

Investment Strategy Group

September 1, 2010

INVESTMENT STRATEGY BULLETIN

Q: When is Valuation Irrelevant?

A: when it is based upon a projection for earnings over the next 12 months!

Our approach of equity market valuation based upon normalized or trend earnings is often challenged with the retort that it is backward looking whilst markets are forward looking “discounting machines” and so we also need to take note of the valuation of the market relative to expected earnings.

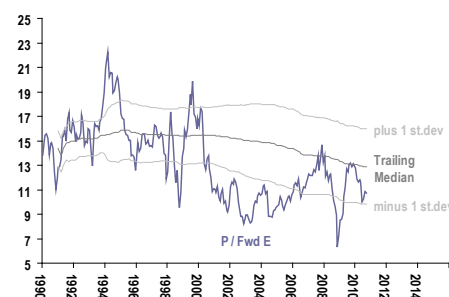
Whilst we have demonstrated previously that analysts consensus earnings expectations are an extrapolation of the recent trend, and that the exclusion of exceptional items (such as writedowns) from reported earnings that gives rise to operating (or pro-forma) earnings contain more useful information than what remains, we have given less attention to the merit of forward earnings based valuation measures. The upper chart shows the MSCI Emerging Markets Index price to 12 months forward FORECAST operating earnings: it appears in a number of reports from sell-side strategists, in various guises, and purports to show that Emerging Market equities are cheap and should be bought. Looking at the chart, Emerging Market equities do, indeed, look “cheap”, with valuation materially below the trailing median level. In the middle chart however, we show that very same price to 12 months forward earnings ratio plotted against realized index total return over the 12 months following each valuation observation: if this valuation measure was useful, the line should slope clearly downwards from top left to bottom right and the dots should be clustered around it. In fact, there is no such slope, the dots are widely dispersed and it is pretty obvious that there is no relationship at all between forward valuation and forward returns! This measure of “cheap”, proposed by many strategists and analysts, is simply irrelevant; it is no more valid as an investment tool than rainfall in the Scottish Highlands or Belgian Breakfast Cereal consumption!

The very same scatter plot for the S&P500 index clearly draws the exact same conclusion (see bottom chart): there is no statistically valid predictive relationship between 12 month forward earnings based P/E ratios and realized investment returns.

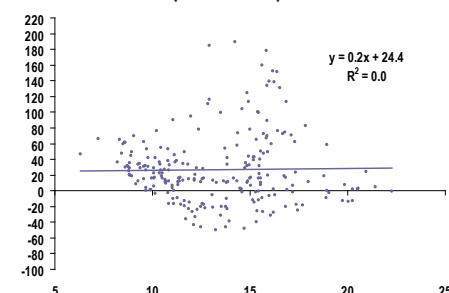
So, whilst the markets decline, and an army of analysts observe the price to forward earnings ratio declining (remember that earnings “forecasts” lag and so will only decline when actual earnings roll-over), it appears that the market is getting more and more “outrageously” undervalued with every passing day. Armed with a simple scatter plot, however, it is safe to say that an investor with a 12 month horizon would be better served ignoring valuation altogether and, instead, focusing simply on market momentum. You don’t need a Wall Street Strategist to measure that!

On the other hand, for an investor with a view over the whole cycle, 5-10 years out, a simple scatter plot of the price to trailing 10 year reported earnings versus forward real returns is far more illuminating. Measured against trend/normalized earnings, valuation has meaning and predictive power, otherwise it just seems to represent an easy way for analysts/strategists to reflect a prior view and convince themselves the market is cheap and implied returns are attractive.

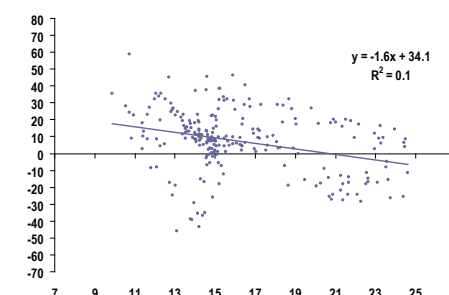
MSCI Emerging Markets Price / 12 Month FORWARD Operating Earnings



MSCI Emerging Market Index Price / 12 Month FORWARD Operating Earnings (horizontal axis) versus MSCI Emerging Markets Index REAL Total Return 12 Months FORWARD (vertical axis): 1990-2010



S&P500 Price / 12 Month FORWARD Operating Earnings (horizontal axis) versus S&P500 REAL Total Return 12 Months FORWARD (vertical axis): 1990-2010



Source: Datastream, Lombard Odier calculations

Semimonthly publication of Lombard Odier Darier Hentsch
Contacts: Investment Strategy Group

CP-PBIS-STRATEGY@lombardodier.com

IMPORTANT INFORMATION

Please see important information at the end of this document.

