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Flying Over the Handlebars: The Aftermath

Scott Adams, whose satirical and syndicated cartoon Dilbert has graced newspaper pages across the country since 1989, recently penned an essay¹ in which he vividly recounts flying over his motorcycle's handlebars at age 15. The impact of the accident would scar him for years... not physically, as he incurred no major injuries, but psychologically, for it would change his entire approach to life as a teenager and eventually as an adult. In the aftermath of the accident, the young Adams committed himself to a "danger avoidance lifestyle," vowing to avoid "all unnecessary risk." It was not until this past year as a 54-year old man that Adams both literally and figuratively ventured back into the water of risk-taking by whitewater kayaking in Costa Rica.

Not only can a physical brush with danger shift one's behavior and path, but an economic one can as well. For instance, the hyper-inflation environment in Germany in the 1920s transformed its citizen's attitudes about the risk of currency debasement. This fear of inflation remains so deeply ingrained in the psyche of the nation that generations later many believe it is restricting the ability of German policymakers to react to unfolding events in the region. Separately, depression-era children in the U.S. spent cautiously for decades subsequent to the economic meltdown in the 1930s. Extreme events can leave a lasting impression on one's risk appetite.



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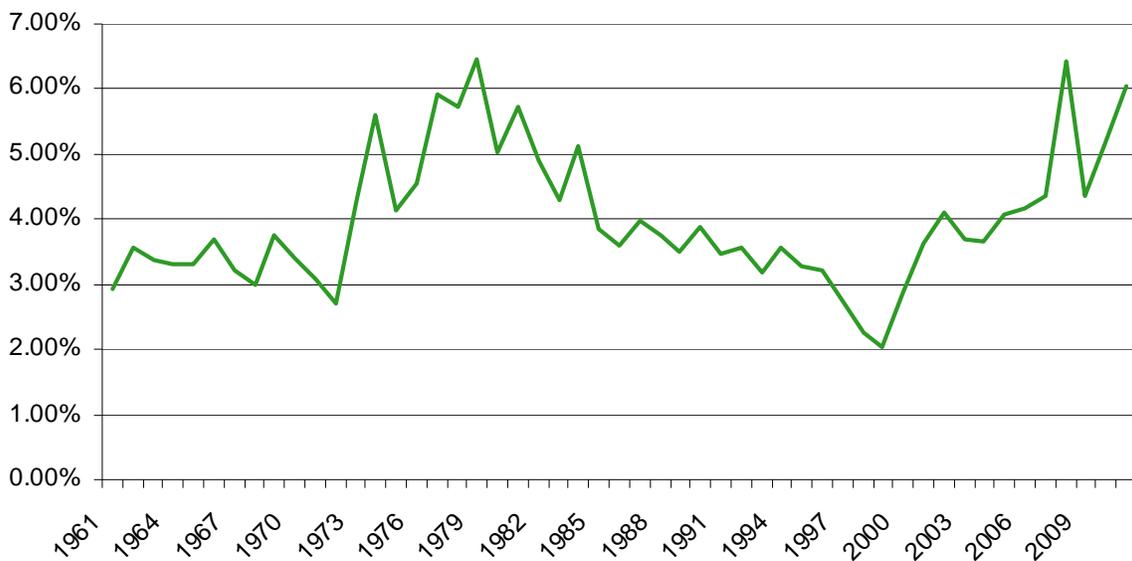
After gathering quite some speed during the 20-year bull market that ended in early 2000, equity investors tumbled over their handlebars in 2001-02, seemingly regained their footing for a few years, and then took an even more horrific tumble down a steep embankment in 2008-09. Just as Adams became more cautious after anxiously flying through the air as a teenager, investors have reacted similarly after facing a very serious economic crisis by committing to a "danger avoidance lifestyle" for their portfolios. Over the past

¹Wall Street Journal, December 31, 2011

three years, money has steadily flowed out of equities and into fixed-income instruments, especially U.S. Treasuries and highly-rated corporate bonds.

