Economic Update

Broadleaf Partners, LLC

Valuations and Extremes

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I am a big believer in the view that valuations are rarely a useful tool for investors except in those cases when they reach extremes. I think we are in one of these situations today.

As you may recall, many technology stocks were highly valued for a period of quarters and even years during the late 90's, but eventually hit triple digit price earnings levels in 2000. Ultimately, the fund flows that went wild chasing no-earnings dotcom ideas dried up, technology sales as a whole came to a halt, and the rest of the economy caught cold. Valuations initially were not a very good timing tool, but eventually climbed to obscene enough levels that selling, in hindsight, was the only sensible decision.

I think the same logic applies to valuations today, only in reverse. Many solid growth companies with financially sound balance sheets are trading at single digit price earnings levels. Fund flows have gone wild as the greed for cash - and in the case of margin calls the need for cash - has risen to new levels. While the fundamentals look terrible for the economy right now - remember they looked similarly great in tech's heydays - eventually some better news will come along. We will likely then look back - in hindsight -and realize that buying was the only sensible decision.

Two recent thoughts on the subject came to my attention this morning. First of all, an analyst issued a report on Starwood Hotels. While we do not own Starwood (HOT), we have been following it closely. We know that the hotel industry is not in great shape today given worldwide economies. Nevertheless, an analyst guessed that the company's assets were worth $43 per share and yet the stock is trading at $17 per share today. While he may be off a bit, there is a big gap between these two figures. Analysts already expect earnings to fall thirty percent in the next twelve months to $1.50 or so per share, putting the forward multiple at roughly 10x depressed estimates. Readers may also recall that Eddie Lampert became a billionaire when he bought KMart not for their great retailing acumen a few years back, but on the basis of their real estate holdings. When things are cheap, they can be so for reasons that not everyone can see.

This morning, CNBC was also talking about how Volkswagen's market capitalization exceeded Exxon Mobil's, one of the most highly valued companies in the world. This is a shocking extreme of another sort, particularly given the fact that General Motor's market cap has recently approached levels last seen in the early 1930's. Apparently, fund flows are

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going wild as short sellers of Volkswagen are being squeezed and forced to buy back and cover their bearish bets. With Volkswagen's shares apparently hitting triple digit P/E territory today, I can see why someone would want to sell. But if you have borrowed the shares to do so, remember that you are beholden to the gods of margin calls. You do not, therefore, have the privilege of acting in a long term manner.

To sum it up, valuations are at extremely low levels today. I think we will look back in a couple of years - in hindsight - and realize that buying now was the only sensible decision. Equally important, however, is an ancillary observation. Do not borrow money to invest in the stock market or allow someone else to do so on your behalf. In so doing, you may retain your ability to think longer term, but you may similarly lose your right to act longer term. Knowing that there is a difference between the two can truly rock your world.

Kindest Regards,

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