The Long & Short of It
Quarterly Newsletter
Second Quarter 2010

Pricing in Uncertainty
Thirteen months into the rally that ensued from the March 2009 bottom, uncertainty raised its ugly head and, along with it, volatility. This resulted in a second quarter selloff of about 11% in domestic equity markets and somewhat worse in international equity markets. Positive price performance could be found in U.S. Treasury bonds, gold, and gold mining stocks as investors reduced risk exposure and moved toward safety.

RVM's Contrarian Value Equity Composite Portfolio Fundamentals *as of 6-30-10*

	RVM Equity Composite	S&P 500
Number of holdings	32	500
Wtd. Avg. Mkt. Cap. ($B)	58.5	75.4
Price/Earnings Ratio	11.2x	18.6x
Price/Book Ratio	2.7x	3.3x
Price/Cash Flow	6.2x	10.3x
Dividend Yield	2.9%	2.1%
Return on Equity	18.8%	21.0%

A media onslaught fueled uncertainty during the quarter. We kept a close watch on the countless *Wall Street Journal* articles written in the days following large market declines. Areas of concern included: Greek debt crisis, European debt crisis, end of the Euro, European banks' ill health, China's slowing economy, declining global growth, politicization of the Federal Reserve, excessive public employee compensation (especially early and lucrative retirement packages), state and local budget deficits, BP's blowout, oil-soaked pelicans, drilling moratorium, growth of the Federal government, rising national debt, austerity in Europe, immigration policy, financial reform, McChrystal's release, Chinese Yuan, Iranian nukes, Supreme Court nominees, "Flash Crash," terrorism as "man-made disasters," bombs in Times Square, cessation of federal housing subsidies, fears of declining home prices, Turkey's shifting alliances, aid flotillas, implementing ObamaCare, protectionism, falling consumer prices, weaker consumer spending, eroding consumer confidence, funding Fannie and Freddie's failures, fraud at Goldman Sachs, value added tax (VAT), Medicaid and Medicare cuts, Stimulus III, small business credit crunch, jobless recovery, Russian spies, carbon taxes, and last but not least, expiration of the Bush tax cuts.

Surely, there are things we missed, but you get the idea. The second quarter's deluge of reports supported innumerable reasons to be concerned about uncertainty and risk. That said, a continuation of this environment for the next six months seems improbable, and any relief would be appreciated by investors and the markets.

In his 1995 book Risk, John Adams states:

> *Risk is defined, by most of those who seek to measure it, as the product of and utility of some* ***future*** *event. The future is uncertain and inescapably subjective; it does not exist except in the minds of people attempting to anticipate it. Our anticipations are formed by projecting past experience into the future. Our behavior is guided by our anticipations. If we anticipate harm, we take avoiding action.*

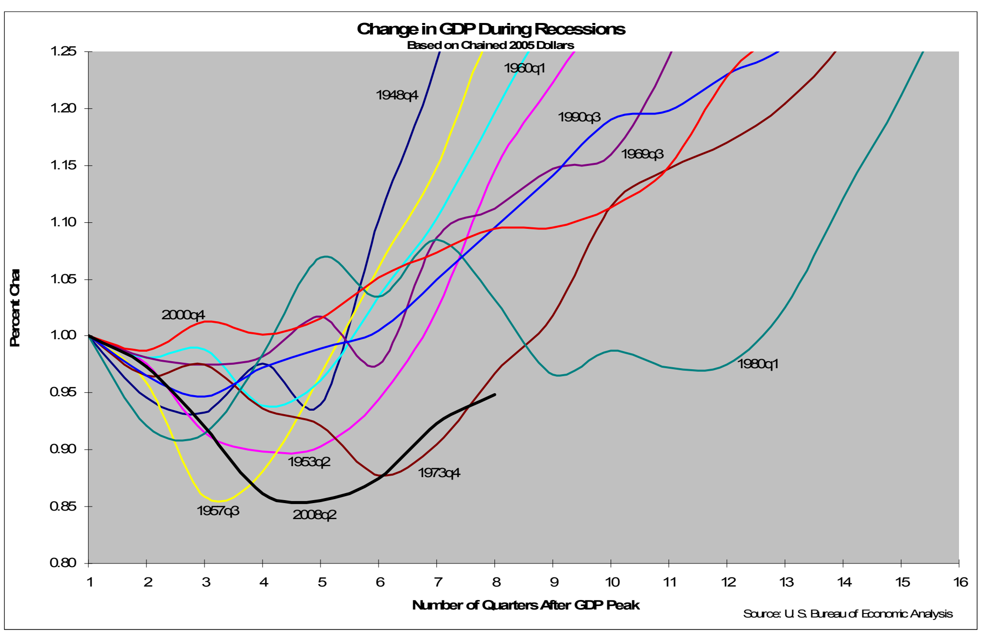
For most events in which people participate, this *avoiding action* involves getting away from danger. Let's consider the example, "do not play in the freeway." The consequence of this avoiding action is a reduction in the number of accidents. Fewer people playing in the freeway might reduce the number of people getting hit by cars, but the possibility of danger could remain unchanged or even continue to increase. In short, despite improved accident statistics, this reduction does not mean the freeway has become a safer place to play.

