

April 15, 2010

During the quarter, the bond market declined slightly as interest rates rose a little. Common stocks advanced firmly, especially in March, after pausing from mid January through most of February. For the quarter, the Dow Jones Industrial Average rose 4.11%, the S&P 500, including income, rose 5.35%, and the NASDAQ Composite rose 5.68%.

The U.S. economy continues to recover steadily and doggedly, as have the economies of quite a number of countries around the globe. Consumer and business confidence have continued to rise. In the U.S., we have had positive job creation, even excluding the Census worker hirings, in March for the first month in 2 1/2 years. The recovery is largely global as positive employment growth is seen in many countries. The U.S. unemployment rate appears to have peaked last winter. Purchasing manager indexes, housing affordability indexes, industrial production, airline traffic for both passengers and air freight, as well as trucking activity are among various indexes at recovery highs. There remain potholes in the economy, certainly in areas such as commercial and residential real estate, construction and capital spending, bank lending and finance, but there are also broad signs of gradual recovery elsewhere in the spectrum of industry categories.

There is still a lot of slack in private industry, with little sign of inventory building, so there is negligible upward pressure on pricing, especially with the average work week not lengthening, and average wages per hour flat. Temporary hiring, generally a prelude to permanent hiring, is up and has been strengthening for months. We are not seeing signs of wage inflation but prices of metals, materials, gold and oil are buoyant, and we expect some signs of inflation i.e., via the Consumer Price Index, by sometime in 2011.

We have all read in the business press what a sorry decade the first ten years of the 21st century has been. Yet, it is interesting (and helpful, we hope) to note that since 2000, nominal and real GDP are up 42.7% and 16.0%, respectively. S&P earnings in 2000 were peaking at \$56.13. The 2006 peak was \$86.54, over 50% higher. S&P trough earnings were \$49 and \$57 in 2008 and 2009, respectively, well above the 2001 trough of \$39. Now, in this first full calendar year of recovery, S&P earnings consensus is \$75 so that is not a bad showing for a decade with 2 recessions.

The following chart shows the S&P 500 prices at each year-end for the decade since 1999; also the earnings of that index for each year and the price-earnings ratios (based on year-end price and full-year earnings – trailing earnings). The chart shows average yearly earnings for the decade of \$66.85, an average year-ending price of 1309.68, and an average price-earnings ratio of 19.6x. The corresponding last five year average numbers are \$70.69 for earnings, 1230.68 for average price and 17.6x for the price-earnings ratio. In contrast are the current figures of \$75 consensus estimate for S&P earnings, the index stands at 1198 and the price-earnings ratio is 15.9. Note that the low earnings multiple for the decade was 16.2x.

	S&P 500 EPS	S&P Price	P/E Ratio
1999	\$51.68	1463.40	28.3
2000	56.13	1320.30	23.5
2001	38.85	1148.10	29.5
2002	46.04	879.80	19.1
2003	54.69	1119.90	20.5
2004	67.68	1211.90	17.9
2005	76.45	1248.30	16.3
2006	87.72	1418.30	16.2
2007	82.54	1468.40	17.8
2008	49.69	903.30	18.2
2009	57.07	1115.10	19.5
10 Year Average	66.85	1309.68	19.6
5 Year Average	70.69	1230.68	17.6
4/12/2010	75.00 ¹	1198.00	15.9

¹ Consensus estimate for 2010, which we believe is low.

Our take on the S&P 500 profits this year is that the \$75 estimate will be exceeded. Corporate management overreacted, in our judgment, to the 2008-2009 financial crisis, and reduced employment excessively. Thus, the stunning employee productivity figures of the past two years, despite a deep recession. We believe that profit margin rebounds will be surprisingly good this year and that corporate earnings estimates are too low. We believe S&P 500 earnings will probably exceed \$80, early indications of which should be seen when Q1 earnings are reported later this month. If so, earnings multiples may be significantly lower than the market expects. That is, the S&P could end the year up greatly more than the 5% it is up at this writing. If the S&P earns \$90-\$100 in 2011, then the current earnings multiple is 12-13.3x.

Another confirming measurement we make is to compare bond yields to common stock earnings yields. The current yield on the U.S. Treasury 10 year bond is 3.8%. The average earnings yield (the price-earnings ratio inverted) on our top 13 portfolio holdings of common stocks is 5.9%, a 50% premium to the 10 year bond yield. One expects stocks to offer higher returns than bonds because stocks are usually riskier. Yet a 50% premium to bond yields seems pretty attractive, especially in light of our discussion that earnings estimates are likely low. Moreover, our clients' average costs for their individual portfolio positions that are trading currently at that 5.9% earnings yield are well below current prices, except for portfolios that we began managing only in the past six months. Of those top 13 stocks, only 4 have not risen out of our buying range; for the other 9 issues, there is a cushion between their respective costs and current prices, so that stocks could decline a fair amount without invading original principal, a major no-no. While conjuring up a decline in stocks is not pleasant to contemplate, we state the risk to illustrate our dedication to not overpay for good companies, a rule we emphasize in our daily thinking about stocks and bonds; it was a concept that was violated by many in 2007 and 2008.

