

Portfolio Insight

1st Quarter 2009

“It’s different this time...”

These are famous words, attributed to investing legend Sir John Templeton, who described them as the four most dangerous words in investing. His “it’s different this time” warning is worth consideration. In some respects, it is certainly correct. For example, the markets will always be subject to periods of excessive pessimism and optimism. Similarly, economies will always experience cycles of contractions, recessions, recoveries and expansions. However, both between and within those economic and market cycles, there are always differences from previous ones. Occasionally, those differences are significant. We believe this is one of those times.

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A little perspective is in order. In the mid-1960’s the Johnson administration departed from the relatively restrained US fiscal policies in place since WWII when it enacted several major government social programs, dubbed the “Great Society”. At the same time, the US expanded its role in Vietnam. Over time, this ‘guns and butter’ policy led to significant government borrowing which combined with loose monetary policy to result in a long period of economic instability and inflation throughout the 1970’s. It was the era of Keynesian economics, as Richard Nixon so famously declared. This ended in the early 1980’s when tight monetary policy by the Paul Volcker-led Federal Reserve and supply-side economic policies of the Reagan administration led to the end of high inflation. That success set in motion a very long and relatively steady economic expansion accompanied by unprecedented bull markets in both bonds and stocks.

The US economy performed far differently in these two periods, as did the fixed income markets and the stock market. In the first period, 1965-1981, annual CPI inflation rose dramatically from 1.6% to a high of 14.8% in March, 1980. Ten-year treasury rates rose from 4.1% in 1965 to 15.8% by September, 1981. This rise in interest rates created negative inflation-adjusted returns to bond holders. In the next period, inflation fell from the March 1980 peak of near 15%

to an annual low of 0.0% in January 2009. Ten-year treasuries declined in yield from near 16% to just over 2% in December 2008. Contrary to the experience of bond holders in the 1960’s and 1970’s, bond owners in the following decade and afterward made significant nominal and real returns. This pattern held true for equities as well. From 1964 to 1981, the S&P 500 returned about 7% per year. From 1982 through 2000, it returned about 19% per year. From an investor’s point of view things were certainly different during these two distinct periods in US economic history.

It is debatable whether this era of robust economic growth and bull markets ended in 2000 or 2007. Suffice it to say, economic conditions have deteriorated since 2000. Responses to 9/11 and Hurricane Katrina, combined with an LBJ-like ‘guns and butter’ policy of big spending for two war zones, the Medicare Part D drug benefit, and sizeable tax cuts set the US on a course of burgeoning budget and trade deficits. At the same time, the Federal Reserve ‘easy money’ policy, as well as actions by Congress, the financial services industry and consumers all contributed to the multiple economic problems we, and the world, now face.

As we said earlier, things are likely to be different again.

LENDING & SPENDING – SO YESTERDAY

As part of our research process, we look at equities from both a macro and a company-specific view. As part of that macro view we look at the economic cycle, politics, regulation, social phenomena and scientific/technological innovations. We believe there are significant changes from the past twenty-five years occurring in each of those areas.

Economic

Unlike the period from 1981 to 2000 when the US experienced two recessions in twenty years, this decade we have experienced two recessions in the brief span of seven years. The current one began with bubbles in property values and consumer debt. After administering massive doses of monetary stimulus post-9/11, the Fed took away the punch bowl starting in 2004. But when it tried to spike the punch again last year to revive the economic party, it found few

consumers with a desire to partake. Banks were unwilling to serve the punch, even to each other. Debt levels were and still are too high, collateral values seemed too risky, and/or the ability of borrowers to repay was questionable. We believe the Fed's recent unprecedented efforts to both aid and circumvent the banks will eventually get the economy moving, but we think only at a tepid pace. Consumers are now deleveraging and will continue to do so for some time. Here is a major departure from prior recessions: the consumer is not in a position to lead the economy back to health.

One thing that has not changed is the paradox of thrift: savings are the basis for an individual's financial wellbeing, but in order to grow the economy now, we must neither save too much nor too abruptly. In order to counteract the effects of a retrenching consumer, Washington has passed a massive stimulus and investment program, moving back toward the Keynesian economic theory. In addition, large budget deficits are planned for several years. While they are indeed troubling, we must admit they are not much different from Washington's usual approach to problem solving.

