

Confessions of a Value/Contrarian Investor Michael B. O'Higgins

For those of you who don't know anything about me, I am a US-based money manager who entered the investment business as a stockbroker in early 1972, the last year of the "Nifty Fifty" mania, and got a quick — albeit quite expensive for my clients — education on the dangers of overpaying for stocks during the ensuing 1973–1974 bear market, in which the market averages declined by 48% and the average high p/e growth stock, of which my employer, Spencer Trask & Co., was one of the prime promoters, fell over 80%. It was that traumatic experience that led me to develop the "Dogs of the Dow" strategy, which I later exposed to the investing public in my best-selling book, *Beating the Dow* (HarperCollins, 1991), and to start my own money management firm in early 1978.

Since my conversion to value investing, I have tended to be a more cyclically-oriented value investor who normally restructured his portfolios annually at year end and held the positions for the following 12 months. This investment approach worked very well through May of last year, but has since been quite disappointing, to say the least.

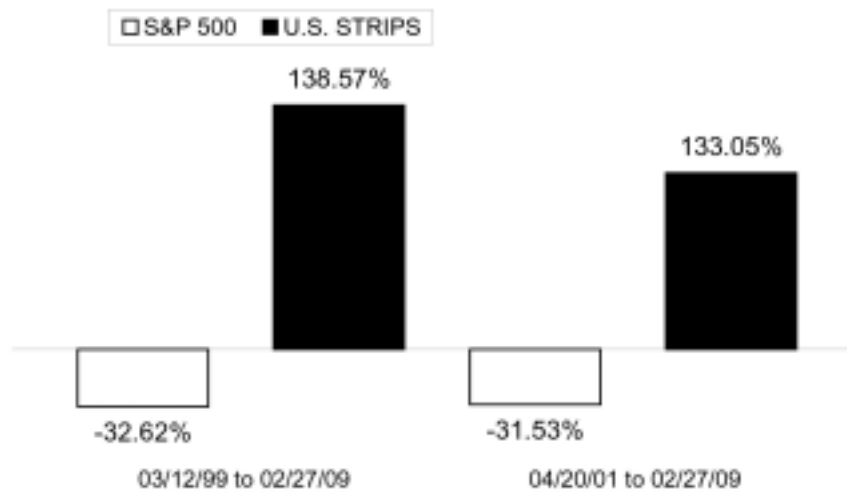
Five times since early 1999, I have written short articles for this newsletter giving my views on the investment outlook and the vehicles that I recommended using to capitalise on the developments which I foresaw. Investors who followed the recommendations made in the first three articles and invested equal amounts each time would have done very well through the end of February of this year, with average cumulative returns of 146.9% versus -22.0% in the S&P 500 (see Figures 1 and 2). Those who followed the investment recommendations made in **all five** would have done relatively well, with average cumulative gains of 64.3% versus losses of 29.7% in the S&P 500. Unfortunately, those who

only followed the advice given in my last two articles would have lost a cumulative average of 59.7% versus losing **only** 41.3% in the S&P (see Figures 3 and 4).

Going into 2008, I felt that my portfolios should "muddle through" virtually any of the types of markets

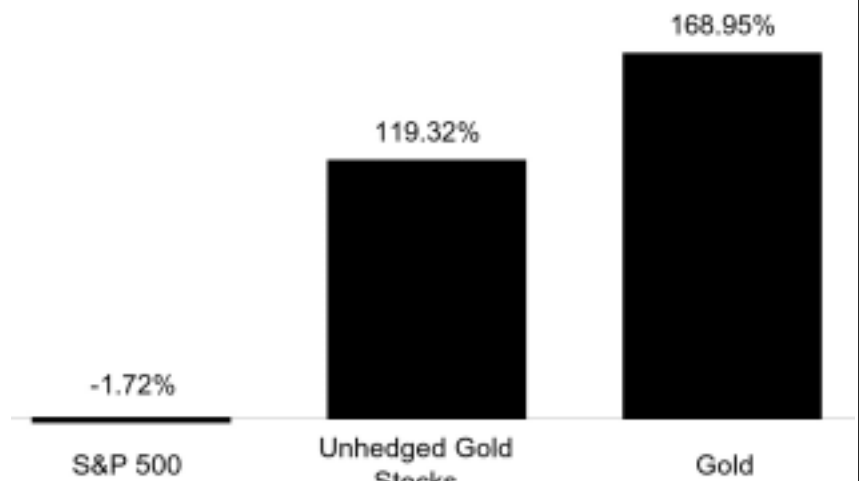
that we had experienced, with the exception of the 1929–1932 collapse, by being diversified over what I believed to be four undervalued and uncorrelated "themes": Dogs of the Dow (the five cheapest of the ten highest dividend-yielding DJIA components), Dogs of the World (the

