

KWAG May E-mail Update

Good afternoon. We have to admit, over the last few years, the media has gotten very good at spreading their message. In some cases, this message has been balanced and even educational. However, more often than not, their message is embellished and somewhat misleading - particularly on critical issues like our national debt, high unemployment, and excessive government spending - and how they may, or may not affect investment portfolio's. We believe that these are critical (and highly contentious) issues that our country must absolutely address. However, it's important to recognize that while these issues are critical to the country as a whole, they are not necessarily central to building successful investment portfolios. The problems our country face make for flashy headlines and elicit a heightened level of concern, much of it warranted, but they are largely unrelated to the most important factor to investors—corporate profitability! So when you're watching all the depressing news about the problems faced by our government, it is absolutely critical to remember that we invest in companies—not the government!

Corporate Profits

When you get down to basics, the U.S. economy is largely driven by an engine that is made up of the publicly-traded corporations that we buy stock in. That makes us part owners in these companies and, as such, it's probably good to know that these U.S. corporations are healthy and in excellent shape. Don't believe us? All you have to do is look at their financial statements and see the levels of cash they have on hand, their strong and growing revenue streams, and their stronger than expected quarterly income statements. By all measures, U.S. companies are extremely healthy and growing stronger every day.

Something that is frequently lost in all the noise we hear coming out of Washington is the positive role most of these companies have played in our recovery. As these publicly-traded companies continue to grow, the economic stimulus they provide will assist in dealing with some of the serious fiscal problems our leaders need to address. A strong and vibrant economy can't fix all of the government's problems on its own, but it can make a huge difference. Of course, no matter how well our companies do going forward, our elected leaders will be required to make some tough decisions, and these decisions will inflict

some pain on a part of the American citizenry. However, the impact on our publicly-traded corporations and the stock market will be almost non-existent and not nearly as much as most people seem to think...

In other words, corporations power the U.S. economy and our government—not the other way around.

Cause & Effect

We know that's not something you will typically hear being discussed on the evening news, but it's true nonetheless. Why else would the S&P 500 index (large company stocks) be up 8.4% year-to-date through the end of April? And why would the Russell 2000 index (small company stocks) be up 10.4% over the same period? It's because corporate balance sheets and income statements are strong and getting stronger in spite of all the problems faced by the federal government. In other words, the government's problems simply don't have much of an impact on our corporate business models.

Corporate revenues are growing because the global economy is growing, and as corporate revenues grow, companies need to expand in order to meet greater demand. This demand generates additional jobs and still more economic growth. So the fact that stock prices have been rising over the past few years is no fluke. It's a function of the normal business cycle and it's the kind of thing we see in the recovery phase following every recession. As long as the global economy continues to grow (and we believe it will), the future for stocks remains bright.

So while we're fully aware that there is no shortage of bad news coming out of Washington, with serious and divisive issues like the budget deficit, high unemployment, and out of control federal spending, we also recognize that the fortunes of companies we invest in are largely unaffected by those things. In other words, just because the federal government has money troubles, it doesn't mean the companies we invest in have money troubles as well. In fact, right now, it's quite the opposite.

Good News

1. Earnings season is off to a strong start in 2011, with 306 of the companies in the S&P 500 reporting first quarter earnings thus far. Net income for

these firms **grew an average of 20.8%** from the same quarter a year ago. Let's not forget, 2010 earnings were excellent.

2. In addition, the reported earnings continue to outstrip analyst expectations, with the average earnings for firms who have reported thus far exceeding expectations by an impressive 4.55%. This is particularly good news for investors because when corporate earnings exceed expectations, stock prices invariably go up.
3. Revenue data has also been strong, with revenues growing at a rate of 8.7% in the first quarter, up from the 8.05% level reported by these same firms in the fourth quarter of 2010. Since it's difficult to keep growing earnings into future without also growing your revenue stream, this is good news as well.
4. Net profit margins are also looking healthy, with overall net margins for firms reporting thus far at 10.45%, up sharply from the 9.41% margin one year ago and the 9.91% reported in the fourth quarter. So not only are sales revenues growing, but the amount of profit generated by each dollar's worth of sales is also growing.
5. Finally, analysts' expectations for the remainder of the year remain strong and are continually being revised upward. In 2010, total net income for firms in the S&P 500 was \$794.0 billion, up from \$544.7 billion in 2009. In 2011, analysts now expect total net income for these firms to be \$919.9 billion, or 45.8% above 2009 net income and 15.9% above the 2010 number. While we don't put much stock in longer-term analysts' forecasts, the current expectation is for 2012 net income for S&P 500 firms to surpass the \$1 trillion mark for the first time in history.

We could go on and on, but you probably get the point. The bottom line is that the economic recovery is still humming along just fine, even if we don't hear much about it on the evening news.

A Dose of Reality

Now that we've painted such a nice rosy picture of the recovery, we also want to impart a dose of reality. Let's remember that the magnitude of the average

annual peak-to-trough dip in the stock market is more than 10%. Let's also be aware that every-other-year, on average, we see a stock market dip in excess of 15%. In the last few years, stocks have gone nearly straight up and volatility has gone from the most extreme levels in history to well below average. At some point, we know higher volatility will return (and we've seen a hint of this recently) and we will experience a typical pullback in the range of 10-15%. When this occurs, it is critical for stock investors to maintain their composure and remember that events like this are to be expected and are completely normal. In fact, pullbacks are actually healthy for the market in the long run because they help keep irrational exuberance at bay and thereby act to prevent asset bubbles like we saw in the late 1990's. So when pullbacks occur, we will remain patient, rebalance as needed, and use the dip to our advantage as much as possible. After all, if the world gives you lemons...

Some Perspective

In the meantime, please don't lose sight of the fact that we've known about the federal government's issues for a long time now and that nothing being reported in the news now comes as any surprise. When the market has an off day, week or month, the media invariably seizes on the opportunity to boost ratings by claiming that they know the reason why, and to prove it they point to the biggest macroeconomic issues of the day. Truthfully, when the market is down in the short-run, all anyone really knows is that there were more sellers than buyers on that day. Financial headlines will always tend to focus on macroeconomic issues. While these trends are important to understand, we believe long term investors will be better served by less attention to the popular media and more attention to corporate financial statement analysis.

Please Stay in Touch

As usual, if you have any questions about our updates, the newsletter, your accounts or our managers, please feel free to call or e-mail us at anytime. Enjoy the spring weather...and thank you for your continued confidence in our firm. The recent referrals are much appreciated and, as always, please know that we remain 100% committed to your financial well-being.

- Joe and The Gang at KWAG