

Reprinted from

welling@weeden

<http://welling.weeden.com>

VOLUME 9

ISSUE 3

FEBRUARY 9, 2007

INSIDE

Listening In
Why Overvalued,
Overbullish,
Overbought Market
At Peaks With
Rates Rising Is
Bad News

PAGE 1

Guest Perspectives

GAIL DUDACK

*Not-So-Scary
Margin Debt Levels*

MIKE WILLIAMS

*"No Savings"
The Bull Case*

Trading Ideas

BERNIE SCHAEFFER:

*Range Bound:
Forget Excuses,
Trading Range
Perpetuates Itself*

CHRIS BLOOMSTRAN:

*Fortress
Mentality*

KMW:

*Sub-Prime Woes
This Is News?*

Acute Observations Comic Skews

ALL ON WEBSITE

listeningin

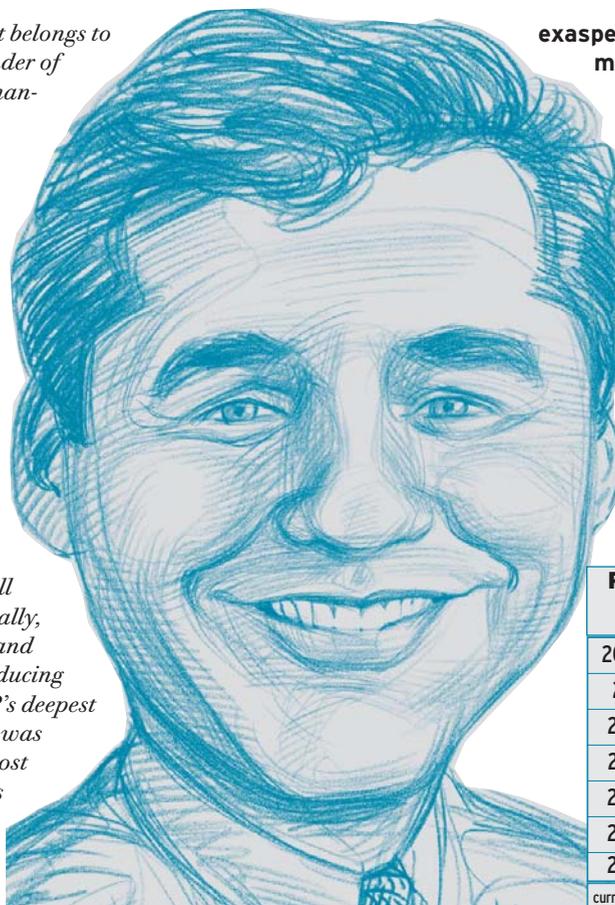
Going Full Cycle

John Hussman Sticking With Defensive Posture At Odds With Crowd

*The genial visage to the right belongs to **John P. Hussman, Ph.D.**, founder of **Hussman Econometrics** and manager of its **Hussman Strategic Growth Fund** and **Hussman Strategic Total Return Fund**. Both of which, to get the full disclosure out of the way up front, have long counted me as a shareholder. As the scorecard over yonder indicates, it has been a rewarding relationship, albeit a somewhat taxing one lately, as John's increasingly defensive posture has seen the growth fund lagging the S&P over the short run. Still, since its inception, the fund has produced an overall total return of 12.38% annually, vs. just 1.39% for the S&P—and taken a much-less agita-producing route to its returns. The S&P's deepest drawdown over this period was more than 47%, while the most the fund was ever down was less than 7%, which actually says a great deal about the merits of John's approach for capturing "full-cycle" market returns. Typically, John's market commentary is at least as even-keel as the growth fund's returns, but lately he's gone out on a bearish limb. I couldn't resist calling to ask why. Listen in.*

—**KMW**

John, the letters you write every week on your website are usually eminently professorial. You typically eschew saying anything that could be even remotely construed as a market forecast, but your latest missives seem to be breaking out of that mold. Are you betraying a little



exasperation with a stock market in which your defensive portfolio has been lagging the indices?

Well, I have good friends who are Buddhist monks, and they often emphasize to me the importance of equanimity. But right now I really have come to see it as my responsibility to counter rampant bullish arguments that don't have any

basis in the historical evidence.

It's not merely that you're frustrated?

No. You've known me long enough to know that I went through a similar period of lagging performance in my newsletter model portfolio in the late stages of the internet bubble. I read an interesting piece in **Science**, the other day, on risk aversion. I don't have it right here, but the gist of it was that scientists have isolated some cortical regions that

Returns Scorecard

	HSGFX	S&P 500
2000*	16.4%	-9.4%
2001	14.67	-11.89
2002	14.02	-22.10
2003	21.08	28.69
2004	5.16	10.88
2005	5.71	4.91
2006	3.51	15.79
current value of initial \$10,000	\$21,206	\$10,783

*from inception on 7/24/2000

	HSGFX	S&P 500
2000*	16.4%	-9.4%
2001	14.67	-11.89
2002	14.02	-22.10
2003	21.08	28.69
2004	5.16	10.88
2005	5.71	4.91
2006	3.51	15.79
current value of initial \$10,000	\$21,206	\$10,783

*from inception on 7/24/2000

RESEARCH
DISCLOSURES PAGE 8

Kathryn M. Welling
Editor and Publisher

Jean M. Galvin
Business Manager and
Webmaster

Karin-Marie Fitzpatrick
Editorial Assistant

Alexander Isley Inc.
Graphic Design

Netsential.com Inc.
Web Hosting

Weeden Securities Corp.
Board of Directors

Donald E. Weeden

Barry J. Small

Robert A. Cervoni

Timothy McDonald

Robert DeMichele

Daniel V. Panker

Richard Sharp

Richard Schmaltz

Craig Hetherington

Christopher Mahler

Todd Trimmer

Harold Piskiel

welling@weeden, an exclusive service for clients and prospective clients of Weeden & Co. LP, is published biweekly on Friday mornings, by welling@weeden, a research division of Weeden & Co. LP. Editorial and partnership offices are located at 145 Mason Street, Greenwich, CT 06830.

