

“DISSECTING THE ECONOMIC SECTORS”

This past year has been one for the record books. In our last issue, we addressed several of the most commonly asked questions from our clients. These questions related to stock market performance, interest rates, gold, inflation, and economic growth. In this issue, we were going to address another set of commonly asked questions; however, we thought we would take a little different path and drill down to the portfolio level and the reasons we own what we own.

Over the past several months, a lot of major changes have occurred in the investment landscape (i.e., healthcare reform, prospects for higher interest rates with the Fed’s recent increase in the discount rate, improvement in the labor market, and political surprises). These changes can have a significant impact on the portfolio strategy and the stocks we buy for our clients. We think the best way to explain the portfolio strategy is to present the different sector positions relative to the general market (S&P 500) and discuss our reasons for a positive or negative view of each sector.

There are 10 broad economic sectors represented in the S&P 500. Below we list each sector, our general weighting in each sector and the market (S&P 500) weighting. This will hopefully provide a good understanding of where we see the opportunities going forward.

Sector	DMKC Model Stock Portfolio	S&P 500	Percent Over / (Under) Weight
Consumer Cyclical	8%	10%	(2%)
Consumer Staples	13%	12%	1%
Energy	—	11%	(11%)
Financials	19%	16%	3%
Health Care	22%	13%	9%
Industrials	22%	10%	12%
Information Technology	10%	19%	(9%)
Basic Materials	—	3%	(3%)
Telecommunication	—	3%	(3%)
Utilities	6%	3%	3%

In this newsletter we briefly address the reasons for our positive or negative position in each sector.

CONSUMER CYCLICAL – UNDERWEIGHT

As the name implies, this sector is tied to consumer discretionary spending – primarily U.S. consumer based. Given the high unemployment rate, relatively high debt service levels, and the trend toward a higher savings rate and less debt-supported consumption, we do not see a strong consumer-led recovery. Therefore, we are underweight in this sector. However, we do see opportunity in the home improvement industry as the housing market appears to be in recovery mode and have therefore concentrated our holdings in Home Depot and Lowes. We believe these companies are attractively priced relative to earnings potential, have solid balance sheets, and solid growth possibilities as the economy continues its recovery.

Year to date performance for this sector is 10%.

CONSUMER STAPLES – NEUTRAL

Although we are somewhat pessimistic regarding U.S. consumers’ ability to lead this economic recovery, we believe that companies that have more exposure to the foreign consumer and that sell more non-discretionary, lower-priced items are attractive. Examples of holdings in this sector include Procter & Gamble (PG), Kimberly Clark (KMB), Sysco Foods (SYY), and Avon Products (AVP).

All of these companies, except Sysco Foods, have significant exposure to consumers outside the U.S., and in particular, to many of the emerging countries, where living standards are greatly improving. We like Sysco because we believe one of the first areas in which the U.S. consumer will increase their purchasing is dining out, which is a key driver of the company. These companies pay attractive dividends, trade for reasonable levels relative to earnings, and are strong financially.

Year to date performance for this sector is 5%.

ENERGY – UNDERWEIGHT

Currently we have zero exposure in energy. Unlike the situation during the 2005-2008 time period where demand was strong



and supply constrained, today we have the opposite situation. Although the global economy appears to be in recovery mode, demand remains weak relative to a few years ago, and supply is strong. There remains ample excess capacity at OPEC, which recently announced they would add production as the price of crude moved above \$80 per barrel. In addition, non-OPEC countries continue to ramp up exploration and production, and new technology is adding to potential new supply. Conservation and alternative energy sources will also have some impact on demand, although not by a significant amount at this point in time.

Long term, we have a more positive view toward this sector as global economic growth picks up and developing countries demand more crude. Year to date, the energy sector has underperformed and is one of only three sectors with a negative return. So, being underexposed in this area has been a net positive for our portfolios.

Year to date performance for this sector is -0.2%.

