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FUNDAMENTALLY

Market Bottom? For Some Investors, It's Close Enough

By PAUL J. LIM

EVERY time the market suffers another steep drop, it's tempting to think that stock prices may have come down so much that the elusive market bottom is finally in sight.

Prices have certainly come down. On Friday, the Standard & Poor's 500-stock index was 44 percent below its peak of a little more than a year ago. Since then, the price/earnings ratio on the S. & P. has dropped from 16.8 all the way down to 12. With numbers this low, is the sell-off nearing an end?

It's certainly possible, and some canny investors have begun nibbling at stocks. But don't count on being able to time the market.

While cheap stock prices are always a welcome development for bargain-seeking investors, low P/E ratios haven't always been an accurate gauge of predicting turnarounds in the market.

If they were, stocks would have surged sharply in the mid to late '70s, when the market's P/E ratio sank into single digits. Instead, the S. & P. was pretty much flat throughout that time.

"Cheap valuations are simply a symptom of what's wrong, not the catalyst to get the market out," said Richard Bernstein, chief investment strategist at [Merrill Lynch](#). After all, just because stocks are trading at extremely low levels today, it doesn't mean they can't become even cheaper tomorrow.

To be sure, investors may be hopeful now that some respected investors — including [Warren E. Buffett](#), chief executive of [Berkshire Hathaway](#), and Jeremy Grantham, a chairman of the investment management firm GMO — say they've begun to selectively buy stocks.

But both have gone to painstaking lengths to stress that they weren't predicting that the worst of the sell-off was over.

In an Op-Ed article in The New York Times, Mr. Buffett wrote: "I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month — or a year — from now."

Similarly, Mr. Grantham said in an interview that even though his firm began buying stocks in early October, after prices fell to attractive levels, the market had a tendency to "overshoot" during sell-offs. "Market bottoms have this Murphy's Law style of being much lower than you ever expected in your worst nightmare," he said.

Mr. Grantham adds that he thinks the odds are roughly two to one that stock prices will sink to new lows next year. If the economy is in a modest recession, Mr. Grantham thinks the S. & P. could fall from its current level of around 870 down to 800. But if the recession turns out to be a severe one, "the S. & P. could fall to a range that's closer to 600 than 800," he said.

If that's the case, why did GMO begin to buy stocks in this market? Because Mr. Grantham doesn't believe in trying to time short-term market moves.

Mr. Grantham noted that GMO began buying only after its portfolios had fallen below some key thresholds. For example, in GMO's global balanced portfolio of stocks and bonds, the firm's minimum allocation to equities is usually 45 percent. But after the market sell-off, that equity allocation dipped to around 38 percent. So once stock prices began to look attractive, GMO started rebalancing back into what it regards as the most undervalued types of equities: emerging markets stocks and high-quality domestic blue chip shares. After a few rounds of purchases, stocks now make up around 55 percent of GMO's global balanced portfolio.

Mr. Grantham says that although he doesn't know how well he timed his purchases, "we do know that seven years out, these will be good purchases for us."

But what if you are determined to be opportunistic? How can you tell if the market is poised to rebound anytime soon — or at least sooner than seven years?

There is no sure-fire answer. But one way is to pay close attention to the asset allocation recommendations of Wall Street strategists. "It turns out to be a tremendous contrarian signal" for spotting market trends, said Mr. Bernstein.

For more than two decades, Mr. Bernstein has tracked recommended equity allocations in balanced portfolios managed by Wall Street firms. He found that when the consensus recommendation for stocks exceeds 60 to 65 percent of a balanced portfolio — as was the case between 2000 and 2004 — it tends to be a bearish indicator for future stock performance. On the other hand, when market strategists recommend keeping only around half of your portfolio in stocks, as was the case in 1997, it tends to be a bullish sign.

The most recent survey taken by Mr. Bernstein, about two weeks ago, shows an allocation of around 58 percent stocks. While that's down from the mid-60s percentages of the start of last year, it's still far from real pessimism. "We're still hovering right around the long-term average," he said. His own assessment is more bearish. He recommends allocating 50 percent in stocks, with the rest in bonds and cash.

In addition to investor sentiment, it's also worth keeping tabs on the sentiment of another group of Wall Street pros: the analysts who follow individual companies.

In recent weeks, these analysts have begun to lower their forecasts for 2009 earnings. Mr. Bernstein notes that for the first time in seven years, the ratio of upward earnings revisions to downward revisions has fallen to 0.5 — meaning that for every corporate earnings forecast that has grown more positive, two have become more pessimistic. "Analysts may be finally appreciating that the financial crisis has turned into a full-blown economic crisis," he said.

Still, analysts are far from throwing in the towel on their earnings forecasts, which may be needed for the market to start to rally.

While profit projections have declined, they may still be way too bullish. According to a survey of analysts by Thomson Financial, earnings growth estimates for S. & P. 500 companies in 2009 have fallen well below the rosy 22 percent forecast at the start of October. Still, they're expecting corporate profits to grow more than 12 percent next year. Since many are predicting a difficult first half of the year, thanks to the weakening economy, this would assume a tremendous profit surge in the latter half of 2009.

Christopher N. Orndorff, head of equity strategy at Payden & Rygel, an asset manager based in Los Angeles, predicts that "the earnings releases in January are going to be poor." That should drive down earnings forecasts for 2009 even lower, he said.

If earnings forecasts begin to fall substantially, he said, "it will be very difficult for stocks to rally."

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