Lombard Odier · Investment Strategy Bulletin · August 2010

Page 1/3

IMPORTANT INFORMATION

This document reflects the opinion of Lombard Odier Darier Hentsch & Cie or an entity of the Group (hereinafter "Lombard Odier") as of the date of issue. It constitutes research, which is intended primarily for internal staff, but may be distributed upon request to certain institutional or sophisticated private investors for authorized purposes only. This document is not intended for distribution, publication, or use in any jurisdiction where such distribution, publication, or use would be unlawful, nor is it directed to any person or entity to which it would be unlawful to direct such a document.

This document is furnished for information purposes only and does not constitute an offer or a recommendation to purchase or sell any security. The opinions herein do not take into account individual clients' circumstances, objectives, or needs. Each client must make his own independent decisions regarding any securities or financial instruments mentioned herein. Before entering into any transaction, each client is urged to consider the suitability of the transaction to his particular circumstances and to independently review, with professional advisors as necessary, the specific risks incurred, in particular at the financial, regulatory, and tax levels.

The information and analysis contained herein have been based on sources believed to be reliable. However, Lombard Odier does not guarantee their timeliness, accuracy, or completeness, nor does it accept any liability for any loss or damage resulting from their use. All information and opinions as well as the prices indicated are subject to change without notice. Past performance is no guarantee of current or future returns and the client may consequently get back less than he invested. Performance data of mutual funds do not take into account the commissions and fees charged on the issue and redemption of the units or shares.

The investments mentioned herein may be subject to risks that are difficult to quantify and to integrate into the valuation of investments. Generally speaking, products with a high degree of risk, such as derivatives, structured products, or alternative/non-traditional investments (Hedge Funds, private equity, real estate funds, etc.) are suitable only for sophisticated investors who are capable of understanding and assuming the risks involved. Upon request, Lombard Odier is available to provide more information to clients on risks associated with specific investments.

If opinions from financial analysts are contained herein, such analysts attest that all of the opinions expressed accurately reflect their personal views about any and all of the subject securities or issuers. In order to ensure their independence, financial analysts are expressly prohibited from owning any securities that belong to the research universe they cover. The description of the rating system used by Lombard Odier for its financial research is available on www.lombardodier.com.

United Kingdom: UK regulation for the protection of retail clients in the UK and the compensation available under the UK Financial Services Compensation scheme do not apply in respect of any investment or services provided by an overseas person. This document has been approved for issue in the UK by Lombard Odier Darier Hentsch (UK) Limited (LODH (UK)), Queensberry House, 3 Old Burlington Street, London. W1S 3AB. LODH (UK) is authorised and regulated by the Financial Services Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS. LODH (UK) does not provide tax advice.

This document may not be reproduced (in whole or in part), transmitted, modified, or used for any public or commercial purpose without the prior written permission of Lombard Odier.

Media: Lombard Odier would like to offer you for your information the enclosed Investment Strategy Bulletin.

In connection with the use of the enclosed document Lombard Odier kindly draws your attention to certain particular items/conditions. The information sent is for your personal information only. In case of quoting please cite Lombard Odier in no other capacity than as source of information only. For the sake of good order Lombard Odier would like to remind you that responsibility regarding quoted content and compliance with applicable regulations rests with you. The information provided does not constitute the provision of investment advice or an offer of any financial services especially not to the public. Lombard Odier kindly reminds you that further distribution of the received document to third parties without its prior written consent is prohibited.

© 2010 Lombard Odier Darier Hentsch & Cie – all rights reserved.

