The Cheap Get Cheaper

"If you can keep your head when all about you are losing theirs..."
-*If*, by Rudyard Kipling

Europe On The Ropes

Here we go again. The current market correction, measured from the April highs, briefly met the common definition of a "bear market" this week with a 20% peak-to-trough decline. At press time, the S&P 500 Index has shed 10% of its value for this year to date. The prospect of a global recession, led by Europe, is looming over markets and damaging investor psyche. The European debt crisis is the latest of several major macroeconomic events to roil the markets in the past twelve years, and increasing volatility is causing investors to spurn equities, further feeding the decline. With no obvious catalyst for economic improvement in sight, market sentiment is horrible and investors seem to be giving up hope.

The current disdain for stocks is understandable. Since the start of the last decade (January 1, 2000 through September 30, 2011), the S&P 500 index has provided a total return of -4.48%, including reinvestment of dividends. This horrendous twelve years includes three "once in a lifetime" market events: the bursting of the "tech bubble" in 2000-2002, the financial crisis of 2008-2009, and the current "European debt crisis." Of course, each situation originates from a unique set of circumstances. The early part of the last decade was much more than the unwinding of a technology bubble; it was a very predictable reversion to more normal market valuations at a time when virtually all stocks were priced for perfection. The financial crisis was a liquidity-driven event resulting from excessive leverage. The European situation is not at its core a liquidity issue, but a political one. Using only this unusually volatile period as the basis for evaluating the merits of equity investing is problematic at best. Over time, the historical record for stocks is much more favorable. Our objective, however, is not to rely upon the tired mantra of "stocks for the long run." Our job is to assess the current set of risks and opportunities and determine how to best position our clients for the future.

Economic Risks Increasing, But Recession Far From Certain

The risks to global economic growth are undoubtedly increasing. The European crisis of confidence is almost certainly tipping a number of those countries back into recession. China is now attempting to engineer a "soft landing", in an effort to cool domestic inflation. Here in the U.S., high unemployment and a weak housing market

> "When headlines are driving market sentiment, a distinction between an economic forecast and an investment framework is critical."

continue to impede the recovery. It should be noted, however, that the U.S. financial system is far better prepared to weather the European situation than it was a few years ago. Banks are much better capitalized, and the Federal Reserve has been as aggressive as it can be in providing liquidity. Despite the pervasive gloom, the consensus opinion among economists – even at this point – indicates a less than 50% chance of a renewed contraction. In fact, of the eighteen economic data points released the week of September 30th, fourteen exceeded expectations, according to Bespoke Investment Group. Unfortunately, European concerns have overwhelmed the economic data of late.

Uncertainty Abounds

Perhaps a more insidious impediment for the markets is the uncertainty at all levels. Policy makers are gridlocked in their effort to deal with crushing sovereign debt. Businesses, facing uncertain demand and burdensome tax and regulatory regimes, are sitting on large hoards of cash rather than investing in new projects or adding to payrolls. Consumers are overextended and worried about their jobs, if they have one. As we have seen countless times before, markets tend to reflect uncertainty in the form of larger-than-normal discounts to intrinsic values... which is to say that stocks, while attractively priced today, can get cheaper.