For investors, selling an asset perceived to be risky is the *avoiding action*. As more investors choose to sell, the drop in price becomes larger. Investments perceived as risky therefore garner lower prices. Interestingly, the larger the drop, the greater the perception there is that risk exists and/or is increasing. For a normal example, in response to a flourish of motorcycle accidents, it might become extremely popular to drive a Volvo. At that point, motorcycles would be perceived as suitable only for the non-thinking. But in investing, reality runs contrary to normal life. The more its price declines, the more attractive that investment becomes. After large declines, an investment frequently offers the bold investor a greater yield for each dollar placed in it. In motorcycle terms, this would mean that the less we choose to ride motorcycles, the safer and more efficient form of transportation they become. Clearly, this makes no sense. Yet in the realm of investing, mass consensus about the wisdom of participating in or avoiding a particular investment can have a large inverse impact on that prospect.

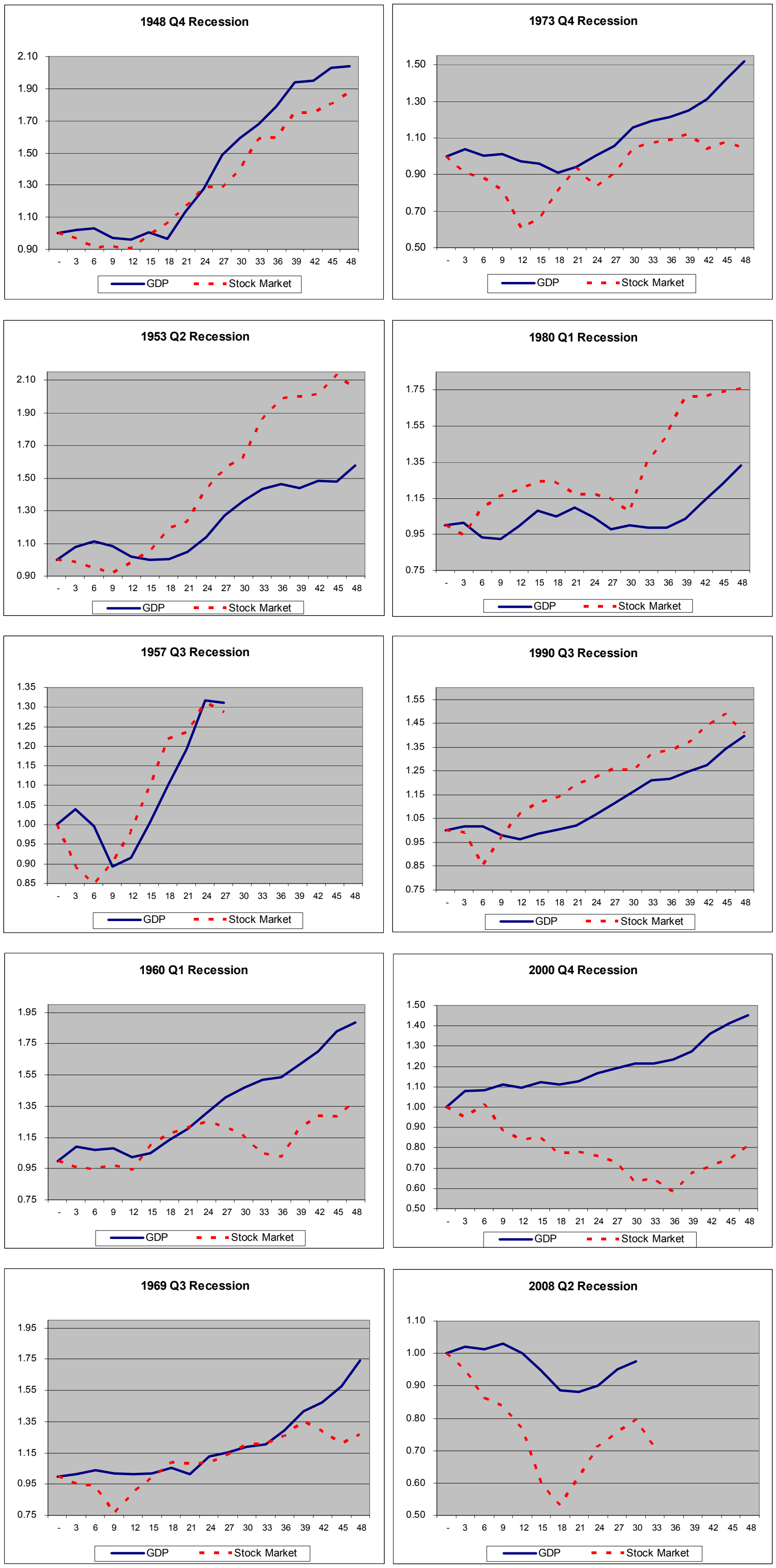
An overriding theme across much of this quarter's news involved the government's activities. When a political party enjoys a majority position, it hopes to accomplish all it can while controlling both the House and Senate. Historically, as new legislation is introduced during the first two years of a Presidential administration, stocks perform poorly. The utility of the finished legislation is often less important for short-term investment performance than the debate surrounding that legislation's future impact. As uncertainty peaks during these debates, the stock market tends to bottom. As our country moves towards the November elections, Congressional posturing will likely die down and the incidence of new major legislation will begin to ebb. Washington will then probably move toward a benign gridlock and begin dressing up the economy for the next Presidential election. At that moment, stock market performance should start to improve and ultimately sustain itself.