FINANCIALS – OVERWEIGHT

We are slightly overweight in this sector, but are selective in the companies we want to own. We think there are still a lot of credit issues to work through, which will take time and will pressure earnings for the foreseeable future. However, we also believe that the stronger banks will take market share and enjoy better pricing due to the elimination of a significant amount of competition during the past economic crisis. And when the credit cycle turns more positive, we believe the earnings power of the super regional and money center banks will be much stronger than the market is currently anticipating.

As an example, from 1999 through 2006, J.P. Morgan averaged approximately \$2.6 billion per year in provision for bad debt. In bank accounting, this provision is a direct offset to earnings. However, as a result of the current credit situation, J.P. Morgan took a \$32 billion loan loss provision during 2009, but still earned over \$2 per share. The \$32 billion charge equates to over \$8 per share in reduced earnings. If over the next several years, we get back to a more normal credit situation, J.P. Morgan's provision will drop, possibly to \$10 billion per year or lower. This could add between \$5 and \$6 per share to earnings, giving the company earnings power of potentially \$7 to \$8 per share. We are not sure what kind of multiple investors will pay for J.P. Morgan, but we

believe that given the quality of the organization, 8 to 9 times earnings is not unreasonable. That would equate to a price per share in the mid \$60 range, which is significantly above the current price of \$45 per share. This kind of earnings leverage is present in the other bank shares we own as well.

Another reason we like bank stocks is the dividend potential. Currently, none of the banks we follow are paying a meaningful dividend, but we believe they will begin increasing their payout this year as capital levels are strong, credit conditions improve, and the economy gains momentum. This will increase their appeal as income producing stocks.

We realize not all is rosy for the banks; the regulatory environment is increasingly restrictive, higher taxes will be imposed on them to replenish the FDIC insurance reserve and some banks may be forced to divest profitable businesses. We will keep an eye on these challenges for the industry to make sure they do not offset the positives we see.

Year to date performance for this sector is 11%.

HEALTH CARE - OVERWEIGHT

This is a tough sector to analyze, given all the uncertainty and changes resulting from health care reform. We think that sub-industries within this sector will be impacted differently, and we have focused our holdings in the pharmaceutical area, while avoiding insurance companies. We believe the pharmaceutical industry will be a net beneficiary of health care reform even though they face pricing pressure and taxes (\$80 billion over 10 years) to help pay for the reform. However, there will be an additional 32 million newly insured potential customers.

In summary, we think volume trumps the pricing concessions. We see demand growing in the U.S. with the aging of the baby boomers and see significant opportunity overseas as developing countries start demanding and paying for better health care. In addition, we like the fundamentals of this industry. These stocks peaked in the late 1990's and have been out of favor for the past 10 years. Earnings have been under pressure due to litigation issues, patent expirations, and relatively weak product pipelines. This has forced a major restructuring in the industry, and we believe these companies have restructured to a point that they are very lean and efficient. As a group, they have very solid finances, significant cash on the balance sheet to fund research



and pay dividends, and have reasonable earnings prospects even in the face of patent expirations. As a group, they pay an average dividend yield of close to 4% and trade for an average P/E ratio of 10 times, compared to 15 times earnings for the market.

Year to date performance for this sector is 4%.

INDUSTRIALS - OVERWEIGHT

This is our largest overweighted position, and is one that we have consistently added to over the past 12 months. Due to their cyclical nature, these stocks took a severe hit during the recession and were priced at levels not seen for many years, making the price point very attractive. In addition to the attractive prices, fundamentally, these companies offer solid balance sheets, attractive dividend yields, and strong free cash flow. Longer term fundamentals also appear attractive as these companies should benefit from trends in alternative energy, electric utility upgrades, clean air regulation, and general infrastructure spending. Most of the companies we own in this group offer significant international exposure, which should provide additional growth opportunities due to the infrastructure needs in emerging countries.

Although we are positive on the long term fundamentals, we are a little nervous about the short term prices, as several of these stocks have had significant appreciation over the past 12 months. We may take some money off of the table in this group and allocate to areas we believe offer more attractive prices. However, we will likely maintain our overweighted position for the foreseeable future.