Those investors who remain in equities are demanding a greater margin of safety. The equity risk premium (ERP), or the amount above the risk-free rate investors require in return for owning stocks, serves as the best measure of the risk tolerance of an equity investor. Since 2009, investors have demanded a historically high ERP to be compensated for taking on greater levels of perceived risk of holding stocks. As seen in Exhibit 1 below, the current ERP rests just over 6%, one of the highest levels seen in the past 50 years. Higher risk premiums mean lower valuations and lower equity prices. However, rather than viewing this as a permanent feature, we believe these lower prices have created attractive buying opportunities for long-term investors.

Exhibit 1. Equity Risk Premium (1961-Current)



Data Source: Aswath Damodaran, <http://pages.stern.nyu.edu/~adamodar/>. Chart created by LMCM.

A combination of the readily apparent risks to the economy and the impact of poor returns since 2000 explain the high equity risk premiums, and therefore the extraordinarily low valuation levels in the market currently. Certainly, there are plenty of worries including the health of the European economy, the upcoming Presidential election, the sustainability of economic growth in China, and random and highly unpredictable world events that may occur in the future similar to the Arab Spring or tsunami/nuclear meltdown in Japan from last year's class of surprises. However, I believe a disproportionately large portion of what I see as extraordinarily low valuation levels in the market is the "risk avoidance" attitude that has become ingrained into investors' psyches.

Current attitudes towards equities could persist for some time, with the timing of the next bull market far from certain. However, market prices reflect expectations about the future, and today's low expectations will create excess returns for patient, rational, and long-term investors. A recovery in housing and the passage of time will only help unwind the current aversion to stocks.

At LMCM, we assess the level of risk priced in the market by reviewing a variety of measures we affectionately call our “Risk Dashboard.” After the S&P 500 Index tumbled over 14% in the third quarter due to concerns surrounding Europe, many of our Risk Dashboard’s indicators were one to three standard deviations above average, which generally has been a good time to invest. In the fourth quarter, as if on cue, the S&P 500 Index rallied 11%. Today, our risk indicators are still decidedly bullish, although noticeably less so compared to three months ago. As seen in the table below, risk aversion has decreased, as demonstrated by the moves junk bond spreads and the Volatility Index have made from extreme to more moderate levels. Other indicators of risk listed below have moved only modestly. Most importantly, stock multiples remain low, reflecting the high equity risk premium outlined above and have been lower only 7% of the time since 1993. Hence from a longer-term perspective, equities remain quite attractive and opportunities are still presented to valuation managers.

Indicator	% of Observations Below Current Reading as of 10/5/11	% of Observations Below Current Reading as of 1/5/12
Investment grade bond spreads over Treasuries	93%	93%
Junk bond spreads over Treasuries	89%	68%
Volatility Index (VIX)	96%	62%
Median three-month correlations of S&P 500 stocks	99%	98%
S&P 500 forward P/E ratio	1%	7%
S&P 500 price/book ratio	3%	7%

Source: LMCM Risk Dashboard, January 5, 2012 and October 5, 2011

The path to normalcy will have bumps. Investors will remember flying over their handlebars each time their bike tire hits one of these bumps, creating corrections and future opportunities which we fully intend to take advantage of in our strategies. But in time, investors will once again venture back into the water. When this occurs, the equity risk premium will gravitate toward normal and multiples will expand, leading to rewarding returns for equity investors.

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²Data is available since 1987.

³Data is available since 1990.

About the Author

Jay Leopold is the Portfolio Manager of the Legg Mason Capital Management All Cap strategy and is the Chair of the LMCM Risk Analysis Committee. Jay is a former president and director of the Baltimore Security Analysts Society. He graduated cum laude from the Wharton School at the University of Pennsylvania with a B.A. in Finance and received his CFA designation in 1989.

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