

“FINDING THE GOOD NEWS”

Written by Gary Lucas

THE LOST DECADE

We have had to endure two of the worst Bear markets in history (2000 – 2002 down 47%, and 2007 – 2009 down 57%), the 9/11 attacks and resulting wars in Iraq and Afghanistan, \$150 per barrel of oil, the worst recession since the Great Depression, unemployment above 10%, sky-high deficits, and a global financial crisis. From a return perspective, the past decade was the worst in history, going back to the 1930s. On a total return basis, the market, as measured by the S&P 500, was down 9.1% (-25% without dividends). The only other decade with a negative total return was 1930 – 1940 when the market dropped approximately 2%.

Today, there is plenty to worry about. We have a debt crisis in Europe, bank failures, strained public sector finances, inflation fears, deflation fears, and political uncertainty. These items will most likely lead to additional impediments such as increased taxes, more government regulation and higher interest rates. Overall, the long term, buy and hold investor has not been rewarded for their patience.

THE GOOD NEWS

These challenges to the economy are concerning. But if all the current news was good, maybe investors should have more to worry about. Remember 1999? The news was pretty good then. The “New Economy” was immune to the business cycle, the U.S. was enjoying the longest uninterrupted economic expansion in post-war history, the stock market had averaged 18% annual returns for the past 10 years, and 17% per year during the 1980’s, we had budget surpluses, and we were in the middle of the technology revolution. Things were good. The only problem was that all of this good news was reflected in the price of the stock market.

Today, we believe we have the opposite situation, when there is an awful lot of bad news reflected in prices. If one takes a closer look, however, there are bits of good news scattered in with the

headline-grabbing bad news. Corporate America is very healthy, the U.S. economy is growing, profits are strong, consumer confidence is rising, the employment situation is improving (at least, beneath the surface), interest rates, even if they rise from here, are low by historical standards, and consumer finances are improving.

Based on history, the odds favor much better returns over the next 10 years than what investors received during the past 10 years. The markets have never experienced two decades in a row of negative returns. Following the last time returns were negative, the market returned 9% per year and 19% per year over the next two decades. And following the 1970s, another poor 10 year period for stocks, the market returned 17% per year and 18% per year over the next two decades. While we do not anticipate these kinds of returns, our point is that historically, returns improve significantly following below average return decades, and we have just come off of the worst decade in history.

STOCKS ON SALE

Investor behavior is driven by fear and greed. It is often harder to get someone to invest when prices are down, as emotions make it difficult to commit money. If you could buy Arizona real estate at half or a third of the value it traded for 10 years ago, most people would think that is a pretty good deal. The same probably holds true for a new car. But this is not necessarily the case with stocks. There is a tendency, due to fear and greed, to buy high and sell low, to have a false sense of security when all of the news is positive, and to be overly cautious when the news is bad.

To illustrate why we think that there are some pretty good opportunities available in the stock market, we profile several companies across various sectors that our clients own in their portfolios.

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➤ Consumer Staples – Procter & Gamble

	Current	2000	Change
Price	\$61	\$59	+3%
Dividends	\$1.93	\$0.64	+202%
Dividend Yield	3.2%	1.1%	
Earnings per Share	\$4.03	\$1.24	+225%
Price Earnings Ratio	15x	39x	-61%
Balance Sheet Strength (credit rating)	AA-		

1. The stock is 60% cheaper than 10 years ago, relative to earnings (PE ratio of 15 compared to 39 in 2000).
2. Earnings are up 225% or 13% per year and dividends are up 202% or 12% per year.
3. The stock provides a dividend yield of 3.2%, over double what it yielded in 2000.

➤ Consumer Staples – Sysco Foods

	Current	2000	Change
Price	\$31	\$30	+3%
Dividends	\$1.00	\$0.22	+355%
Dividend Yield	3.2%	0.7%	
Earnings per Share	\$1.99	\$0.68	+193%
Price Earnings Ratio	15x	44x	-66%
Balance Sheet Strength (credit rating)	AA-		

1. The stock is 66% cheaper than 10 years ago, relative to earnings (PE ratio of 15 compared to 44 in 2000).
2. Earnings are up by 193% or 11% per year and dividends are up 355% or 16% per year.
3. The stock provides a dividend yield of 3.2%, over four times more than 2000.

➤ Energy – Exxon Mobil

	Current	2000	Change
Price	\$62	\$48	+29%
Dividends	\$1.76	\$0.88	+100%
Dividend Yield	2.9%	1.8%	
Earnings per Share	\$5.93	\$2.27	+161%
Price Earnings Ratio	10x	21x	-52%
Balance Sheet Strength (credit rating)	AAA		

1. The stock is 52% cheaper than 10 years ago relative to earnings (PE ratio of 10 compared to 21 in 2000).
2. Earnings are up 161% or 10% per year and dividends are up 100% or 7% per year.
3. The stock provides a dividend yield of 2.9% or 60% more than in 2000.

