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Have You Seen *The Sign*?

A Swedish pop-rock group called Ace of Base had a number one hit in 1993 called [The Sign](#). Like the movements of our stock market, first in one direction then in the other, this song was number one on the U.S. hits chart for 6 non-consecutive weeks. It also was ranked the 51st song on Billboard's Top 100 All-Time Songs for the first 50 years of rock, so it was pretty big to say the least. (For those of you who YouTube, the video and song are linked in the hyperlink above).

As investors we are always looking for The Sign. Will the markets be up? Down? Should we run toward the financial sector, or run from it as quickly as if it were a house on fire in the hills of Los Angeles? Will large cap growth stocks outperform small cap value ones, or is it vice versa for the next twelve months? Etc., Etc.

In 2008 the investor class was shell-shocked to see their S&P 500 portfolios, even with dividends included, drop 37.0%, while in 2009 that same portfolio gained 26.5% and then another 5.4% for the first quarter of 2010. And on April 12th, the Dow Jones industrials crested the 11,000 barrier for the first time in 19 months. Talk about a yo-yo.

Wouldn't it be nice if we had a magical genie that would whisper in our ear and point us to The Sign, telling us what was to come before that whatever decided to come?

I can't promise you I've seen The Sign, but I do have a few thoughts which might lead you down the path toward The Sign.

Signpost 1: *The economy alone does not the stock market make.*

Many investors equate one with the other thinking they are identical twins. While they are part of the same family, they are siblings, but not identical twins.

The market is said to be a harbinger of the economy, moving either upwards or downwards in advance of the economy. The last 12 months are ample proof of that dictum: The market is up an astounding 42.7%. That compares with historical averages which place the stock market up 8% to 10% annually. While most would agree the economy today is better than it was when the Tar Heels were March Madness 2009 winners, nobody would claim that today after neighboring Duke has won the 2010 tourney, that the economy is screaming growth, racing on all cylinders, at the same recovery speed as the market has done.

Like a stool needs at least three legs, the market also needs other support. Here are two more siblings. They also drive market performance.

Signpost 2: *In a rational investment world, earnings growth and dividend yield determine stock performance.*

Would that we always had a "rational investment world." Investment Advising 101 teaches that if you take a company's projected year-over-year earnings growth and add it to the company's dividend yield that, by and large you can fairly predict what the stock price will be in twelve months. While this is a good rubric, if it were the only leg needed on that stool then you would never need guys like Chip and me. You could, as the ad says, do this yourself in the morning, then sleep comfortably in a Holiday Inn Express that night.

Would too that we always had our good health, for then we wouldn't need doctors.

Markets love it when profits exceed expectations as well as when they are strong in and of themselves. First quarter 2010 earnings are projected to be up 36.8% compared to Q1 of 2009. This was the second straight quarter of year-over-year profit growth. In addition, the sentiment expressed by the chief market strategist at D.A. Davidson that, "We're going to see a healthy number of positive earnings surprises," is also the Street's general wisdom, and is another factor driving earnings growth in a positive direction.

Wall Street loves numbers. Here are a few more. The negative and positive outlooks of company executives are matched and measured to see what one quarter's announcements look like when compared to historical numbers. The long-term average says there are 2.1 negative outlooks for every one positive outlook. But now that ratio has fallen to 1.3 to 1.

In the fourth quarter of 2009 9.7% of the companies raised their earnings outlooks while only 5.2% lowered them. This was the widest spread since 2001. Analysts predict that revenue will be up 10% year-over-year for Q1 relative to a year ago. If so, that would best even the 8% year-over-year revenue growth of Q4. Don't forget; you've heard it here before: the trend is your friend.

And finally both revenue estimates for the S&P 500 companies as well as their earnings projections are smoking. 70% of them beat estimates from the fourth quarter on the revenue side and 72% beat estimates on the earnings side. The last number averages only 61 percent, so this is 17% higher.

Get it? Things are looking up.

Signpost 3: Investor Psychology Skews the Logic of Quantitative Analysis.

