulation from the U.S. consumer economy.

Each quarter we profile a few of our holdings for our clients' information. The companies below were selected for this issue because we have not previously profiled them. This is not a "buy now" or "top picks" list, and may not be suitable for every reader.

IRET

Investors Real Estate Trust (IRETS) owns a mix of multi-family and commercial rental properties in the Upper Midwest. This REIT trades at a 20% discount to its REIT peers because it operates in states with little or no population growth. However, the continuing loss of rural population is masking the growth in urban areas in which IRETS operates. Grain prices have recently zoomed to historic highs based on foreign demand for U.S. grains and meats plus

new ethanol demand. These grain belt states are suddenly looking attractive.

IRETS debt is 97% fixed rate, so IRETS stands to win from inflation. The dividend yield is over 6%, and the dividend has increased every year since the company was founded in 1970. The current CEO has been with IRETS in various capacities since 1970. The ratio of price to funds from operations is about 12.



Genzyme (GENZ) is a large biotechnology company (\$3billion+ annual revenues) focused on rare inherited disorders, kidney disease, orthopedics, transplant, cancer and diagnostics. At a P/E ratio around 18 (non-GAAP), the stock is modestly valued given their growth record. The company has a very big pipeline, with 21 compounds in phase 2, phase 3, or postmarketing studies. Their current major products have several years of remaining patent life. The current CEO has been in office since 1985 and has managed spectacular growth. I favor drug companies be-

cause they are somewhat insulated from competition and the economy.



Quintana (QMAR)

owns a fleet of dry bulk carriers. These are ships which carry iron ore, grain or coal, typically from the Americas to China. Quintana places their ships under multiyear charters, which cover most of the ship's cost. Charter rates have been very strong due to several factors. First, the shipyards are booked up, and dry bulk carriers are the least profitable ships for the shipyards to manufacture, so new supply is slow to come on-line. Second, as China reaches around the globe for raw materials, shipping distances are lengthening. Third, as ports become overcrowded, ships spend more time waiting in line. Fourth and fifth, the rising price of iron ore yields a twofold benefit to Quintana: more ships are needed to meet the rising demand for ore, and Quintana's ships become more valuable as steel prices rise.

Just as we went to press, Quintana's stock surged and got a

bit pricey, so we sold it in our tax free accounts.

CONCLUSION

I believe inflation will limit real returns for bonds, and most real estate will remain under pressure. I believe the broad stock market is overvalued, even as the U.S. economy is slowing. Under these circumstances, I favor stock investments in reasonably valued, financially strong companies that can ride out a downturn. I favor sectors such as pharmaceuticals, energy, and precious metals, which can prosper despite a weakening U.S. economy.

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