Market Commentary 9/30/11

To Infinity . . . And Beyond!

The original “Toy Story”, released in 1995 was Pixair’s first feature film, and the first feature film created entirely with computer generated imagery. The story is about a group of toys belonging to a young boy that come to life whenever humans are not around. The toys are led by Woody, a pull-string cowboy, until the arrival of a new astronaut action figure, the bombastic Buzz Lightyear. Buzz insists that he is a true space ranger, not a toy, and that he can fly. His delusion grows the more that he is challenged by Woody, until Buzz insists on proving his ability by jumping from a high shelf , shouting his classic line “To infinity . . . and beyond!” As Buzz plunges to the floor, hurtling to certain destruction, he lands squarely on top of a rubber ball and bounces up again “flying” back to safety. In the end, we all know that Buzz can’t fly, but he escapes with his dignity and delusion intact.

At the risk of sounding like the financial market’s version of Woody, I don’t believe that anyone can make the markets fly either. It seems to me that many investors believe it, judging by the sharp rebounds that the markets experience on any positive comment by the Fed chairman or his colleagues in the Eurozone.

That being said, the market is dealing with something of a dilemma. The dramatic decline during this most recent quarter brought the S&P 500 back almost exactly to where it was in September 2008, just prior to another precipitous decline. Volatility as measured by the VIX, often considered a gauge of fear in the stock markets, is back to the same elevated levels reached in 2008.

The major difference is that earnings and earnings expectations are much higher now than they were in 2008, making current market valuations much more attractive. In 2008 trailing earnings on the S&P 500 were approximately $70, compared to about $91 now, reducing the price/earnings ratio from 18 in 2008 to 12 today. With a PE of 12, and projected earnings growth of 15%, the market is now cheaper on a valuation basis than 2008 when corporate earnings were already in the midst of a steep decline.

A significant contributor to this high level of fear and low market valuations are concerns about global financial and economic risk, especially in the Eurozone. The countries of the European Monetary Union face a difficult problem because they have much higher levels of debt to GDP, insufficient revenue to support entrenched social programs, undercapitalized financial institutions with no real central regulator, and member states that will find it difficult to sacrifice domestic interests for the benefit of the Euro.

The recent decline in our stock market reflects the fear that problems in Europe could lead to weaker earnings growth here, combined with uncertainty about our ability to finance additional fiscal or monetary stimulus. The low valuations have provided a floor for spikes higher, but the sustainability of any move will require real structural solutions here and abroad, rather than the short-term policy responses that we have seen so far.

With stocks trading substantially below the average market PE of 15, and interest rates at historic lows this should be great time to dive into the stock market. Corporations have grown top-line revenues and streamlined operations, generating healthy earnings. The commitment of the Federal Reserve to keep interest rates low “for an extended period of time” should also help to reduce capital costs and support earnings. But this interest rate policy could be a warning sign that our economy is unable to generate sustainable growth, and financial problems in Europe could further contribute to a global economic slowdown. A weak domestic economy, coupled with a global slowdown, could cause the revenue growth of multi-national corporations to suffer. In a

market as volatile as this one currently, the share price of any company reporting disappointing results or reducing expectations could experience a sharp decline.

In this environment we remain cautious investors. We will continue to rely on our investment analysis to identify companies with attractive valuations relative to earnings, growth, and cash flow, with strong balance sheets, but will carefully weigh potential opportunities against risks in the global marketplace. Our investment process reflects the belief that successful investing should be based not just on valuation measures, but on an assessment of management's ability adapt to the changing economic environment and generate consistent results these difficult times.

Sincerely,

Daniel A. Morris