Here's where the fun begins for investment advisors. We take the rational rules for investing and then, like the proverbial Italian momma making her family's secret spaghetti sauce, add a pinch of Westover experience and wisdom, oftentimes based on what we see arising from the irrational machinations of investors or the market itself. Put another way, those machinations give us the opportunity to buy good companies when bad things happen to them and to avoid buying bad companies when bad things happen to that group. Drawing that distinction between companies is where your investment advisor earns his keep.

The well respected technician Don Hayes has constructed a figurative 180 degree pendulum by which he says he can measure investor psychology. He says the pendulum swings from greed at one extreme to fear at the other. Contrary to Gordon Gekko's dictum, in our universe Fear Is Good. When the market is fearful, those who brave it fare best. Why? Because the retail investor typically gets it bassackwards. So when he is fearful, one should be greedily investing and vice versa.

If Fear is at the 0 degree mark on the Hays Pendulum and Greed lies at the 180 degree mark, right now we're at the 100

degree mark, slightly leaning toward greed, he opines. This suggests care and caution for short-term investing.

However, that pendulum oscillates quickly and can swing from 100 degrees to 80 degrees, favoring Fear and therefore favoring investing, in a blink of the eye. Volatility drives that oscillation. I think it's fair to say that many investors still do not believe in the reality of that +40% twelve-month blast off. Many rational men, respected academics, talking heads and economists present rational reasons for the implausibility of that run and offer cogent and enlightened reasons why it is not sustainable going forward. Those reasons make rational sense in academia, on the talk shows of CNBC and the cocktail circuit, but not in the investing world where irrationality also plays such a key, key role.

The ultimate reality for investors comes from the mouth of Bill Parcells, the former Super Bowl coach of the New York Giants: "You are what your record says you are." Reality: the market is up big time over the last year. Period. End of Story.

If you add those other two legs to your investment stool, it should support you.

Where Do We Go From Here

In general, and subject to certain exceptions, the signs are still good, but you don't want to delay. Don't wait till the Dow breaks 12000.

You don't need to be trained as an economist to know which direction this economy is heading in. All you need to do is be sensitive to your surroundings, listen and hear what the economy is telling you. Here's a simple way to do that.

Take a gander at the front page highlights from *The Wall Street Journal* for April 13th, measuring them simply on this scale: Are they more or less positive or more or less negative about the economy? I've included them from the What's News section which is the overview of what's happening in the economy. See if you don't agree that, as a generalization, this is encouraging.

- Alcoa reports narrower first quarter loss than analysts' predicted. (This is the "less bad" news we've seen a lot of recently).
- The Dow hits its highest mark in 19 months.

- Greek financial markets jump higher in response to the bailout committed to them by the European Union.
- ConocoPhillips agrees to sell its interest in a Canadian oil-sands project. (This creates work for M&A attorneys and shows economic vitality in this sector when compared to the absence of M&A work 12 months ago; they also sold for a price much higher than projected).
- Iceland issues a report slamming its former government and regulators for failing to prevent its 2008 meltdown. (Shows a nation accepting responsibility for its own failings and the end of its country-as-Wall Street victim world view).
- Morgan Stanley hires hundreds of salespersons to turn its trading operations around. (Do you hear that? In this economy, Morgan Stanley is adding folks to the workforce).
- UBS expects a pre-tax profit of \$2.35 billion in the first quarter and the exodus of wealthy clients is slowing. (This is their second profitable quarter in a row).

Not a reader of *The Journal*? No problem. Surely then you read *The New York Times*. Let's look at the two headlines above the fold in its Business Section for that same day:

- "Surprise! The Bailouts Are Working".
- "Move to Aid Greece Helps Draw Dow Close Above 11000"

Again, those headlines tell you the economy is moving in the right direction.

The research department at Merrill Lynch tracks the U.S. consumer, examining 10 metrics in order to determine how he's doing at any given moment. I won't bore you with the details, but here's the Executive Summary as they see it on April 9th: 5 of the 10 are positive while 2 are negative. I'll take a 5 to 2 victory in any Phillies World Series game this year. How about you?

