DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter
Q4 2010
Doucet Value Momentum Portfolio
Doucet Value Income Portfolio
Bienville Model

Groundhog Day, Kamikaze Politicians & and Sugar Highs from the Fed

October, 2010

> **"The US Economy remains almost comatose…The current slump already ranks as the longest period of sustained weakness since the Great Depression… Once in a lifetime dislocations…will take years to work out. Among them: the job drought, the debt hangover, the defense-industry contraction, the [banking] collapse, the real estate depression, the health care explosion and the runaway federal deficit."**
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> **- Time Magazine, *September 1992*.**

Reading this quote, one would assume that the best investments in 1992 would have been liquor, can goods and firearms! Today's top business stories are filled with twists on the same headlines seen 16 years ago leading up to mid-term elections: "The Jobless Recovery," "Washington Gone Wild with Taxpayer Money," "U.S. New Manufacturing Expertise - Debt, Derivatives, and Deficits," and "Kamikaze Politicians." The roar emanating from the news media today is drowning out of the quiet voices of financial prudence from yesterday.

The 2010 mid-term elections are rapidly approaching. Polls are suggesting the possibility of a repeat of the 1994 mid-term election which produced a stalemate in Washington – a Democratic President and a Republican Congress. It was "Nightmare on Pennsylvania Avenue"…right? The government actually had to shut down for a short time because of a chess match gone awry between the Executive and Legislative branches of the Federal Government. But something amazing followed: The United States Government, among other things, had budget surpluses from 1998 to 2000[1] and the S&P 500 Index rose 220% from 1995 to 2000.

Today, the pattern of recovery is more similar to recoveries of the past than investors might realize. As we suggested in our July, 2010 newsletter, every single recovery in the past 40 years followed a similar path: An initial burst of economic growth followed by a few quarters of slower activity, including intermittent "growth scares." History provides powerful clues to investors that coming months may be an excellent period for stocks, although many will miss the opportunity because they are not looking far enough back in their rearview mirrors to see the signs. Fear abounds as cash on corporate balance sheets bulge and money continues to flow into bond mutual funds and out of equity mutual funds. Businesses and investors alike sit cautiously on the investment sideline continuing to witness the epic battle occurring between a normal cyclical recovery and severe structural and policy imbalances in the United States. However, past election cycle economics, the potential for stalemate in Washington, high unemployment, fundamentally cheap equity valuations and the fact that the Federal Reserve is providing investors with a free "put" on their stock portfolios are all identifiable reasons why the current investment environment could be attractive for stocks.

Election Cycles: Third Year is the Charm

Presidential elections profoundly impact the stock market. "It is no mere coincidence that the last two years (pre-election year and election year) of the 44 administrations since 1833 produced a total net market gain if 718.5%, dwarfing the 243.3% gain of the first two years of these administrations."[2] Chief among the causes are "wars, recessions, and bear markets which tend to occur in the first half of the term; prosperous times and bull markets, in the latter half."[2] In fact, the last time the Dow Jones Industrial Average ("Dow") experienced a negative annual return in the third year of the president's term was 1940 during FDR's second term as German tanks rolled across Europe. Otherwise stated, the third year of a president's term in the past 17 consecutive terms resulted in positive performance on the Dow with an average return of 16.6%.[2] Additionally, since 1914, the Dow has gained 49.5% on average from its mid-term election year low to its subsequent high in the following year (3rd year of the Presidential term).[3] With the Dow hitting its low this year on July 2nd at 9,686, this could suggest the Dow would reach 14,481 at some point in 2011!

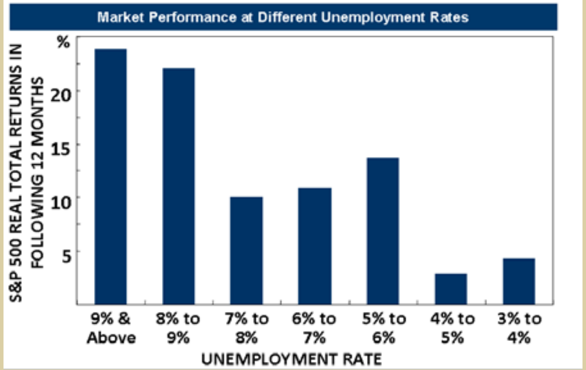
So Is Gridlock Good?