Recessions and Stock Market Performance – Fear Peaks

In post-recession recoveries, there will frequently be a pause in the rate of growth. Although a "double-dip" is quite rare, a slowing of the growth rate should be expected. The likelihood of each quarter's growth rate being greater or less than that of the prior quarter has historically been about 50/50. Recently emerged from the bear market, investors are quick to duck for cover or even panic. Analysts describe the S&P 500 as a good but less-than-perfect leading indicator, seeing as it has "correctly" predicted 10 of the last 5 recessions. When it comes to forecasting, the market's vision is indeed less than perfect. Frequently,



Post World War II Recessions:
Percent Change in GDP & S&P 500 for 48 Months Following Stock Market Peak



even if recovery is not in jeopardy, a mere slowing of the growth rate can discourage fearful investors. Between now and the upcoming November elections, we may find ourselves in such a moment.

In the first quarter of 2010, GDP growth slowed to 2.7% from 5.6% after three sequential periods of accelerating growth. Expectations for the second quarter are currently showing a mild acceleration, back to about 4.0%. There is also no guarantee against a double-dip. The early 1980's remain imbedded in our memories and thus far, Washington has continued to pursue change over certainty.

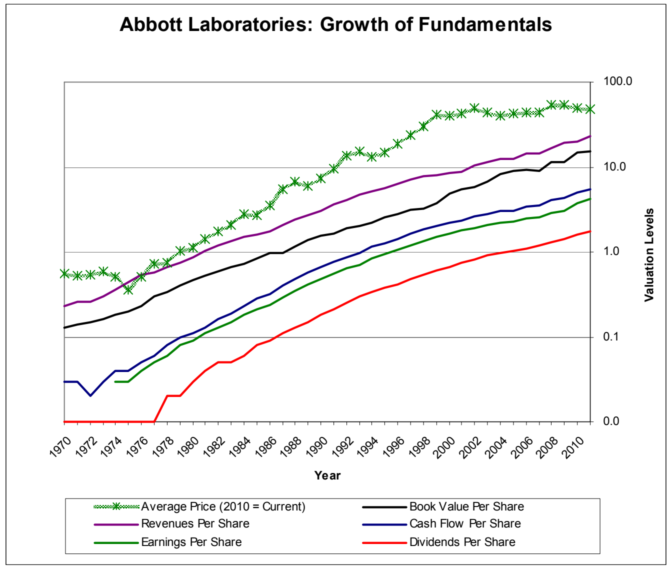
During the 1980 recession, the first dip was very shallow compared to that of the Great Recession of 2008. The subsequent rebound was also a bit too strong to be sustained; thus the ensuing "double-dip" recession of the early 1980's (see graph to left, "1980 Q1 Recession"). More comparable in magnitude are the dips starting in 1953, 1957, and 1973. From these deeper declines the economy had more direct ascents, though a few times the market dipped mid-recovery, anticipating a slowdown that never materialized. Circumstances are quite different today; there remains a lot of cash on the sidelines that will likely be put to work as soon as investors begin to feel safe again. Skittish investors experiencing a pause in growth during a recovery—as well as the push to pass legislation before a potential shift in balance of power—provides good reason for a correction as uncertainty lingers. We will watch for the eventual continuation of recovery and the stabilization of the laws of the land for better markets.

