Market Comments

April 15, 2009

The S&P 500 declined 10.98% during the first quarter of 2009 as the stock market continued in the worst bear market since the 1930's. On March 9th, the market closed at 676.53, its lowest level since September 12, 1996, 55% below the all time high of 1576.09 posted on October 11, 2007. From March 9, the S&P 500 rallied strongly into the end of the quarter to finish at 797.87, up 18% from March 9.

The market's recent strength has continued during the first two weeks of April, as the S&P 500 has pushed to its highest level (865) since February 9.

We continue to expect that 2009 will be a volatile year, but with a positive bias as the year wears on.

There are several reasons for our constructive outlook for equities.

First, the massive decline in stock prices between October, 2007, and March 2009 drove equity valuations to very low levels viewed from a longer term perspective. As we have discussed in prior market comments over the past several quarters, cheap valuations alone do not necessarily mean that stock prices will stop going down, but eventually inexpensive valuations provide the foundation for good equity returns over time.

As noted above, stock prices in March reached levels not seen since 1996. In 1996, the S&P 500 earned $41 per share; in 2009, on an operating basis it is likely the S&P 500 will earn about $60 per share. In 1996, the 10 year Treasury yield averaged about 6.5%; currently, the 10 year Treasury yields about 2.8%. Stock valuations are a function of the level of earnings, the rate of growth of future earnings, and the current level of interest rates (higher rates mean future earnings are worth less, lower interest rates mean the value of future profits is higher). Clearly, with current (recession-level) profits about 50% higher than in 1996 and interest rates less than half of 1996 levels, stock valuations at the lows of March had reached unsustainably pessimistic levels.

Second, history strongly argues for investors to be optimistic after large declines in stock prices. At the end of December, trailing 10 year returns for stocks were -1.4% annualized, the worst decade for stocks since 1939, and in the 98th percentile of all trailing 10 year stock return periods dating to the 1920's. Over the long run, stock returns in the U.S. average 8-10% per year. Given the current low level of equity valuations and the likelihood that stock returns will revert toward their long term averages over the next decade, the current environment should allow for good returns for stocks on balance going forward.

Third, investor sentiment is negative and pessimism is high. Typically, stocks do better when investors are worried and expectations are low, which typically occurs after extended stock market declines and periods of economic weakness. When the majority of investors is pessimistic about future equity returns and focused on the negatives surrounding stocks, it is likely that most potential risks have been discounted in stock valuations.

Finally, cash levels are high, and yields on cash are extremely low by historical standards. Consequently, there is significant buying power for equities once investors return to the market.

Low yields increase the opportunity cost of holding cash, especially once stocks begin to provide positive returns and attract buyers.

There are still significant risks facing the equity market at present. There is uncertainty regarding what government policies will be as efforts to address the financial crisis and stimulate the economy unfold. It is likely that government will have a larger role in the U.S. economy than has been the case for a long time, and that is likely to have a negative impact on valuations as the market recovers. Deleveraging by both consumers and corporations is likely to slow the pace of recovery relative to prior post World War II expansions. Lending institutions remain cautious and credit spreads remain high relative to historic levels, and it is likely that spreads will have to narrow before the stock market can sustain a meaningful rally. The economic dislocations of the past two years will both negatively impact 2009 earnings and make estimating the level of 2009 and 2010 earnings more difficult than normal.

While these risks are material, it is likely that the precipitous decline in stock prices and stock valuations over the past six quarters has discounted much of the potential impact of these factors on corporate earnings going forward.

We believe that the economy will eventually stabilize and then recover, and that corporate earnings will move considerably higher from 2009 levels over time. That said, the current recession may worsen or linger, and consequently we think it remains important to balance portfolios between those companies that will do relatively better if economic conditions worsen or stay poor for an extended time (consumer staples, health care, etc.) and those companies that would benefit from an eventual improvement in the economy (technology, industrials, consumer discretionary, and commodity-related). Our expectation is that as 2009 unfolds, the timing of recovery will get closer, and as equities historically anticipate economic improvement before it is apparent in the headlines, those companies with greater economic sensitivity will show better absolute and relative performance as the year goes on.

Our valuation work suggests that our portfolio holdings are significantly undervalued viewed from a longer term perspective.

Our companies tend to fall into one of three valuation categories. The first category is comprised mainly of those companies with the strongest business franchises and the strongest balance sheets; these companies tend to be relatively less sensitive to changes in the broad economy, and their stock prices have generally weathered the current decline better. We anticipate that companies in this group could experience 30-50% stock price appreciation over the next several years. Examples include PepsiCo, and health care companies like Gilead Sciences, Express Scripts, and Allergan.

The second group of companies consists of companies that either have good but not great balance sheets, and/or more economic sensitivity than the first group. In general their stock prices have declined further as their earnings have been hit harder by the recession, but they are strong companies with favorable long term operating outlooks and higher stock price potential from current levels than the first group. We expect that this group of companies on average could see stock price advances of 50-100% from current levels over the next several years. Examples of companies in this group include Best Buy, Union Pacific, Target, Roper Industries, and Fluor.

The third group of companies is mostly made up of firms that have relatively greater economic exposure and/or direct exposure to the credit markets or lending activities, where in some cases investors seem to have had questions regarding the viability or survival of these companies, given the massive implosion of their stock prices over the past six months. We believe that the companies in this group will survive the current financial crises, and we expect that their stock prices could appreciate 100% or more over the next several years. Examples include Wells Fargo, Capital One, and Chesapeake Energy.

In sum, we expect continued stock market volatility for the remainder of 2009, but believe equity valuations remain low and we expect better returns for equities on balance over the next several years.