According to a recent Rasmussen Report[4], the Presidential Approval Index – the difference between the number of voters who strongly approve of the president's performance and the number of voters who strongly disapprove – recently matched a record low of -17 for the current Administration's term. This is just part of the reason it is widely anticipated that control of one or both houses of Congress will change hands in November. The politicians who backed unpopular pieces of legislation such as the Frank/Dodd Bill and the Healthcare Bill appear to have been Kamikaze politicians for those causes. Early polls predict the death of many their re-election bids and the possibility of stalemate in Washington. Since 1945, gridlock has been good for the markets. Stalemates have occurred four times following mid-term elections and the Dow has risen on average 19% in the year following those elections.[5]

Since the life cycle of a corporation – or an individual investor, for that matter – is longer than an election cycle, some level of certainty is required for them to prudently deploy capital. Stalemate, in the minds of many voters, would reduce the impact of the restraints on investment capital like healthcare costs, increased union power, a politically-guided energy policy, the fear of higher taxes…and the list goes on. In an economic environment where uncertainty wanes, both investors and businesses alike can begin to plan, spend, invest and even hire again.

High Unemployment is Good For the Market?

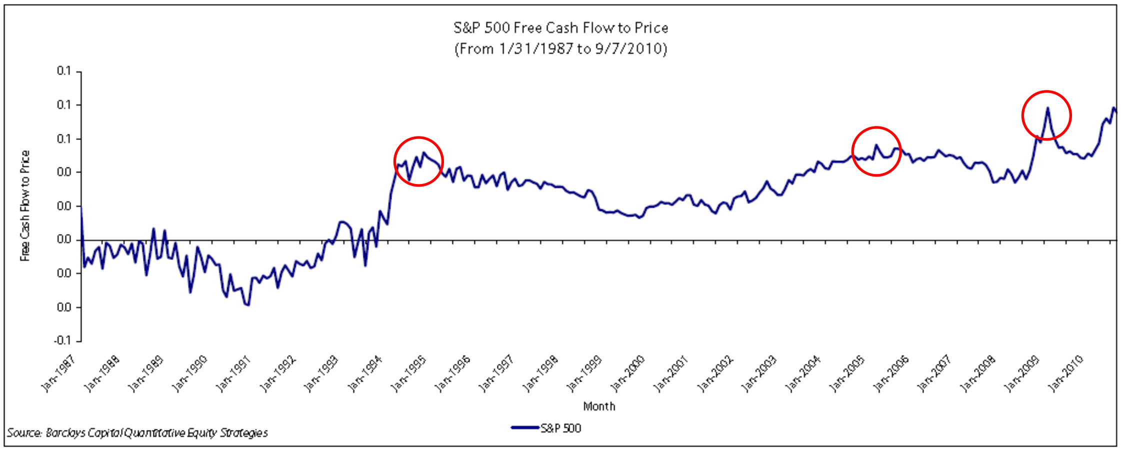
Most economists believe unemployment is a lagging indicator of economic activity, in other words, demand dries up before employers initiate downsizing their work forces. Likewise, employers must see demand come back before they will begin hiring workers again. Since the stock market is forward looking, higher unemployment is oftentimes a good buy signal for stocks. Since 1951, it has been considerably better to buy stocks when the unemployment rate is over 8% than when unemployment is 5% or lower.[6]



Attractive Valuations: Buy Low

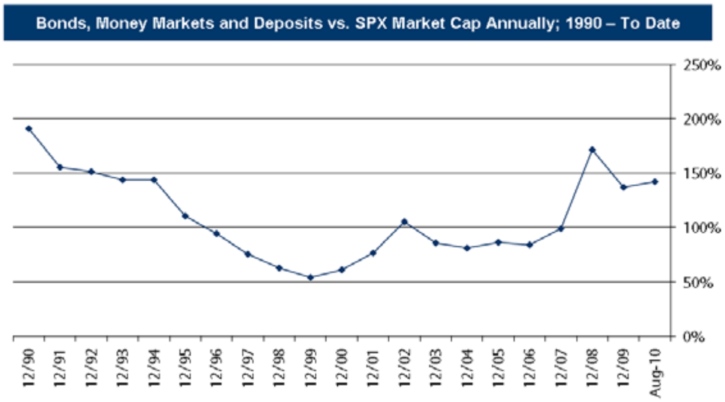
Believe it or not, there are some market tailwinds out there to counter balance the hurricane-like headwinds of the economy. If there is a silver lining to a severe downturn in the markets is it makes stocks cheaper on several fundamental levels. History suggests a more prudent entry point in stock for investors occurs when equities are "cheap" based on certain fundamental metrics and other catalysts. But are stocks cheap based on these fundamentals now? Consider the following:

- *Price to Earnings Multiple: The S&P 500 is currently valued at 12 times projected earnings for 2011, according to data compiled by Bloomberg. That is the cheapest level since 1988, excluding the six months between October 2008 and March 2009 after Lehman Brother's demise, based on forward earnings.*
- *Free Cash Flow: A company's free cash flow – the cash available after financing operations and investments, available to pay down debt and make distributions to other stakeholders – is a significant measure of a company's value. As one can see from the chart below, the ratio is currently at its highest levels since the mid 1980's. This statistic previously reached peaks in 1995, 2005 and early 2009, all very good years to be buying stocks.*


