



INVESTMENT COMMENTARY

“CONCERN IS WARRANTED, BUT OUR POSITIVE LONG-TERM OUTLOOK REMAINS INTACT”

7/19/10

It has been just under three months since our last commentary outlining our investment philosophy and outlook. Quite a bit has happened since then. The BP Gulf of Mexico leak has become a tragic headline story. European sovereign debt concerns have escalated. China has moved aggressively to curb inflation in its property markets. Significant financial regulation legislation has been negotiated and is about to be signed by the President. And the S&P 500 has dropped approximately 9%.

This market decline is understandable considering these issues. However, other equally important things have also changed for the better. The stock market, already inexpensive by historical standards, has become even more so. The forward four-quarter price/earnings multiple for the S&P 500 has declined from 13.7x to 12.2x. This wasn't just driven by lower prices, but also by increasing corporate earnings estimates, which are up approximately 2.5% since April.

Sentiment has also turned decidedly bearish, which as I mentioned in our last letter is a very good thing. As Warren Buffett likes to say “buy fear, sell greed.” Depending upon which sentiment indicator you look at, we haven't seen this level of pessimism since the spring/summer of 2009.

Finally, liquidity remains very favorable and should remain so at least into the November mid-term elections. There has been no change in the Federal Reserve's communications about its currently very accommodative monetary policy.

So while there are many technical indicators signaling sell, for intermediate to long-term value investors like us, our bullish conviction remains intact.

Despite this view, we recognize that the U.S. stock market has declined for specific reasons. In addition to the issues listed above, some recent economic indicators have softened and employment remains

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stubbornly subdued. In fact, a leading economic forecasting firm that we monitor has indicated a double dip recession is a real possibility. At today's currently depressed price/earnings multiple, we believe much of this risk is already priced into equities; however, we have taken pro-active steps over the past month to raise some cash in preparation for a potential double dip.

Let me close by discussing the over-weight position we currently have in emerging markets that I previously mentioned. Although it definitely merits further discussion, in the spirit of keeping these letters short, I will quickly summarize our rationale.

Two of our most important metrics when evaluating investment opportunities across equity markets are price/earnings relative to earnings growth, and price/earnings relative to bond yields. This essentially measures how expensive equities are compared to their growth rates and compared to a fixed income alternative.

Based on these two indicators, U.S. equities compare favorably with worldwide medians. For example, the US MSCI index (an index which allows us to compare global equity markets consistently) traded last week at an 11.5x price/earnings multiple and forecast earnings growth of 22.4%, resulting in a PEG (price/earnings divided by earnings growth) ratio of 0.51. The worldwide median is 0.52, so the U.S. equity market is slightly less expensive than the median. When comparing the U.S. price/earnings multiple to its long-term government bond rate, you get the same relative performance. It is slightly less expensive than the worldwide median. Isolating these two indicators, the U.S. equity market offers a slightly better than median investment opportunity relative to other world markets.

However, there are several international equity markets, particularly in Asia, that perform much better on these important metrics. When you also consider these markets operate in relatively stable countries with far superior balance sheets and budget outlooks than the U.S., therefore reducing sovereign credit and inflation risk, you can begin to see why we believe this over-weighted position is warranted.

With that, we wish you a relaxing and enjoyable summer. If you would like more information on any of the topics discussed in this letter, please do not hesitate to give us a call.

By:
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