➤ Financials – State Street Bank

	Current	2000	Change
Price	\$38	\$68	-44%
Dividends	\$0.04	\$0.35	-88%
Dividend Yield	0.1%	0.5%	
Earnings per Share	\$3.29	\$1.82	+81%
Price Earnings Ratio	11x	37x	-70%
Balance Sheet Strength (credit rating)	A+		

1. The stock is 70% cheaper than 10 years ago, relative to earnings (PE ratio of 11 compared to 37 in 2000).
2. Earnings are up 81% or 6% per year.
3. The company has the capacity to pay a meaningful dividend (was \$0.95 in 2008) once the regulatory environment improves.



► **Healthcare – Johnson & Johnson**

	Current	2000	Change
Price	\$58	\$53	+9%
Dividends	\$2.16	\$0.62	+248%
Dividend Yield	3.7%	1.2%	
Earnings per Share	\$4.85	\$1.70	+185%
Price Earnings Ratio	12x	31x	-61%
Balance Sheet Strength (credit rating)	AAA		

1. The stock is 60% cheaper than 10 years ago, relative to earnings (PE ratio of 12 compared to 31 in 2000).
2. Earnings are up 185% or 11% per year and dividends are up 248% or 13% per year.
3. The stock provides a dividend yield of 3.7%, three times more than in 2000.

► **Industrials – Fluor**

	Current	2000	Change
Price	\$45	\$24	+88%
Dividends	\$0.50	\$0.50	0%
Dividend Yield	1.1%	2.1%	
Earnings per Share	\$3.10	\$0.66	+370%
Price Earnings Ratio	15x	36x	-58%
Balance Sheet Strength (credit rating)	A-		

1. The stock is 58% cheaper than 10 years ago, relative to earnings (PE ratio of 15 compared to 36 in 2000).
2. Earnings are up 370% or 17% per year.
3. The company has the capacity to pay a much higher dividend due to strong earnings and cash flow.

► **Technology – IBM**

	Current	2000	Change
Price	\$128	\$135	-5%
Dividends	\$2.60	\$0.51	+409%
Dividend Yield	2.0%	0.40%	
Earnings per Share	\$11.50	\$4.44	+159%
Price Earnings Ratio	11x	30x	-63%
Balance Sheet Strength (credit rating)	A+		

1. The stock is 63% cheaper than 10 years ago, relative to earnings (PE ratio of 11 compared to 30 in 2000).
2. Earnings are up 159% or 10% per year and dividends are up 409% or 18% per year.
3. The stock provides a dividend yield of 2.0% or five times more than in 2000.

► **Technology – Microsoft**

	Current	2000	Change
Price	\$25	\$59	-58%
Dividends	\$0.52	\$0	
Dividend Yield	2%	0%	
Earnings per Share	\$2.08	\$0.85	+145%
Price Earnings Ratio	12x	69x	-82%
Balance Sheet Strength (credit rating)	AAA		

1. The stock is 82% cheaper than 10 years ago, relative to earnings (PE ratio of 12 compared to 69 in 2000).
2. Earnings are up 145% or 9% per year.
3. The stock provides a dividend yield of 2%. Microsoft also has over \$30 billion of cash on the balance sheet, equal to over \$3 per share that they could pay out in the form of a special dividend.

►►► As the data points out, these are not dying companies that have poor fundamentals. They are all high quality businesses that have had solid results over the past 10 years.



CONCLUSION

Just because a stock is cheaper now than it was before does not mean that it is a good value. One needs only to review the market performance of the past several years, and this becomes quickly apparent. We need to make sure that the prices we pay make sense in absolute terms, not just relative to where they have been in the past, especially when the past was a bubble environment. We think that paying 12x earnings for Johnson & Johnson and Microsoft, 11x earnings for State Street and IBM, and 15x earnings for Sysco and Procter & Gamble are attractive prices and will provide reasonable returns over time, given the quality and growth prospects for these companies. Other stocks in the portfolio have similar investment characteristics.

Even though we believe there is opportunity in the stock market, we also understand the risk and possibility for market corrections. Your asset allocation, or the mix between stocks

and bonds in your account, is the best way to manage the risk in your portfolio. If the 12% drop in May has you up at night worrying about your investment portfolio, it may make sense to re-evaluate your exposure to stocks, and take some money off of the table. If the drop in the market was uncomfortable, but tolerable, and you have the ability to withstand more short term declines, then your portfolio structure is probably appropriate. Finding the right allocation and sticking with it even during uncertain times helps prevent the buy high, sell low tendency we all have when our emotions drive the investment decision.

As always, if you have any questions or concerns about your account, please feel free to give us a call anytime. We are always available to visit with you, and we would be happy to meet with you in person to review your portfolio, if that would be helpful. ■



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INDEX VALUES AND RETURNS*				
	12/31/09	6/30/10	Price Change	Total Return
S&P 500	1,115.10	1,030.71	-7.57%	-6.65%
Dow Jones Industrial Average	10,428.05	9,774.02	-6.27%	-5.00%
Nasdaq Composite	2,269.15	2,109.24	-7.05%	-6.62%
Barclays Capital US Govt/Credit Intermediate Index**	NA	NA	2.71%	4.56%
Consumer Price Index	2.70%	2.0%***	NA	NA

*Results according to Bloomberg unless indicated
 **Results according to Barclays Capital
 ***As of May 2010