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HISTORY RHYMES: BORROWING FROM THE BARGAIN HUNTER'S PLAYBOOK OF THE 1940S

Thus far into 2012 the global markets have unequivocally begun the year by shrugging off 2011's overhang of pessimism and malaise. Insofar as the market environment has been dominated by three macroeconomic style risks over the past year relating to: 1.) possible systemic credit risk in Europe, 2.) recession in the US and 3.) a hard landing in China, the bears have to date come up short on all three fronts. Even so, we cannot eliminate these risks from the picture, but the latter two in particular (which we had not embraced, no less) have fallen from the foreground to the background thanks to better than expected US macroeconomic data and a new easing cycle that is now underway in China. Effectively, these two risks appear to have been postponed for the time being while the European morass still exists in full form, but has enjoyed a recent respite. We suspect that the combined fading of these risks in the near-term has been the primary contributor to the most upbeat start for equities since 1987. We believe the jump out of the gate in 2012 illustrates an investment phenomenon that has dogged pessimists since the origin of the publicly traded market. In a nutshell, stocks can rise, even sharply—irrespective of the risk backdrop—in the event that bad news becomes overly discounted in security prices. This relationship between stock valuations and their intrinsic values has the potential to whipsaw investors (in both bull and bear markets) who fixate too heavily, or even solely on fundamental outlooks or forecasts while ignoring valuations.

For investors who follow individual stocks, this phenomenon is all too common and is often witnessed around earnings announcements. A classic example and one that has already manifested itself this month on a few occasions occurs when earnings are expected to be poor, but turn out less poor than suspected. One very simple illustration comes from the recent earnings release of Goldman Sachs (not owned in portfolios) whereas the firm reported a 51.5% year-over-year decline, it did not match the sell-side analysts' *expectation* of a 67.7% decline, and the shares rose nearly 7% in the trading session following the announcement. What this illustration demonstrates—and represents both a deliberate and important source of returns in our investment strategy—is that when security prices are not correctly calibrated with their fundamentals then there may exist an opportunity to profit. Similarly, the opportunities to profit scale with the size of the calibration error. This reality underscores the logic of buying at the point of maximum pessimism, where the calibrations are most out of line and the rewards for stepping in are the greatest. Furthermore, based on the reasoning that an investor only requires an inequality between what is discounted in a security price and what actually unfolds in the fundamentals in order to profit, this same investor can profit in any number of economic contexts, good or bad, assuming they can continue to spot examples of this disequilibrium. In short, the value investor is also equipped to profit in economic conditions that are less than ideal, i.e. recessions, panics, crises, insofar as investor sentiment has led to large dislocations between price and intrinsic value.

Bringing the described above logical framework into the present context of the global market reveals many potential opportunities, in our opinion. Perhaps even a set of opportunities that is unmatched over the past several decades depending upon one's perspective and the eventual outcomes related to the European debt crisis. For evidence, we can turn to any number of broad valuation techniques in a historical context. In the analysis below we will draw from a historical valuation study comparing earnings yields on the Standard and Poor's index to high grade bond yields that was first published in a 1947 letter to investors from Sir John's investment counsel firm, Templeton, Dobbrow, and Vance. Examining valuation levels by comparing the yields between equities and fixed income securities is a

