



RESEARCH REPORT

August, 2010

Market Overview & Strategy Comments: *Earnings Have Been Solid – Isn't It Time for the Market to Acknowledge It?*

One of the more frustrating aspects of stock market investing is when stock prices do not follow earnings. This year, companies have been reporting strong earnings growth, yet the market fails to acknowledge it. We look at some of the reasons why.

<u>Key Statistics</u>	<u>Current</u>	<u>Change Since Previous Month</u>	<u>2010 Change</u>
Dow Jones Industrial Average *	10465.94	7.1%	0.4%
S&P 500 Index *	1101.60	6.9%	-1.2%
S&P 500 Ave. P/E Ratio **	13.6x	0.8x	-2.0x
NASDAQ *	2254.70	6.9%	-0.6%
1 Year Treasury Bill Yield	0.29	-3 bps	-18 bps
10 Year Treasury Bond Yield	2.94	-3 bps	-91 bps
30 Year Treasury Bond Yield	3.98	+7 bps	-65 bps
Municipal Notes - 1 Year Yield	0.55	-5 bps	+10 bps
Municipal Bonds - 10 Year Yield	3.25	-30 bps	-25 bps
Reuters/Jefferies CRB Futures	\$274.35	+6.1%	-3.2%
Gasoline NY RBOB (\$ per gal.)	\$2.11	+2.2%	+2.6%
Natural Gas (\$ per MMBtu)	\$4.92	+6.7%	-11.6%
Gold (\$ per troy oz.)	\$1181.70	-5.1%	+7.9%

* price only ** based on 2010 earnings estimates.

The Reuters/Jefferies CRB Futures Price Index is an arithmetic average of commodity futures prices with monthly rebalancing.

Gasoline NY RBOB price excludes local, state and federal taxes (the "wholesale price").

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One of the more frustrating aspects of stock market investing is when stock prices do not follow earnings. This year, companies have been reporting strong earnings growth, yet the market fails to acknowledge it. Even if we go as far back as 2000 when the market first peaked, earnings and dividends for the S&P 500 Index are 50% higher today, yet stocks have not been able to muster positive returns over this period. Furthermore, if we compare 2010 earnings to the more recent 2006 peak, we are within 10% of those earnings and may exceed them in 2011, but yet again stocks are still well off their 2007 highs.

By any estimation, P/E ratios (the price of a stock divided by its earnings) are historically low. Currently, the P/E ratio on the average stock in the S&P 500 Index is now about 12x the coming year's earnings, well below the historical average of about 15x and also below the levels normally associated with today's low inflation and interest rates (about 17x). In comparison, when the markets peaked in 2000, P/E ratios for the same group of stock were about 25x, and when stocks peaked in 2007, they hit about 18x.

While no one is happy with the market's performance, we nonetheless remain encouraged by the low valuations we are seeing; they point to solid earnings that are not yet reflected in the market. We would rather have a market go down with shrinking valuations rather than sinking earnings as a market with a low P/E is much easier to "cure" than one with falling earnings.

In good times, investors often pay 15x-25x per dollar of earnings for a stock, while in tough times (or when interest rates and inflation are high), investors have paid anywhere from 8x-12x earnings. Why the different ranges? It is because *the market's performance is not only a function of whether earnings are going up or down, but also how investors choose to react to these earnings reports* – whether they greet good news with skepticism or enthusiasm. How investors choose to react is reflected in P/E valuations – rising valuations mean investors like what they see and are willing to participate in the market, while falling ones mean the opposite.

So what are some explanations that can be offered for today's falling valuations?

- Due to pessimism about the economy, investors are pulling money out of the stock market, as evidenced by the outflows from stock mutual funds and reduced investment in 401k and other retirement vehicles. As investors move money out of stocks, valuations shrink regardless of fundamentals.
- The general risk adverse nature of investors these days. Many investors are only willing to invest in the safest of short-term CDs and Treasury bonds despite the record low yields offered on these securities. The volatility and mini-crash this year haven't helped and have left these investors unwilling to commit to stocks. When risk aversion rises, valuations shrink.

The irony is that the lack of interest in stocks is coming at a time when they offer excellent value relative to history and to other investments.



