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STAYING OUTSIDE THE BUBBLE: WARNING SIGNS OF INDUSTRY DOWNTURNS

Preservation of capital is the cornerstone of successful long-term investing: seek stability and a reasonable rate of return by relying on fundamentals, and minimize downside by balancing exposure to risk. Staying on track often requires discipline and a wariness of popular investments with valuations that defy rational pricing. The most promising and prominent of these tempting prospects can quickly become bubbles, which inevitably leave investors and entire sectors lost amid collapsing returns.

As we have recently witnessed, technology and financial “innovations” have allowed money flows to surge with unprecedented volume and turn with ruthless precision, creating an environment in which investors need to stay ever-vigilant for indications of a newly forming bubble. For investment professionals, protecting client assets starts with the simple awareness that overvaluation itself is an unattractive baseline for investment success. This sensibility leads to disciplined pruning of high-priced investments – even in exuberant times where upward momentum seems boundless.

After the dramatic popping of the extraordinary global credit bubble and the resulting collapse of the real estate bubble, the lessons of overindulgence were duly noted. The underlying themes of market cyclicality, however, seem to have been lost even before the dust cleared on the crash: just as the economy begins to regain its footing, the effects of speculative excesses are emerging again. Global markets are re-inflating on a wave of government stimulus, and another bubble may well be on its way.

Staying outside of these bubbles is paramount to preserving capital. It calls for a steady awareness of themes in industries that run parallel to peaking sectors and an enduring adherence to the fundamentals of investing. With these elements serving as the foundation of investment decisions, picking up on the warning signs of

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market bubbles becomes a valuable exercise that serves investors' long term goals. Emerging markets – specifically China – are a current example, and in the near-term commodities may follow suit.

Bubbles are marked by four stages of growth; bowing out before the burst is a matter of identifying the turning point and resisting the pressure to chase overvaluation.

Stage 1: On solid ground

All bubbles begin as good investments, otherwise sectors would not gain enough momentum to suffer from overvaluation. In these cases, reasonable purchases are identified that embody the potential of a market segment, inspiring expanded money-flows and drawing institutional interest. That interest in turn becomes a sales drive, with profit motive and momentum from institutions that warps standard index or portfolio architectures. With the drums beating on specific investments, measurements become skewed to the positive and encourage further purchasing.

The mid-1990s tech bubble serves as a clear example of this behavior. Personal computers created new demand across the technology sector from increased processing capacity and memory to networking capabilities. As the investing world began to hypothesize about the potential of computing power and the Internet, well-grounded companies like Microsoft were rightfully heralded as the gatekeepers of a new era. Their initial success, however, was extrapolated to better support the investment argument.

Stage 2: Earnings above expectations

With analysts and investors clamoring to participate in a sector on the rise, momentum in asset valuations invariably exceeds expectations. In a true bubble environment, this manifests as a consistent and prolonged upward swing that becomes unmoored from the tangible output of the segment. As prices for investments within the bubble increase, consensus for future growth builds and the investment thesis broadens to justify rising prices.

Returning to the tech sector, investments became tied to a productivity boom that promised ever-increasing efficiency across a near limitless swath of industries. The term “vaporware” entered into the business lexicon as a term to define technology offerings that did not yet exist but promised great advances in the newly unfolding age of advanced computing.

Support for such initiatives defied logic, and companies cashed in by taking over the market. In 1999, 289 Internet-related Initial Public Offerings (IPOs) represented about 60% of the IPOs issued and earned 5.5 times more money from the year prior, cumulatively raising \$24.66 billion. By year end, these IPOs were valued at nearly 266% over their initial offering price.¹

Stage 3: Momentum of the masses

In this environment, momentum begets momentum. Investments with popular appeal are easier to sell, and institutions that are grounded by research departments and sales forces continue to establish multiple avenues that encourage money flow. Their efforts often result in products that expend money flows and extend

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positive performance in the form of mutual funds, Exchange Traded Funds, private equity investments, and other vehicles. The continued outperformance and increased access draws a wider set of investors eager to capitalize on the trend.

Under these conditions, the bubble expands and market participants scramble to keep up with the performance. The masses are driven to invest further in the momentum - even if they recognize that asset prices are unjustifiably high.

