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Portfolio Insight

3rd Quarter 2010

Overview

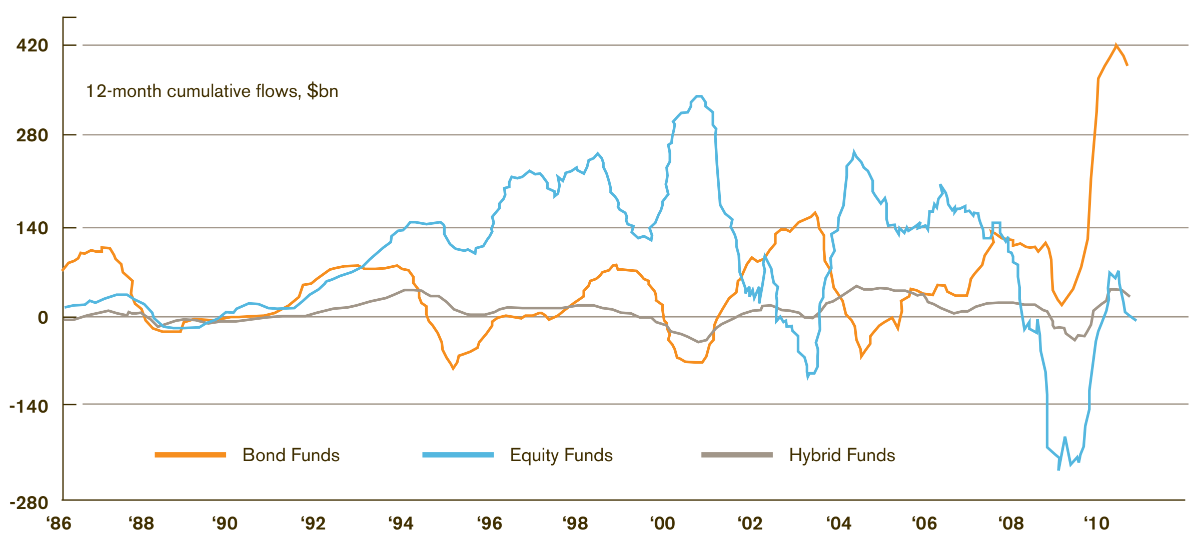
The US stock market has meandered this year reflecting general expectations of an economic slowdown in the second half of the year and into 2011. Monetary and fiscal stimulus efforts initiated in 2008 and 2009 that contributed to an economic recovery in late 2009 and early 2010 off an extremely depressed level waned by mid-year 2010. Such stimulus produced a temporary, subsidized demand for cars and homes plus some inventory restocking. Domestic aggregate demand, however, remains weak. The Federal Reserve has essentially run out of responsible policy options with which to stimulate the economy. Central banks can impact long-term price stability, short-term cyclical swings, and short-term financial crises as lender of last resort. However, they are not well-suited to stimulating long-term real economic growth.

"We believe this long period of valuation convergence has created a condition where the long-term relative performance between equities and bonds is much more favorable for the former."

The large fiscal stimulus package initiated by President Obama has had some positive effects on the economy. The National Bureau of Economic Research recently declared that the recession ended in June 2009 which was coincident to the implementation of the stimulus. Given the benefit of the stimulus but the clear future debt obligation, the American public and business sector no longer seem willing to depend on Keynesian stimulus for growth. The debt levels accumulated over the years by the federal government have created an economic and political lightning rod as we move toward the November mid-term elections. Most pundits agree that Republicans will make significant gains in Congressional seats. Recent departures of three key administration economic advisors, plus the possible departure of the White House Chief of Staff, may result in policy shift by the White House. These changes could result in a slowing, perhaps even a change, of fiscal and regulatory policy from Washington.

We believe such a change would be well-received by investors and business. It may not result in a strengthening of the recovery, nor an immediate improvement in the jobless situation in the country.

MUTUAL FUNDS: NET CASH INFLOWS



Source: Investment Company Institute, Haver Analytics, Credit Suisse

Consumer deleveraging is going to be a significant drag on the economy for a long time. In addition, state and local governments need to deal with their own deficits and unfunded pension obligations which will also impede growth. However, the business sector is in good financial shape and may see a new political environment more to their liking if it results in fewer costly programs and new burdensome regulations.