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Another important valuation parameter is “earnings yield.” The earnings yield is simply the inverse of the P/E ratio. We can compare the earnings yield on stocks to yields available on bonds to get an idea of the relative attractiveness of bonds versus stocks. With today’s P/E ratio on the S&P 500 Index at approximately 12x, the earnings yield is about 8%, implying that earnings per share are roughly 8% of the price of the average stock in the index, similar to the interest rate on a bond. Since the yield on bonds isn’t anywhere near this level, we get an idea of the relative attractiveness of stocks to bonds.

The current earnings yield on stocks in the S&P 500 Index is its highest since the early 1980s and compares very favorably to historical norms. In 2000, ten-year Treasury bonds had yields about 2x the earnings yield, while today its earnings yield is almost 3x that of bonds. It’s relatively rare for the earnings yield to exceed bond yields. The last time it did was 2003, another great time to be buying stocks. This spread between earnings yield and bond yields is simply another indicator of the current disdain for stocks relative to the comfort of Treasury bonds.

What could change this trend towards shrinking valuations?

- Recognition that companies are doing well despite weak economic growth. As 2010 earnings are showing, companies in general are doing quite well; they continue to produce positive earnings and dividend increases, and thus stocks are getting cheaper in relation to their earnings and dividend streams. Once investors recognize these earnings are not a fluke, they may choose to come back into the market.
- As investors run out of patience with the anemic returns offered on short-term money funds and bonds, not to mention real estate, they are likely to start looking beyond Treasuries and money funds and consider high quality, dividend paying stocks.
- Mergers, acquisitions and share repurchases are already having a positive impact on certain stocks and sectors. If this activity spreads, it could give the whole market a lift.
- Recognition that low interest rates and inflation are not going to change in the near term. As mentioned earlier, P/E ratios historically are quite a bit higher when inflation and rates are this low.

At some point we may get the best of both worlds – rising earnings and valuations, which created the unusually high returns stocks saw in the 1980s and 1990s. The last major bull market saw P/E ratios more than double, earnings more than quadruple and prices rise over 10x before the benefit of dividends!

In portfolios, we continue to see robust earnings gains this quarter with a variety of diverse companies held in Concord equity portfolios producing excellent results. We continue to be impressed by the very strong earnings despite anemic economic growth here at home, further evidence of not only the benefits of cost cutting done during the recession but also the positive impact of the growth in emerging markets. In conclusion, while we don’t know when P/E ratios will reverse course and move higher, we are encouraged by the strong underlying health we see in companies which makes us believe that significant upside exists for stocks once investor interest returns.

CORE HOLDINGS LIST FOR 2010

Source: FactSet, First Call, Value Line, Bloomberg & CAM Estimates.

