

August 8, 2011

Oarsman Capital's 'Take' on the Recent Market Turmoil

Like you, we are deeply concerned by the decline in stock prices over the past three weeks. As we write this note, the broad U.S. stock market (as measured by the S&P 500 Index) has declined 16% from the level reached in April and then again in July. We want to take this opportunity to relate to you our sense of what is causing this unsettling volatility and, more important, to try to put the decline into a broader context that we hope will be helpful to you as you help us manage your investments in the period ahead.

First, as to what has unleashed the recent and sudden downturn: Above all, we believe the downturn reflects a sudden decline in the level of confidence that investors have in the political leadership of this country and in the European Union. After all, it has been readily apparent since April or May that global economic growth was decelerating, and that this would eventually weigh on the corporate profits that form the basis for stock prices. But as noted above, stocks flirted with new post-2008 highs as recently as mid-July. Over the past three weeks, however, politicians and bureaucrats on both sides of the Atlantic have demonstrated yet again that they are unable to take decisive but politically difficult actions that would simultaneously support near-term economic stability and growth and also address in a serious way the longer-term fiscal challenges that face us. Thus, while the Standard & Poor's downgrade of U.S. government debt on Friday was widely anticipated, it nonetheless served as a stark reminder of this loss of confidence.

As for the broader context: First, we note that the magnitude of the current decline (though not necessarily its timing or rapidity, which are more troubling) is not an unusual market reaction to a meaningful downshift in the rate of economic growth. That is, given the clear (and apparently persistent) deceleration in the global economy that began to be apparent in April/May, we are not surprised to see stock prices lower than they were before the slowdown. While no doubt the confidence-eroding events of the past three weeks have done nothing to kindle hopes of a near-term up-tick in growth, it also seems unlikely that they have meaningfully impaired the outlook, either.

Second, we want to point out what we believe is a crucial distinction between the current situation and that of late-2008 and early-2009, which eventually led to a much steeper drop in stock prices. Namely, we are not currently seeing signs that the vital global 'financial infrastructure' of bank-to-bank lending and short-term corporate financing is under undue stress. To date, interbank-lending and corporate-bond credit spreads - indications of liquidity and risk-aversion in these huge markets - have not deteriorated meaningfully. This is in stark contrast to 2008-2009, when the entire global financial system essentially seized up, with no institution other than central banks willing

to extend credit, and it was not at all clear for a period of many weeks how that situation would resolve itself.

Finally, and perhaps most important, we can list a number of important positives about today's market environment - i.e., we can point to a number of things that have not gone wrong:

- Despite the S&P rating downgrade, U.S. Treasury bonds have continued to appreciate in price, as has the foreign-exchange value of the dollar;
- As noted above, credit spreads and interbank lending rates have not exploded;
- Large, multi-national companies have continued to report robust growth in both earnings and revenues;
- The cash dividends paid by U.S. companies are growing from levels that already exceed investment-grade bond yields;
- The U.S. economy, though not growing as rapidly as we thought six months ago, continues to expand; each 1 percentage point of annual growth represents almost \$150 billion of incremental wealth creation, which it seems to us is a non-trivial, even if disappointing, figure.

With the recent 'correction' in prices, many stocks of 'blue-chip' U.S. companies (e.g. Intel, Microsoft, Johnson & Johnson, Pfizer, PepsiCo and RPM, to name just a handful) are now trading at 12, 10 or even 8 times earnings; and the market as a whole is trading at an earnings multiple (i.e., P/E ratio) of less than 12 . All of these figures compare favorably to the long-term historical average of between 14 and 16 times earnings.

Moreover, while high-quality bond yields continue to fall (5-year US Treasury Notes now pay less than 1.1% annually!), annual cash-dividend rates of these same high-quality, growth stocks exceed 2.5% and many are in the 3.5% - 4.5% range. While none of these facts will prevent prices from falling further over coming days or weeks, all give us a great deal of confidence that stocks bought or held from today's levels will be satisfying investments over the next five, ten or twenty years.

Again, please know that we are carefully monitoring your investments and the myriad economic and market forces that affect them, and will always do our utmost to position your portfolio to provide superior long-term performance.

We hope you are well and look forward to chatting with you in coming days and weeks.

Alan & Bob