Bull markets typically have three or four phases. We have just finished the first -- when the snap back surprises most, but not all, of the "smart guys" and when few people or money are in the market. The second, which I believe we are in now, is when lots of people and lots of money, both of which have been waiting on the sidelines until they clearly see The Sign, start to trickle back in. (The third phase sees money gushing into stocks. We're not there yet, thank goodness.)

Why do I think this positive run will be sustained? I've got many reasons, but how about the law of supply and demand? We are in an unusual sweet spot for stocks for the next year because of two elements of the law of supply and demand: (1) Too much supply of US Treasuries, mattress money and bank reserves coupled with (2) a finite and limited supply of stock.

When there is more of a product, the price goes down; scarcity drives it up. Right now, in an effort to save us from the clutches of The Great Recession, Washington has been issuing and continues to issue more debt in the form of US Treasuries, than ever before in our history. And just how much larger has that issuance been in 2009 and 2010 -- by an order of magnitude of 7X historical norms. That gusher of supply will inevitably drive Treasury prices down disappointing long term bond holders and encouraging them to jump ship. And where will they jump? I conclude not to money markets and savings CDs which pay nothing and even less than bond yields, but to that riskier asset class called stocks.

For the last 12 months John Q has been building up his cash, increasing savings, reducing debt, and avoiding the market. He's sat on the sidelines as the Dow moved from below 7000 last March to 8 to 9 to 10 and now to 11000. Soon enough he and his friends will be like iPad buyers knocking on Apple's door, anxiously waiting for it to be opened. But when our buyer finally gets inside the US Stock Market Store, there will not be an unlimited supply of stock to buy. What will happen? Prices, in this case for stock, will go up.

And finally, for the last twelve months banks have been hoarding boatloads of cash, declining to make loans to creditworthy small and medium businesses. Those banks will loosen their purse strings over the next twelve months. Business will put that capital to work creating jobs, products and services. That, in turn, will accelerate the growth of the economy keeping the market on a sustained upward path.

Listen to the Music

Last quarter our quiz asked for the chronologic order of these four Beatles' songs, each sung by a different mop head. Barb Marvel, the daughter of a wonderful, classy and extremely positive octogenarian by the name of Jean Lewis, secured her husband's help to correctly identify the order (Neither the year nor the album name was asked):

1. *Please Please Me*. John. 1962 (Album: Please, Please Me).

2. *Yesterday*. Paul. 1965 (Help).
3. *Yellow Submarine*. Ringo. 1966 (Revolver).
4. *Something*. George. 1969 (Abbey Road).

I try to make these quizzes both fun and less than difficult because I want to encourage lots of participation. Lately, however, we only get about 10 guesses out of a mailing to 500 folks. So that's good news for you - your chances of winning are decent, almost 1 in 10, which may be the same as what the stock market might do for the year. Let's see if the odds of your winning will be lower than the return for the S&P this year. To do that please participate. You'll have fun and might even get to enjoy a nice night out at a restaurant of your choice.

Typically our quiz comes from the music world, but this time let's go to politics. We Delawareans are proud of our native son, Vice President Joe Biden.

Can you name the state from which the previous six Vice Presidents hailed from as well as their names? And, in order to break ties among the winners, can you tell us who the March Madness NCAA basketball champ was in the year The Sign was at the top of the pop charts, 1993? Have no idea? Yes, you do. Put that thinking cap back on. You know how the economy is evolving even though you don't have a PhD in economics, and what else do you know? You know the author of this report. Well then what team won in '93? I thought you'd get it.

One stanza from that 1993 ditty by Ace of Base captures the challenge for all investment advisors:

I saw the sign and it opened up my eyes
I saw the sign
Life is demanding without understanding
I saw the sign and it opened up my eyes
I saw the sign.

Speaking for both Chip and me, we hope you see it too, The Sign that is. But also remember that like life, the stock market is demanding without understanding.

Best to you and yours.