Year to date performance for this sector is 12%.

INFORMATION TECHNOLOGY – UNDERWEIGHT

In general, our investment discipline and selection criteria tend to give us a negative bias toward this sector, as most of these stocks do not pay meaningful dividends, they often trade at relatively high PE ratios, and there is significant obsolescence risk. However, coming out of a recession, this group historically has performed well. And we see significant pent up demand from Corporate America for technology products and services. We believe capital spending will lead this economic recovery rather than consumer spending, and we also believe there will be a continued push for productivity-enhancing investments.

Although we are underweight in this group relative to the market, the current exposure of about 10% is higher than normal for us, so we are somewhat positive on the prospects for many of these stocks. Our strategy is to stick with the biggest and best companies that tend to pay dividends (even though not significant), have broad product diversification and a large share of recurring revenue through software and service. We think these characteristics help offset the negatives mentioned earlier of obsolescence and volatility.

Year to date performance for this sector is 2%.

BASIC MATERIALS – UNDERWEIGHT

In general, we typically will not own this sector to any large degree, as these stocks tend to be very volatile. Copper, steel, paper, and chemicals make up the majority of this sector. Because dividends tend to be below average, there is some balance sheet weakness, and since these are commodity businesses, pricing power does not exist. There is typically no sustainable, competitive advantage with many of these stocks and returns on equity tend to be sub par. There may be times where there are trading opportunities in this group, but at this time, we think there are better opportunities elsewhere.

Year to date performance for this sector is 3%.

TELECOMMUNICATIONS – UNDERWEIGHT

While stocks in this sector tend to provide attractive dividend yields (i.e. AT&T at 6.4% and Verizon at 6.1%), they offer very little growth potential in our opinion, as they pay out the majority of their earnings in dividends. In addition, the group is not as defensive and stable as it used to be due to the fact that the business model has changed from the more stable, regulated fixed line businesses to the more cyclical consumer dependent wireless businesses. Also, profit margins continue to be pressured due to stiff competition, and debt to equity levels are relatively high.

Year to date performance for this sector is -4%.

UTILITIES – OVERWEIGHT

We like this group as a contrarian play. It offers attractive dividend yields on average of 4% and we believe earnings will show improvement as electricity demand grows with the improved economic activity. The group has been a laggard



since the stock market recovery began last March, and is also lagging this year. However, we think the poor relative performance has resulted in attractive price points. Also, this group adds some defensiveness to the portfolios as utilities have historically been much less volatile than the overall market. Our goal with this group is to clip the 4% dividend and hopefully get mid-single digit appreciation over time as earnings improve. Our biggest concern is that utilities tend to be interest rate sensitive, and we expect rates to rise from here. If the rate increases are gradual and the result of a better economy, we think the higher earnings prospects will offset the negative interest rate impact. However, if rates rise significantly, this group will likely underperform.

Year to date performance for this sector is -4%.

Hopefully this discussion gives a general understanding of our viewpoints on different market sectors and why we are positioned the way we are in the portfolios. As always, please feel free to give us a call if you have any questions about the information in this newsletter or with your accounts in general. ■



BILLINGS
 1430 Country Manor Blvd., Suite 3
 Billings, MT 59102
 (888) 988-2035

DES MOINES
 3900 Ingersoll Avenue, Suite 300
 Des Moines, IA 50312
 (800) 998-9773

INDEX VALUES AND RETURNS*				
	12/31/09	3/31/10	Price Change	Total Return
S&P 500	1,115.10	1,169.43	4.87%	5.39%
Dow Jones Industrial Average	10,428.05	10,856.63	4.11%	4.82%
Nasdaq Composite	2,269.15	2,397.96	5.68%	5.91%
Merrill 1-5 Year Bond Index**	102.09	102.32	0.23%	0.90%
Consumer Price Index	2.7%	2.1%***	NA	NA

*Results according to Bloomberg unless indicated
 **Results according to Merrill Lynch at mindex.com
 ***As of February 2010