



April 2010

## **INVESTMENT PERSPECTIVES**

### **The Patient Investor**

There is a time in every investment cycle when future prospects for all asset classes (stocks, bonds, real estate, art, commodities, etc) look absolutely terrible and other times when future prospects appear to be incredibly positive. In between these high and low extremes (generally 6 to 18 months for each), there is almost always a much longer period (usually 3 to 6 years), when every asset class is neither exceptionally undervalued nor overvalued. We hope to outline why we believe we have entered one of these long “in-between” periods and why exercising patience is critical in order to be rewarded with above average returns.

There is an old and unresolved debate among historians that the game of chess was invented as a way for a king to teach his generals the art of patience. The king found that in battle the younger headstrong generals would attack quickly without a well thought-out strategy or consideration for the survival of his armies. Their idea was that brute force was always the best way. The older, more experienced generals would exercise patience, lie in wait for an opponent, and attack with a series of well executed counter offensives. As the younger generals found, sometimes the hardest decision was not to act on their basic impulses, but to be patient and wait for the right time to take the offensive.

### **An Example of Impatience: Bonds**

Many advisors are recommending that their clients buy bonds and bond funds; they are suggesting these are “safe” alternatives to stocks. As a result, bond funds saw investment inflows of \$400 billion in 2009 and \$90 billion so far in 2010, while stock funds saw a net investment of zero. These numbers are unprecedented.

Bonds have performed well over the past 25 years due to a secular decline in interest rates, and corporate junk bonds have done extremely well over the past year as concerns about corporate balance sheets have waned. Junk bond funds are up over 70% from their lows and now should no longer be called high yield (since they are low yield relative to their real risk). Also, low yields on bank savings accounts, money market accounts, and certificates of deposit are causing investors to look to higher yielding products. Our

concern is that we believe that the secular decline in interest rates is about to end and that chasing yield in bonds will not result in outsized returns.

### **The “In-Between” Period**

We believe the reasons that we have reached this long period of gradual economic recovery are as follows:

- Low Interest Rates – Although the Federal Reserve has indicated that rates won’t stay low “forever”, the current low rates will be a very positive force in helping the economy move forward out of the recession.
- Stimulus Program – There are those who argue that the stimulus program has not worked, although much of the money still remains to be spent in 2010. Based on some data we have seen, it appears that just over \$200 billion has been spent with another \$150 billion in the pipeline, and about \$225 billion remaining to be spent - this adds to about \$575 billion. The remainder of the \$787 billion, about \$212 billion, is allocated for tax cuts of which about \$90 billion remain.
- Corporate Profits – Corporate profits have exceeded expectations in recent quarters and companies in the S&P 500 Index are expected to report year-over-year earnings growth of 37% for the first quarter. Additionally, companies are now starting to report top-line sales growth. Many corporations are in a strong financial condition with a record amount of cash on their balance sheets.
- Exports – U.S. economic growth has the potential to benefit from a solid improvement in net exports. In the third and fourth quarters of 2009 exports rebounded significantly from the recession lows, growing at an annualized rate of about 18% year-over-year. Demand for U.S. goods and services should continue to be strong, particularly from fast growing emerging markets, as the global economic recovery gains momentum. Additionally, in March the Obama administration set a goal to double U.S. exports over the next five years.
- Manufacturing – A reasonable manufacturing recovery is underway in the U.S. as evidenced by the most recent Institute for Supply Management (ISM) index. Also, industrial production has risen at a robust annualized rate of 9.6% over the past six months.
- Economic Growth – We are in the early stages of the recovery and the pace of GDP growth thus far is stronger than the past two weak recoveries. U.S. real gross domestic product (GDP) grew at an annualized pace of close to 4% in the last six months of 2009 including 5.6% in the fourth quarter of 2009. Despite widespread reports about the U.S. consumer being under pressure, total retail sales have increased 5.4% in the past year.
- Stock Valuations – We believe that the stock market is reasonably priced – the Price/Earnings ratio on the S&P 500 is now about 15 times expected 2010

earnings. This is about average for the stock market over its history. Since the S&P 500 hit its low of 683 just over a year ago on March 9, 2009, it has risen 486 points (about 71%) as of March 31, 2010.

- Employment – The unemployment rate remains quite high at 9.7%, and counting those that are under-employed or have stopped looking for work, the rate is closer to 17%. We believe that these rates are now beginning to slowly move lower. Consumer confidence is improving despite these high unemployment rates.

### **A Disciplined and Clear Investment Process**

While we fully expect periodic setbacks in both the economy and the stock markets over the next several months and years – this always happens during recoveries from recessions – we cannot overemphasize the importance of adhering to a disciplined and clear investment process for all buy, hold and sell decisions in any asset class.

For buy decisions, our approach is best documented in a piece entitled “Our Investment Research Process” in the Research Library portion of our Web page – <http://www.hutchinsoncapital.com/research-library.html>. As is evident, we believe that our research process, which has been in place for over fifteen years, is quite thorough and focused.

On all decisions related to common stock that we currently hold in client portfolios, our disciplined approach includes a quarterly review of the company’s past and most recent quarterly income statements and balance sheets, and a review of our selected quantitative and qualitative metrics for the company (usually 4-6 metrics for both quantitative and qualitative metrics).

Additionally, our Research Library includes an Investment Perspective entitled “Selling is Harder than Buying”. We continuously follow this disciplined process in making sell decisions.

Regarding bonds, we take a very different approach to investing in bonds than we feel most other firms do. Bonds will always be part of our balanced approach to investing because they are one of the few investments that provide stability in poor stock markets; we call them our “shock absorbers”. We focus on high quality issues primarily because repayment of principal is critical – the risk of default on lower quality bonds is not worth the additional risk. We also “ladder” (an equal amount invested in each year over a specific number of years) our maturities to try to minimize interest rate risk. We prefer an eight year ladder at this time which produces an average duration (average maturity life) of approximately 3-3 ½ years. Whether rates are going up or down, we believe this approach will minimize the risk of loss of capital prior to the bond’s maturity. In taxable accounts we always focus on after-tax yields because what matters is the income that you keep after taxes.

## **Summary**

In these “in-between” periods there will still be exciting investment opportunities but they will require careful review and selection – and patience. In our view, patience in investing translates into taking a long-term perspective. When we initiate a new investment, we assess a company’s prospects for the next 3 to 5 years. By contrast, it appears that the vast majority of Wall Street analysts are focused on a company’s outlook for only the next 1-2 quarters. Research from the New York Stock Exchange indicates that the average holding period for NYSE-listed companies is only about 6 months. In other words, many short-term investors are simply “renting” stocks as opposed to “owning” them. As you probably can tell by now, we are in the ownership camp (e.g., we take the long-term view).

Similar to the young generals mentioned previously, there seems to be an innate human tendency to “take action” rather than establishing the discipline and patience to invest for the long-term. The overriding obsession with the short-term focus on taking action can create opportunities for contrarian investors like us who are willing to assume a long-term perspective. As always, we will continue to make our investment decisions based on quality, valuation, and future earnings growth potential for common stocks and in investment-grade high quality bonds laddered over an eight year period. We will not let short-term emotional concerns drive decision making.

We plan to continue to exercise patience!

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

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