Telephone: (203) 861-9814
Fax: (203) 618-1752

Email: welling@weedenco.com
jean_galvin@weedenco.com

First-class postage is paid at Stamford, CT

Copyright warning and notice: It is a violation of federal copyright law to reproduce all or part of this publication or its contents by any means. The Copyright Act imposes liability of up to \$150,000 per issue for such infringement. welling@weeden does not license or authorize reproduction by clients or anyone else. However, multiple copies are available to clients upon request and limited reprint arrangements are available. Copyright 2007, K.M. Welling and Weeden & Co. LP. All rights reserved.

Victor Juhasz

Page 1 Illustration

apparently have a relationship to loss aversion. My immediate response upon reading that was that I must have those regions firing right now—because my willingness to stick to a discipline comes out of two things. One is a constant effort to look at *all* the data and evaluate the merits of the various arguments. The second is enough experience with market cycles to know that the market does, in fact, experience cycles and not simply diagonal moves. One of the other things that you know about me is that every time we talk, I very explicitly try to ask about what bullish and bearish arguments you're hearing that are most compelling. That's part of my discipline. If someone were to look over my shoulder, on most days, I'm doing exactly that. I'm evaluating various arguments and indicators that other people are endorsing and trying to find out whether or how they are useful. So a lot of my resolve comes from having done that enough to know that the arguments currently being advanced in favor of rising stock prices are largely vapid. For example, I can't tell you how many investors are hanging their hats on the simply indefensible idea that stocks undervalued here. That is the core of my concern. Notice, I am not making the argument that earnings will come down and that therefore stock prices will come down. My argument is that stocks are very richly priced *on the basis of normalized earnings*. In fact, on the basis of normalized profit margins, the P/E multiple on the S&P 500 is about 25.

At nosebleed level, you're implying?

Right. Even if you allow for some increase in the normal level of profit margins on the basis of labor competition from China and other factors, it's extremely difficult to make the case that we should go 100% of the distance and say that—at 18.5 times *peak earnings*, which is where we are now, and at 25 times normalized profits—stocks are undervalued. I would actually estimate that the true multiple on normalized profits would be somewhere in the low 20s, because China and global competition have had *some* effect in restraining the rate of wage increases here. But not enough to do the job of re-setting historical profit margins to the present level.

Have you noticed, too, how prevalent the argument is that stocks can't fall as long as earn-

ings are rising here? Which is the cart and which is the horse?

Yes, and that actually gets to my point about my defensive posture not being based on qualms about the short-term direction of earnings. It's based on the level of overvaluation with respect to normalized earnings. It's a longer-term valuation argument based on what stocks are worth in terms of the future cash flows that investors will receive over time. I am not arguing that stocks will go down because earnings are headed down. I'm not making that argument because there's no historical evidence *at all* that short-term fluctuations in the stock market have any correlation with the short-term direction of earnings, say, over a period of a year. In fact, if you

run a correlation between one-year changes in the S&P and one-year changes in earnings, you'll get something close to zero or slightly negative.

Geez, John, don't Wall Street analysts have a hard enough time these days without you saying their profits forecasting theatrics are bogus?

Well, not only is there no correlation between stock prices and short-term earnings direction, but No. 2, the prospects for multiple expansion on record earnings at record profit margins, with interest rates *higher* than they were, say, six months ago—that's a *very fragile* proposition. Which is why I lately seem to be making less of an effort to maintain

equanimity in my weekly comments.

Why you've actually been making market calls, you mean?

Yes. Basically the reason is that there are very few voices that even allow for the *possibility* of very negative outcomes. Yes, you do see some negative comments but they're along the lines of, the market is due for a correction—but then we'll continue higher. I don't think it's necessary to rule out that possibility, nor is it necessary to rule out the possibility that stocks could even provide reasonable returns over the next year or so. But I think it is a *very large mistake* to rule out the possibility that stocks could lose a third of their value.

But John, the market keeps making almost daily new highs on one index or another.

There's no denying that market action has been generally favorable here. The problem is that the market

“Not only is there no correlation between stock prices and short-term earnings direction, but the prospects for multiple expansion on record earnings at record profit margins, with interest rates higher than they were, say, six months ago—that's a very fragile proposition.”

has gotten to an extreme where it's overvalued, overbought, and overbullish enough that those technical metrics will not turn negative until after the market has lost a great deal of ground. Another way to think about it is this: We're longer overdue for a 10% correction than at any time in history except before the '98 decline. Another is to suppose that the market *doesn't* correct soon. Suppose instead it advances another 10%—and then has a 10% correction. You know what? In that case, boring old T-bills will have outperformed the stock market between now and then. So unless you have a sure-fire method to get out on the 10% rally,

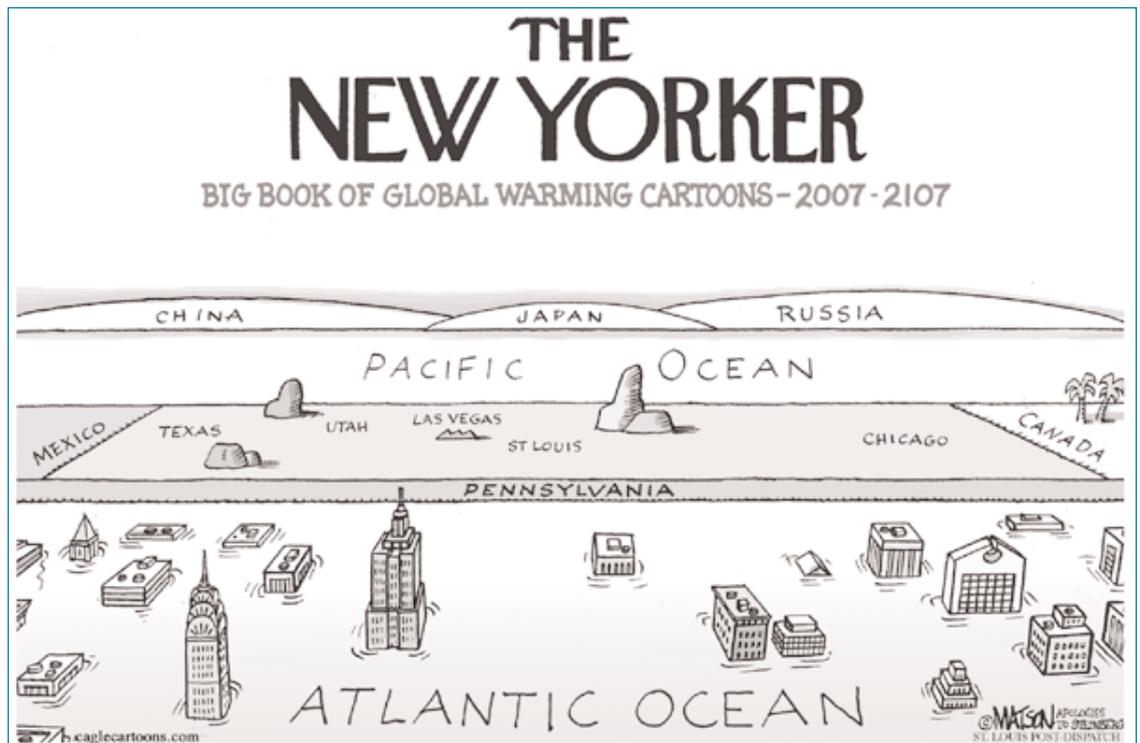
prior to the drop, you're better off getting out now. And, I would argue, if you *do* have that method, it's saying to get out now. My point is that people staying fully invested here are, effectively, saying they are very excited about potential returns that are very small in the context of the full market cycle.