Figure 1 **Beating the Dow with Bonds Article**



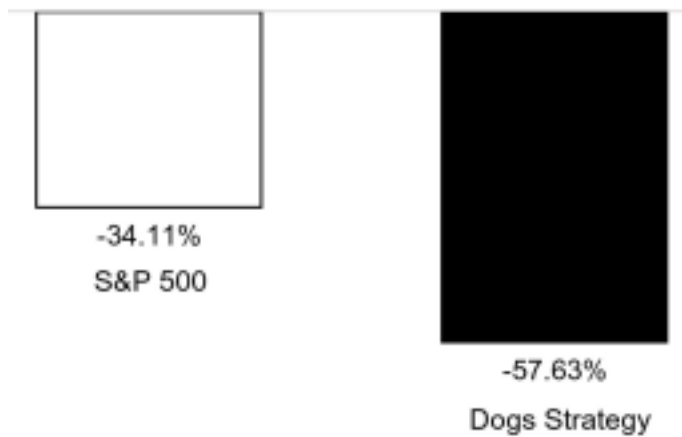
Source: O'Higgins Asset Management

Figure 2 **Beating the Dow with Gold Article, February 28, 2003 to February 27, 2009**



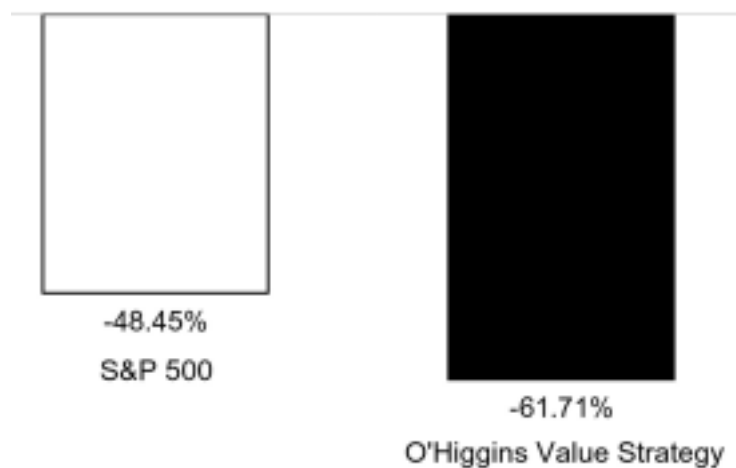
Source: O'Higgins Asset Management

Figure 3 **Beating the Dow with Dogs Article, December 31, 2004 to February 27, 2009**



Source: O'Higgins Asset Management

Figure 4 **Beating the Dow with Value Article, December 31, 2007 to February 27, 2009**



Source: O'Higgins Asset Management

What might we reasonably have done differently, given that we didn't foresee a decline of the magnitude of 2008's worldwide, stock, bond, and commodity collapse? For one, we could have given more weight to the relative strength shift that was occurring between the value and growth sectors of the market in the late summer of 2007. Though value investing has been safer and more profitable than growth investing over the longer term (see Figure 5), the two sectors have tended to take turns outperforming one another for six to seven years at a time. As shown in the Figure 6 chart of the performance of the Russell Value Index versus the Russell Growth Index, growth stocks, which had dramatically outperformed value stocks from 1993 through 1999 and significantly underperformed value stocks from 1999 through August of 2006, began to noticeably outperform again in June of 2007.