(We think it appropriate here to interject that our clients are to be congratulated for maintaining their commitment to their investments and/or for committing new funds for stocks and bonds in the midst of the deep pessimism in 2008-2009. It took no little courage in light of the depth and severity of the crisis and the unprecedented nature of some of the steps taken by the government authorities for you to place confidence and trust in a new firm and with a manager that had been away for awhile. We are very mindful of that faith and trust and want you to know the seriousness with which we take our responsibilities to you.)

Another item we count as bullish for stocks is that money flows still drastically favor bonds, and, in stocks, they favor emerging markets. We believe that domestic companies are generally easier to know than those in emerging markets halfway around the world. Sooner or later, we think there will be a shift toward the value we see in domestic equities.

Our next to final thought for the day is a paean to long-term investing. That particular brand of certainly traditional investing has taken a setback in popularity because of the mediocre performance of stocks in general in a decade marred by two major declines in the popular averages caused by two recessions. Yet there are not many traders in the Forbes 400. Maybe a couple. One of the most widely utilized and successful means of building wealth is to simply allow compounding to take place in powerful, well protected organisms i.e., companies with strong business franchises or businesses with high barriers to entry.

More important than hiring a money manager to perform the dynamics of buying and selling stocks profitably, which emphasizes the agility and timing capabilities of the manager himself, is the idea of owning and holding shares in outstanding companies for long periods of time; here the emphasis is not on the money manager's agility, but upon his skills in identifying great companies and, in turn, upon the skills of the management of the companies in which he invests the client monies. Undoubtedly, more money has been made by simply owning and holding and not selling a few great companies over an investment lifetime than by trying to outfox the general market or by active trading. Here the emphasis is on the competitive advantages of the business itself and if the managements of those businesses can exploit those competitive edges and maintain them over many years. In our experience, more money has been left on the table by exiting wonderful companies way too soon because of some short-term development either within the company or in the economy than has been lost by buying stocks that have gone down. We believe the man from Omaha and also one of his guiding lights, Philip A. Fisher, learned this a long time ago. (This is not to say that if stocks get egregiously overpriced a la 1999-2000, we won't sell or trim positions; we certainly would.)

The other under-advertised benefits of BUY-HOLD is the savings in taxes, commissions and so-called friction costs of a high turnover, highly active portfolio. The idea is to compound assets indefinitely, uninterrupted by taxes and other costs, which cut into the compounding. That is what is both plausible and allowed under U.S. tax law. That is what BUY-HOLD can provide. We recognize this distinction is not so important for non-taxable accounts but such accounts still benefit from lower commissions and the absence of other costs caused by turnover. Compounding gains long-term is much harder to do with non-leadership companies, which is one reason we try to avoid such concerns. We are not into kissing frogs to try to turn them into princesses. We are not omniscient as we hardly need to remind you; not all the companies with which we begin building a portfolio will measure up to our expectations to become one-decision stocks. Some, however, will meet or exceed our expectations. We have had a lot of experience

over the years and some modest successes in identifying companies that can grow for years and years, and we continue to strive in that particular niche.

ADDENDUM:

The graph on page 5 shows in the last 20 years how earnings yields (inverted price-earnings ratios) of common stocks compare to bond yields. Looking at the left axis, the 10 year Treasury yield has declined from 9% in 1990 to slightly less than 4%.

Still looking at the left axis, the S&P 500 earnings yield spent the 1990s and 2000-2002 with a lower yield (return) than the Treasury yield, but since 2002 has provided superior yield (returns) to that of Treasuries. In 2010, the graph shows you get just below 6% earnings yield from the S&P 500, nearly 50% better than the nearly 4% Treasury bond yield.

Using the right axis, the S&P yield/Treasury yield line shows the relationship described above; since 2002 the line has been over 1.0, whereas in the prior 13 years, the line shows less than 1.0 except for very brief movements in 1993, 1995, 1998 and 2001. Over 1.0 means stocks are more attractive than bonds (and reflects the mediocre results for equities in the last 10 years. On the other hand, it reflects also poor sentiment which as potential buyers of stock, we want to see); under 1.0 means bonds offer higher returns than stocks, a condition not seen since 2002.

If inflation returns in 2011 and bond yields rise, stocks may become relatively less attractive but that is then and this is now.

Please call if you have questions.

Roland D. Underhill
Managing Director