			Recent	2010	2011	2010	2011	Est EPS	P/E to	Market		Div
August 1, 2010	<u>Company Name</u>	<u>Ticker</u>	<u>Close</u>	<u>EPS</u>	<u>EPS</u>	<u>P/E</u>	<u>P/E</u>	<u>Growth</u>	<u>Growth</u>	<u>Cap(\$mm)</u>	<u>ROE</u>	<u>Yield</u>
	Standard & Poors 500	SPX	1,101.60	\$80.98	\$89.72	13.6x	12.3x	8.0	1.5x	9,968,967	13%	2.1%
Financials:	Bank Of America	BAC	14.04	\$0.96	\$1.64	14.7x	8.6x	9.1	0.9x	140,849	3%	0.3%
	Berkshire Hathaway Cl "B"	BRK/B	78.12	\$3.91	\$4.13	20.0x	18.9x	5.0	3.8x	75,678	7%	0.0%
	MasterCard	MA	210.04	\$13.61	\$16.25	15.4x	12.9x	17.9	0.7x	23,279	54%	0.3%
Consumer Staples:	Avon Products	AVP	31.13	\$1.96	\$2.29	15.8x	13.6x	6.5	2.1x	13,353	64%	2.8%
	Coca Cola	KO	55.11	\$3.47	\$3.75	15.9x	14.7x	7.9	1.9x	127,142	30%	3.2%
	Colgate Palmolive	CL	78.98	\$4.79	\$5.25	16.5x	15.0x	9.8	1.5x	38,384	91%	2.7%
	Diageo Plc ADR	DEO	69.88	\$4.54	\$4.98	15.4x	14.0x	8.2	1.7x	43,772	48%	3.3%
	Fomento Economico Mexico	FMX	48.68	\$2.76	\$3.51	17.7x	13.9x	18.6	0.7x	10,521	11%	1.3%
	H.J. Heinz	HNZ	44.48	\$2.99	\$3.23	14.9x	13.8x	9.5	1.5x	14,147	59%	4.0%
Health Care:	Becton Dickinson	BDX	68.80	\$5.16	\$5.58	13.3x	12.3x	10.6	1.2x	16,053	24%	2.2%
	Johnson & Johnson	JNJ	58.09	\$4.72	\$5.07	12.3x	11.5x	6.8	1.7x	160,216	26%	3.7%
	Novartis AG	NVS	48.74	\$4.86	\$5.18	10.0x	9.4x	3.7	2.5x	128,558	16%	3.4%
Consumer Discretionary:	Johnson Controls, Inc.	JCI	28.81	\$2.08	\$2.51	13.8x	11.5x	13.9	0.8x	19,389	NMF	1.8%
	Target Corp.	TGT	51.32	\$3.82	\$4.35	13.4x	11.8x	13.1	0.9x	37,796	17%	1.9%
	Toyota Motor Co. ADR	TM	70.23	\$2.88	\$4.90	24.4x	14.3x	46.6	0.3x	121,076	2%	1.3%
Technology:	Cisco Systems	CSCO	23.07	\$1.68	\$1.91	13.7x	12.1x	11.8	1.0x	131,756	17%	0.0%
	EMC Corp.	EMC	19.79	\$1.21	\$1.38	16.4x	14.3x	13.9	1.0x	40,680	8%	0.0%
	Google	GOOG	484.85	\$27.42	\$31.39	17.7x	15.4x	18.5	0.8x	119,353	20%	0.0%
	International Business Machines	IBM	128.40	\$11.29	\$12.42	11.4x	10.3x	9.3	1.1x	161,948	74%	2.0%
	Qualcomm	QCOM	38.08	\$2.37	\$2.58	16.1x	14.8x	16.9	0.9x	61,126	8%	2.0%
Industrials:	3M Co.	MMM	85.54	\$5.71	\$6.34	15.0x	13.5x	11.3	1.2x	61,001	28%	2.5%
	ABB Ltd. ADR	ABB	20.18	\$1.09	\$1.37	18.5x	14.7x	4.2	3.5x	46,548	23%	0.0%
	Danaher Corp.	DHR	38.41	\$2.22	\$2.53	17.3x	15.2x	13.8	1.1x	25,067	11%	0.2%
	United Technologies	UTX	71.10	\$4.71	\$5.37	15.1x	13.3x	11.7	1.1x	66,057	21%	2.4%
Energy:	Apache Corp.	APA	95.58	\$9.78	\$12.01	9.8x	8.0x	9.2	0.9x	34,485	NMF	0.6%
	Petroleo Brasileiro S.A. ADR	PBRA	31.85	\$3.88	\$4.47	8.2x	7.1x	6.2	1.1x	58,934	20%	0.5%
	Sasol LTD ADR	SSL	39.64	\$3.81	\$4.83	10.4x	8.2x	5.0	1.6x	25,349	17%	3.0%
	Schlumberger, Ltd.	SLB	59.66	\$2.81	\$3.81	21.3x	15.7x	15.3	1.0x	71,188	18%	1.4%
Telecom Services:	America Movil ADR	AMX	49.61	\$3.68	\$4.32	13.5x	11.5x	13.0	0.9x	70,354	46%	0.5%
	China Mobile Hong Kong	CHL	50.94	\$4.31	\$4.41	11.8x	11.6x	5.3	2.2x	204,399	24%	3.2%
Transportation:	CSX Corp.	CSX	52.72	\$3.84	\$4.45	13.7x	11.8x	10.7	1.1x	20,015	13%	1.8%
Exchange Traded Funds:	iShares MSCI EAFE Index	EFA	51.91	-	-	-	-	-	-	33,482	-	2.6%
	iShares MSCI Emerging Mkts	EEM	41.40	-	-	-	-	-	-	38,974	-	1.4%

0% weighting in utilities and materials.

The above is a list of common stocks currently held in clients' portfolios. Not all stocks are held in all portfolios for various reasons. Upon request we will furnish a list of all equity recommendations made within the past twelve months. This list includes the name of the security, date and nature of the recommendation, price at which the recommendation was acted upon, and the current market price of the security.

It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list.

Please contact Mickey Herst for a copy of the list.

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