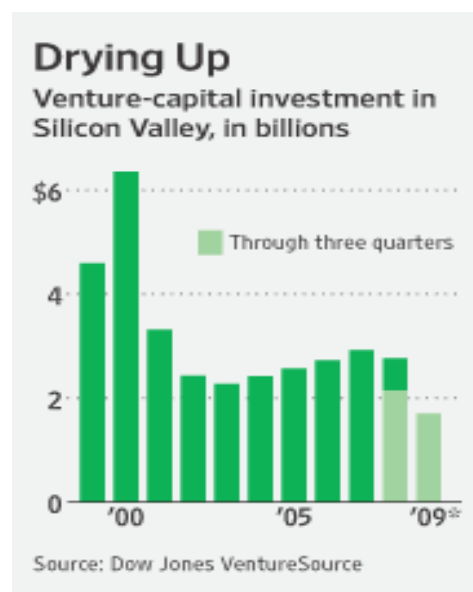
“Cheap stocks are heading for, if not extinction, at least endangered-species status,” lamented Barron's in January of 1997. “When the market rose 30%, furious investors bailed out of funds that ‘only’ gained 20%.”ⁱⁱ

An analysis conducted by a Princeton University-based economics group echoed the observation that investor expectations of tech performance exceeded rational bounds, as reflected by the pricing structure and the extraordinary trading volume. “[Investors] were seeing live, in action, the unfolding of lots of examples of valuations disconnecting from fundamentals.”ⁱⁱⁱ

Stage 4: The burst

Even in the face of such incredible momentum, when asset prices become unmoored from fundamentals, the overvaluation is exposed by an inherent lack of substance in the investments. When a real challenge to pricing emerges, the resulting pause in confidence breaks the upward trend and the promise of continued extraordinary returns reverses dramatically. This quickly filters through the expanded network of sales channels and the bubble implodes around the unsubstantiated pricing architecture.

The tech collapse brought the Nasdaq Composite from 5046.86 to 1114.11, a 78% drop. Out of about 400 publicly traded Internet-related companies tracked by Pegasus Research, 35% traded below \$2 a share with more than half trading below \$5 in 2000.^{iv} Indeed, pet food retailer Pets.com – the “poster-child” of the bubble – traveled in less than one year from an \$82.5 million IPO to bankruptcy.^v Faith in new tech innovations suffered a crippling setback, with venture-capital investments in the sector dropping from over \$6 billion in 2000 to just over \$3 billion in 2001.^{vi}



Reversal of fortune in emerging markets

The tech bubble paints a clear picture, and a similar pattern is evident in the rise and fall of the financial service and real estate industries. In fact, just months after the global collapse of financial and lending institutions, investors were already charging towards the next best thing. Despite a flawed long term outlook, emerging markets gained that telltale mass momentum and are quickly headed for a Stage 4 burst.

That trend began with an overarching lack of understanding of the depth required to supply fundamentally sound long term growth. Emerging markets like China have long been dependent on positive external capital flows from the developed world. Since this external capital flows through multiple pipes including direct investment, ETFs, private equity, credit facilities and export markets, it becomes much larger than the capital base in emerging markets. Shifts in tides of speculative money flows therefore have a powerful impact on emerging economy investments. Also, as emerging markets typically rely on less mature financial marketplaces – lacking reliable tools like a functioning IPO market in down cycles – the booms and busts have proven to be more pronounced.

Indeed, performance in emerging markets has followed speculative money flows very tightly over the last decade. These trends have been well supported by the advance of “open architecture” investment structures and the resultant designation of emerging markets as a standalone asset class within a diversified portfolio – Stage 3 in a classic bubble formation. In 1995, allocations to emerging markets in endowment and foundation portfolios ranged from zero in most cases to perhaps 5% in the most progressively managed accounts. Today, base allocations are significantly higher. Yale’s current target for emerging market investments is 10%. Harvard’s (not to be outdone) is 11%. And, according to a Pyramis Pulse Poll, which surveyed 109 of the largest endowments and foundations in the U.S. at the end of 2009, 42% planned to strategically increase allocations further into emerging market equities.

Investors will do well to remember that underlying economic growth does not always spell strong equity market returns. In the 1990s, China doubled its GDP, yet its equity markets offered a negative real return with annualized returns of 0.18% for the ten year period.

