HAWK 100

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Cap Trade Reform

During the August recess, congressional representatives met with constituents. Discussion quickly reached boiling point over the legislative agenda—health care, cap and trade, and deficit spending.

Unfortunately, the full legislative agenda has obscured financial reform from full discourse. Beyond bonus bickering, debate has been absent since the collapse.

Hawk100 has long promoted fair and equitable capital markets for individual investors. As president of Hawk100 and as presidents council representative for CFA Institute, the global investment profession standard setter, I have been an outspoken critic of certain common practices that unnecessarily cost investors. Hawk100 encourages widespread adoption of fiduciary standards that require business practices to inure to investors' benefit before the firm or professional.

Proprietary access to order flow information affords an unfair advantage to certain speed traders who potentially front-run trades ahead of investors to the firm's profit. Regulators should close the information gap between investors and professionals without constraining technology advances and applied innovations. Regulators could remedy most improprieties with a requirement to unfailingly represent client interests with highest priority.

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September, Redux.

For the next month or so, I expect media headlines to revisit the 2008 financial collapse. While you reread about losses to the likes of AIG, Lehman, Morgan Stanley, Merrill, Fannie, Freddie and others swept under last year, consider this fair warning of another potential avalanche. The root cause for an avalanche may be found in technical or fundamental shifts causing asset values to fall from lofty peaks. Nonetheless, Hawk100 recommends caution and prudence when investing with risk.

Heading into September, Hawk100 makes two observations of financial market conditions. One, stocks have soared since March. The accompanying chart above illustrates the 52% recovery from March 9 through August 27. Two, core fundamentals deteriorated over the same period. The accompanying table below compares fundamental statistics for the S&P 500 Index and reveals fractured valuations. These observations lead to our subdued outlook for U.S. equities.

Stock prices in the U.S., represented by the S&P 500 Index, have rallied in rare form. The advance from March 9 to August 27 had never before occurred as far (52.4%) and as fast (120 trading sessions). Only twice in the postwar era has the S&P 500 advanced more than 40% over such a short time. That occurred in 1975 and again in 1983. In both cases, the economy had just emerged from recessions. Interestingly, in the 120 days following the 1975 and 1983 advances, stocks dropped 2.8% and rose 16.2%, respectively. Note the wide discrepancy between results subsequent to earlier outsized returns. Particularly with technical indicators, past performance does not predict future results.

To explore whether company financial results fundamentally support advancing prices, Hawk100 undertook research of selected company performance through August. We screened for companies with annual revenues in excess of $2 billion to define a representative sample of firms with macroeconomic exposure. The sample led Hawk100 to surprise observations when comparing the state of affairs as of the end of August 2009 versus August 2008.

Aggregate revenues declined 1.9%, less than the 2.5% year over year decline in nominal GDP through the second quarter, at last measure. Common shareholders lost 43% of the total share value. While markets obviously declined since last August, earnings and cash flows deteriorated at significantly faster paces. Today's S&P 500 earnings valuation multiple is a full 630% higher than a year ago. This could foretell trouble, but the earnings multiplier tends to accelerate ahead of actual earnings recoveries as shareholders become attracted to the potential for economic profits.

Valuation Multiples (Price Ratios) S&P 500 Index	August 31, 2009	2008	Change
Sales	2.0	2.3	Less dear by 14.2%
Earnings	129.2	17.7	More dear by 630.4%
Cash flows	24.8	11.0	More dear by 124.5%
Book value	3.8	5.2	Less dear by 26.5%
Dividend yield %	2.1	2.2	More dear by 6.1%

Hawk100 computations based on data from Standard and Poors, EDGAR Online, and Bloomberg.

Though not fully mended, indicators show an improved U.S. economy of late. The Conference Board's index of Leading Economic Indicators rose four consecutive months and now suggests the economy "will turn positive soon." Perhaps, we missed the avalanche after all.

By Richard Clemens, CFA, President