More likely, they're not thinking at all in terms of a full cycle.

Which is unfortunate, since most bear markets include three or more 10% declines, albeit punctuated by recoveries, before they're done. Let's just note, for posterity, so I can look either like an idiot or a genius, that the S&P is trading as we speak at 1446. (Hopefully, my arguments will look reasonably cogent in hindsight.) Part of my motivation for speaking now is that investors seem to have lost all aversion, not only to risk, but also to extraordinarily simplistic investment themes. "It is plain easy to make money in the stock market. You just back up the truck." Likewise, it's simply incorrect to believe that current earnings or forward earnings are valid measures of underlying value here. So for me to watch investors wholeheartedly betting their financial well-being on those skewed metrics is alarming. That's why, over the past several weeks, you've seen me move from balance to comments that have more of a tone of concern, even warning.

For you, you've been practically pounding the table.

Well, put it this way, if you put a Bollinger Band around my rhetoric, I'd be pushing the upper band. The market's risk/reward profile is just so unrewarding here. So why take the risks, unless you honestly believe you're going to catch all of whatever gain is left—and be able to turn around and sell before the correction? And if that's what you believe, what is going to allow you to sell *before* the correction? It *might* be that as the market advances internals weaken. But if you're relying on weakening internals to act as your sell signal—when we're already at record highs with rich valuations and overbought conditions and when bulls are predominant over bears—then what you're really saying is, I'm going to stay in here and wait for internals to deteriorate, all the while believing that



stock prices are going to go a lot higher between now and that point. And that's a stretch of imagination.

And problematic because technical indicators look backwards?

That is true in terms of gauges of market action. But measures such as price/volume behavior and market internals are extremely useful ways of measuring the speculative component of investment conditions. In fact, you have to look at them to properly invest in a richly valued market, because historically over-valuation has *not* been enough to drive stock prices down. You can find a large number of periods when stocks were at elevated valuations and became more so—otherwise you would have never seen 1929, 1987, 1972, or 2000. So there very clearly is value in tracking market internals. What happened as recently as in 2003 is good example. The market didn't get down close to historical norms in terms of price-to-book, price-to-revenue, price-to-dividend, and so forth at the lows. But the improvement in the quality of market action was dramatic enough that it was the main reason we lifted 70% of our hedges—despite the fact that stocks were actually still slightly over-valued. So 2003 was a decent year for us.

"Decent." You're so blatantly promotional.

Well, I feel it's important to comment about what is going on in the markets for my own shareholders, but I try to make a point not to promote the fund or (usually) any particular view I have on the markets. That's because I'm very averse to attracting shareholders who don't understand what I do—precisely because it will invite their frustration at points like this, when I'm very defensive for reasons that are unpopular on **CNBC**. My stance is very much at odds with the kind of arguments that are just hammered into investors by the popular media, such as all variations of the Fed model—assertions like, "Stocks look cheap on a capitalized earnings basis," or "Stocks look cheap based on forward operating earnings." Or, "Stocks look cheap relative to bonds." All of which, basically, misguidedly assume that the forward earnings yield divided by the Treasury bond yield is a valid measure of valuation. People are so

used to hearing those baseless assumptions go unchallenged that it's difficult to present a more reasoned valuation analysis in the one-to-three minutes that one gets on TV. To be fair, though, it's not just on television that we're bombarded today with mindless financial "reporting." There was a statement in a *Wall Street Journal* article recently that I found just stunning in its ignorance. Let me find it. This was in one of their lead market stories, on page C1 of the must-read of Wall Street: "According to both Thompson and Reuters, the S&P 500 is trading at less than 15 times this year's expected earnings, which is cheap compared with long-term averages of about 20 times earnings." There is absolutely *nothing* in the data to support that assertion of a long-term average of 20 times. As you know as well as anybody, **Cliff Asness's** [of AQR Capital Management, LLC] work suggests that, based on the historical relationship between forward earnings and reported net earnings, the appropriate norm for price-to-forward earnings is 11 or 12. In fact, putting the "long-term average" at 20 suggests that the Journal reporter views roughly the past decade as the "long term."

Just guessing, but 10 years is probably double the duration of his or her career in journalism.

Maybe so. But if you look over any longer span of time, you see we've actually been in an unusually rich valuation period for about a decade. And, true to form, overall stock returns during the past decade have not been up to par. So, for example, over the last eight years or so, the S&P 500 has slightly *under-performed* Treasury bills in total return.

Even though interest rates have been scraping along at generational lows—

Exactly. Yet people have a tendency to think, Well, maybe this is a brand new world. Maybe valuations deserve to be this high and even higher. But today is *not* different from history in any way that matters—and history—including the last 10 years—says that rich valuations produce sub-par long-term total returns. Yet investors are evidently in a great rush to abandon standard valuation measures and employ new ones that are entirely unproven historically.

In a bull market any rationalization will do.

I actually heard a guy on TV this morning going one step further and starting to add back into "earnings" expense items and even investment items, like R&D. Then he said, once you add all of those other things back into "earnings," stocks are actually trading at a price/earnings ratio of 11. So I'm thinking to myself, Why don't you just go ahead and say that *all* revenues are earnings, and bring your "P/E" down to 1.5?