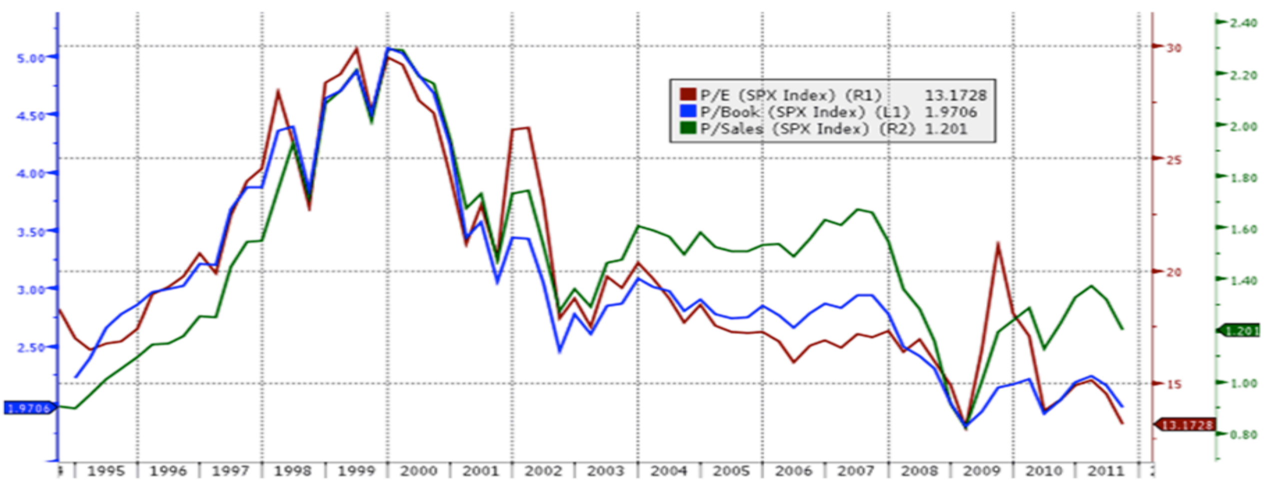
Headwinds to a Strong Recovery

With economic risks building, we may well be in for a sustained period of very anemic (or zero) growth. For our investment outlook to have any credibility, it is important to acknowledge this possibility. Over the past two years, earnings and stock prices have advanced sharply. But this was more the result of strong operational leverage, not a sustained improvement in organic demand. We are still in the midst of a global deleveraging process, and it will simply take time to work through.

The Economy vs. The Market

In times of turmoil, when headlines are driving market sentiment, a distinction between an economic forecast and an investment framework is critical. Although the former may leave little room for optimism in the near term, the latter is actually more promising. The best opportunities tend to present themselves when pessimism is rampant and stock prices are falling. Today, for investors with time horizons of more than a few years, we see a strong probability of positive returns

Valuations Reflect Low Expectations



Source: Bloomberg

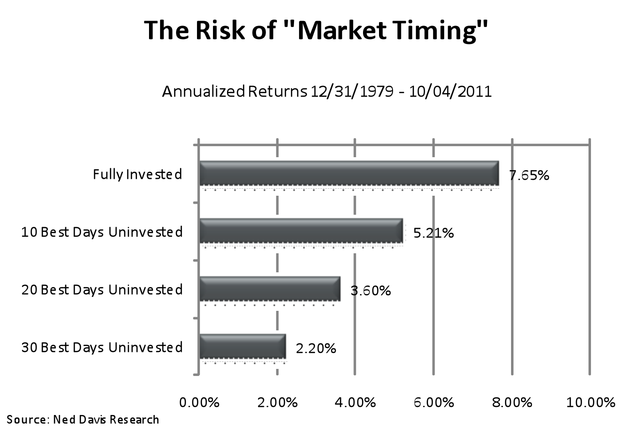
approaching the historical averages, particularly with a disciplined approach to stock selection.

Valuations Favor Equities

Valuation is integral to our expected returns outlook. Equity prices appear to already reflect the possibility that corporate earnings will contract significantly. As shown in the accompanying graph, valuations by several measures are at their lowest levels since the early 1990's. Further, the amount of earnings available for a dollar of equity investment (known as the "earnings yield") is very attractive compared to the alternatives. Today, this yield for the S&P 500 (at 12x trailing earnings) is 8.3%. By contrast, the yield on the ten year US Treasury notes stands at 2% - the equivalent of a 50x P/E! In other words, while the price for risky assets today is relatively low, the price – and risk - of stability is exceedingly high.

Risks of Market Timing

With an increasing risk to the earnings outlook and our repeated reference to a "multi-year time horizon" the question arises: "Why not sit on the sidelines for a while (in cash), while this plays itself out?" A good question, but one that assumes an ability to correctly identify the proper time to jump back in. The largest gains tend to occur in the early stages of a market recovery, and missing them can be severely detrimental to long term returns, as shown here.