But the "Dogs of the Dow", a value strategy, had outperformed growth stocks during enough of the latter's outperformance cycles that I was reluctant to abandon my time-tested strategy. In addition, as it turns out, the way that I would have played the new trend — i.e. buying the Russell Growth Index Fund (IWF) and selling the Russell Value Index Fund (IWD) short — would have ended up costing me several percentage points, since IWF had a "negative return" of -38.22% while IWF gave its investors a total return loss of -36.5%. So, given what I had experienced in my 35 years since 1972 and, given that the only place to hide in 2008 was in historically overvalued US Treasuries paying almost no interest in apparently reflationary conditions, I, like most other investors who also lack a crystal ball, probably couldn't have been expected to do much different.

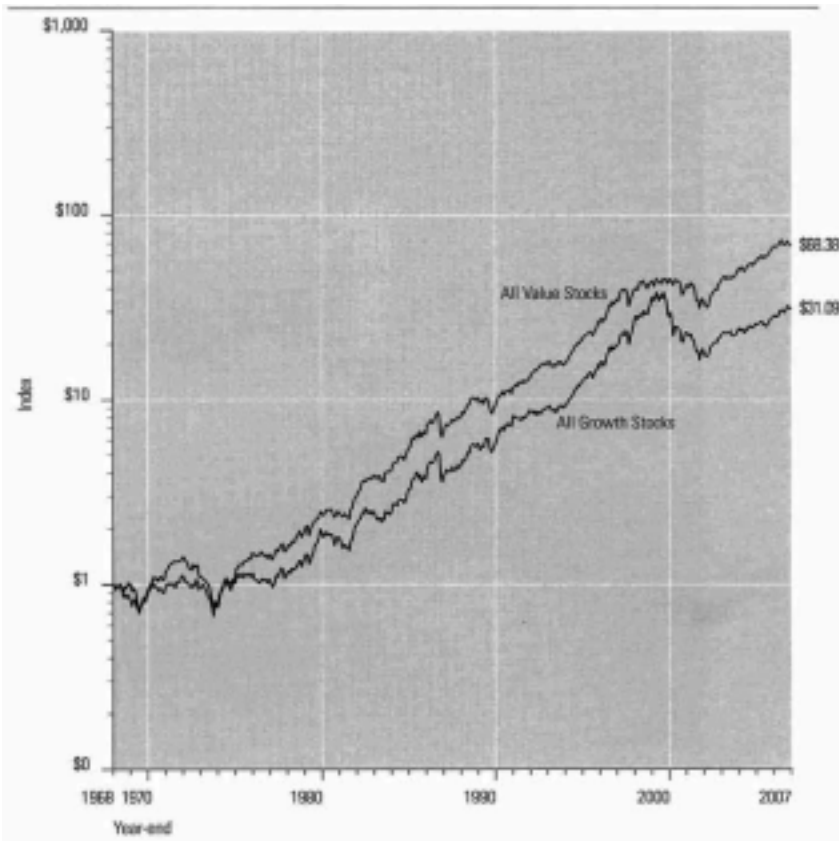
Now that I have so blatantly excused myself for presiding over the destruction of so much of my and my investors' wealth, and having lost a large amount of the credibility that I worked so hard to build up over the last 36 years, I would like to share my opinions on how I would invest my remaining assets to protect and

five most undervalued country ETFs), Energy, and Precious Metals. And that is exactly what happened through late May when we were +6.3% and the S&P was -3.7%. But, then, in the five months that followed, from May to October of 2008, everything that I owned went down, went down big, and went down so fast that I was unable to react to it in time to avoid the catastrophic losses that my investors and I suffered.

So, how, you might ask, does someone with an outstanding record for 30 years virtually destroy it in six

short months? The same way that almost every other value investor of note, including the legendary Bill Miller, Marty Whitman, and others did: by assuming that the value-based strategies, such as the Dogs of the Dow, that had worked so well since the 1930s, would continue to work in the 2000s; by failing to understand the enormity of the sub-prime/collateralised debt obligation/credit default swap bubble; and, finally, by believing that the financial and monetary authorities would be able to contain the meltdown once it began. How wrong we were!

