

## Legg Mason Capital Management Market Commentary



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### Who's afraid of a sideways market?

For the last 25 years, investors have experienced two types of stock markets — bull and bear — that either went up or down over a multi-year period. But there is a third type of market, with which many investors today are not as familiar. It is called a “sidewinder,” and it produces a sideways market — one that barely changes over time.

It has been a generation since investors have experienced a prolonged sideways market (although they were not uncommon through most of the 20th century).<sup>1</sup> On October 1, 1975, the Dow Jones Industrial Average<sup>2</sup> stood at 784. Nearly seven years later, on August 6, 1982, the Dow closed at the exact same 784. Even though nominal earnings grew over the time period, the price paid for those earnings dropped. By the end of 1975, the trailing price-earnings multiple for the S&P 500 was almost 12 times. By the fall of 1982, the trailing price-earnings multiple for S&P 500 earnings had declined to nearly 7 times.

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<sup>1</sup> There were a variety of sideways markets during the 1900s that preceded the sideways market of October 1975 to August 1982. On June 30, 1933, the Dow Jones Industrial Average (Dow) stood at 98.14. Nine years later, on May 26, 1942, the Dow closed at 99.41. From March 6, 1945, until June 13, 1949, the market went sideways, starting at 161.5 and ending at 161.6. Over the next nine years, from January 13, 1950, until December 31, 1958, the Dow jumped 197% in price before settling into a four-year slump (567 on November 17, 1958, and closing at 568 on October 22, 1962). Then, off again we went with a roughly 70% gallop straight up over the next three years, 1963-1965, only to be followed by a four-year mind-numbing sideways market grind into 1970. Between October 10, 1966, and February 4, 1970, the Dow went from 754.5 to 754.5.

<sup>2</sup> The Dow Jones Industrial Average (Dow or DJIA) is a widely followed measurement of the stock market. The average is composed of 30 stocks that represent leading companies in major industries. These stocks, widely held by both individual and institutional investors, are considered to be all blue-chip companies.

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## *“Stock pickers can thrive if the market moves sideways.”*

Some stock market forecasters have drawn analogies to what happened in the late 1970s and what may be happening today.<sup>3</sup> There are concerns about the rate of corporate profit growth against the backdrop of a weak economic recovery. There are worries about contracting multiples which typically peak at the bottom of a cycle for earnings growth rates.<sup>4</sup> Others fear that a decline in the U.S. dollar will foster higher commodity prices, thus causing inflation to rise.

### A strategy for sideways markets

What’s an investor to do if we are confronting a sideways market over the next several years? For those who embrace a passive index approach to investing, the results could be uninspiring. The current yield of the S&P 500 Index is 2.2%.<sup>5</sup> This is a far cry from the 5% yield of the late 1970s.

Others claim we are now in a “traders’ market.” They argue that in a sideways market, the “buy and hold” strategy is dead, and the only way to make money is to trade stocks rapidly. I have little to say about this approach other than to point out that it is quite difficult for the overwhelming majority of investors. The idea of buying a stock that is quickly going up and then selling it before it rolls over is intellectually appealing but incredibly difficult to employ successfully. If you are contemplating a trading strategy, take a breath and truthfully admit to yourself that only a very small percentage of people are able to do it profitably.

Long-term investors may think their only hope for a decent total return is to invest in high dividend yielding stocks.<sup>6</sup> While dividend yield does comprise a significant part of a stock’s total return, it is not the only source of total return one could expect in a sideways market. Indeed, despite a stock market that is

largely spinning its wheels, there is ample opportunity to earn excess returns from buying and holding value-creating businesses over a three- to five- year period of time.

## *“We believe there is ample opportunity to earn excess returns in a sideways market from buying and holding value-creating businesses over a three- to five-year period.”*

We decided to study the behavior of the 1975 to 1982 sideways markets after recalling the exceptional investment performance generated over these years by Warren Buffett at Berkshire Hathaway and Bill Ruane at the famous Sequoia Fund.<sup>7</sup> Over this period, Berkshire Hathaway and the Sequoia Fund generated cumulative total returns of 676% and 415%, respectively, and average annual returns of 34% and 28%, respectively.<sup>8</sup> Remember, these were not traders. Both Buffett and Ruane bought and held, over a multi-year period of time, outstanding companies.

Our research team examined the return performance of the 500 largest stocks in the market between 1975 and 1982.<sup>9</sup> What we discovered surprised us.

Taking the 500 largest stocks at the beginning of each year (1975-1982), we found that, on average, 3% of this large-cap basket of stocks went up in price by at least 100% over the course of the following year. Put differently, on average, only 16 out of 500 stocks doubled in any one year. Even for the best stock pickers, it would have been a significant challenge to consistently identify these stocks in advance each year.