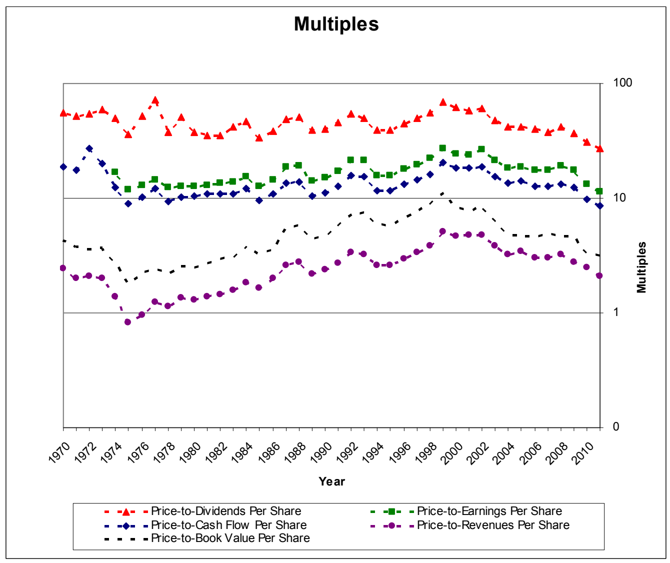
Stable, Growing Fundamentals

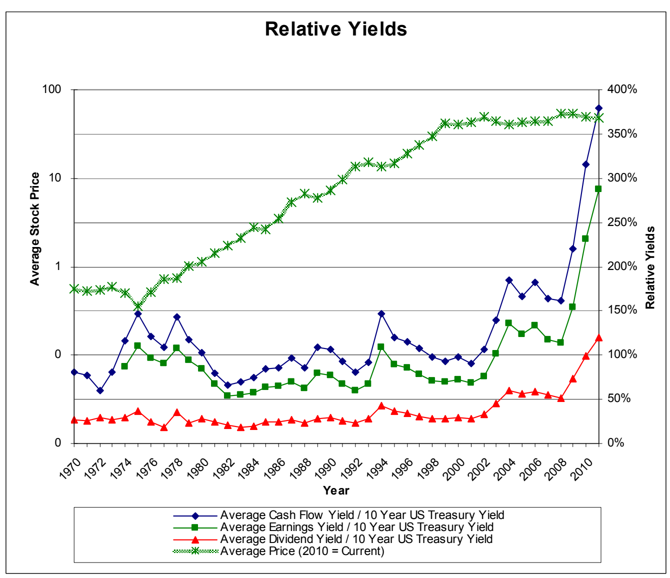
In the end, keep in mind that one invests not in GDP or the administration but rather the stocks and bonds of individual companies. Underlying the macro-political-economic hubbub are individual companies with very strong balance sheets, motivated employees, and good management. When they all work together, they accomplish amazing things and become vital, profitable businesses that deliver ever-improving products and services to people who need or want what they offer. The world turns and these companies deliver. Large, domestic blue-chip companies, very popular in the late 1990's and ever so overlooked for the past decade, are reaching valuation levels that are extremely compelling. After ten years of near-zero returns, numerous private and professional investors are succumbing to the pressures of their recent experiences and avoiding these stocks. Indeed, we very often hear nowadays that "Buy and Hold is Dead" and "Stocks are Dangerous to Your Wealth." Perhaps these pundits are the same optimists who, in early 2000, touted the "New Economy" as a path to riches and declared Warren Buffet passé.