Figure 5 **All Growth Stocks vs All Value Stocks, 1968–2007**



Source: Ibbotson

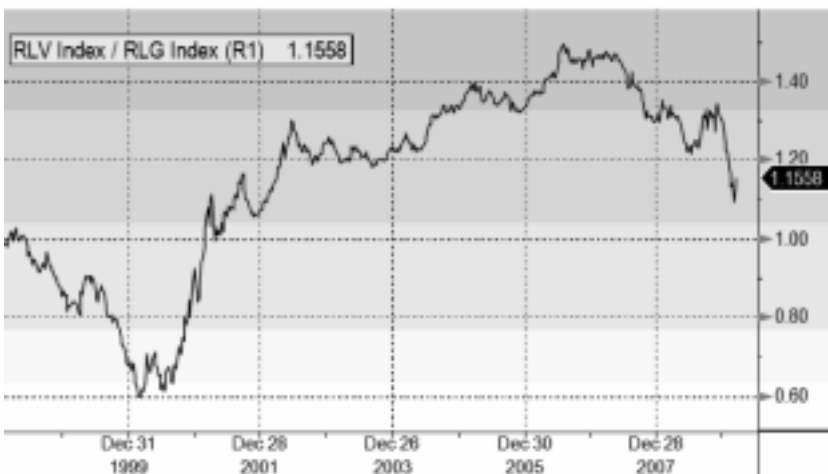
enhance their purchasing power under the conditions that I foresee, for what it's worth.

While many of the developments that we have witnessed in the global financial markets and world economy over the past year and a quarter are reminiscent of those that occurred during the Crash of 1929–1932 and the ensuing Great Depression, leading many market analysts and economists to assume that we are headed for a similarly deflationary environment, my guess is that our future will be very different than that, simply because Federal Reserve Board chairman “Helicopter Ben” Bernanke is doing — and likely will continue doing — exactly what he said that he would do in his famous November 21, 2002 speech entitled “**Deflation: Making Sure ‘It’ Doesn’t Happen Here**” if deflation threatened to take hold. Among many other policy options at the Federal Reserve’s disposal that he enumerated at the time, including possibly dropping money from helicopters, the most outrageous and widely quoted one was this:

But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.

And, if it weren’t enough to have a hyperinflationary monetary policy being aggressively pursued by the US Federal Reserve Board and most other central banks around the world, we have the most inflationary fiscal policy in peacetime history being put in place by the federal government,

Figure 6 **Russell Value/Russell Growth Index Ratio, November 28, 1997 to March 19, 2009**



Source: Bloomberg

now firmly under the control of our left-of-centre Democratic Party. The last time we had a leftist Democrat in the White House and both houses of the US Congress controlled by his party was the period from 1978 through 1980, the infamous, stagflationary Carter years, when we had a very weak economy, a lacklustre stock market, rising interest rates, and high inflation (see Table 1). So far, Obama is off to a similar start. Since the day of his election, stocks have declined sharply, while precious metals have rallied a similarly opposite amount (see Table 2). My guess is that what we are in for over the next four years, given Obama's radical goals and outstanding communication and political skills, is "Carter on steroids". As a result, I have invested my investors' and my money largely as follows:

25% in gold and silver mining stocks using the Market Vectors Gold Mining Index ETF (GDX); 12.5% each in the SPDR Gold Trust (GLD) and the iShares Silver Trust (SLV), which move tick for tick, respectively, with the price of gold and silver; and the remaining 50% in the iShares Treasury Inflation Protected Securities ETF (TIP). Time will tell, but that's my story and I'm sticking to it.

Table 1 Carter Administration, 1976–1980

Investment	11/01/76	11/03/80	Total Return
Gold/oz.	122.60	640.50	422.4%
Silver/oz.	4.32	19.40	349.1%
Platinum/oz.	153.29	677.31	341.9%
Crude Oil/bbl	13.90	36.00	159.0%
Natural Gas/mcf	1.47	2.91	98.0%
S&P 500 Return	86.03	130.76	52.0%
Cons. Price Index	57.90	84.70	50.8%
LT Govt Bonds Return	5.10	4.85	-4.9%

Source: O'Higgins Asset Management

Table 2 Obama's First Term, November 2008 to March 2009

Investment	11/04/08	03/19/09	% Change
Platinum/oz.	836.00	1,125.00	34.57%
Silver/oz.	10.22	13.61	33.17%
Gold/oz.	763.25	959.40	25.70%
NASDAQ	1,780.12	1483.48	-16.66%
S&P 500	1,005.75	784.04	-22.04%
Dow Jones	9,625.27	7400.80	-23.11%

Source: O'Higgins Asset Management