You might be onto something there! Still, you have to admit, earnings and margins *have* been strong—

It's interesting, if you actually start looking at earnings, you see that a number of factors have been boosting them at the same time. Probably the strongest is that profit margins are about 50% higher at present than historically and a great deal of that can be explained by the low level of labor compensation.

Except in executive suites.

No kidding. At least federal tax revenues are still holding up because the marginal tax rates are hitting where the money is. But overall labor compensation is very depressed, relative to corporate profits and to GDP. So we're not really seeing some new era of productivity, what we're seeing is labor compensation that after the

last recession never snapped back to any great degree and is only starting to rise now, outpacing consumer and producer inflation over just the past few quarters.

Of course, higher wages don't ding profits if productivity rises—

True, but even adjusted for productivity, unit labor costs picked up from zero in 2004 to nearly 3% annual growth by last year's third quarter, and are probably higher now. [For all of 2006, productivity rose 2.1% after climbing 2.3% in 2005, the Labor Dept. said Wednesday, marking the fourth straight year efficiency gains have slowed. The government also reported that labor costs increased 3.2% last year, up from 2% in 2005 and the biggest rise since 2000.] Meanwhile, the unemployment rate is relatively low, which means we're likely to see continuing upward pressure on unit labor costs—and downward pressure on margins.

You would *think* so. But it hasn't been working that way—

True enough. But the experience of the last year, with profit margins growing even though unit labor costs were also rising, was *very* unusual—and, historically, divergences like that have proven dangerous. They've almost invariably been resolved by earnings dropping, rather than by labor costs easing. So it's very likely that profit margins will become increasingly difficult to sustain in coming quarters. What this means is that unless investors want to assume that today's record-high profit margins are now the norm, they should not be using the current price-to-earnings multiple of 18. And, to calculate that "current P/E," I'm using *reported net earnings*. Using forward operating earnings further confounds attempts at valuation by adding in estimated growth that already assumes rich profit margins and then assumes growth on those. It also assumes that you remove any of the bad stuff that normally causes a difference between operating and net earnings.

Haven't you also pointed out that profit margins are also being distorted by the unusually large chunk of total corporate earnings being chipped in by the energy and financial sectors?

Yes. The cyclically peak earnings from these cyclical and traditionally low-multiple sectors are, in effect, suppressing the P/E on the S&P 500, making overall valuations look more reasonable than they really are; they're being capitalized in the overall index as if they were being earned by companies in much higher P/E sectors. To argue they deserve even higher multiples is preposterous.

Another argument I'm hearing a lot is that that historical yardsticks don't work; that earnings aren't mean-reverting and margins are on, at worst, a permanently high plateau.

I clearly disagree. I'm certainly not assuming that there is no such thing as intellectual capital. Obviously, there are some companies like **Google** (GOOG) that—

Defy gravity?

Well, without going there, it's clear that Google essentially earns its returns on intellectual capital rather than on a great deal of physical capital or even personnel. But the vast majority of businesses either sell stuff or do stuff. You either buy goods or you buy services. So the vast majority of profits and business activity are dependent on labor inputs and physical inputs. I don't think that's suddenly changed simply because some small portion of the economy represents relatively pure information technology. I mean, Google is not yet **General Electric** (GE). Then, let me turn to this idea that profit margins aren't mean-reverting. Yes, in 2000, it looked as if valuations would break free from all historical prece-

dents. But profit margins did, in fact, come down—and they came down enough for the stock market to drop by half. What’s interesting to me is that the same thing happened to corporate profits. The profits of the S&P 500, in fact, also dropped by half. So the idea that profit margins are somehow impervious to any mean reversion is contradicted by what profits did as recently as four years ago.

Memories are short.

It’s fascinating to me how people are willing to make these very grand assumptions about this being a new world where stock valuations are rich and profit margins are not mean-reverting and stocks will provide good returns despite high price earnings multiples—despite the fact that the most recent evidence that we have, over the last eight years, contradicts every one of those assumptions. What we really have is a market that’s moved from a very extreme peak in terms of valuations and margins back in 2000, to a lesser extreme but still a historically very elevated level.

And barely grazed median valuations at its intervening low—

Well, at the bottom of the bear market in October, 2002, the market just grazed historical *average* price earnings multiples, using trailing earnings. It didn’t get near the *median*, which is closer to 12. And now we’re back up to a multiple that looks much more like the multiples that we saw in 1987, 1962, 1972, 1965, and 1929.

Interesting dates you’re throwing out. I guess they explain why your fund is now fully hedged.

They help. Rich valuations are one component of my concern, but they’re not the whole story.

I guess the good news is that hedges are pretty cheap here.

Yes. That’s actually a beautiful thing.

But that’s because nobody else wants them.

The implied volatility right now is at 10% on S&P 500 index options, which is great because the way that we normally hedge is with options combinations. We’ll be long a put and short a call, which—if you’ve ever looked at these put/call parity calculations—is a position equivalent to a short future where you’re earning interest on the implied short sale. But we also have the ability to stagger the strikes of our puts and calls, provided that only one of our strikes is in the money when we put it on. So, for instance, instead of being long a 1400 put and short a 1400 call right now with the market at 1446, we can be long a 1430 put and short a 1400 call, which doesn’t make a whole lot of difference in terms of cost—because option premium is so cheap. But if the market drops below 1430, it really makes a difference to our returns. Obviously, I have to start rolling the strike prices down on the put option as it gets into the money. But this kind of hedging can be of great assistance to our returns, without ever putting us into what would behave as a net short position. The investment restrictions I wrote for the fund are designed so that we don’t get in a position where we establish an option hedge that has more intrinsic value at risk than we have on the long side.

So you don’t use options to add speculative juice to the portfolio?

There are bear funds who will do that for you. I’ve never been much of a fan of bear funds because, on average, that’s not where you want to be. Also, I don’t think many investors have the sort of pain tolerance needed to see others making money and to predictably lose money at the same time. I think people are willing to go along with an intelligent hedge, but not to actually and predictably lose money continuously as the market rises. So we just don’t get into

outright bearish positions.

And beneath your hedges, Hussman Strategic Growth is fully invested?

