



HIGH QUALITY STOCKS – OCTOBER 2010

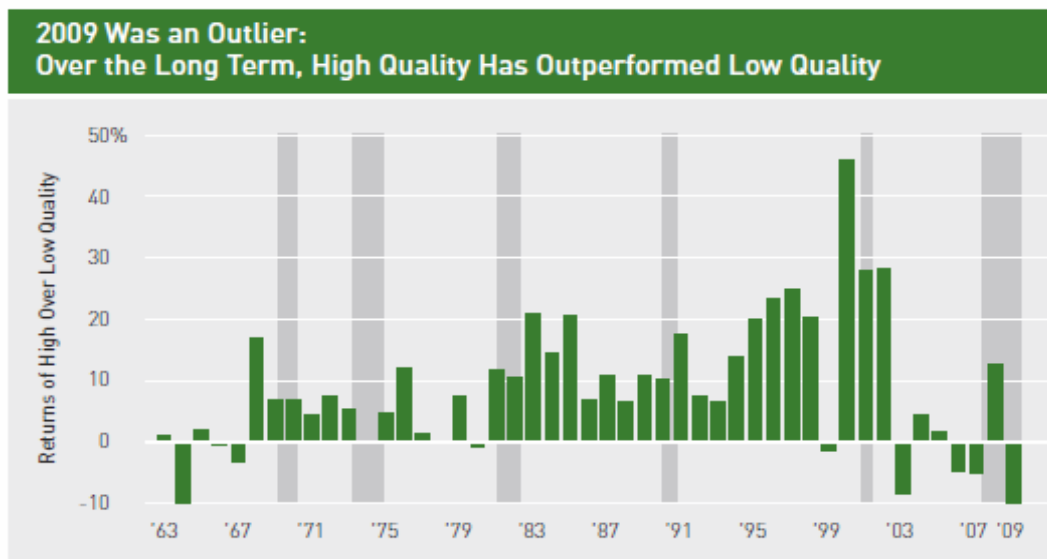
At the end of September, we made changes to our stock portfolios. We became more conservative, by shifting toward higher “quality” stocks, from more of a “growth” bias. By high quality, we mean companies that have demonstrated a long track record of earnings and dividend growth and stability. These companies typically have strong balance sheets. We analyzed long term trends and cycles to come to this decision. Below we briefly describe our thought process, as well as in which vehicles we’ve chosen to invest, and some historical perspective on high quality vs. low quality stocks.

Background

Stocks remain overvalued on a long term historical basis. One of the measures we use, the 10-year P/E ratio, shows that the market is about 30% overvalued relative to its long term average (going back to 1871). Several other long term valuation metrics show similar results. Against this backdrop, the economy appears to be slowing down, according to economic leading indicators. Longer term, we expect the economy to remain sluggish, with below average growth, due to continuing deleveraging of balance sheets and high unemployment.

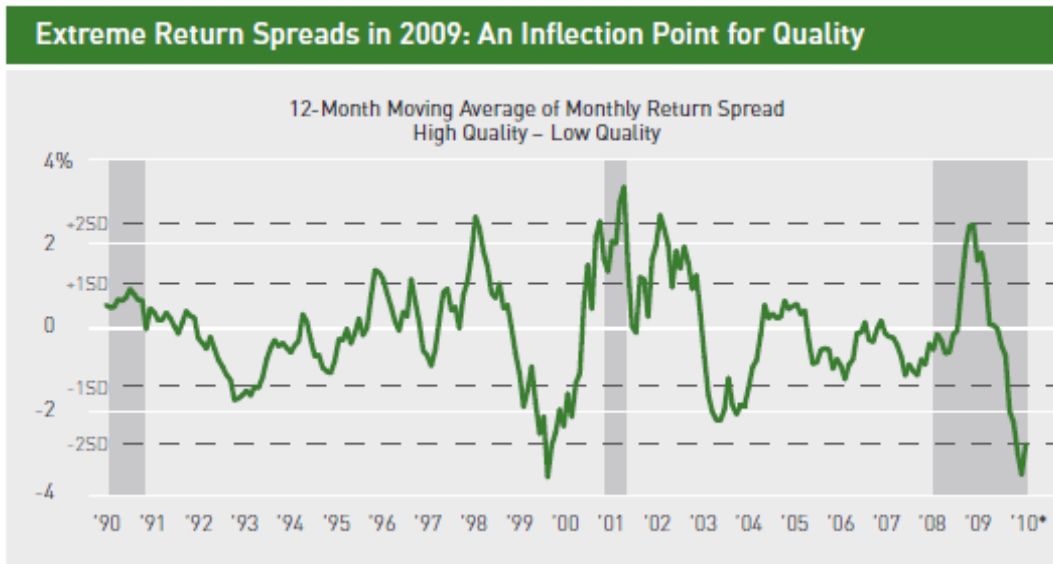
Historical Performance

High quality stocks tend to be more defensive, and hold up better than lower quality stocks during market downturns. For example, in 2008, the S&P High Quality index declined 32.8% while the S&P Low Quality index declined 46.1%. Previously, in the 2000-2002 downturn, high quality stocks increased 4.5% while low quality stocks declined 24.7%. High quality stocks typically are less volatile, with much lower standard deviations than low quality stocks. The flip side is that low quality stocks tend to outperform sharply during recovery rallies, such as 2003 and 2009. However, as seen below, high quality stocks have outperformed during most periods over the past nearly 50 years:





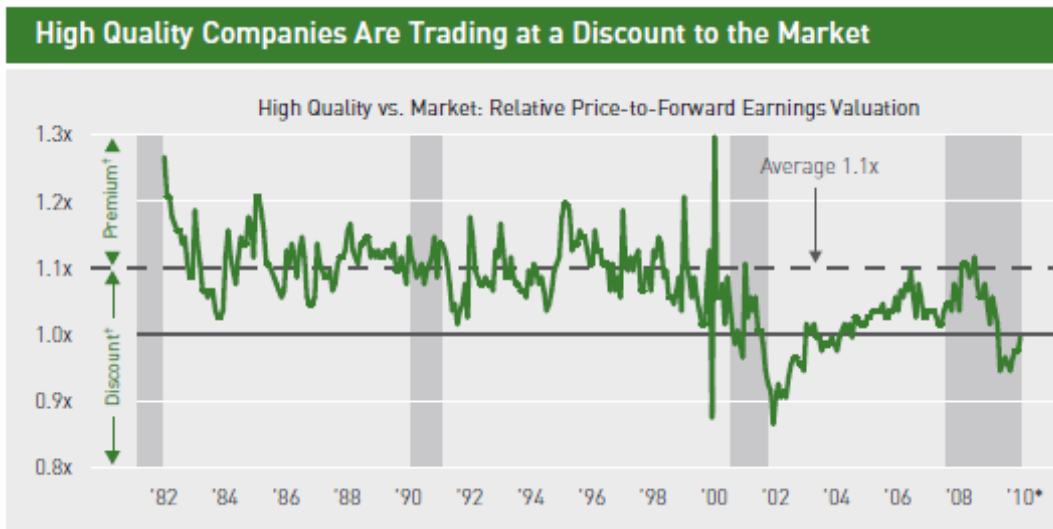
The recent outperformance of low quality stocks has been at extreme levels, last seen in the late 1990's, as shown below:



While this chart reflects data as of early in the year, and high quality stocks have already begun to outperform, these cycles tend to play out over long periods.

Valuations

Given the lower risk nature of high quality stocks, they typically trade at a premium to the overall stock market. However, recently they are trading at a discount to the market, as shown below:





As a result, we believe that high quality stocks can potentially outperform even if the market rally continues, while we'd also expect them to continue to hold up better in a market decline. In essence, we can trade up to higher quality without having to pay up for it.

Fund Descriptions

Most investment fund products define themselves by the growth-value paradigm. However, high quality vs. low quality is just beginning to emerge as a new way to define fund styles. As a result, many investors have different definitions of quality. Also, there are not many fund products defined by quality. We have identified two strong funds that meet our definition of quality and have strong performance track records. They are both ETFs, which have lower fees than the mutual funds we exited.

PowerShares S&P 500 High Quality Portfolio (PIV) is based on the Standard & Poor's High Quality Rankings Index. The ETF just recently changed over to this strategy on June 30, so historical data for this fund is inaccurate. However, the new fund is based on S&P's quality index, which goes back to 1956. The methodology measures the long term growth and stability of a company's earnings and dividends over the most recent 10 years, in order to capture a complete business cycle. The holdings are weighted by quality ranking, as opposed to market capitalization. The fund's fee is 0.50%.

Vanguard Dividend Appreciation Fund (VIG) tracks the Dividend Achievers Select Index. The index is made up of companies that have increased their dividends for at least 10 consecutive years. The companies in this index typically have strong cash reserves, solid balance sheets and a record of consistent earnings growth. The index has more than 25 years of history. The fund has a very low fee of 0.23%.

Impact on Portfolio

We generally are swapping out of growth stocks into high quality stocks, which tend to be weighted toward value. Growth stocks have outperformed value and the market for the past three years. Since we think that the growth cycle has largely run its course, we are tilting portfolios towards value. As a result, we are selling funds such as MainStay, American Growth, and Rainier. These funds tend to be heavily weighted in technology stocks, such as Apple and Cisco. The high quality funds we are purchasing are more heavily weighted in consumer staples, such as Pepsi and Johnson & Johnson.

Conclusion

We are shifting from growth stocks to higher quality stocks, due to 1) overvalued stock market, 2) slowing economy, 3) cheap high quality stocks relative to the market, 4) downside protection historically provided by high quality stocks, and 5) end of the growth stock cycle.



Sources and References

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4. GMO Quarterly Letters, by Jeremy Grantham (www.gmo.com)
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6. The Vanguard Group (www.vanguard.com)