Adding Value Through Active Management

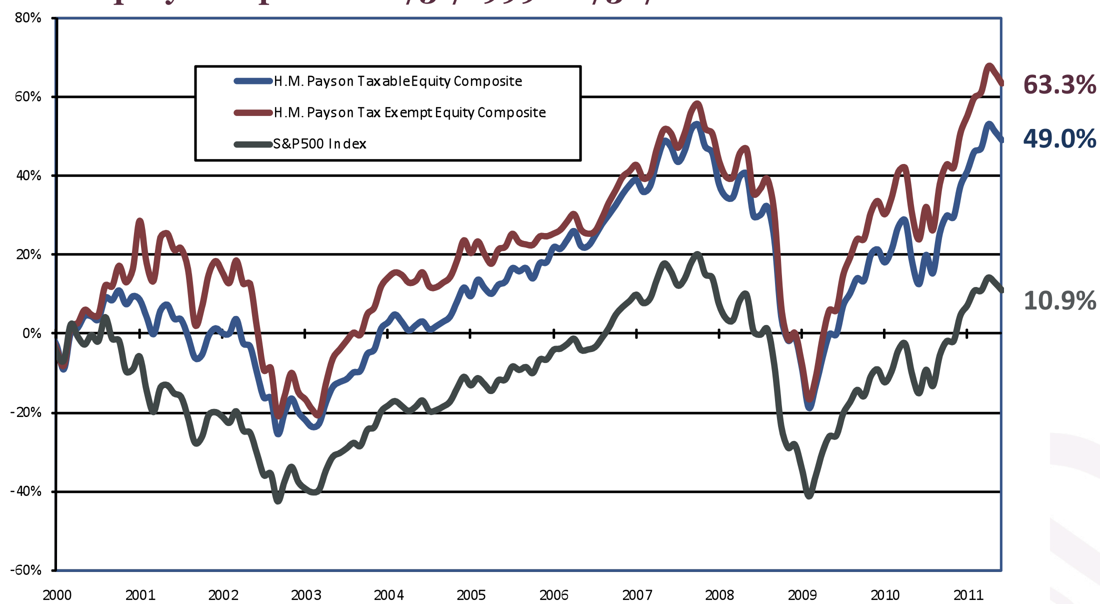
More relevant to our clients than our view on the economy and the overall market is that we build and actively manage portfolios of individual securities - not passive indexes. Investment value can be found in any market environment, and it happens to be prevalent today. Our research department continually scours our investable universe for companies with characteristics that are likely to produce above-average returns over time: high and sustainable profit margins, strong balance sheets, and shareholder-friendly management. Regardless of the macroeconomic outlook, our portfolios are comprised of companies generating healthy profits and returning cash to shareholders through dividend increases and stock buybacks.

"Value" can also be defined in a variety of ways. Today, with the economy stalled, it is largely a question of where we find growth - because the market is not commanding a high price for it. Two good examples would be IBM and Apple, which have returned 19% and 16% this year respectively. Each trades at approximately 12x this year's earnings estimate. As we have stated in recent communications, our affinity for stocks extends to portfolios where income is a consideration. For the first time since the mid-1950's the dividend yield on the S&P 500 exceeds that of the ten year treasury. On top of that, the quality companies in our portfolios are well-positioned to continue increasing payouts to shareholders.

As shown in the accompanying graph, our clients have enjoyed equity returns far exceeding those of the index through this period of unprecedented challenges. This is directly attributable to our flexible approach, dispassionate assessment of risk, and attention to valuations. Periods such as the current one can shake one's faith in the markets to the core. But if we have learned anything from the past decade, capitalism –

though imperfect – is an incredibly resilient economic system. Although we cannot predict the outcome in Europe, China - or even here in the U.S. – we believe investors who can keep their heads in times like this will ultimately be rewarded for suffering through the volatility.

Equity Composites 12/31/1999 – 6/30/2011



Source: HMP Research Department

Performance data is based on the actual investment results of portfolios we manage and include equity accounts and the equity portion of balanced accounts. The taxable equity composite includes all taxable advisory and trust accounts and includes accounts with a wide variety of investment objectives, time horizons, risk tolerances, and constraints. The tax-exempt equity composite includes fully discretionary tax-exempt accounts with market values greater than $400,000 and without restrictions or extreme needs. Historical returns presented have been calculated using total return, including realized and unrealized gains and losses, plus income. Returns exclude the effects of cash held in the portfolio, are net of trading expenses and exclude management fees.

Market Log- 10/5/11

S&P 500: 1144.03
10 year T-Note: 1.91%
Crude Oil: $79.68
Gold: $1,640.30

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