When we extended the holding period to three years, the results were more encouraging. Over rolling three-year periods, on average, 18.6% of the stocks doubled; 93 out of 500.

When we extended the holding period to five years, the results were eye-popping. On average, an astonishing 38% of the stocks went up 100% or more; that’s 190 out of 500.

<sup>3</sup> “The Late-’70s is Setting Historical Basis for Comparison,” Strategas Research Partners, Sector Strategy Report, June 8, 2009.

<sup>4</sup> In February 2009, the trailing price-earnings multiple of the S&P 500 Index was 10.4x. Currently it stands at 25x trailing earnings. It is difficult to imagine that market multiples can rise from here. The stock market’s next phase will likely focus on the rate of corporate earnings growth to back fill the already expanded multiples. If the growth of earnings is sluggish, multiples may contract. For further discussion see “Equity Portfolio Strategy Insight: The Return of Fundamentals and the Multiple Contraction Playbook,” Adam Parker, Bernstein Research, September 29, 2009.

<sup>5</sup> As of January 28, 2010. Subject to change. *Past performance is no guarantee of future results.* Please note that an investor cannot invest directly in an index. The S&P 500 Index is an unmanaged index of 500 stocks that is generally a representation of the performance of larger companies in the U.S.

<sup>6</sup> Bill Gross recently recommended this strategy in his latest Investment Outlook (December 2009).

<sup>7</sup> Robert G. Hagstrom, *The Warren Buffett Portfolio: Mastering the Power of the Focus Investment Strategy*, (John Wiley & Sons, 1999).

<sup>8</sup> Returns are average annual calendar-year returns for 1975-1982.

<sup>9</sup> I wish to acknowledge the Legg Mason Capital Management Research Department, including the work of Randy Befumo, Director of Research, Arturo Rodriguez, Security Analyst, Peter Shapiro, Research Analyst, and Graham Savage, Associate Analyst.

**Performance of 500 stocks at the beginning of each year, 1975-1982** (based on market capitalization)

Number of doubles or greater over rolling periods (top 500 companies)

1-year	1975	1976	1977	1978	1979	1980	1981	1982	Total
number of companies	46	5	0	2	27	34	2	8	124
% of 500	9.2%	1.0%	0%	0.4%	5.4%	6.8%	0.4%	1.6%	3.1%

3-year	1975-1977	1976-1978	1977-1979	1978-1980	1979-1981	1980-1982	Total
number of companies	148	36	48	132	101	93	558
% of 500	29.6%	7.2%	9.6%	26.4%	20.2%	18.6%	18.6%

5-year	1975-1979	1976-1980	1977-1981	1978-1982	Total
number of companies	268	186	112	193	759
% of 500	53.6%	37.2%	22.4%	38.6%	38.0%

Source: Legg Mason Capital Management, January 2010. *Past performance is no guarantee of future results. This chart is for illustrative purposes only and is not indicative of any specific investment. This chart illustrates historical performance of the top 500 companies in the U.S. based on market capitalization for each year from 1975-1982.*

The obvious question is, how can 38% of the stocks in an index go up 100% or more over a time period when the index itself barely moved? The answer is revealed not by a finance professor, but by one of the most influential evolutionary biologists of our generation — Stephen Jay Gould.

***“During the sideways market of 1975 to 1982, an average of 38% of the largest stocks in the market appreciated over 100% during each five-year rolling period.”***

### The spread of excellence

In his highly acclaimed book, *Full House: The Spread of Excellence from Plato to Darwin*, Gould talked about the importance of distinguishing between the trends of a system from the trends in the system. “The old Platonic strategy of abstracting the full house as a single figure (an average)... and then tracing the pathway of this single figure through time, usually leads to error and confusion.”<sup>10</sup> Because people have a “strong desire to identify trends,” it often leads them “to detect a directionality that doesn’t exist.”<sup>11</sup>

Putting it in Gould’s terms, investors who observed the stock market between 1975 and 1982 and focused on the “full house” (the market average) came to the wrong conclusion. They wrongly assumed that the

direction of the market was sideways, when in fact the variation within the market was dramatic and led to plenty of opportunities to earn high excess returns.

Gould tells us that by studying the variations in a system, we will be able to better observe changing patterns over time. These changing patterns, he explains, are thought to be trends to improvement, or what he refers to as the “spread of excellence.”

Applying this idea to the stock market, we see that what we first thought to be a trendless sideways market was in fact a market full of variation. That quickly brings us to the next two questions: Where did the trends of improvement occur and who made the list?

