Advisor

Newsletter
2nd Quarter 2010

Correction… No one likes (a) Correction

The stock market recorded its first serious correction since bottoming in March 2009 with the S&P 500 falling by 11.4% during the quarter. Selling was indiscriminate affecting all market capitalization sizes, geographical regions, and investment styles to about the same degree. Our conservative approach helped most of our equity portfolios outperform our benchmark by 2.5% or more. The quarter was marked by a significant increase in volatility highlighted by the 'flash crash' on May 6th. Our portfolios experienced much less volatility, and while we never like to report losses, we were pleased that most equity portfolios captured only about 60% of the decline that began in late April.

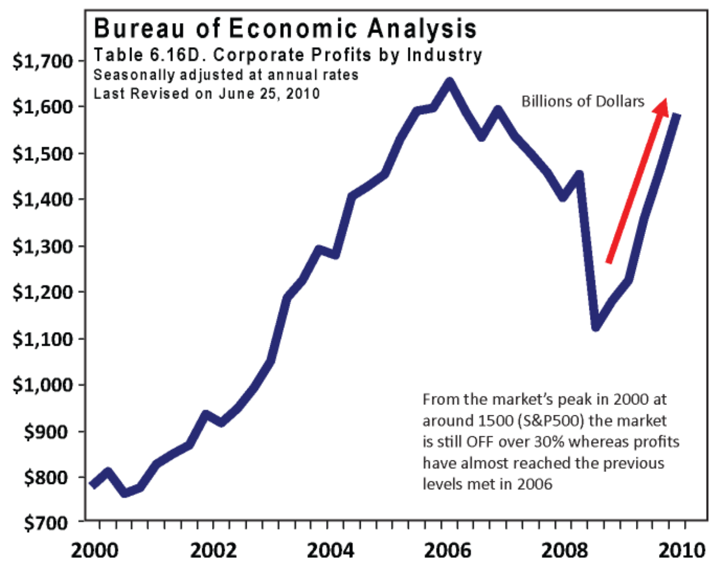
The theme of the last few quarterly reports was "caution" as we expected the long-term challenges of the global economy to disrupt the stock market advance. ***Our current theme is one of opportunity.*** First, however let's survey the bad news. The biggest obstacle to growth is worldwide deleveraging, which unfortunately will be played out over many years. The catalyst last quarter, refocusing investors on this risk was the European debt crisis that started in Greece . Domestically unemployment will stay high, the housing market will limp along for many years, and state and local governments will cut spending and raise taxes to balance their budgets, as will the Federal government eventually. All of these conditions will cause our markets to be volatile and growth to be sub-optimal.

Fortunately, the economic news isn't all bad. Manufacturing, instead of consumption, has been the bright spot which is a welcome change from past upturns. The stock market was disappointed with June's ISM (Institute of Supply Managers) reading of 56.2, but this number is still consistent with annual GDP growth of 4%. The transportation industry –truckers, railroads, and package delivery companies- are all showing positive trends which is not consistent with a double dip recession that is worrying the markets. There is even more robust earnings dynamics from emerging economies, Australia , and Canada . Even parts of Europe are doing well. German firms are boosting investment, with more firms planning to create jobs than reduce them for the first time in two years, according to the DIHK German chambers of commerce. U.S. business investment appears to be on the upswing as well. A recent survey by CFO Magazine found that companies expect capital spending to increase by 9% over the next year compared with 1.5% in December. Finally, while a lot of attention gets focused on our debt burden, the U.S. is still a very wealthy nation. Household net worth—the value of houses, stocks and other investments, ***minus debts***—stands at $54.6 trillion. So while overall it appears the economy has lost some momentum in recent months it is still positive and is certainly not collapsing.

Liquidity could positively surprise investors in the second half of 2010. According to research firm Preqin, U.S. focused buyout firms have a record $280 billion in unallocated capital that firms generally agree to invest within five years or return to investors. Globally the figure is estimated to be as high as $492 billion. Our guess is that this money will be spent. A pickup in takeover activity could lift investor's spirits.

The most important criteria determining whether or not stocks are good values is price. The economy was ideal in 2000 but stocks were no bargains because prices were too high. Today despite the many challenges stocks appear very attractive because of low prices and strong balance sheets. What the enclosed charts show is that while the stock market is still more than 35% below its '07 peak Corporate profits have recovered most of its decline since its peak in 2006.

U.S. companies have a record $1.84 trillion of cash on their balance sheets according to the Federal Reserve. Best of all, they are starting to share the wealth with investors. According to Standard & Poor's so far this year 135 companies have raised, initiated or reinstated dividends, while only two companies have cut them.



We took advantage of the opportunity due to the market correction to buy companies with steady-growth, strong balance sheets, healthy dividends, and exposure to emerging economies. **Many high-quality stocks with likely growing earnings are trading at only 10x-12x 2011 earnings and are yielding more than the 10-year U.S. Treasury Note.** Our advice is to ignore the volatility and stick with bargain Blue Chip stocks.

Be sure to contact us if you have any questions.

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