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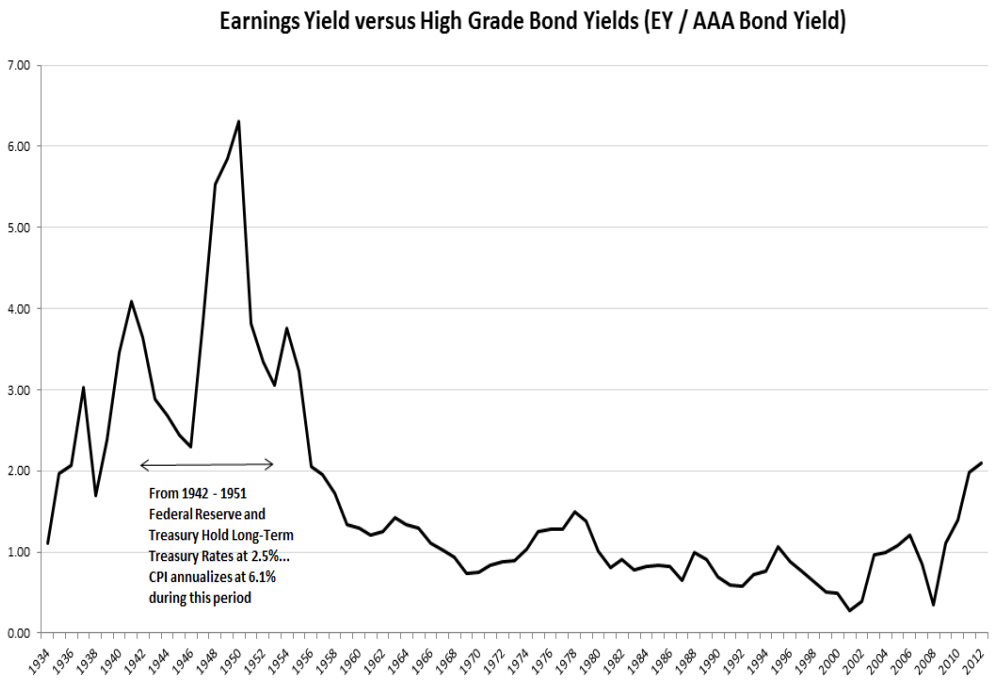
traditional valuation technique popularized by Benjamin Graham and embraced by countless others since. With that said, it seems fitting to employ this technique today as the current environment seems broadly analogous to the 1940s, even more so than the often cited 1930s, in our opinion.

To begin, investors in the 1940s were similarly tortured like those today by a totally concocted and artificial set of low interest rates created by the US government. In the 1940s, the US government designed a market intervention scheme to finance its deficit and debt activity beginning in World War II and then through post-war recovery and reconstruction. In fact, the US Treasury and Federal Reserve struck an explicit accord that would limit near term Treasury rates to 3/8 % while the long-term yield would remain pegged at 2.5%. While the near-term yield was held at 3/8% from 1943-1947 the long-term rate was pegged at 2.5% from 1942-1951. If these methods sound all too familiar to the present day, i.e., pledging near-term rates near zero as well as holding long-term rates low through operation twist, it is no coincidence; current Fed policy is clearly being lifted from the 1940s playbook. Not surprisingly, Bernanke is a historian of fed policy and has even mentioned his predecessors' tactics in earlier lectures[1] including those of the 1940s on how to combat deflation. We believe that from a Federal Reserve policy making standpoint, and now judging from the striking similarities between valuation relationships then and now, we are reliving similar conditions that followed the depression as central bankers then fought tooth and nail to prevent a return of deflation, just as they are now. Bearing all of the above in mind, let us now turn to the continuation of an original analysis that is 65 years in the making.



Sources: Templeton, Dobbrow and Vance (data from 1934-1947), Lauren Templeton Capital Management, LLC, Bloomberg

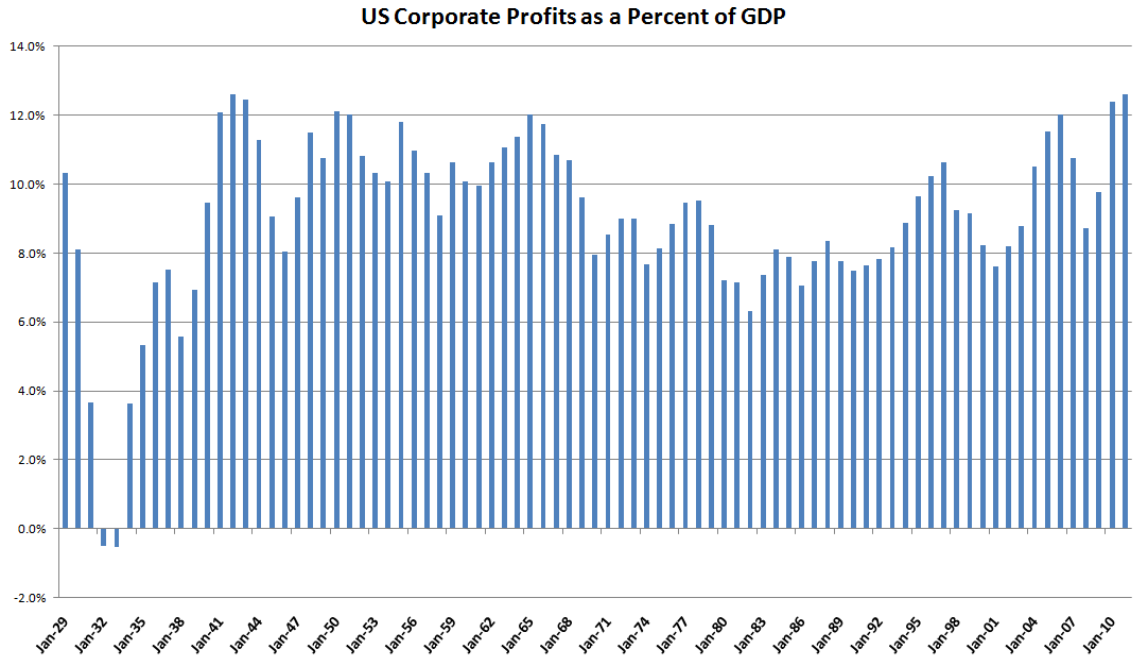
[1] Bernanke, Ben. Deflation, Making Sure "It" Doesn't Happen Here, Remarks to the National Economists Club, Washington, D.C., 21 November 2002.