Political

The election of Barack Obama and a Democrat-controlled Congress assure the political scene is clearly different, especially when viewed against years of actions influenced by Ronald Reagan's election in 1980 and continued by the succeeding three presidential administrations under both Republican and Democratic controlled Congresses. This largely laissez-faire approach to the economy, with deregulation, anti-labor union policies and unfettered free trade as economic centerpieces, is now being called into question by Congressional Democrats.

Our country, and indeed the world, is faced with significant challenges due in large part to uncontrolled leverage, new, unregulated financial instruments and the lack of effective risk controls. In fact, American-style capitalism has become the object of vociferous criticism throughout some of the world's economies, including China, Brazil and much of western Europe.

It is clear that the tone of the US has swung from the conservative principles established by Reagan to a more liberal agenda. We expect a more populist environment in Washington, which may be less friendly to business interests.

Regulatory

We can count on another change: re-regulation, the antithesis of the past twenty-eight years. Financial services will not be the only industry impacted, but it will surely be the most changed, and with the greatest affect on the economy. We expect comprehensive re-regulation in order to prevent the reckless excesses

that occurred in the past decade, causing both asset and credit bubbles. The regulatory changes are likely to reduce risk-taking by banks, hedge funds and other financial institutions for years. This will contribute to the slow economy we anticipate, but it may also be a more stable one.

Social

Demographics have been a major economic factor over the past half century, although the effect is often not evident. Unlike the past fifty years, when they were a positive economic stimulus, demographic trends will now become a drag on the economy. Over the past year or so, the leading edge of the Baby Boom generation entered early retirement at the age of 62. Therefore, many are now contributing less to the nation's tax revenues and are drawing on social security. This will continue unabated for the next 20+ years. Baby Boom births in the U.S. peaked in the late 1950's. Statistics tell us that peak spending years for most people are ages 45-50. For Baby Boomers, 2007-2009 is when the largest number of boomers will turn 48-50, the later stages of the highest spending years. Baby Boomers will become smaller contributors to the growth of our economy.

There are now aging populations in the U.S., Europe, Russia, China and Japan—and very young, growing populations in Indonesia, India, Brazil, Mexico, and the African continent. The U.S. is better off than the other 'aged' countries, as we have higher immigration, both legal and illegal, which has brought in younger workers. A positive factor is that the younger 'post boomer' generations are in the midst of an 'echo' baby boom. Births in 2008 in the US were at an all time high. This will be helpful in 15-20 years, when these children become adults and enter the work force. In the meantime, their needs and demands will drive societal changes as surely as their grandparents did at the same age.

Science /Technology

In our 3rd Quarter 2006 Review & Outlook we wrote an article captioned "Where's the Growth? – Not in the Rearview Mirror". We believe in its message just as much now as we did then. At the time we underscored our belief that the U.S. was headed for a prolonged period of below-trend economic growth and that delivering above average equity returns going forward would require adding to portfolios a dose of scientifically innovative companies that because of unique competitive advantage were likely to grow their earnings faster than the market.

We believe a similar commitment to innovation is shared by members of the Obama administration's economic team as well as the President himself. In a recent speech outlining his budget proposal President Obama underscored improved public education, cost-effective health care, energy efficiency and deficit reduction as key components of his long-term economic recovery plan.

The stimulus bill passed in February 2009 put rhetoric into action with increased funding for the National Institutes of Health as one example. NIH funding has grown only 1% a year in recent years, after climbing 14% annually from 1997-2003. According to healthcare investment banker Leerink Swann, under the stimulus bill NIH funding could potentially increase \$6.5 billion and \$10 billion over the next two years, respectively. This would represent 20% increases each year.

Innovation can, and must, cause us to be a more productive economy. This is the way to deal with our trade and budget deficits, and our national debt. The alternative is a lower standard of living due to economic stagnation and/or high inflation. We can't rely on government spending programs to keep our economy growing. The fiscal stimulus plan includes some tax breaks, some government spending programs, and some transfer payments, particularly help for the unemployed. Infrastructure, such as roads and bridges, gets many headlines. We believe innovation and science are getting more attention—and more money, on a proportionate basis. These last two areas in particular are part of our current investment thesis and now represent up to 30% in fully discretionary portfolios assigned to our Growth Equity strategy

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The stock market has moved up over the past several weeks. We are cognizant that the global economic landscape continues to be cloaked in deep fog, with the possibility of a fiscal, monetary, or political misstep still present. However, in recent days, we see a few ‘green shoots’ in several leading economic indicators in the US. We are focused on analyzing industries and companies to find those that benefit from the longer term changes we have discussed and can successfully create their own path forward.