



2010 Second Quarter Performance Report

It was an ugly quarter. Greece exposed not only its own fiscal mess, but the inability of the European Union to act effectively in a crisis. Not that our own government showed any talent for crisis management in reacting to the BP oil spill; a level of ineptitude only matched by BP itself. After demonstrating just how sleazy the political process really is, we got health care and financial reform bills, but 8 out of 10 people don't know what's in them and 9 out of 10 people do not like the bills.

The bears, who had been wounded badly by the market's 70% recovery, used the negative backdrop of world news to renew their call for economic Armageddon. The bears would have us believe we are about to suffer a Greek tragedy, despite the fact that our debt to GDP ratio is half theirs, our labor union's power is a fraction of theirs, our private sector contribution to GDP is twice theirs and we control our currency instead of being part of the Euro. Other than just about everything, we are just like them.

Record gains in the productivity of American businesses have come at the cost of high unemployment, but that's what always happens in a recession. What the bears don't want to admit is that the recovery is following a very predictable time table. First the crisis is over, then big company profits improve, then it filters down to small companies, and finally employment goes up as small companies hire. We are half way through the process. The crisis is over, corporate profits are up and their expectations have improved dramatically. Small businesses are just beginning to see the recovery reflected in their order books. Eventually small businesses will need more workers to fill their orders, but it doesn't happen overnight.

The economy will follow this predicable path to full recovery unless the bears are right and this is one of those extremely rare double dip recessions (one in the last seventy years) where the economy is slapped down again by an economic shock. I'm not saying that couldn't happen, I'm just saying that the odds are against it, it would require an unforeseen major shock to the world economy and most of the same people who are calling for a rare double dip, missed predicting the recovery.

With that, I think it is safe to assume that last quarter's 11% decline in the market is nothing more than a long overdue correction in market recovery that is morphing into a cyclical bull market. Of course a lot of stocks suffered losses of two to three times the market averages last quarter. It was the usual suspects: anything to do with offshore drilling, and the cyclical technology and natural resource stocks that suffered the most. Fine, it gives us the chance to buy a few of the great companies in these industries at discount prices.

Later in this letter I discuss what I think will be a major theme over the next few years; the attractive investment opportunity available in large cap stocks. Given the choice of owning large cap or small cap stocks I'd prefer to own large caps. They typically have better balance sheets, more international exposure, more transparency and better management than small caps. Usually, you have to pay a higher price for a dollar of big cap earnings to get this extra margin of safety. When big caps are priced at a discount to small caps, when they yield more than treasury bonds, when the world is in an economic recovery, when great companies are trading at rock bottom valuations...it's a great time to be an equity investor.

In times like these, you don't have to research some obscure biotech company that might have a cure for cancer to make a buck. You can buy the big cap pharmaceutical company that has deals with dozens of startups and get paid a nice dividend while you are waiting for the next big thing. You don't have to buy some Chinese company with god knows what for disclosure and limited shareholder rights. You can buy a dominate international corporation that is building a strong franchise in China and the rest of the developing world. You don't have to take the chance of buying a regional financial institution with a small book of loans in one area. You can buy world financial powerhouse with diversified assets that have already been tested under fire.

The Dow Jones Industrial Average is a pretty good proxy for the blue chip stocks we are talking about. The Dow could outperform the other indexes over the next few years, if for no other reason than it has underperformed for so many years in the past, but whether it does or not, investing is about balancing risk and reward. There is simply less risk in big cap stocks and when they are priced below their historic multiples, offer good yields and are in a favorable economic climate; we want to own them.

On the fixed income front; strength in the dollar, thanks to Euro worries and flight to quality, caused interest rates to plummet again. Ten year treasures dropped below 3% and corporate and municipal bond yields followed. We are still finding some value in short term, just above investment grade corporate bonds and tax free bonds that have a story, but it keeps getting harder to find a reasonable yield in what we consider an unreasonably low interest rate environment.

It was a tough quarter. Nobody likes a correction, but they are an inevitable part of a market recovery. Nothing that's real goes straight up and we think this recovery is very real.

THE DEATH OF OPTIMISM

Sometime in the last few years it became un-American to be optimistic.

Anyone unpatriotic enough to believe that the United States isn't on the road to ruin must either be a communist or a fool. How did this happen? When I was a Cub Scout, I was

taught that I lived in the greatest country on earth. We could overcome any obstacle, defeat every foe and offer the opportunity of prosperity for all.

Has America changed since then, or are we just suffering from a temporary state of depression? Do we need a revolution, or just a big dose of anti-depressants? I'd try drugs before picking up a rifle, but maybe I can cheer you up a little before you have to resort to either option.

First of all, let's look at the source of our melancholy. No doubt we have some real problems, but when pessimism becomes the central tenet of our religious and political life, it might be time to rethink things. There have always been panic mongers who attempt to enrich themselves by capitalizing on whatever can scare people at the moment. There have been preachers who have predicted the end of the world and politicians whose only qualification for office was an ability to convince voters that the current government was high jacking the American dream.