As we can see, the current ratio between the earnings yield and high grade bonds currently stands at 2.1, which represents an attractive valuation level not seen in the past 57 years. To put this into context, the progenitor of value investing, Benjamin Graham (who taught Sir John, Warren Buffett, and others) eventually advised[2] purchasing only stocks one could find that carried an earnings yield twice the AAA corporate bond rate. Currently, the *average of the entire S&P 500* meets this Ben Graham criterion.

Returning to the broader temporal discussion of relating the current environment to the more extreme valuation disparities of the 1940s, the comparisons become more difficult. For instance, judging from the above, we might be inclined to conclude that stock valuations today are less attractive than they were during the late 1940s and early 1950s, but upon closer inspection we contend otherwise. First and foremost the above trend annualized inflation of 6.1% from 1942-1951 distorts the comparison with today's considerably more benign level of 2-3% on average (which is in line with historical trends). Suffice it to say that the Federal Reserve and US Treasury succeeded in not only vanquishing deflation and financing deficits, but also in erasing substantial portions of debt as inflation registered at 18.1% and 10.2% in 1947 and 1948 alone. Given that inflation historically depresses P/E multiples and thereby inflates earnings yields, we can appreciate the events lying behind the extraordinarily high earnings yields when compared to a pegged interest rate in the 1940s and early 1950s. Thankfully, in the present we are not being confronted with inflation of that magnitude and hopefully will not in the future, but as investors we stand both cognizant of the risk and guarded of its probability. In any event, we can now better appreciate where today's market sits in the context of historical valuations, and we can conclude that they are likely more attractive. By a similar extension of logic, we believe that the potential for returns in the event that outcomes in Europe prove less dire than expected could be rewarding for those stomaching the current environment and remaining invested in bargain priced equities. In a sense, the market has reached levels of pessimism not seen in the past five decades based on these foregoing valuation measures.

Moreover, investors today are most likely receiving more earning power for their investment as corporate profit margins have recently pushed above levels last seen in, oddly enough, the early 1940s that occurred prior to the onset of runaway inflation. As we can appreciate, the early 1940s represented a relative boom as the US industrial machine was ramping up to meet the demands of entering World War II. Additionally, this economic activity is widely credited for pulling the US out of the depression. In the following illustration, we can see the exceptional profitability levels of corporations in the United States during the past few years within an 82 year context.

[2] Lowe, Janet, The Rediscovered Benjamin Graham, New York: Wiley, 1999



Source: Bureau of Economic Analysis, Bloomberg

In light of these illustrations, we find it difficult to refute the plentiful evidence that stocks remain bargains, especially when employing these time tested valuation techniques. While the future outcomes remain uncertain surrounding the exact manner in which foreseeable risks such as those in Europe will be resolved, we believe the decision to purchase stocks when they are bargains remains sound. This decision to purchase bargains whether based on our experience, lessons from our mentor, or thoroughly documented studies also has a long history of better than expected outcomes that come to eventually reward investors confronting widespread fear and pessimism. To surmise the current environment from Sir John's advice, the only way that a stock can become a bargain is from other people's selling, and the only way to have better performance than the crowd is to behave differently than the crowd, which amounts to buying what other people are selling.

We appreciate the opportunity to earn your business and look forward to serving you in the future. If at any time you have questions or comments regarding our views or your investment with our firm, please do not hesitate to contact us.

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