S&P 500 Free Cash Flow to Price
(From 1/31/1987 to 9/7/2010)

Source: Barclays Capital Quantitative Equity Strategies

- *Earnings Yield: Earnings yield (EY) is simply the reciprocal of the price/earnings ratio of a stock. Generally speaking, if the EY of a broad stock index is less than the rate of the 10-year Treasury yield, the stock index could be considered overvalued relative to bonds. If the earnings yield is higher, stocks might be considered undervalued. Currently, the EY on the S&P 500 Index is 8.6%. Long run average EY is 7%. The 10 year Treasury closed Oct 19th at approximately 2.5%. This may mean stocks are very cheap (relative to bonds) and might make an attractive buy now; or that investors have such a pessimistic view of the economy that they expect earnings growth to decelerate over the next few quarters (or even years).*
- *Flow of funds: Mentioned in previous newsletters, the flow of funds into bonds, cash and cash equivalents has been unprecedented. Most of the money currently flowing into bonds funds is being invested into bond funds with short average durations which helps make those assets less susceptible to interest rate fluctuations versus bond funds with longer durations. Over the past 20 years, bonds, cash and cash equivalents have represented an average of about 110% of the market capitalization of the S&P 500.[7] Currently, this level has been elevated to 150%.[7] Investors would need to purchase about $2.85 trillion worth of equities just to get the ratios back to historical norms.[7] With low trading volumes seen in equity markets, the impact of even a modest shift from bonds to stocks could have a profound effect on stock market performance.*


Bonds, Money Markets and Deposits vs. SPX Market Cap Annually; 1990 – To Date

The "Fed Put"

The Fed has recently purchased more than $1.5 trillion worth of securities (Treasuries and mortgages) in the open market through a process known as "quantitative easing." The theory behind this monetary policy tool is to increase the money supply and U.S. inflation, and aid in the recovery of the stock market. A strengthening equity market helps create a positive "wealth effect," thus restoring consumer and investor confidence so the theory goes. However, while the markets have rebounded since their lows in July, the dollar has sunk about 13% in the same time versus a basket of foreign currencies. The Fed is again sending out smoke signals that there is another round of easing coming soon which Wall Street refers to as QE2. In the short term, as long as the Fed continues to compete for paper with fixed income investors, these investors will be forced out on the risk curve and have to consider purchasing stocks, real estate and other assets to get more attractive total returns. The Fed's activities in the markets should give stock investors a level of downside protection in the immediate term and this could help create a "put" of sorts for investors on their stock portfolios. In the long run, it could bring back the fire of real inflation. But there is an old saying in Wall Street parlance, "Don't fight the Fed."

Conclusion

Every time investors think this time is new, history reminds us that economic cycles are merely "recycled." Economies recover in fairly predictable patterns, elections have similar effects on the markets, and entry points in stocks tend to be safer when unemployment peaks and stocks are fundamentally cheap by several valuation measures. In our opinion, all of these signs are positive for the market in the near term. And while there never is a perfect time to invest in equities, if this time is not different, investors who go out on the risk curve should be rewarded. So for now, don't fight the Fed.

Firm News

We are pleased to announce the launching of our new website. Please visit us online at www.doucetcapital.com. You may access past newsletters, as well as log into your accounts by clicking on client login. If you have not previously set up online access to you accounts, please contact Rebecca Purvis and she will be happy to assist you.

Chris has been chosen to serve on the Field Advisory Board of Institutional Securities Corporation, our broker/dealer. Five investment professionals were chosen to participate on the board based on his or her area of expertise. Chris brings his portfolio mangement skills and bond experience to the group. The first meeting of the board was held in Dallas at ISC headquarters on October 13th.

Sincerely,

Chris L. Doucet

Chris L. Doucet
Chief Executive Officer

Footnotes

1. Congressional Budget Office
2. Jeffrey A. Hirsch & Yale Hirsh, Stock Trader's Almanac 2010, p.130
3. Jeffrey A. Hirsch & Yale Hirsh, Stock Trader's Almanac 2010, p.78
4. www.rasmussenreports.com
5. Market Watch, "Who Cares About Gridlock?" Mark Hulbert, Oct. 4, 2010
6. Barclays Capital, BCA Research, Sept. 13, 2010
7. Barclays Capital, Simfund, Factset and FDIC, Sept. 13, 2010
8. Federal Reserve Statistics Release, Oct. 21, 2010
9. Definition: M2 represents money and "close substitutes" for money. Economists use M2 when looking to quantify the amount of money in circulation.

Admin Notes

- Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure.
- Proxy Solicitations: If you receive calls regarding proxy voting, we suggest that you inform the caller that you have delegated Doucet Asset Management full authority to vote the proxy on your behalf. Please note that we are not able to prevent these calls from being placed to you directly.

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