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BY FAILING TO PREPARE, YOU ARE PREPARING TO FAIL

After more than two years of exhaustive meetings, summits and the like, there is now a much wider recognition in the markets of the probability of a Greek exit from the Euro. More specifically, the June 17 elections in Greece are believed to be the deciding factor, with the left-wing faction gaining ground on a platform of weaker austerity measures. The main creditors of the EU, such as Germany, rightly maintain their stance that the conditions of Greece's austerity are non-negotiable as caving in would set a dangerous precedent for Italy, Spain, Portugal and Ireland to follow suit.

With that said, Benjamin Franklin's famous musing that "failing to prepare is preparing to fail" rules the day as the probability of Greece's exit from the Euro has become tangible. To this point, observers around the world have set their own plans in motion as corporations, governments, European citizens and of course investors too have undertaken behaviors to prepare themselves as they see fit. For corporations, much of the preparation has focused upon protecting their cash resources from a possible contagion and resultant set of bank runs across the Eurozone periphery. This has led to a daily sweeping of cash deposits by most firms from European periphery banks into accounts held in the U.K. or U.S. Meanwhile, European governments have reportedly agreed to prepare for Greek exit with a €50 billion going away present for the indebted nation. Next, citizens of Greece and other peripheral debtor nations are methodically transferring deposits to Germany and other creditor nations, and then finally, the large majority of global investors are dumping their equities in favor of remarkably expensive German bunds and U.S. Treasuries.

At our firm, we too are preparing for Greek exit, albeit in a dissimilar fashion. Principally, we have focused on refining our wish lists of securities that we would like to purchase at bargain prices. Within this examination, we are also contemplating the near-term risks that we would be willing to accept, and those that we would not, in making these purchases. Chief among the risks that we would not be willing to accept among our prospective purchases is the potential for loss of purchasing power through a debased currency. This effectively eliminates any purchases of Greek equities in the midst of its exit, as the reinstated Greek drachma could conceivably be devalued some 50%. Likewise, we would be hesitant to make initial purchases in the Euro either, not because we fear its total dissolution, but rather that loose monetary policy from the ECB might be the EU's most effective policy tool in stemming contagion. It seems reasonable that the ECB would need to guarantee bank deposits and generally open its coffers to stave off contagion. Unfortunately, some form of devaluation along the way seems probable.

That is, unless Germany gives in to heavier fiscal transfers via Eurobonds or a similar scheme. On this matter, Germany is in the driver's seat and is correct to be wary of exposing its good credit to the overwhelming demand from European voters to sustain subsidy. However, a recent compromise initiative in the form of a "redemption fund" is gaining ground and has not been explicitly shot down (as of yet) by the Germans. The idea of the redemption fund is at its core a de facto Eurobond whose sole purpose is to extend broad credit across the Eurozone for the explicit purpose of reducing debt to GDP back to the 60% mandated level over a finite 25 year period. In addition, for a country to participate in this scheme, they would have to implement constitutional amendments guaranteeing that the debt not refinanced will not crest the 60% ratio going forward. What becomes of this idea remains to be seen.

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In any event, based on our initial assessment of purchasing power risk, we would be predisposed—but still open minded—to focusing on potential bargains in the U.K., Switzerland, or Norway to name a few possible markets. Likewise, as was the case with our purchases during the heat of the crisis last fall, we would primarily be interested in purchasing the: 1.) highest quality and 2.) most competitive global enterprises possessing 3.) significant footprints and potential for continued growth in the emerging markets. Conversely, we would generally avoid the European markets that have shown a renewed embrace of socialism, the welfare state, and government led economies, such as France. Similarly, those economies that have rendered themselves uncompetitive in their labor markets having been subsidized and spoiled by access to cheap credit and its distortive effects also represent low priorities (i.e., Portugal, Italy). Effectively, we would focus our attention on taking ownership in a business that is unlikely, under any normal market circumstances be priced at a bargain valuation. In addition to searching for bargains in Europe, where the market fallout would likely be most intense, we would of course continue to search for bargains elsewhere across the globe with a particular emphasis on well-run companies possessing solid long-term growth prospects tied to the emerging market consumer. We believe that in the event of a chaotic Greek exit that all equity markets would be affected, but we disagree that all of the economies would be affected the same. In sum, we strongly suspect that opportunities will be created.

