LESSONS FROM MUTUAL FUND MANAGERS

Principles to help investors interpret market direction and reap the rewards

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"Markets are voting machines in the short term but weighing machines over the longer term and investing is a process not a speculation sport."

This is a comment that Warren Buffet has made many times when asked about the short term change in investments and markets. With this thought in mind, what are the driving principles in the long term direction of the market and how can investors benefit from them?

Here is how Mutual Fund Managers, professionals who know ins and outs of the market best, approach the process and what you can learn from them to become a savvier investor.

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Mutual Fund Managers use S&P 500 as the base

The S&P 500 Index is a barometer for the overall health of U.S. markets. The S&P 500 index measures performance of the 500 most widely held common stocks of large capitalization U.S. companies. The interpreting of the direction and potential value of the index is influenced by many factors that need to be taken into account and weighed.

Facts Managers Always Keep In Mind

- The direction and value of the S&P 500 is most closely tied to the direction and the anticipated level of earnings.
- Earnings direction is driven by economic activity.
- Economic activity is due in large part to money availability.
- Money availability Is driven by Federal Reserve policy.

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How Managers Determine Earnings Impact

Markets and Investment Managers are forward looking. They discount future expectations and earnings impact. To understand the direction of earnings you need a starting point. Information on the combined earnings of the overall S&P 500 index can be found via Google or Yahoo. The number that is presented represents the consensus earnings of all companies and is updated each week. Now comes the hard part, determining why they are changing and what level they can reach.

Each week, analyst estimates are compared to the start of the most recent quarter. Changes to revenues, margins and earnings are the items most focused on. What do Investment Managers ask when observing these changes?

Have revenues changed? And why?

- Is demand increasing / decreasing?
- Industry specific changes?
- Acquisitions?
- Major trends continuing or reversing?

Why have margins changed?

- Influence of operating or financial leverage (magnification in the change due to fixed costs in operating or financial structure).
- Productivity changes.
- Higher / Lower taxes.

Earnings

- Sales changes.
- Share buybacks reducing number of shares.

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Mutual Fund Managers' Take On Earnings Direction

Financial news is never-ending. Its range spans political, economic, industry or company specific information and is reflected in the valuation of the underlying stocks in the index. Day-to-day news influences price in the short term but ultimate valuation is based on longer term economic activity. The daily information one hears is a point in time and must be looked at over an extended period to gauge a trend. One needs to ask: does the trend show improvement or is it showing deterioration? Does it have staying power? These questions can be answered by leading economic indicators. These economic measures will indicate change before the economy moves in a particular direction and are a major influence on GDP over a number of future months.

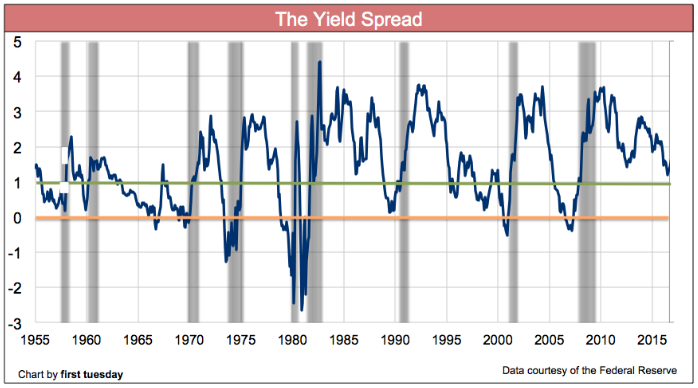
***Best examples of leading economic measures*:**

- Purchasing Managers' Index (PMI) which provides economic health of the manufacturing and services sectors. Index levels above 50 indicate expansion for a number of months.
- Leading Economic Index (LEI) or Composite Index of Leading Indicators, based on ten components of the economy (from consumer sentiment and S&P 500 Stock Index to new building permits and unemployment insurance) that taken together provide a strong indicator of the economy's direction. Typically, three consecutive monthly LEI changes in the same direction suggest a turning point in the economy.

Managers' Interpretation of Money Availability

Money availability is the grease for economic health. As monies are reduced, the ability to lend and expand business is lessened. Managers look to the yield curve for clues. Among other things, the yield curve reflects the spread between the 10-year Treasury and the fed funds rate.

- An inverted yield curve (negative spread between the Fed Funds and the 10-year Treasury) has led all recessions since the 1969-70 recessions.
- The lead time between inversion and recession has averaged 17 months.



The chart at left graphically shows tightening followed by recession (grey bar), the expansion of spread and the movement into an improving economic environment.

When the Yield curve spread increases:

- There is a greater appetite to lend by financial institutions.
- The money supply expands further which leads to continued economic growth.
- This environment has Managers look to get more aggressive and invest into more cyclically oriented companies in the technology, financial services and industrial sectors. They benefit from operating and financial leverage and typically see a higher growth rate and valuations.

When the Yield curve spread contracts:

- Lending is reduced as there is less incentive for financial firms.
- Future growth and money supply contracts are retarded.
- This period often sees a flat to downward direction in the market, during which Investment Managers tend to look to be in less cyclical industry groups and stick to companies in the healthcare, utilities, and consumer staples sectors, as their earnings are less variable and provide earnigs-per-share consistency.

Mutual Fund Managers keep an eye on the Fed

The Fed influences the economy via the money supply by buying and selling Treasury securities. When they buy securities, money is quickly put into the banking system. As money flows into banks, more money is available to lend and interest rates are driven down, helping to stimulate the economy. The exact opposite happens when the Fed sells securities into the banking system.

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As the appetite for lending contracts, the economy and GDP levels are reduced and investors prepare for potential recession. This causes the direction of the stock market to go down and managers look for safer investments. For example in 2006 the money availability influenced by the Federal Reserve increased dramatically pushing up the cost while investors in bonds that had longer maturities (+10 years) increased demand pushing down yields. This provided a warning for a recession that officially took place in 2007 prior to the financial meltdown.

Conclusion

Mutual Fund Managers make it their business to know the markets because it *is* their business. As an individual investor there are key basic principles you can learn from these professionals: the domino effect that determines future direction of earnings initiated by the interrelated connection of earnings, economy, money supply and the Federal Reserve and how this knowledge can be used to make smarter investment decisions.

HUDSON VALLEY INVESTMENT ADVISORS, INC.

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Our investment clients include: Pension Funds, Profit Sharing Plans, Foundations, Endowments, Trusts, Individual Retirement Accounts, SEP Plans, 401K Plans and Managing Customized Investment Portfolios for Individuals.

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