What's changed is that we have institutionalized fear. The negative nabobs now have a national pulpit on cable TV, talk radio and the Internet to espouse extreme positions, free from the confines of inquiry and rebuttal that journalists have traditionally been bound by. The far right and left of the political spectrum are united in one thought, the world is on the brink of destruction and they are the only ones who can save it. It makes for great entertainment and it sells advertising, but it's no way to run a country, or a portfolio. Good news is an inconvenient truth for the merchants of fear, but here are some facts that they would prefer to ignore.

WE REALLY ARE IN A WORLD WIDE ECONOMIC RECOVERY

It's not just a stimulus bubble, a cheap money one timer, or governments cooking the books. We are experiencing real economic growth and it looks like this growth is sustainable, in which case, unemployment will decline and government budget will improve as tax receipts go up. Corporate profits are soaring, productivity is off the charts, retail sales are strong, auto and home sales are up and consumers have improved their balance sheets.

There was a legitimate concern that a wave of protectionism would choke off the world economic recovery, China would implode and that energy prices and interest rates would increase before we could get on our feet again. That didn't happen!

INTEREST RATES AND ENERGY PRICES ARE LOW AND UNLIKELY TO GO UP SIGNIFICANTLY

In large part the recession was caused by high energy prices and increasing interest rates, followed by a spike in energy prices and a complete shutdown of the credit markets. Oil prices are down when they normally would be going up in the pre-summer driving season and the last time I looked, I could refinance my mortgage at less than 5%. For the 90% of Americans who are employed, this is like getting a big bonus check.

THE STOCK MARKET IS CHEAP

Even after last year's once in a lifetime rally, the market is still cheap because corporate profits have seen a tremendous recovery. The market is trading at about 13 times this year's expected earnings, which are estimated to be about 35% better than last year's earnings, and those estimates have been going up every quarter.

The fear mongers have been so successful, that despite a 70% market rally, individuals still haven't been buying stocks. This has helped keep valuations at reasonable levels and avoided the bubble that would normally develop in a monster stock market rally.

I started in this business in 1982. The Dow was at 850, 10% below where it was ten years earlier. Today the S&P is about 1100, about the same as it was ten years ago, but thirteen times what it was in 1982. That's a compounded annual rate of return of about 9% for the past 28 years despite the recent "lost decade".

In 1982 you had to be insane to buy stocks. Money markets were yielding 15%, tax free bonds were at 9% and inflation was outpacing the growth in corporate profits by two to one. We had just lost the Vietnam War, communism was on the march and the country was broke and deeply divided. What followed was the longest, greatest bull market in history.

THE GERMAN ECONOMY IS TEN TIMES THE SIZE OF THE GREEK ECONOMY

One third of the German economy is exports. What has been bad news for Greece has been good news for German exporters because a weak Euro makes them much more competitive. "The European Problem" will hurt Greek government workers, but it is a welcome development for German heavy equipment makers and their employees.

What Europe needs more than anything is growth in their economies and that has to come from exports to emerging markets. A weaker Euro is just the prescription they need to end their economic malaise. If Germany can get a point of GDP growth thanks to a weaker Euro they should send Greece a thank you letter instead of complaining about guaranteeing their debt.

WE CAN SOLVE OUR DEBT PROBLEM

Depending on how you measure it, our public debt will equal our gross domestic product in about ten years. At that point we will be flirting with duplicating the balance sheets of Greece and Italy. So far, we have been given a free pass to run up our deficits without trashing our currency or raising interest rates because we look like a pillar of strength compared to a dysfunctional Euro, an endless recession in Japan and risky emerging markets.

To get the debt /GDP ratio to 100% from the current 52%, you have to assume that we continue to run budget deficits at a rate of 4-6% of GDP even after the economy returns to normal growth rates in 2012-13. If we can keep deficits in the 3% range, we will keep the debt/ GDP ratio below 70%. If we can get the deficit down to 3% of GDP and grow the GDP by 3%, we don't have a problem at all. So let's be clear, over the next ten years we need to increase taxes or reduce spending by 2-3% of GDP to avoid a fiscal mess.

That means that by 2020 we need to save or increase revenue by \$450 to \$650 billion in a \$5.6 trillion dollar budget. Federal spending can still go from the current \$3.5 trillion to \$5.6 trillion in 2020. We just need revenue to go up or expenses to go down by about 10% of projections.

Modest tax increases and rational cuts could solve the deficit problem. We haven't mortgaged our children's futures, at least not yet. The United States has walked to the brink of fiscal crises before and always done the right thing. I think the chances are very good that as the economy improves, we will focus on deficits as we did in the nineties and fix the very fixable problem. If we don't, there will be plenty of time to buy gold and move investments off-shore, but to bet against the US right now seems like a bad idea.

THE WORLD IS NOT RUNNING OUT OF ENERGY AFTER ALL

We probably won't be drilling a lot more deep water wells anytime soon, but we will be drilling in apple orchards in Pennsylvania and in wheat fields in Colorado. We won't be finding oil, but we will find enough gas to last most of the next century by extracting it from vast shale fields.