The Case for Equities

Investors have seen the weak economy as one of several reasons to reduce equity exposure. Two major bear markets within ten years and, for some, the loss of confidence in the fairness of the stock market, have also greatly reduced retail investors' appetites for volatility. For the past decade, equity returns as measured by most broad indices have been negative with high volatility. From August 31, 2000 through August 31, 2010, the S&P 500 index return was -1.8% per year. Growth stock returns as measured by the Russell 1000 Growth index were even worse at -5.4% per year. The returns from fixed income as measured by the Merrill Lynch Corporate & Government index rose 6.5% for the same period.

"We like quality, but we do not measure quality by market capitalization or dividend yield."

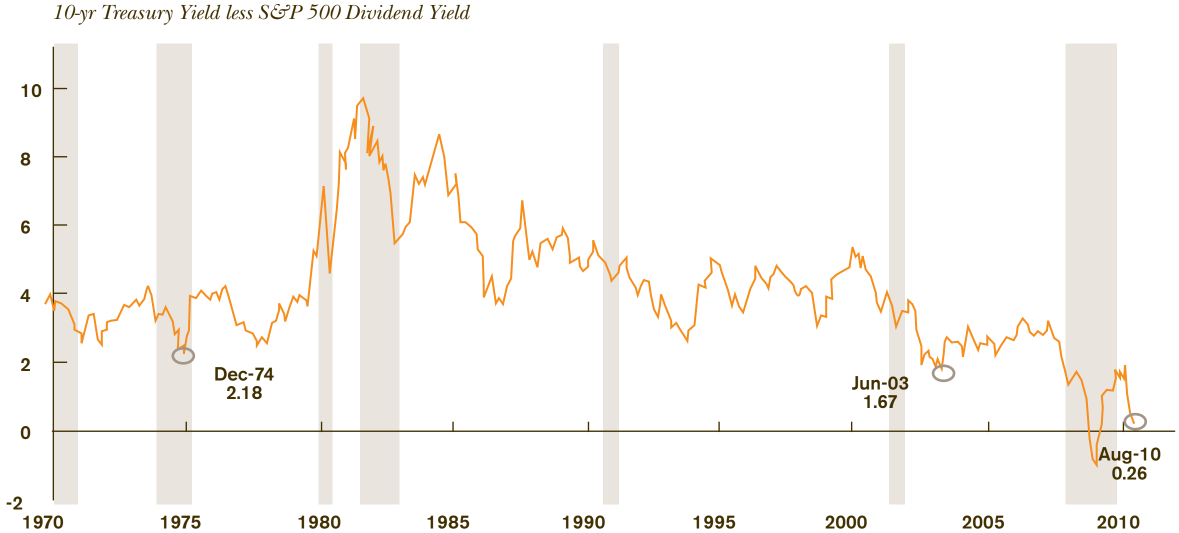
One key differentiator of returns among these asset classes was the high dividend/interest yields of the winners. After the most recent bear market, investors have increasingly decided to go with what has worked. Millions of people approaching retirement age have lost much of their wealth as measured by their securities holdings and the equity in their homes. In response, they have sought the yield and perceived stability and safety of bonds and other high-yielding securities. According to Credit Suisse and the Investment Company Institute, net inflows into bond funds were $387 billion in the twelve months ended June 2010. This was below the peak of $413 billion in the March 2010 quarter, but these readings are among the highest in ICI's 25 years of records. Conversely, net new money into equity funds during the twelve months ended June 2010 amounted to a paltry $1.7 billion. Federal Reserve policy rates of near zero percent have further driven investors from money market instruments into long-term, high yielding securities. This abnormally high demand for income has driven interest rates on treasury bonds and high grade corporates to at or near all-time lows.

It is not just retail investors who have increased allocations to fixed income. Institutions such as pension funds and others have also done so. In most cases, public pension plans have set unrealistically high required rates of return which they must earn to avoid increased funding requirements which politicians are now unable or unwilling to provide. These rates of return must be earned despite their requirement of maintaining specific levels of bond holdings which now have very low yields. In an effort to achieve required rates of return, these institutions are reducing their holdings of US equities and allocating the proceeds to securities in emerging markets, private equity, commodities, and structured derivative products. These actions seem to us like investment driven by need and hope, and even perhaps a touch of desperation.

The largest contributor to the poor relative performance of the broad stock indices, particularly growth stocks, over the past ten years was the high valuations that existed as the decade began. The earnings yields (inverse of the price/earnings ratio) on the Russell 1000 Growth Index (RLG) and S&P 500 (SPX) were approximately 2.1% and 3.6% at December 31, 1999. The yield on the 10-year treasury was 6.4%. At August 31, 2010, the earnings yields on the RLG and SPX had risen to approximately 6% and 8% while the yield on 10-year treasuries is now 2.7%. As the chart below indicates, the dividend yield on equities is now comparable to U.S. Treasury yields.

S&P RECORD CHEAP RELATIVE TO TREASURIES

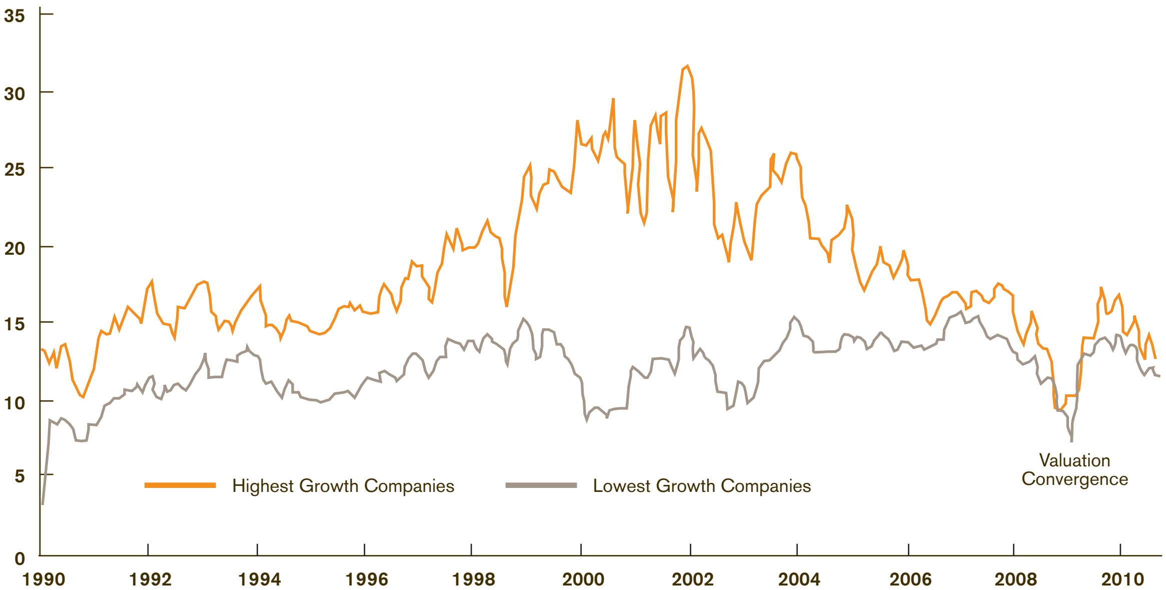
10-yr Treasury Yield less S&P 500 Dividend Yield



Source: FactSet. Thomson Financial. Morgan Stanley Research

VALUATION CONVERGENCE: NO PREMIUM FOR GROWTH

S&P 500: Average FY2 P/E by Long-Term Growth Estimate Quintile



We believe this long period of valuation convergence has created a condition where the long-term relative performance between equities and bonds is much more favorable for the former.

If stocks are attractive now, what kind of stocks should be owned? While the unusually high demand by some investors for income securities is understandable, we believe it is creating an unusually attractive opportunity for long-term investors willing to invest in growth stocks. There are numerous high quality, attractively-priced growth companies which have dividend yields above their debt yields. For example, AAA-rated Johnson and Johnson (JNJ) recently sold $550 million of 10-year notes at 2.95% and the same amount of 30-year bonds at 4.5%. At the same time, JNJ shares offer a dividend yield of 3.7%. Over the past seven years the company has grown its revenue and earnings per share over 7% and 8% annually. The shares are selling at their lowest P/E ratio (13x) since 1994, with the lone exception of the early 2009 bear market bottom. This multiple is down from 31x in early 2000. As the chart above indicates the valuation gap between high-growth and low-growth companies has closed. Investors are no longer paying a premium for growth.

The current consensus recommendation of equity bulls is to buy high quality companies, especially those which pay good dividends. These companies typically produce high returns on capital and have strong balance sheets which provide financial strength and flexibility with which to survive tough times. The largest companies are usually mentioned. We agree with consensus that these are good qualities to own at this time. Our JNJ example bears this out.

However, we disagree with broad statements which imply smaller companies should be avoided, as though all companies within a class of equities are monolithic. We like quality, but we do not measure quality by market capitalization or dividend yield. We prefer to invest in companies which we believe have the opportunity to grow despite the slow growth environment we expect in developed economies. Many of those companies typically have a culture and history of innovation. There are many emerging companies that have a global reach with which to access the higher-growth geographies of the world.