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One Thing is Certain: Uncertainty

By Rob Rohn, Principal

As investors return from vacations, put away the summer novels and pick up the daily financial press, they must confront much uncertainty in the world, economically and politically. It is a challenging time to be responsible for the management of financial assets, with seemingly limited safe asset alternatives among a minefield of choices and many changes afoot.

We face economic uncertainty in this country. While real GDP growth was recently revised upward to a 3.3% pace in the second quarter, it has slowed dramatically and may turn negative in the third or fourth quarter. We may manage to skirt the definition of recession but that would be a pyrrhic victory as the economy feels lousy and is unlikely to get better soon. Ed Hyman, respected economist of ISI, calls for “no recession and no recovery”. The headline cause of this situation is the real estate bubble deflation and the resultant damage to vulnerable credit markets.

Housing prices will stabilize and credit markets will heal eventually (though more bodies may float to the surface first). But these have derailed our economy’s “little engine that could” - the US consumer. The collapse in value of their single largest asset and the scary spike in everyday costs of living like gas and food have left wounds that may take a long time to heal. Rising unemployment, now over 6%, will further add to the pain. Consumer spending represents about 70% of GDP and, now that stimulus checks have been spent, probably will shrink for the first time since 1990. The corporate world outside of financial services has fared better but that cannot last. Tight credit markets, parsimonious consumer spending habits and higher input costs are crimping growth there as well. Corporate profits are likely to fall from record levels later this year even excluding the write-offs in financial services. Looking at 2009 and beyond, most expect only moderate growth but there is a wide range of views (+4% to -3% for 2009 according to a recent survey by ISI) demonstrating the level of uncertainty.

These economic pressures have clearly spread to the rest of the world. Over the summer the economies of the UK, Germany and Japan have sunk to the brink of recession and the G7 countries in aggregate are unlikely to manage more than 1% GDP growth in coming quarters. Developing markets are faltering as well. Heady growth rates in places like China and India are waning and those economies must confront a sobering transition from hyper-growth. Growth in the developing world so far seems to have decelerated in a gradual manner from close to 10% to something in the mid single digits. However, the recent decline in demand from the developed world has not yet fully been reflected. And stock markets in emerging economies (one of the most reliable leading economic indicators) are now down 30% from their highs.

There is also political uncertainty. We return from Labor Day confronted with very different choices in the US Presidential election, surprisingly close in the polls, and relatively unknown politicians with limited records on each ticket. We could see Democrats control both the White House and Congress for the first time since the early 1990s. And even after we know the result of the election (hopefully soon after Election Day), uncertainty remains as both platforms are built on a theme of “change”.

Change is afoot on the geopolitical scene as well. The US is no longer a lone “superpower” and will probably not be able to exert its influence as actively as it has over the past 20 years. Both China and Russia have now made it clear that they will not accept such a world order. China, of course, has recently staged its Olympic “coming out party” in a way to demonstrate its rightful place in the world. Russia has “come out” in a different way, demonstrating confidence in its strength and determination to influence world events. Rhetoric in the news since the invasion of Georgia is reminiscent of the

Cold War. So, investors must discount a future where the US will face more challenges to its interests abroad, and will likely have a declining share of influence in the world as well as a declining share of its GDP.

These uncertainties as well as the twists and turns in the financial markets warn investors that they cannot rely on recent investment trends either. Easy credit and rising operating leverage turbo-charged the robust economic growth in this country and led to double digit corporate profit growth over the last five years. In the process, risk aversion diminished across asset classes and the consequences are likely to be felt for some time. Nor can one count on strength in overseas markets driven by even faster growth and the tailwind of a weakening dollar. And, the upward spike in oil and commodity markets which has driven the energy and materials sectors may be breaking down, as high marginal demand from developing markets seems to have peaked.

