Market Comments

March 10, 2010

The stock market ended the first two months of the year essentially unchanged, as the market grappled with economic data that showed some improvement, but an economy that was operating at far less than optimal efficiency.

This week marks the one year anniversary of the low point of the 2007-2009 bear market.

On March 9, 2009, the S&P 500 closed at 677, down 57% from its all time high of 1565 posted on October 9, 2007.

Since March 9, 2009, the S&P 500 has advanced 68% to 1135, recovering a little more than half of the 2007-2009 decline during one of the strongest 12 month periods for stocks in history.

While we believe that progress going forward for the equity market will be more difficult over the remainder of 2010 than it has been over the past 12 months because the market is not nearly as undervalued as it was in March of 2009, we remain very constructive on the outlook for stocks for both the rest of this year and on balance over the next several years.

The reasons for our continued positive outlook on stocks include:

1) Valuations, while not as compelling as a year ago, remain attractive for stocks. The S&P 500 currently trades at about 14.5x estimated earnings of $78 per share (up from about $62 per share in 2009, and down from $88 per share in 2007), and about 12.0x early estimates for 2011. While the low valuations in some part may be due to investor skepticism about the timing, magnitude, and duration of a recovery in corporate earnings, the trend in earnings is positive, as corporate profits have significantly exceeded expectations during each of the past three quarters. We believe fair value for the S&P 500 approximates 1250-1300 for 2010, roughly 10-15% above current levels, and 1400-1450 for 2011, about 25% above current levels.

2) Economic data shows that the economy, although still fragile, is showing signs of improvement. We expect to see continued economic growth during 2010, as the monetary and fiscal stimulus brought to bear in late 2008 and early 2009 gains momentum. Importantly, many companies significantly cut costs as the economy slowed in 2008; consequently, those firms should see material earnings improvement going forward even if revenue growth is only modest. We believe such earnings gains will drive higher stock prices over time, and given that analysts' expectations for earnings are lagging actual quarterly earnings performance, there seems to be room for continued upside earnings surprises, especially if revenue growth turns out to be somewhat better than expected.

3) Despite the large gains in stock prices over the past year (the best 12 month stretch for stocks since the Depression), returns for equity investors over the past decade were disappointing and far below normal. This week marks the 10^{th} anniversary of the March, 2000, S&P 500 high of 1552 (which capped a 10 year bull market run of 353% and an annualized total return of 19%, about double the long term average). From the March 2000 peak, the S&P 500 declined 25% during the subsequent decade, and resulting in a total return of -1.12% annually, far below normal, despite solid underlying earnings growth throughout the 2000-2009 period (S&P 500 earnings advanced from $55 peak earnings in 2000 to $60 of trough earnings in 2009). The next decade is likely to see equity returns that are much closer to long term norms (8-10% annual total returns on average) as corporate profitability and earnings continue to improve and as valuations for stocks return toward more normal levels (15x-20x P/Es instead of 12x-15x P/Es).

4) Investor sentiment, notwithstanding the large rally in stocks over the past year, remains muted. Even though interest rates remain historically low, investors have parked huge sums in money markets, and bond funds have pulled in $350 billion in new assets despite very low current yields. We believe there is ample buying power on the sidelines to support stocks over the next several years if and when sentiment toward equities improves.

5) Longer term, if interest rates remain relatively low (i.e., 10 year yields trading between 3-5%), investors will need to allocate capital to higher earning assets, such as stocks, in order to earn returns on capital that allow them to maintain and grow their purchasing power. Aging populations in developed areas of the world will compete for investment return, and if return is not available in the fixed income markets because of low interest rates, it is likely that capital will return to equities and bid up valuations to the point where valuations for bonds and stocks are in better balance than is currently the case. Many very high quality stocks now carry dividend yields that are similar to the yield on 10 year Treasuries (3.70%); those companies that can grow their dividends will provide inflation protection relative to Treasuries, and investors over time will accept the short term volatility of stocks in exchange for much better long term total returns afforded by high quality business franchises.