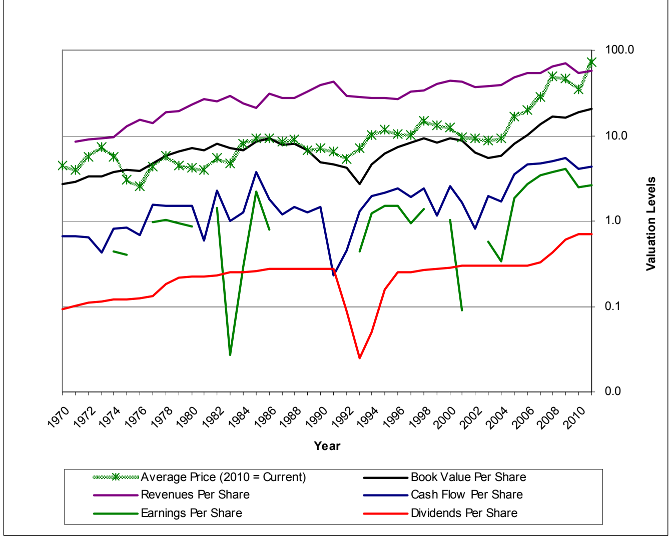
For example—and there are many—let's examine Abbott Laboratories and its low multiples on stable growing fundamentals. By contrast, we will also consider Cummins Incorporated and its higher multiples on volatile/cyclical growing fundamentals. Neither of these stocks is currently owned by RVM, its clients, or principals.

Abbott Laboratories (ABT) develops, manufactures, and sells a broad range of medical, diagnostic, and nutritional products worldwide. After more than a decade of horizontal movement, the current stock price remains below its 1998 highs. On the other hand, the per-share fundamental measures of value (dividends, earnings, etc.) have exhibited very stable growth over the same time frame and, in fact, for much longer than

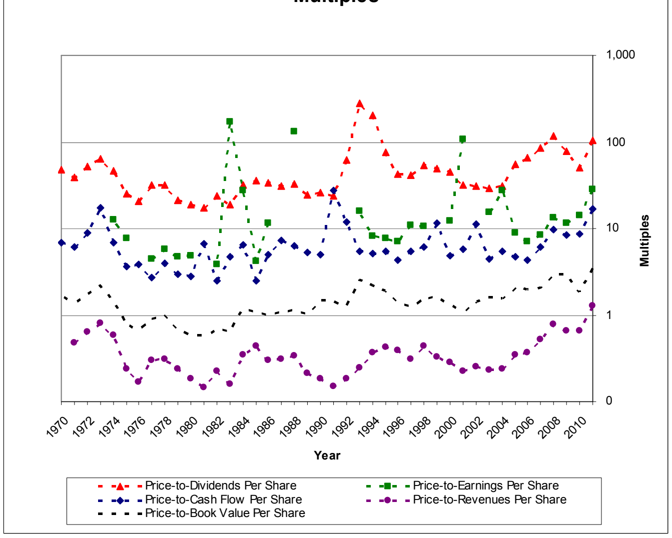




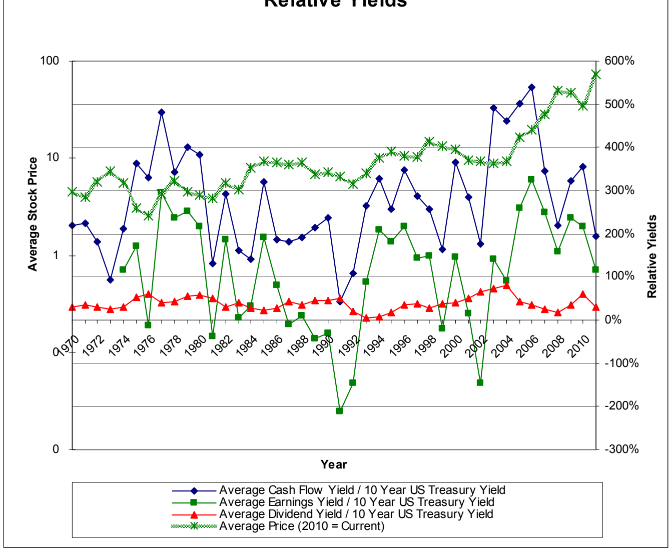




Cummins: Growth of Fundamentals



Multiples



Relative Yields

what appears on the chart (see “Abbott Laboratories: Growth of Fundamentals”; history back through 1969 is shown). On average, these measures of value have nearly doubled since 1998.