So what is an investor to do in such an environment? One compelling alternative in this uncertain time is the shares of high quality companies with predictable and sustainable earnings and cash flow growth. In our view, sustainable growth companies have been a forgotten asset class for most of the last five years. Until recently, asset managers have been busy building allocations to equities of companies enjoying strong earnings momentum, international assets, alternative investments in strong commodity markets and hot hedge funds (high profile endowments now have 30% of their assets in “alternatives”). Unfortunately, one cannot easily build a position in sustainable growth companies. Characteristics like quality, predictability and sustainability of earnings growth require deep fundamental research and good judgment on the future. That is our endeavor at Sustainable Growth Advisers.

The relative predictability of the earnings and cash flows of great businesses will likely attract more attention as we continue down this uncertain path. These businesses do not need a strong economy here or abroad or a particularly favorable political agenda. Their strong competitive positions, the repeat nature of their business models and their long runways of growth provide ample opportunities even in challenging times. The companies in our portfolios have consistently generated double digit earnings growth through all economic conditions and we expect they will deliver again this year with earnings up approximately 13%. The standard deviation of the aggregate earnings growth behind our portfolio has been about 3% over the past 10 years, while the standard deviation of earnings growth of the S&P 500 is about 12% (see chart 1). Furthermore, this earnings growth is real and has not been manufactured through accounting treatment or “smoothed” through write-offs and one-time events. Earnings purity as measured by Thompson Baseline is over 90%.

Ambivalence towards this asset class over the last five years has left these companies at historically low valuations, even after good relative performance recently. Our portfolios are still trading at valuations that mark historic lows. The Enterprise Yield on the portfolio (our version of a true free cash flow yield available to shareholders) is still over 4.5%, near an all-time high, and higher than that of the S&P by our calculations. Looking at it another way, our portfolios still trade at a discount to the market on a multiple of real cash flow. While we have seen widening of the quality premium in the bond markets (spreads are now at 600 bps between high yield bonds and Treasuries), quality seems to remain at a discount in equities. And this Enterprise Yield is significantly more than 100% of the bond yield, a first in my 20 years of investing (See Chart 2). These measures and our DCF analysis indicate more than 50% appreciation potential to fair value. The magnitude of that opportunity at a time when there is such a stark contrast between the predictability of this asset class and an environment fraught with uncertainty is remarkable. We suggest the valuation anomaly will correct, yielding a high return with low risk in an uncertain time.

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Chart 1

SGA Portfolio Earnings Growth More Predictable

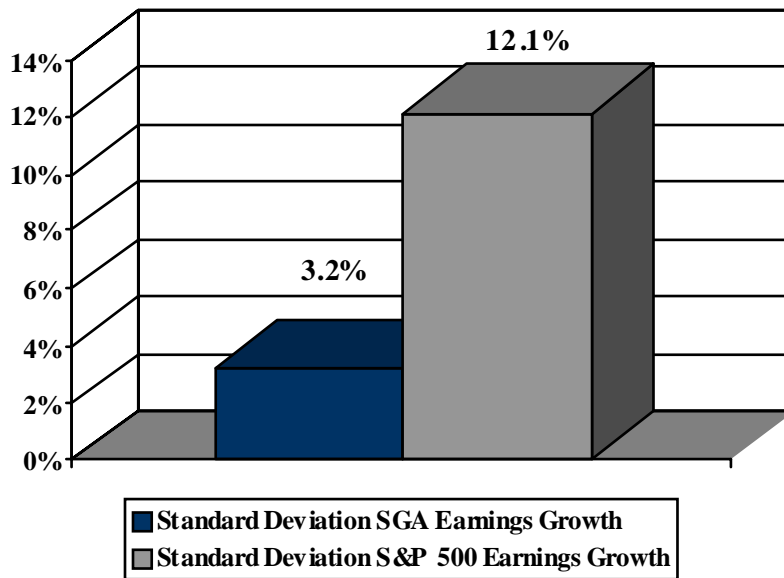


Chart 2

SGA Portfolio Is Attractively Priced on Cash Basis

3.7%=Bond
4.6%=SG A