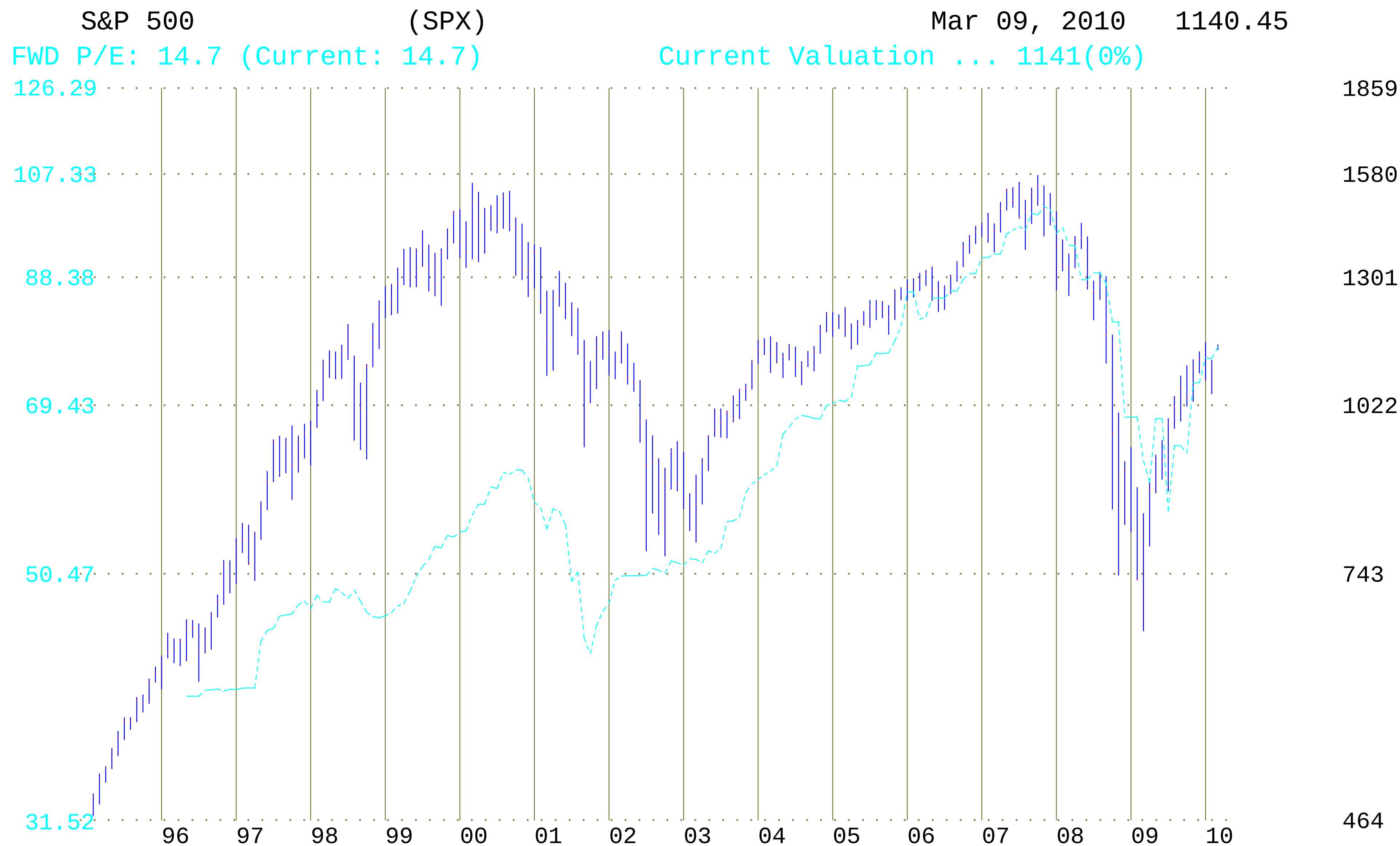
Our positive outlook for equities is mindful of the risks facing investors at present. Those risks include the need for continued debt workout, deleveraging and restructuring for many consumers, companies, and countries, a difficult consumer spending environment, high rates of unemployment, political uncertainties, the likelihood of higher taxes, and an ongoing threat of global terrorism and the high cost to combat it.

That said, in our view current equity valuations to some degree reflect those risks and appear to give little credit to companies with resilient and enduring business franchises, strong balance sheets, high levels of free cash flow, and good management teams that are adept at making solid capital allocation decisions that benefit shareholders for the long run.

We continue to favor two types of companies in the current environment: 1) those companies with strong franchises and a demonstrated ability to grow shareholder value through a range of economic conditions (examples would include PepsiCo, Express Scripts, MasterCard and Strayer Education), and 2) those companies that are clearly beneficiaries of an improving economy (examples would include Best Buy, Caterpillar, Union Pacific, and energy companies). A number of companies have both “enduring franchise/consistent growth” and “beneficiaries of an improving economy” attributes. These include Apple, Berkshire-Hathaway, Goldman Sachs, and Google.

We are encouraged that, despite large recovery moves for our companies over the past year, valuations remain very reasonable, both on an absolute basis, and relative to 1) their historic valuation ranges, and 2) companies with less balance sheet quality and/or less attractive long term growth prospects. In general, high quality companies with good long term growth potential remain undervalued for investors with time horizons that are measured in years as opposed to weeks or months.

Edson L. Bridges III, CFA


S&P 500
(SPX)
Mar 09, 2010
1140.45
FWD P/E: 14.7 (Current: 14.7)
Current Valuation ... 1141(0%)
126.29
107.33
88.38
69.43
50.47
31.52
1859
1580
1301
1022
743
464
96
97
98
99
00
01
02
03
04
05
06
07
08
09
10