Between 1975 and 1982, the greatest number of companies in the S&P 500 were located in the following five sectors: industrials, materials, utilities, financials, and consumer discretionary. Interestingly, the energy, healthcare, information technology and telecommunication services sectors contained the least number of companies.

When we calculated which sectors had the highest percentage of companies that went up in price by at least 100% over the time period, the lineup changed. Analyzing the five-year rolling average, we see that energy was the top sector, with the highest percentage number of outperformers (67.8%), followed by industrials (42.7%) and infor-

<sup>10</sup> Stephen Jay Gould, *Full House: The Spread of Excellence from Plato to Darwin* (Three Rivers Press; New York; 2006), p. 217.

<sup>11</sup> Gould, p. 41.

**Industry analysis** (based on rolling five-year periods)

Sector	number of companies <sup>12</sup>	% of total companies <sup>13</sup>	Sector	number of companies doubling <sup>14</sup>	% of companies outperforming <sup>15</sup>
Industrials	307	15.4	Energy	135	67.8
Materials	303	15.2	Industrials	131	42.7
Utilities	278	13.9	Information technology	26	42.6
Financials	259	13.0	Financials	109	42.1
Consumer discretionary	253	12.7	Consumer discretionary	253	36.8
Consumer staples	217	10.9	Healthcare	217	34.5
Energy	199	10.0	Materials	199	31.0
Health care	87	4.4	Telecommunication services	87	30.6
Information technology	61	3.1	Utilities	61	28.4
Telecommunication services	36	1.8	Consumer staples	36	23.5
<b>Total</b>	<b>2000</b>	<b>100.0</b>	<b>Total</b>	<b>759</b>	<b>38.0</b> <sup>16</sup>

Source: Legg Mason Capital Management, January 2010. The tables above list the 10 sectors of the S&P 500 Index, the number of companies within each sector and the percentage of companies that outperformed over each five-year rolling period. *Past performance is no guarantee of future results.* This chart is for illustrative purposes only and is not indicative of any specific investment.

mation technology (42.6%). At the bottom of the list were telecommunication services (30.6%), utilities (28.4%) and consumer staples (23.5%). Despite the fact that energy and information technology were among the sectors with the fewest total names in the S&P 500 Index during the period, they had between them the highest percentage of outperformers in the rolling five-year periods. We might say Stephen Jay Gould's "spread of excellence" flowed through these two sectors.

The years between 1975 and 1982 were unsettling. Regional wars in Southeast Asia and the Middle East had become commonplace. The repercussions of the failed Nixon administration continued to ripple through our political system. In those seven years, Americans were led by three different presidents: Ford, Carter and Reagan. Unrelenting double-digit annual increases in oil prices caused economic dislocation, which in turned caused inflation to soar, forcing banks to raise their lending rates. By 1980, inflation was growing by over 13%. That same year, the prime rate hit 21%.

It is easy to analyze the list of companies and quickly dismiss high performers as nothing more than companies that benefited from the rise in oil prices and inflation. Energy companies are strongly in the

above-average list; so are the materials and utilities companies, which included mostly natural gas distributors. The companies in the consumer discretionary, consumer staples and healthcare sectors were superior performers because of their ability to raise prices to match or even exceed inflation.

But to see this sideways market as nothing more than a game of how to beat inflation strikes me as an oversimplification. We decided to dig deeper into the results to see if we could discover any additional anomalies that might help us understand more about the market's behavior.

We asked our friends at Empirical Research Partners to examine the largest stocks in the stock market between 1975 and 1982.<sup>17</sup> Empirical employs quantitative research and has data on stocks reaching back to 1952. They analyze individual stocks and markets within four distinct buckets.

- Valuation
- Capital Deployment and Financing
- Earnings Quality (growth)
- Market Reaction (momentum)

<sup>12</sup> Total number of companies over each five-year rolling period between 1975 and 1982. Please note that some companies may be counted more than one time in this analysis.

<sup>13</sup> The percentage of the total from the given sector.

<sup>14</sup> The number of companies within a given sector that doubled or greater within the rolling periods examined.

<sup>15</sup> The number of stocks that doubled or greater divided by the total number of companies in the sector over the time periods examined.

<sup>16</sup> Weighted average.

<sup>17</sup> I wish to thank Empirical Research Partners, Michael Goldstein, Brian Cho, Nicole Price and Norman Sanyour for their dedicated research help.

According to Empirical Research, the Valuation-based strategy performed best during this period. Not only was it the best among the four, it outperformed its historical average return by 60%. The second best-performing strategy was Earnings Quality (growth), which outperformed its historical average by nearly as much as the Valuation-based strategy. The Market Reaction (momentum) strategy performed worst.