Yes. Actually that has been something of a frustration for me lately. Whether the market moves up a little bit or not, I know exactly why we’re hedged and exactly what the tendency is for the market to occasionally move against us. That’s built into my tolerances. What’s been a little bit disappointing is the extent to which investors have endorsed low-quality stocks over the past year. By that I mean stocks which have poor earnings reliability and weak balance sheets. The return that we expect when we’re fully hedged is the difference between the performance of the stocks we are long and the indices that we use to hedge, and then we add to that the implied interest on the hedge, which is usually somewhere around the T-bill rate. So, if our stocks do about the same as the market indexes, we would expect to earn about 5%, less about a percent in fees, something like that. In other words, our expected return would be roughly in line with short-term interest rates. The difficulty that we had last year was that our stocks slightly underperformed the indices, by 2 or 3%. Not a huge gap, but we’re very used to our stock selections consistently outperforming the indices. Now, that 2 or 3% gap isn’t a lot, but when you’re hedged, that takes away from the risk-free interest rate that you’re earning on the hedge. So we ended up with a low single-digit return on the Strategic Growth Fund, which was a disappointment. But what was even more unusual and disappointing was that our stock selections lagged a lot of the low-quality issues that were snapped up by investors last year. I’m very used to our stock selection outperforming the market regardless of the environment.

Well, you probably weren’t loaded up on the REITs, which ran up 37% or so last year.

No, we weren’t. We didn’t have lots of small-cap Chinese stocks either.

Sometimes it just doesn’t pay to have standards.

It makes me cringe when one of these one-year winners goes on TV and talks about his small-cap China fund, because you just know what is coming.

Doesn’t the fact that trash has done so well in the market lately tell you to fine tune your stock selection process since this Energizer Bunny market just keeps going and going?

No. One thing that I think about a lot when I’m selecting stocks for the fund is that I really want the fund to hold something of value.

You dreamer, you.

In other words, I want our shareholders to understand that when they look at the fund, they’re looking at a portfolio that I honestly believe has a value greater than the amount of the fund’s net assets. I don’t want to hold speculative issues that I’m hoping will go up even though I don’t see fundamental value underneath them.

You don’t want a lot of water in the portfolio?

I don’t have a lot of willingness to compromise on the requirement that the net asset value of the fund is backed by what I believe to be the intrinsic value of the stocks that we hold. Which prevents me from holding a lot of garbage. And I’m willing to walk away from the garbage even in markets like today’s, because I know that those stocks do move in cycles. They take a lot of heat during recessions, during market downturns, during periods of credit stringency, and so forth. Part of the reason that we’ve created alpha in terms of stock selection in the

fund is our insistence on holding things that I think are values. But every so often, if you look back at market history, you find garbage markets, like last year's—and like the classic garbage market of 1968-'69.

The "Great Garbage Market" that ended the Go-Go Years.

Yes. We saw that kind of thing again to a lesser extent in '72, as the Nifty-Fifty market drew to a close. And we actually saw it again during the bubble years. That time though, it came closer to '98, during the early dot.com part of the bubble. By the time we got to 2000, it wasn't so much the pure garbage that was going up but the growth for the sake of growth stuff that was tied to technology. Anyway, I don't worry about whether my stock selection approach is valid because I honestly believe that it's true by definition. The only issues are whether the various necessary estimates that go into that process are reasonable. And on that, I have a huge amount of historical data to rely. Of course, I'm constantly looking to improve various aspects of what we do in stock selection. Still, what's most interesting to me about our recent lagging performance is that even when I run our very best-performing versions of the stock selection approach (which have done very well historically) on a purely quantitative basis—excluding the personal analysis I do—those models also lagged the market last year. And they did so by more, actually, than my real-time stock selections did. So I did add some value to the process. The upshot is that a lot of value-driven approaches lagged the market a little bit last year. And when we're hedged, a little bit of lag is all we need to put us behind T-bills. Really, that's the bulk of the story. Had our stocks performed reasonably in line with the market from May through the rest of the year, the fund would have been up in the upper single digits, and I don't think anyone would have any concern at all. Instead, we lagged just a little bit on stock selection and that lag was magnified because we were also hedged.

Yet you're not at all inclined to ditch the hedges?

Not at all. I feel a lot of concern over our shareholders' well-being and I'm willing to take some personal discomfort because of what I think is a good position as long as I know that I'm not carrying a lot of risk for my shareholders. I also know that over the long-term that's what they expect me to do. They expect me to not bend just to chase the market or to abandon the discipline as long as I'm reasonably confident about the research behind the positions and about the idea that our portfolio management strategies have worked well on average over the long-term.

Then you don't believe in fairy tales, like Goldilocks?

No. Not as people are using that term to imply a frictionless economy, that's neither too hot nor too cold—nor do I buy their underlying assumption that stocks should be priced based on the short-term economic environment. It's an utterly vacuous notion. What are stocks but a long-term claim on future earnings—and where the dividend yield on stocks is about 1.8%, as it is today, the vast bulk of that claim stretches out years and years into the vanishingly distant future.

Vanishingly distant?

You can think about the duration of equities like we're used to thinking about the duration of a bond—essentially as the average date at which the future payments are received, where you've scaled future payments to present value, so that a dollar received 10 years from now is worth somewhat less and has somewhat less weight in the calculation than a dollar received next year. So, for instance, a 10-year Treasury has a duration of about 7 years. If you look at that concept and apply it to stocks, the stock market right now has a duration of about 60 years.

That seems awfully long.

The calculations are actually pretty clean, using a little bit of calculus on

the dividend discount model.

Now you're starting to frighten me.

Don't be frightened. The mathematical definition of duration is simply the elasticity of the security price to changes in its rate of return. I know, elasticity is sort of an ugly word that nobody wants to hear after they finish Econ 101. But it's essentially the percentage change that you would expect in the security on a 100 basis point change in its long-term rate of return. When you apply that definition to stock pricing, it turns out that the duration of stocks is essentially the price/dividend ratio. And historically the dividend yield on, say, the S&P 500 has been just under 4% on average, which—expressed another way—is a price/dividend ratio of 25. So historically, the duration of the S&P has been about 25 years on average.

It seems like it's been a very long time since it yielded 4%.

Let me look it up—at the market's 1990 low, the dividend yield on the S&P 500 was 4%.