SWITZERLAND

Geneva

Lombard Odier Darier Hentsch & Cie
Private Bankers regulated by the FINMA.
Rue de la Corraterie 11 · 1204 Genève · Suisse

Fribourg

Lombard Odier Darier Hentsch & Cie, Bureau de Fribourg
Rue de la Banque 3 · 1700 Fribourg · Suisse

Lausanne

Lombard Odier Darier Hentsch & Cie
Place St-François 11 · 1003 Lausanne · Suisse

Lugano

Lombard Odier Darier Hentsch & Cie, Agenzia di Lugano
Via Vegezzi 6B · 6900 Lugano · Svizzera

Vevey

Lombard Odier Darier Hentsch & Cie, Agence de Vevey
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse

Zurich

Lombard Odier Darier Hentsch & Cie
Utoquai 31 · Postfach 1457 · 8032 Zürich · Schweiz

EUROPE

Amsterdam

Lombard Odier Darier Hentsch & Cie (Nederland) N.V.
"Weteringspoort" Weteringschans 109 · Postbus 58007 · 1040 HA Amsterdam · Nederland
Holds a bank license from De Nederlandsche Bank and is registered with the Autoriteit Financiële Markten.
E-mail: amsterdam@lombardodier.com

Brussels

Lombard Odier Darier Hentsch & Cie (Belgium) S.A.
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
Bank supervised by the Banking, Finance and Insurance Commission.
E-mail: brussels@lombardodier.com

Düsseldorf

Lombard Odier Darier Hentsch Deutschland, Niederlassung von Lombard Odier Darier Hentsch & Cie (Nederland) N.V.
Düsseldorf-Stadt · Stadttor 1 · 40219 Düsseldorf · Deutschland
Branch of Lombard Odier Darier Hentsch & Cie (Nederland) N.V. regulated by De Nederlandsche Bank and the BaFin.
E-mail: dusseldorf@lombardodier.com

Gibraltar

Lombard Odier Darier Hentsch Private Bank Limited
Suite 921 Europort · P.O. Box 407 · Gibraltar
Bank supervised by the Gibraltar Financial Services Commission (FSC).
E-mail: gibraltar@lombardodier.com

London

Lombard Odier Darier Hentsch (UK) Limited
Queensberry House · 3 Old Burlington Street · London W1S 3AB · England
Wealth Management Services company authorized and regulated by the Financial Services Authority (FSA).
E-mail: london@lombardodier.com

Madrid

Lombard Odier Darier Hentsch & Cie (España) S.V., S.A.
Paseo de la Castellana 66 · 28046 Madrid · España
Investment company supervised by the Comisión Nacional del Mercado de Valores (CNMV).
E-mail: madrid@lombardodier.com

Moscow

Lombard Odier Darier Hentsch & Cie – Representative Office Moscow
82 Sadovnicheskaya Street · 115 035 Moscow · Russian Federation
E-mail: moscow@lombardodier.com

Paris

Lombard Odier Darier Hentsch & Cie (France)
8, rue Royale · 75008 Paris · France
Investment company approved by the Comité des Etablissements de Crédit et des Entreprises d'Investissement (CECEI).
E-mail: paris@lombardodier.com
Lombard Odier Darier Hentsch Gestion
8, rue Royale · 75008 Paris · France
Portfolio management company approved by the Autorité des Marchés Financiers (no. GP 01-011).
E-mail: paris@lombardodier.com

Prague

Lombard Odier Darier Hentsch & Cie – Representative Office Prague
Praha City Center · Klimentůvská 46 · 110 02 Praha 1 · Czech Republic
E-mail: prague@lombardodier.com

MIDDLE EAST, AMERICAS, ASIA | PACIFIC

Bermuda

Lombard Odier Darier Hentsch (Bermuda) Limited
Lombard Odier Darier Hentsch Trust (Bermuda) Limited
3rd Floor, Victoria Place · 31 Victoria Street · Hamilton HM 10 · Bermuda

Dubai

Lombard Odier Darier Hentsch & Cie – Representative Office Dubai
The Fairmont – 25th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE

Hong Kong

Lombard Odier Darier Hentsch (Asia) Limited
1501, Two Exchange Square · 8 Connaught Place · Central · Hong Kong

Montreal

Lombard Odier Darier Hentsch (Canada), Limited Partnership
1000 Sherbrooke Street West · Suite 2200 · Montreal (Quebec) · Canada H3A 3R7

Nassau

Lombard Odier Darier Hentsch Private Bank & Trust Limited
Goodman's Bay Corporate Centre · West Bay Street · P.O. Box N-4938 · Nassau · Bahamas

Singapore

Lombard Odier Darier Hentsch & Cie (Singapore) Ltd.
9 Raffles Place · Republic Plaza #46-02 · Singapore 048619

Tokyo

Lombard Odier Darier Hentsch Trust (Japan) Limited
Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan