Portfolio Insight

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The stock market provided a moderate gain for 2007 with the S&P 500 up 5.5%, yet declined in the fourth quarter with the S&P 500 down 3.3% as several fears reverberated through the market. Recent weakness in the stock market has been driven largely by four factors: 1) mortgage-related credit stresses; 2) a weak dollar; 3) concern about possible recession; and 4) fears of inflation. We will address these fears in this letter and provide a view of how Chilton structures portfolios to mitigate these and other risks.

Mortgage-related Credit Stresses

Mortgage-related credit stresses are fodder for the front page of the Wall Street Journal. The crisis of confidence in the credit markets stems from an information deficit as much as real financial issues. The lack of clarity in some American and foreign financial institutions stems from: inadequate disclosures about mortgage-related financial instruments, off-balance sheet assets, complex financial engineering, and subpar risk controls. The Fed and a coalition of European central banks are, in separate but coordinated efforts, turning the credit spigot in order to restore the 'fabric of confidence' to the credit markets. Easier credit availability is expected to minimize the spillover effect from the subprime mortgage crisis into the real economy.

Weak Dollar

A weak dollar is aggravating the impact of higher oil and imported goods prices on the consumer, but delivering enhanced earnings via more competitive exports and currency translation for many US companies selling abroad. As such, this issue is likely as much a positive for some sectors of the US economy as it is a negative for others. A weak dollar also makes investing in dollar assets unattractive to foreign investors. After six years of a weakening dollar, 2008 may bring a more stable dollar.

Recession Concerns

Recession concerns are palpable among investors and news commentators. In the past two months, the US stock market has suffered a 10% correction, the first one since 2002, but only one of 45 since 1945. This compares to ten actual recessions in the real economy post WWII. Recessions are typically accompanied by overbuilt inventories or the hangover of excessive capital investments made during the previous economic expansion. However, except for the housing sector, there is little sign of excess business capital spending in the U.S. and inventories appear lean, driven by just-in-time manufacturing processes. As a result, the manufacturing sector is unlikely to be the leader of a possible recession.

It is far more likely that the consumer services and goods sector—now 70% of the US economy and already bedeviled by slumping sales in housing and apparel retailers—could be the catalyst for recession. Falling house prices, stalled new home sales, and layoffs by builders indicate a clear recession in the housing industry, especially in Las Vegas, California, and Florida, although there are pockets of problems in nearly every state. The U.S. has experienced regional and industry specific recessions in the past (the oil bust of

the 80's in Texas; the collapse of the aerospace and defense industries during the 'peace dividend' period) that did not spill over into national recessions.

The reality is that recessions are only identified well after their onset; if we are in one, then we are already partly through it.

This does not mean that consumer conditions can not worsen. We have pointed out that consumers hardly felt the last recession, as their capacity to spend was helped by significant tax cuts, easy credit, and falling interest rates. Now the benign consumer cycle may be running in reverse. Further tax cuts are unlikely; indeed, many are scheduled to expire in the coming years, raising taxes automatically. Credit markets are tight and interest rates are unlikely to fall as far as they did after 9/11. The Fed has learned a lesson about easy money, as it bears partial responsibility for the current subprime lending crisis. Americans are likely to have to cinch their belts in the days ahead, pay down debt, and refocus on savings, after a very long shopping spree. Since 1982, real consumer spending has increased every year. Debt service as a percentage of disposable income at 19% is now at the highest levels since World War II, and the official savings rate is near zero. The end result is that readjustments in consumption are needed. However painful in the interim, the adjustments will lead to a much needed correction in an imbalance in the economy.

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Inflation Fears

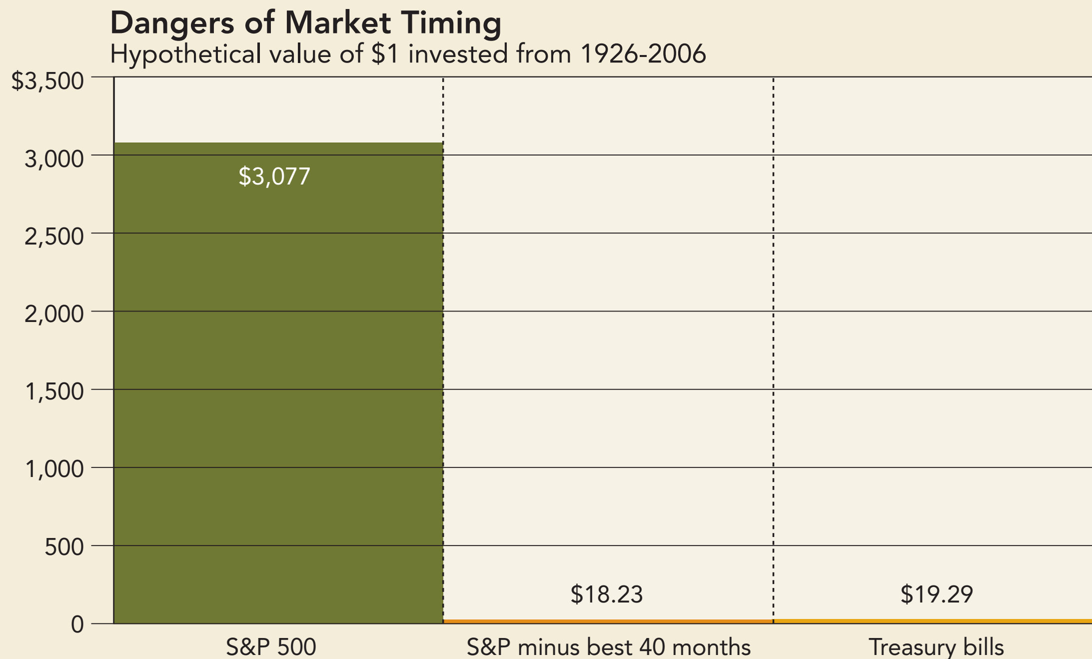
Fear of inflation has been fueled in recent days by economic statistics and a Fed acknowledgement of heightened risks. As one pundit put it, "if you eat or drive, you know inflation is here." It is yet another headwind for consumer spending, as inflation hits everyone, although unequally. In fact, the lowest income consumers have felt inflation severely for three years now, as gasoline prices rose more than 100% and milk, meat, and even vegetables have experienced double digit price increases.

All of these fears are being priced into the stock market at this point. The market is, after all, a discounting mechanism, enabling investors to price in future expectations. The question is what each of these factors might do to company profits in 2008. Here the picture is mixed. There is very little evidence to date that industrial companies will see much of a slowdown. The weak dollar and strong, growing overseas economies provide good tailwinds. Ditto for US companies that sell consumer staples such as Procter & Gamble. Financial services companies will likely have booked their losses by the end of the first quarter of 2008 and should see earnings begin to rise again later next year. The healthcare industry is relatively unaffected by the majority of these factors. Energy is generally a beneficiary of strong international growth and is not much impacted by a weakened US consumer. It is primarily the consumer discretionary sector—retailers, cruise lines, auto makers—who are likely to see profits drop. The stocks are down significantly this year in anticipation of the change; the only question is how much will earnings decline beyond what is currently expected?

Why invest in equities if there is a possibility of a recession?

Given these negatives, some investors have asked why one should be invested in stocks, particularly U.S. stocks. The first answer is that stocks are for long-term investment. Economic cycles, recessions, and profit declines are all a normal part of a free market economy. Any funds needed in the short term should not be invested in the stock market.

Second, we believe that market timing is hazardous to your wealth. As indicated on the following chart, according to an Ibbotson & Associates study from 1926 to 2006, missing just the best 40 months over the past 80 years would have caused the S&P 500 to underperform Treasury Bills during the period! We counsel our clients to maintain an appropriate asset allocation mix for their risk tolerance and objectives, but to avoid timing the markets.



Third, although we could be entering a recession, stocks typically perform well once a recession is declared. On average, from the time the NBER (National Bureau of Economic Research) officially declared a recession, the S&P 500 returned 10.6% over the following 12 months.

Fourth, the Federal Reserve has started cutting the Federal Funds rate with three rate cuts in a row. According to a Ned Davis study, the Fed has cut rates three times in a row on 14 previous occasions, and the average return of the Dow Jones Industrial Average has been 18% one year later.

Fifth, growth companies actually perform best as the economy decelerates. In 2007 for example, growth stocks outperformed value stocks by almost 12 percentage points. We expect the subset of growth firms that are market share takers, have unique high demand products, or are creating 'blue ocean' industries to generate their own positive results and increase earnings. Blue ocean industries are those that are filling new, unmet society needs. Examples of blue ocean companies are FedEx in the 1970's, Microsoft in the 1980's, Cisco in the 1990's and Google more recently.

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Finally, active portfolio management can at times anticipate possible economic and stock market travails and position portfolios to benefit. Our risk control comes from a deep understanding of industries and the individual companies we own. A comprehensive knowledge of the companies in the portfolio enables us to evaluate what kind and how much risk we are taking with each position. In terms of overall portfolio risk, we limit both individual company and sector weights to contain undue stock specific risk.

Perhaps the biggest fear investors have is that this market downturn will turn into a repeat of 2000-2002, when the S&P lost nearly 50% of its value. While it is always dangerous to say 'this time is different', there are significant differences between then and now. The valuation today is roughly 16 times earnings, in line with the long term average, and less

than half the valuation levels at the market peak in March of 2000. Sarbanes Oxley legislation has resulted in more stringent controls over accounting data and multiple regulatory bodies have imposed higher levels of disclosure on formerly murky estimates, leading investors to have a clearer vision of company results.

Conclusion:

While we believe that 2008 may bring a period of slowing growth in the U.S., this does not necessarily portend poor performance in the equity markets. We remain cautiously optimistic on global growth prospects and believe that most of the U.S economic weakness remains centered within the housing-related markets. Our portfolios remain positioned towards large companies levered to international sales with organic growth prospects.