As ABT’s price has held steady and its fundamentals improved, its multiples have declined to around historic lows (see “Abbott: Multiples”). If we turn these multiples over to look at them as yields, and then compare those yields to that of the 10-year U.S. Treasury note (currently just under 3%), the story becomes significantly more interesting (see “Abbott: Relative Yields”). Today, the dividend yields on many stocks exceed the yield to maturity for the 10-year U.S. Treasury Note. Unlike the coupon on the Treasury note, ABT’s dividends are growing and funded by a stronger balance sheet than that of our federal government.

Of course the details of company analysis are always more complicated than just some set of numbers. It is also possible that stable growth for companies like ABT could be coming to a sudden end. Seemingly sure investments in the past have been known to take less than a day to evaporate. But at this time, we would rather own the common stock of large, domestic, and high-quality companies whose stable dividend yields are greater than the yield to maturity of U.S. Treasury paper.

Not all companies today are as cheap as Abbott Laboratories. To contrast, we present Cummins Incorporated (CMI). Though, again, there are several possible examples, CMI illustrates a stock that RVM would avoid in the near term. CMI manufactures, distributes, and services diesel engines for transportation, industrial, and power-generating markets worldwide. It is an exceptional company and with its swiftly rising stock price, per-share multiples are now around twice that of ABT. Its multiples are historically visibly more volatile due to the cyclical nature of its business. Current relative yields do not even begin to approach their historical highs (see “Cummins: Growth of Fundamentals”).

CMI has the burden of investor confidence. It will have to grow its fundamentals very quickly to keep investors happy. Moreover, the stock price will have to continue to do most of the work since the dividend yield is a paltry 1%. The history of that modest dividend is also more unpredictable than ABT's or the coupon from a Treasury note. In addition, CMI's median growth of cash flow per share over the last ten years has been 6.7% versus ABT's 7.0%. In summary, more volatile fundamentals, slower growth, higher multiples, and below-average dividend yields (that are lower than the 10-year UST) make CMI a higher-risk, less attractive investment.

Looking through our list of large-cap domestic companies, we identified the first ten names that had long-term stable growth and dividend yields greater than those of the ten-year UST. By way of full disclosure, ADP, CVX, KO, MHP, MRK, and PG are owned by our clients and in our model portfolio. We cannot go so far as to recommend them to you as the future is uncertain and inescapably subjective. In addition, that is not the purpose of this quarterly missive. But we are happy to be able to point out that, as students of history, we find companies' common stocks to exhibit interesting characteristics during unusual times.

Ten Greater Than "The 10"

Long-Term Stable Growers With Yields Greater than the 10 Year U.S. Treasury Note

Symbol	Company Name	Price (6/30/10)	Price/Earnings Ratio	Yield
ABT	ABBOTT LABS	$ 46.78	14.1	3.7%
ADP	AUTOMATIC DATA PROCESSING	$ 40.26	15.4	3.3%
CVX	CHEVRON CORP NEW	$ 67.86	11.2	3.9%
JNJ	JOHNSON & JOHNSON	$ 59.06	11.9	3.7%
KMB	KIMBERLY CLARK CORP	$ 60.63	14.0	4.2%
KO	COCA COLA CO	$ 50.12	17.3	3.4%
MHP	MCGRAW HILL COS INC	$ 28.14	12.1	3.2%
MRK	MERCK & CO INC NEW	$ 34.97	6.9	4.3%
PEP	PEPSICO INC	$ 60.95	16.1	3.0%
PG	PROCTER & GAMBLE CO	$ 59.98	16.1	3.2%
TC10Y	10 YEAR U. S. TREASURY NOTE	$ 104.78	n/a	2.9%

It has been a difficult decade for equities and optimism—a boon to cynicism. RVM continues to recommend owning some gold mining stocks as a hedge against the periodic and always potential damage inflicted by inflation. The next few years may be a better time than average for such protections. However, valuations for some stalwart companies are very compelling and pessimism is very widespread. Debts needs to be paid down and governments need to find better ways to support private wealth creation, but surely moments such as these comprise the realm in which long-term market bottoms form and the foundations for future increases are built.

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