But that was at a market low, and yields only rose to their long-term average—

Well, yields actually got just a little bit above the average at that juncture. Nonetheless, up until the last 15 years or so, historically the price dividend ratio has averaged somewhere around 25. It's been sometimes as high as the low 30s and sometimes as low as 15. What that means is that, historically, an investor could have placed 100% of his funds in stocks and, over a horizon of somewhere between 15 years on the very low side and maybe 35 years on the high side, he could expect that allocation to leave his future purchasing power relatively immunized with respect to the course that stocks would take over his investment lifetime. In other words, if you had a 35-year horizon, it was absolutely prudent to put 100% of your money in stocks. Because over that time your terminal wealth was not particularly dependent on the path that stock prices would take. But at present, stocks have a duration of nearly 60 years, which means that unless an investor has that long of a horizon, his terminal wealth will be dramatically affected by the course that stocks take over his investment lifetime. This duration mismatch is something that I think has been lost in all of Wall Street's focus on spurious notions like forward operating earnings. The fact is that stocks have become much higher-duration assets, and so risk has to be managed much more effectively in order to immunize an investor's long-term purchasing power. But I don't see investors doing that.

Quite the opposite.

I don't think that they've even factored in anything beyond what's going to happen next week or next month. Anyway, that's the long way around to explaining why the horizon I always look at is over a full market cycle—because if you're a long-term investor, what you retain over the full cycle is what matters. Likewise, it also matters how much risk you assume over the full cycle. All this obviously puts me in a very defensive posture here, and it's also why I do the best I can not to exasperate my shareholders at times like this—when, for very specific reasons, we're defensive, even as various indexes hit record highs. Again, part of the way that I try to do that is by explaining on our website, on a weekly basis, exactly why we have the investment position we have.

You can take the professor out of the academe, but you can't make him stop teaching! And essentially you're preaching that the odds just aren't with the bulls?

Yes, what's interesting is that if you go back and look historically at other times when we had similarly overvalued, overbought and overbullish conditions, coupled with upward pressure on yields, they've general-

ly resulted in awful market returns in the near term – as well as disasters over the long term.

We're in such a dire situation that you recently coined a rather unfortunate moniker for it?

Yes, I admit it, I called the piece, “Hazardous Ovoboby!” What that clumsy acronym was meant to describe is a very simple set of conditions that historically has produced highly undesirable results, *even when earnings have been growing, interest rates have been reasonably low, and the prevailing trend of the market has otherwise appeared quite strong.* Like the current environment, which doesn't have hallmarks that seem particularly extreme.

So what are these ominous conditions?

I went back and looked at points where stocks were *overvalued*, meaning that the S&P 500 was trading at a price/peak earnings multiple greater than 18, *overbought*, meaning that the S&P was at at least a 4-year high, and at least 5% higher than it was 6 months earlier, *overbullish*, meaning the Investor's Intelligence percentage of bullish advisors was above 53%, and where there was *yield pressure*, meaning the 3-month Treasury yield was higher than its level 6 months earlier. All of which we have at present. We've actually had all of those conditions in place since last Nov. 17.

Exactly. What's to worry? The market has kept right on churning out records.

Actually, what's interesting is that the stock market *hasn't* advanced all that much, despite what seems like a roaring market since November. We've never broken more than about 1.5% above that the November 17th level on a sustained, five-day basis.

Okay, so we've been trading in a pretty tight channel.

Which turns out to be characteristic, when these conditions are in place. You have the list [see nearby box], which would actually include the 1961 bear market, too, if my Investors' Intelligence numbers went back that far. But I don't have to go through them individually. Suffice it to say it's characteristic under these conditions for the market to advance by less than 2% or 3% to its final peak and then to suffer a very abrupt decline. Again, my point isn't to make it a forecast as much as it is to emphasize that investors have to allow for the possibility. Especially those investors who have very long-duration portfolios, high-beta portfolios that fully invested, and who have much shorter investment horizons. Those investors ought to be using this as an opportunity to align the duration of their portfolio with the duration of their investment horizon.

They're as mismatched, essentially, as someone borrowing short and lending long?

Yes. It all goes back to stocks being a claim on a long-term stream of cash flows that will be received by investors over time. If you improperly value those cash flows, it will come back to bite you in the form of much lower long-term returns than most investors would find

acceptable.

It's no secret I find your reasoning compelling. But is it possible there's so much money being "invested" today by hedge funds and other businesses with inherently very short-term horizons that the calculations you're making are just not part of the "game"?

That's part of what I think has extended this cycle a bit. But at this point, when *Barron's* does its annual *Roundtable*, and not a single participant is negative–

Which last infamously happened, in 1973–before I had anything to do with it, I hasten to add–when the headline read, "Not A Bear Among Them."

And when *Business Week* runs a survey of market strategists and over 80% of them are bullish and only 1% or 2% are more than fractionally negative, there's a case to be made that the real question is–

Who's left to buy?

Or at least that we might require some modest change in the theme that investors are working on in this market priced for perfection. In other words, it's very true that large declines often emerge from some factor that people haven't thought about yet. But not always. That certainly wasn't the case, for example, in 2000.

No, but denial was pretty universal. As was each investor's conviction that he had the fastest trigger finger in the West.

That's the other reason this “Ovoboby” environment disturbs me, because the tendency has been for the subsequent declines to be very abrupt and deep. The first several days of declines from these peaks have often erased weeks and sometimes months of prior net gains. And while it is true that many technical measures seem very favorable for stocks today, they were also generally favorable at earlier “Ovoboby” extremes. The difficulty isn't that the technicals failed to get you out, it's that they often got you out only *after* a deep initial decline. And the problem with that sort of belated technical signal is that investors have a great aversion to selling on negative evidence *after* the market has already suffered a decline.

Sure, the tendency is to wait for a bounce.

And that becomes the hook for the rest of the bear market. I've got a piece on my website which talks about the thought process that people go through from the top of the bull market to the bottom of a bear: *“This is my retirement money. I can't afford to be out of the market anymore. I don't care about the price, just get me in. It's a healthy correction. See, it's already coming back. Better buy more before the new high. All right, a re-test. Add to position. Buy the dip. What a great move. Am I a genius or what? Uh oh, another sell-off. Well, we're probably close to a bottom, a new low. What's going on? All right, it's too late to sell here. I'll get out on the next rally. Hey, it's coming back. Glad that's over. Another new low, but how much lower can it go? No really, how much lower can it go? Good grief, how much lower can it go? There's*

Hussman's "Ovoboby" In Market History...