Recent tightening of credit policies and restrictions on new loans in China have surprised many observers who believe that China’s current growth is based more on expanding demand than on expanding credit. The market reaction suggests that investors will likely pause for currently fluid policy changes in China to stabilize. With momentum halted, sensible investors will take some time to look at underlying fundamentals – and that may signal the bursting point.

Commodities: the next danger zone?

There are rumblings that even as investments in China begin to drop, a related bubble is surfacing around commodities. A strong link connects the infrastructure development necessary for an exploding geographic market and the value of commodities necessary to fuel that physical growth. This explains the rush to commodities when China’s growth appeared boundless and the resultant run-up in commodities prices over the last decade. As the situation evolves and China faces challenges, commodity valuations may find one of their most recognized supports pulled out from under them.

In addition, commodities have long been sold as “safe harbor” investments – hard assets that would maintain value in the face of currency shifts and inflationary pressures. Over the wildly volatile last decade such “safety” has been a popular investment target. In particular, concern over the declining value of the dollar against other currencies led to a flood of interest in commodity investments that rise in value when the US dollar weakens. At current valuations, commodity investments maintain few of the defensive characteristics

that once made them so attractive. Indeed, with the unraveling of the Euro and the significant advance in valuation of US dollars in the last six months, commodity prices have already started to buckle.

Other red flags abound. Beyond the empty fundamentals supporting the commodities bubble, there are signs that an inflection point is imminent. Job growth, while minimal, is apparent, with current projections at approximately 100,000 jobs per month in 2010. If the global GDP growth continues to improve, higher bond yields will follow sooner than many expect – and investors will reflexively drop commodities in favor of these higher-yielding defensive vehicles. Australia has hiked rates six times since late 2009, both India and China have initiated tightening policies, and the US economic recovery has shown surprising strength in the first four months of 2010. Alternatively, if GDP growth should falter as a result of the spreading debt crisis in Europe or due to a hard landing in China, we may well be in for a long period of very modest global growth. Slowing global GDP growth means decreasing industrial demand for commodities – and lower prices.

Unfortunately, the commodities rush led to holdings in a wide array of fund vehicles, including traditionally risk-averse ETFs. Investors should be wary of more product built around commodities in the coming weeks and months, another indication that sales are being based on mass momentum, not fundamental strength.

Whether or not the high investment levels in commodities lead to a full blown bubble remains to be seen, but investors should recognize that a crisis point is coming for the sector. When that issue resolves, rest assured that another will arise; the cycle of the markets continue, and the wise investors will stand apart from the herds that circle back on the history of bubbles.

About the Authors

Charlton Reynders, III, Chairman and CEO of Reynders, McVeigh Capital Management, has more than 15 years of experience in investment management and social venture investing. His passion for forward thinking investment strategy rooted in fundamentals has provided a guidepost for his success to date.

In addition to his leadership in the traditional investment management world, Chat has structured and funded public/private partnerships that have brought more than \$150 million in revenues to leading cultural institutions around the world – projects that have won numerous awards. In this vein, he has for decades produced socially-oriented IMAX films including *Dolphins*, which was produced in conjunction with the National Wildlife Federation and garnered an Academy Award nomination in 2000, and *Coral Reef Adventure*, which received the largest grant in the history of the Informal Science Division of the National Science Foundation. He currently sits on the Advisory Boards of Project Adventure and the MacGillivray Freeman Educational Foundation.

Patrick McVeigh, President and Chief Investment Officer of Reynders, McVeigh Capital Management, is widely recognized as a pioneer in bringing traditional investment management together with socially responsible investing. He was one of three original employees at Trillium Asset Management; his research was key to asset growth from startup to \$700 million.

A voice of reason and leadership within the socially responsible investing realm, Patrick has served as Managing Editor of *Investing for a Better World*, authored numerous articles on ethics and ecology, and contributed chapters to *The Social Investment Almanac* (New York: Henry Holt, 1992) and *Working Capital: The Power of Labor's Pensions* (Cornell University Press, 2001).

Since 1995, Patrick has been project manager for a series of groundbreaking studies conducted by the Social Investment Forum, tracking the growth of socially responsible investing and its implications in the investment markets. He also served on the boards of SEED: The Haitian Community Loan Fund, directing approximately \$1 million to peasant cooperatives in Haiti to create businesses; the Social Investment Forum; and the San Jose Food Co-operative.

Endnotes

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