So while most of the world is preparing for the worst, we are preparing ourselves for the best, that is, the best opportunities that might be created in such a scenario. Our conviction rests upon the belief that there are three primary sources of alpha available to an investor, the first and most often attempted is to possess better information than the remainder of the market, while the second is to create a better investment process such as a quantitative model, and then finally the third is to exploit human behavior. Although our process incorporates aspects of the first two approaches, we understand that exploiting human behavior is an essential component to gaining an edge over market returns and one that our mentor excelled at throughout his career (as well as anyone we have discovered).

In order to better grasp this discussion of generating alpha through exploiting human behavior let us turn to a hypothetical illustration. In both cases, we will be discussing one company, but priced under two different market scenarios. This company is well run, and has significant competitive advantages and growth potential over the coming decade. The opportunities for the company are well understood by the market, and the stock has historically traded at 18x earnings reflecting investors' optimism. In addition, after examining the firm's probable growth in earnings and cash flows at 9%, one might determine that the current price at 18x earnings coincidentally approximates the intrinsic value of the firm, and for the purchaser at today's price they might anticipate capturing the compounding of earnings over time at the estimated 9% clip, but not much else should be reasonably expected. After purchasing the shares at intrinsic value the company delivers on its long-term prospects, and the investor compounds their initial purchase at 9%, thereby doubling their money in year 8. The logic and outcome of this purchase is respectable, and people can obviously do worse than compounding at 9%. However, turning to the second scenario, the market is now in total disarray and pessimism has dragged down all share prices, even those of companies whose prospects are well understood and formerly prized. In this case, the stock is now trading at 11.9x earnings, representing 50% upside to our original estimate of intrinsic value (at 18x), which has not changed in light of a small country in Europe not being able to pay its bills. In this case, the purchaser at 11.9x earnings is still buying a company likely to compound its earnings and cash flows at 9%, but in the year after purchase a funny thing happens. The market realizes it acted in haste and returns to the stock, driving its valuation back towards 17-18x earnings. For this second investor, if they chose to hold over the same period as the first investor, they double their money in year 4, and rather than compound at 9% over their ten year holding, they compound at 13.6%. As we can imagine, that additional 4.6% compounded over time can lead to a substantial difference in accumulated wealth at the

end of the period. In sum, what the investor did in the second scenario was purchase $1.00 for $0.66 (1.00/0.66 -1 = 52%). To be frank, once an investor realizes that this can be accomplished in the market it is difficult to look at investing through any other lens. Instead, the challenge becomes a matter of collecting as many $1.00 bills trading for $0.66 or less, as possible. In our experience, these opportunities are created in two re-occurring circumstances, where the first and most frequent occurs in instances of neglected stocks that are either completely ignored or generally misunderstood by the investing public. The second, and the matter that we have focused on in this discussion relates to stocks trading at points of maximum pessimism, which can often occur on the heels of a crisis.

So as you can imagine, our preparations are focused on locating the most attractive $1.00 bills trading for $0.66 or less, as possible in the event of a Greek exit crisis. In the stock market it often requires much trouble and resulting pessimism to create dollars trading at $0.66 or less, but once an investor has experienced the benefits of purchasing them, it is often not long before they go looking for trouble on a regular basis. Likewise, we wanted to provide you with our thoughts, and importantly our logical framework for dealing with these events. We would emphasize that this event is a possibility, but there are other possible outcomes that are less dire but get shorter shrift in the press. The truth is that no one knows how the Euro crisis will be resolved, but it pays to have a plan. In addition to Franklin's maxim on planning, we adhere closely to his advice that man has three faithful friends, an old wife, an old dog and *ready money*.

We appreciate your continued interest in our firm. If you would like to learn more about the registered investment advisor Lauren Templeton Capital Management, please visit us at www.laurentempletoninvestments.com.

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