April 30, 1965: The Dow advanced less than 2% to its May 14, 1965 peak, 10 trading days later. The Dow then skidded -10.5% lower over the next 30 trading days.

December 18, 1972 and January 5, 1973: The Dow advanced less than 2% from the first instance, and a fraction of a percent from the second instance, to its bull market peak on January 11, 1973. The Dow then toppled -12.3% over the next 50 trading days, and collapsed to half its value over the following 22 months.

August 14, 1987 and August 21, 1987: No remark is really necessary, but for the record, the Dow advanced less than 2% from the first instance, and a fraction of a percent from the second instance, to its bull market peak on August 25, 1987. The Dow then crashed -36.1% over the following 38 trading days.

April 3, 1998: The Dow advanced another 2.5% over the following 6 weeks to a preliminary high on May 13, 1998, and quickly dropped -6.3% over the following 22 trading days. The market then enjoyed a short-lived 8.1% rebound over the next 22 trading days to a fresh high on July 16, 1998, before suddenly plunging -19.1% to its August 31, 1998 low, 32 trading days later (overall, a -16.1% loss from its April 3 level).

April 23, 1999: From a longer-term perspective, the market was already floating on the suds of the late-1990's bubble. Indeed, despite the recent high in the S&P 500, its total return has underperformed Treasury bills in the years since then. Still, from a short-term perspective, this was the most benign instance on the list. The Dow advanced less than 3% to a peak on May 10, 1999, followed by a selloff of -4.9% over the next 13 trading days. The lack of a deep correction, however, left subsequent gains open to repeated selloffs, erasing them even before the bear market began in earnest.

July 2, 1999 and July 16, 1999: The Dow advanced less than 2% from the first instance and about 1% from the second instance, to a peak a few weeks later on August 25, 1999. The Dow then fell -11.5% over the next 36 trading days.

December 23, 1999 and December 31, 1999: The Dow advanced less than 3% from the first instance and less than 2% from the second instance to the final peak of the market bubble a few weeks later, on January 14, 2000. The Dow then plunged -16.4% over the next 35 trading days.

March 24, 2000: The actual bull market high already behind it, the Dow had enjoyed a bounce off of an early-March low. It advanced less than 2% further, to a short-term peak 12 trading days later. The Dow then dropped -8.8% over the following 32 trading days. Over the following 30 months, the stock market would lose half its value.

November 17, 2006, December 8, 2006 and January 12, 2007: We'll find out shortly...

no way I'll ever make this back. This is my retirement money. I can't afford to be in the market anymore. I don't care about the price. Just get me out." There is this definite tendency for investors not to be willing to sell on a decline. But if they are also unwilling to sell on an advance, they are unwilling to sell at all. That's the danger here.

Has anyone suggested you came up with "Ovoboby" by mining or "fitting" the data?

No. That's not how I work. I come from a family of doctors, so I tend to think in terms of groups of symptoms that imply an accurate diagnosis. For instance, radiologists look for "Aunt Minnies" – a set of spots on an X-ray that can only mean one thing. The symptoms should be groups of things you already understand. That's what distinguishes it from data mining. You might not believe your doctor's diagnosis if the clincher is that it snowed yesterday in Albuquerque, but you have more confidence when the symptoms have an understood relationship to the diagnosis. Think of that in terms of what's widely known about the stock market. We all know that rising interest rates tend to be negative; that high bullishness tends to be negative; that rich valuations tend to be negative, at least in the long term, and that overbought markets at multi-year highs might not be the greatest buying opportunities. But none of those tendencies is *individually* strong enough to draw a firm conclusion, so we ignore what we know. The problem is that when all of those come together, you've got an Aunt Minnie. You only see that constellation of symptoms before short-term panics or bear markets. And when you look from trough to peak, it's easy to forget that stocks also move from peak to trough. In fact, this peak mentality is interesting because it produces all kinds of people coming out of the woodwork saying, "See, I was right," when they're just about to be wrong.

It does?

I'll give you an example. Not very long ago, **Jeremy Siegel** wrote a piece about **Alan Greenspan's** irrational exuberance speech [WSJ: *Irrational Exuberance, Reconsidered*, 12/06/06.] Siegel said, well, if you look from the point where Greenspan made his comments until now, stocks have actually delivered around 8% annualized total returns, which he said was not so bad. So Greenspan was evidently wrong. The problem is that Siegel is measuring those returns from a period of over-valuation to another period of over-valuation. You don't get to do that at any other point except a high. That's the only time the argument works. So another of my concerns is that a lot of the bullish arguments that are coming out are ones that work and look reasonable only because the market is temporarily where it's at. All of the new era arguments

work today because we are at an equivalent peak to 2000. But they didn't work between 2000 and 2002, and they're unlikely to work longer term.

Still, it's a lot more comfortable to conclude that Greenspan was irrational, not the exuberance, and likewise that you're overplaying your bear case with "Ovoboby."

Yes. But he wasn't and I'm not. The general results of my "Ovoboby" study aren't particularly sensitive to alternative criteria. In fact, stocks tend to produce tepid returns under far broader and more subtle definitions. I created that simple, specific example to try to drive the point home. In fact, one of the features that I impose on my research process is to let my analysis be driven by tautologies and definitions. Let me explain. When we value stocks, for example, I take it as a definition that a stock is simply a claim on a long-term stream of cash flows that will be delivered to investors over time, so the factors that go into that model have a structure that isn't arbitrary. I don't like coming up with future valuation multiples out of a hat. Or projecting earnings that have no basis in historical evidence.

There you go, beating up on the Street again.

It's just amazing to me how willing people are to glibly extrapolate earnings trends. Because you can actually show historically that the highest earnings estimates always follow periods of rapid growth of earnings—when in fact earnings are close to contracting. There's a 6% long-term trend line that has connected earnings peaks as far back as you care to look.

That's not a popular factoid among investors.

Six percent just *sounds* too low. Especially lately, because we had such a deep earnings trough during the last recession that subsequent earnings growth rates have been phenomenally high but unsustainable. And yet you have analysts making still quite positive earnings assumptions based on profit margins that are already very extreme and investors assuming multiples will expand on top of that. The risk, as the data suggests, is that rich valuations plus high levels of bullishness and rising rates in an over-bought and record-setting market invariably leads to bad things.

