

Can an Equity Portfolio Deliver Solid Returns in an Environment with Sluggish Economic Growth and High Unemployment?

A rapidly growing economy does not necessarily generate commensurate growth in corporate profits, dividends, and hence, returns to investors. Since 1990, low-growth economies have generated superior stock market performance. It has been said that, historically, buying into equity markets with a high GDP growth rate gives a return that is below the return of markets with a low GDP growth rate. In fact, the correlation of real stock returns and per capita GDP growth may be negative, as shown below.

<u>HIGHEST GROWTH</u>			<u>LOWEST GROWTH</u>		
Decade	Average Rate of GDP Growth	Dow Jones Total Return*	Decade	Average Rate of GDP Growth	Dow Jones Total Return*
1940-1950	11.2%	2.9%	1920-1930	3.0%	8.8%
1960-1970	6.9%	1.7%	1990-2000	5.5%	15.4%
1970-1980	10.0%	0.5%			

* Dow Jones Industrial Average for the decade

Source: Crestmont Research

In summary, quarterly stock return is a weak indicator of change in GDP three to nine months in the future; additionally, quarterly change in GDP does not predict future stock market movement.

There are several reasons for this phenomenon, but the two primary reasons are valuations and monetary policy. During periods where the economy is strong, numerous studies show that investors are usually more aggressive and are more willing to engage in risky behavior (i.e., they chase returns and become less focused on the downside). As a result, they often bid up asset prices (stocks, bonds, real estate, etc.), valuations become rich, and the risk/reward becomes heavily skewed on the downside. In addition, the Fed typically attempts to control economic growth so it does not become robust enough to fuel inflationary pressures. As a result, interest rates often start to rise (or other restrictive fiscal policies are put into place) to curb economic growth. This usually creates a strong headwind for equity investors.

Fortunately, there are numerous ways for a portfolio of select stocks to deliver solid returns in a sub-par economic growth environment. Today, the U.S. is slowly emerging from a deep recession. While many corporations have laid people off and restructured (which negatively impacts individuals), they have increased their efficiencies by trimming excessive expenses wherever possible (which positively impacts investors). In addition, after an economic downturn, companies that have utilized financial discipline can often grow their earnings at a very rapid rate, with very little revenue growth. They have become much more efficient and possess a large amount of operating leverage. For example, prior to the downturn, for every \$1 earned, roughly \$0.45 fell to the bottom line. But for a company that has tightened its belt, improved efficiencies, yet maintained its franchise, for every \$1 earned, approximately \$0.60 now falls to the bottom line. In other words, while still generating the same amount of revenues, earnings have increased by 33%. Several of our portfolio holdings fall into this category and are up nicely for the year (as illustrated in the chart).

Company	Revenue Growth Year-Over-Year	Earnings Year-Over-Year	YTD Returns (through 3/16/2010)
Burger King Holdings, Inc. (BKC)	-3.3%	12.1%	6.9%
Mead Johnson Nutrition Company (MJN)	2.0%	14.8%	17.8%
Nuance Communications, Inc. (NUAN)	-8.6%	81.8%	10.1%
Varian Medical Systems, Inc. (VAR)	-6.5%	14.3%	13.5%

In addition, restructuring activities usually increase cash flows. In fact, today, companies have an aggregate of \$2.1 trillion in cash on their balance sheets. During periods when driving earnings growth is difficult, companies often consider acquiring small- to mid-sized companies with solid franchises, unique niches, and the ability to generate substantial cash flows. Kraft's acquisition of Cadbury is a perfect example of this point. Kraft operates

(Continued on back)

in very mature industries and is exposed primarily to the U.S. market. Cadbury, on the other hand, has substantial exposure to emerging markets, where growth is quite robust. Ultimately, Cadbury proved to be an attractive acquisition candidate for Kraft.

Recently, merger and acquisition activity has begun to increase nicely. As a result, investors may be amply rewarded by identifying companies that trade at substantial discounts to their private-market values and that have unique franchises which generate sustainable cash flows. In a focused portfolio that holds 30 to 35 stocks, one or two acquisitions can have a substantial impact on the portfolio's total return.

Thus, while it may seem counterintuitive, a slower GDP growth period may not be a negative for equity investors. In fact, it may be fertile grounds for select investments to perform very well and produce above average returns.