This makes sense. Momentum strategies work best once the direction of the market has been established. Momentum strategies also are closely aligned with investor sentiment. In sideways markets, sentiment sloshes back and forth largely because the trajectory of the economic recovery is unknown. At times, the data may indicate the economic recovery is gaining strength leading to a short blast in stock prices, only to be followed by weak economic readings that cause sell-offs. In this environment, momentum investors find themselves constantly whiplashed.

*“Based on Empirical Research’s study, we found the optimal stock picking strategy between 1975 and 1982 was to select undervalued growth companies.”*

Examining the results from Empirical Research, we find the optimal stock picking strategy between 1975 and 1982 was to select undervalued growth companies. Today, we sometimes hear a call for investors to now consider an active approach to stock selection. The call is distant and very faint. This timidity is understandable. First, common stocks have, for only the second time since the Great Depression, produced a negative total return for the trailing decade. Ten-year U.S. Treasuries, on the other hand, have generated a positive 6.7% average annual return over the same period. Not surprisingly, investors currently favor fixed-income securities over stocks. Secondly, active strategies, over the past several years, have struggled to cover themselves in glory; they largely underperform passive strategies. But, it is often at the point of maximum pessimism when investors can find opportunities to earn high excess returns.

A recent Goldman Sachs research report identifies several reasons why investors should now choose active common stock strategies over passive strategies.<sup>18</sup>

- As stock market volatility has continued to decline toward its long-term average, correlations between stocks have declined. This means company-specific fundamentals are more of a determinant of future stock prices.
- The prospects for multiple expansion appear limited. As mentioned earlier, it is unlikely we will experience a substantial increase in the market multiple from here. When market multiples rise, it has a tendency to lift all boats. But without a broad-based increase in the market multiple, stock selection becomes ever more so important.
- In a below-average economic recovery there will be market share gainers and losers. In a subpar growth environment, growth becomes the scarce resource. The scarce resource is often bid higher. Companies driven by long-term secular growth trends will be more valuable than those companies whose fortunes are closely tied to a leveraged economy.

## Conclusion

So...who should be afraid of a sideways market? Although it is not certain we will experience a sideways market over the next several years, if we do (and I want to underscore “if”) momentum investors will likely struggle. With no long-term trend in place, it will be tough for a momentum strategy to produce sustainable profits. Second on the list would be index investors. If the price of the index is little changed in the coming years, then the most index investors can hope for is a paltry 2% annual dividend yield.

Who should not be afraid of sideways markets? Stock pickers! Whether the approach is to select stocks that pay higher dividends or companies that are growing shareholder value at an above-average rate, I believe the game is now in the hands of those investors who can identify mispriced stocks.

<sup>18</sup> “Top 5 Reasons to Choose Active over Passive Now,” Goldman Sachs Asset Management, Fundamental Equity Market Insights, March 2009.

Warren Buffett differentiates between the “know-something” investor and the “know-nothing” investor. If you are a “know-nothing” investor — that is, you do not have the skill set to identify which stocks are undervalued — then you should favor a broadly diversified portfolio approach — something akin to index investing. “On the other hand,” says Buffett, “if you are a know-something investor, able to understand business economics and...find...companies that possess important long-term competitive advantages, conventional diversification (index investing) makes no sense for you. It is apt simply to hurt your results.”<sup>19</sup>

Whether we are in for a sideways market for the next several years is open for discussion. However, the central point of this research is to remind investors that, despite the average returns of a broad index, there are significant opportunities and profits to be made by those who understand the variations within the system. No matter how the stock market behaves, or how the underlying economy performs, there will be, in the words of Stephen Jay Gould, a “spread of excellence.” In financial ecology, there are always changing patterns and trends to improvement. As such, the investment landscape favors the stock picker — perhaps now more than ever.

## About the author

Robert Hagstrom currently serves as Portfolio Manager of the Legg Mason Capital Management Growth Trust mutual fund and manages the Growth Equity strategy for institutional investors. Robert earned a B.A. and M.A. from Villanova University. Robert received the CFA designation in 1992 and is a member of The CFA Institute and the CFA Society of Philadelphia. Robert is also known for his best-selling book, *The Warren Buffett Way: Investment Strategies of the World's Greatest Investor*. He has also written a number of investment books, including: *The NASCAR Way: The Business That Drives the Sport*; *The Warren Buffett Portfolio: Mastering the Power of the Focus Investment Strategy*; *The Essential Buffett: Timeless Principles for a New Economy*; *Investing: The Last Liberal Art*; and his latest book, *The Detective and The Investor: Uncovering Investment Techniques from the Legendary Sleuths*.

<sup>19</sup> Berkshire Hathaway 1993 Annual Report.

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