According to Amy Myers Jaffe of Rice University and a lot of others, shale gas will "Rock the World". It should give the world another fifty years of cheap, relatively clean energy. It could break OPEC because it's domestic, to not just the US, but Europe and China too. It will be a viable alternative to coal for electricity generation and diesel for heavy transportation. It will change the political map as we become less dependent on hostile countries to fill our energy needs.

Thanks to enhanced drilling methods, shale can be forced to yield trapped gas at costs that are profitable even at today's depressed gas prices. Shale gas offers the prospects of US drilling technology and US jobs, replacing payments to foreign dictators and terrorists. You'd think the press would be all over this story. It's one of the great developments of the century. I guess they are too busy predicting the decline of western civilization.

NEW RULES

- 1. If you are going to predict a disaster, it has to be worse than what I have already lived through, or I'm just not getting scared.** I have lived through

- recessions, financial panics, regional wars, energy shocks, inflation and deflation. The market still went up at an annual rate of 9%. They don't scare me!
2. **If you are going to predict a disaster you have to disclose how you personally are prepared to deal with it.** If you are going to say that the recession will turn into a depression, please tell me when you sold your house in anticipation of its value going down 50%. When you sold all your stocks and when you bought long treasury bonds, which would be the only thing expected to appreciate in a financial collapse.
 3. **Don't tell me what happened, tell me what will happen.** It makes absolutely no sense to say you are selling a stock because it went down or announced poor earnings. Buying a stock after a good company announcement, or because the economy is humming is also senseless... EVERYBODY KNOWS THAT AND IT'S IN THE STOCK PRICE! There is very little chance that investors failed to react to the news and a good chance that they overreacted.
 4. **If you are going to go into the business of predicting anything, I want to see your track record first.** Ever wonder why there are thousands of people offering market predictions, but only a handful that give you their track record? Ever wonder why thousands make economic predictions, but only a handful is successful, and was the handful good, or just lucky? Ever wonder why they even try?
 5. **Abolish all blue ribbon panels.** For the administration and congress to appoint a panel to figure out how to balance the budget after they exploded it, is like a serial killer asking someone to autopsy his victims. They pass a bill that limits oil companies to 75 million on offshore drilling damages and then have to appoint a panel to figure out why the oil companies weren't more careful? They write a tax code and fund government agencies that do more to subsidize housing than any country on earth, and then they appoint a commission to figure out why we had a housing bubble. THEY CAN'T BE SERIOUS!

FORGET THE NOISE, CONCENTRATE ON THE BIG PICTURE

We've been here before. Recoveries are always met with initial skepticism, are uneven in their progress and irregular in their effect on various parts of the economy. Regardless of the shape and velocity of the recovery, once begun, they are seldom derailed. Forget the noise, concentrate on the recovery.

Stock market recoveries are marked by several stages. Initially the riskiest stocks do best, as companies thought to be near worthless rise from the dead. Then the cyclical stocks run as retailers, transportation and natural resources that typically are decimated in recessions become logical investments in a recovery.

Once the fun and games of the initial market recovery are over, it's time for the blue chips to shine. When the market has finally determined that the recovery is real, the big money begins to move cautiously into the market. At this point big, liquid, blue chip stocks are what institutions are looking for to establish market exposure.

We believe that we are in the later stages of the initial market recovery and approaching the time when big cap stocks will lead the market higher. This is a wonderful time for investors. Major US corporations have clean balance sheets, lots of cash and solid international operations that should provide decades of growth. Best of all, they are remarkably inexpensive.

Add these together and you get a portfolio of the leading companies in each of the eight major industrial groups selling at an average discount of 33% from their historic valuations (source Value Line) and yielding 2.7%, which is 7% more than the yield on a 5yr treasury note and 40% more than these companies have traditionally paid out.

It is seldom in an investor's lifetime that the market offers today's combination of valuation, income and opportunity for growth in great companies in every industry.

	P/E		YIELD	
	2010	15yr Ave	Current	15yr.Ave
PepsiCo	13	21	2.9%	1.5%
Johnson & Johnson	12	18	3.7%	1.9%
Wal-Mart	13	22	2.4%	0.9%
United Technologies	14	17	2.5%	1.5%
Comcast	5*	11*	2.0%	0.2%
JP Morgan	11	16	0.5%	3.5%
IBM	13	19	2.0%	0.7%
Southern Co	13	15	5.4%	4.9%

(*Cash Flow)

With an average valuation of less than 13 times this year's earnings, this portfolio has an average earnings yield of about 8% (1/13) on top of the 2.7% dividend yield for a total current yield of 10.7%. These companies are the best of the best, some of the top companies in every industry. They offer better balance sheets, superior management, better diversification and more international exposure than smaller, more risky companies. Welcome to investor heaven.

IT'S BETTER TO BE AN OPTIMIST THAN A PESSIMIST

Personally, in business and in investing, I have never met a truly successful individual who was a pessimist. We can argue how to be successful, but you have to believe that you will be successful or you will certainly fail. Pessimists are not only less successful than optimists, but according to recent studies, they aren't as happy and have poorer health. Take your choice!