I get the message. Thanks, John.

Welling@Weeden Staff Conflicts Avoidance Policy Disclosures

In keeping with Weeden & Co. LP's reputation for absolute integrity in its dealings with its institutional clients, welling@weeden believes that its own reputation for independence and integrity are essential to its mission. Our readers must be able to assume that we have no hidden agendas; that our facts are thoroughly researched and fairly presented and that when published our analyses reflect our best judgments, not vested pocketbook interests of our sources, colleagues or ourselves. Neither Weeden & Co. LP nor w@w engage in investment banking; w@w's mission is strictly research.

All information gathered by welling@weeden editorial staff in connection with her/his job is strictly the property of welling@weeden. It is never to be disclosed prior to publication to anyone outside of welling@weeden. Editorial staff (a group broadly defined to include Kate Welling's immediate family) will not buy or sell any security mentioned in the journal for at least one week after publication. Staff will avoid not only speculation but the appearance of speculation and may not engage in short-term trading, the short selling of securities, or the purchase or sale of options or futures. Staff may not be otherwise compensated for securities recommendations in these pages. No w@w staff will serve as an officer or director of any publicly traded company. All securities positions entered into by w@w editorial staff will be held for at least six months unless dispensation is received, in extraordinary situations, from Weeden & Co. LP's compliance officer. Any securities position in any company, mutual fund or partnership portfolio featured in welling@weeden that was acquired by staff in advance of the publication decision will be specifically disclosed at first mention. **And that position will be frozen for six months from date of publication, again, absent extraordinary dispensation from compliance. **Kate Welling owns shares in the Hussman Strategic Growth Fund and Hussman Strategic Total Return Fund.

Weeden & Co. Research Disclosures

This material is based on data from sources we consider to be accurate and reliable, but it is not guaranteed as to accuracy and does not purport to be complete. Opinions and projections found in this report reflect either our opinion (or that of the named analyst interviewed) as of the report date and are subject to change without notice. When an unaffiliated interviewee's opinions and projections are reported, Weeden & Co. is relying on the accuracy and completeness of that individual/firm's own research disclosures and assumes no liability for same, beyond reprinting them in an adjacent box. This report is neither intended nor should it be construed as an offer to sell or solicitation or basis for any contract, for the purchase of any security or financial product. Nor has any determination been made that any particular security is suitable for any client. Nothing contained herein is intended to be, nor should it be considered, investment advice. This report does not provide sufficient information upon which to base an investment decision. You are advised to consult with your broker or other financial advisors or professionals as appropriate to verify pricing and other information. Weeden & Co. LP, its affiliates, directors, officers and associates do not assume any liability for losses that may result from the reliance by any person upon any such information or opinions. Past performance of securities or any financial instruments is not indicative of future performance. From time to time, this firm, its affiliates, and/or its individual officers and/or members of their families may have a position in the subject securities which may be consistent with or contrary to the recommendations contained herein; and may make purchases and/or sales of those securities in the open market or otherwise. Weeden & Co. LP is a member of NASD, Nasdaq, and SIPC.

W@W Interviewee Research Disclosure: John Hussman is Chairman of Hussman Econometric Advisers, the investment adviser of the Hussman Investment Trust, and portfolio manager of the Hussman Strategic Growth Fund* and Hussman Strategic Total Return Fund. John's Hussman Investment Research & Insight is published periodically by the Fund Manager, Hussman Econometrics Advisers. All rights reserved and actively enforced. This interview was initiated by Welling@Weeden and contains the current opinions of the interviewee but not necessarily those of Hussman Econometric Advisers or the Funds. Such opinions are subject to change without notice. This interview and all information and opinions discussed herein is being distributed for informational purposes only and should not be considered as investment advice or as a recommendation of any particular fund, security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but is not guaranteed. In addition, forecasts, estimates and certain information contained herein are based upon proprietary research and should not be interpreted as investment advice, or as an offer or solicitation for the purchase or sale of any financial instrument. The Hussman Market Climate is not a formula but a method of analysis. The term "Market Climate" and the graphics used to represent it are service marks of the Hussman Funds. The investment manager has sole discretion in the measurement and interpretation of market conditions. No part of this interview may be reproduced in any form, or referred to in any other publication, without express written permission of Welling@Weeden. Past performance is no guarantee of future results. For further information, see www.hussman.net or www.hussmanfunds.com.

Hussman Funds Disclosure Information

Annualized Fund total returns for periods ending 12/31/06: 1 year: 3.51%, 3 year: 4.79%, 5 year: 9.70%, since inception (July 24, 2000): 12.38%. Past performance does not ensure future results, and there is no assurance that the Hussman Strategic Growth Fund will achieve its investment objectives. An investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than the performance quoted above. More current performance data, as well as special reports and analysis, are available at the Fund's website www.hussmanfunds.com. Returns do not reflect the deduction of taxes a shareholder would pay on Fund distributions or the redemption of Fund shares. Certain of the investments of the Fund presented in this article may no longer be held by the Fund, or may be sold at any time.

Investors should consider the investment objectives, risks, and charges and expenses of the Fund carefully before investing. For this and other important information, please obtain a prospectus and read it carefully before you invest or send money. For a free copy of the prospectus and read it carefully before you invest or send money. For a free copy of the prospectus, see the Fund's website at www.hussmanfunds.com or call the Fund's distributor, Ultimus Fund Distributors, LLC, at 1-800-487-7626.

The Hussman Strategic Growth Fund has the ability to vary its exposure to market fluctuations depending on overall market conditions, and may not track movements in the overall stock market, particularly over the short-term. The Fund has the ability to hedge market risk by selling short major market indices in an amount up to, but not exceeding, the value of its stock holdings. The Fund also has the ability to leverage the amount of stock it controls to as much as 1 1/2 times the value of net assets, by investing a limited percentage of assets in call options. While the intent of this strategy is long-term capital appreciation and protection of capital, the investment return and principal value of the Fund may fluctuate or deviate from overall market returns to a greater degree than other funds that do not employ these strategies. For example, if the Fund has taken a defensive posture and the market advances, the return to investors will be lower than if the Fund had not been defensive. Alternatively, if the Fund has taken an aggressive posture, a market decline will magnify the Fund's investment losses.