April &
May
2009

Monthly Investment Commentary

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Stocks continued to rally sharply in April. The large-cap S&P 500 (based on Vanguard 500 Index) gained almost 10% for the month, and is now down only 2.5% through the first four months of 2009. Smaller-cap stocks did even better, with the iShares Russell 2000 ETF gaining 15.4%, trimming the year-to-date loss to 1.8%. Developed-market foreign equities generally were in line with the U.S., while emerging-market equities outperformed. On the fixed-income side, Vanguard Total Bond Market Index Fund gained about 0.4% in April, and is up about 0.7% for the year. Munis continued their tear in April, and the Vanguard Intermediate-Term Tax Exempt is now up almost 5% for the year. High-yield bonds had big returns, with the benchmark Merrill Lynch U.S. High Yield Cash Pay Index gaining over 11% in April, bringing its year-to-date gain to 17.1%.

A Stock Pickers Market…

We have observed a growing discrepancy since the stock market began to freefall last September. On one hand, the overall economic environment continues to be extremely fragile and deep problems remain. A self-reinforcing cycle of deleveraging is part of a resetting of the economy as consumers and businesses will almost certainly borrow less and spend less in the years ahead, and therefore the outlook for corporate earnings and stock returns is muted. On the other hand, we are finding outstanding opportunities to buy high-quality stocks at the best valuations we have seen in a long time, even after factoring in a very negative economic environment for their companies.

These two views aren't necessarily at odds with one another. We believe there are occasional periods, often driven by economic extremes (the financial meltdown of 2008 or the tech boom/bust earlier in the decade) when stock prices become disconnected from fundamentals resulting in some stocks becoming significantly underpriced, while others become overpriced. Ultimately these mis-pricings must be corrected. We want to lay out some of our thinking why the correction process represents a period of great opportunity for skilled stock pickers to add value in this market. We believe the financial meltdown of 2008 resulted in major market dysfunctions that may have created an unusually large opportunity for CB&T to do very well.

So we believe we are in the midst of a period in which the environment for stock picking may be much better than the overall outlook for the market. Remember, the stock market is merely a market of stocks, and their aggregate performance gives no indication of what's actually happening "under the hood." At its simplest, consider how different the opportunities are for a stock picker if a market return of 5% results from the majority of stocks earning between

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0% and 10%, versus the same 5% market return comprised of most stocks earning between -10% and +20%. Earning good returns doesn't require that all stocks be cheap relative to their prospects, only that some stocks be cheap (and of course that we can identify them).

A number of data points suggest the current picture is much more encouraging for us to outperform the market. For example, the degree to which the valuations of individual stocks are spread apart; we initially looked at data from Empirical Research (see chart 1). This data goes back to the early 1950s, and based on a composite of four traditional measures of valuation compares the magnitude of the variation between the cheapest group of stocks relative to the overall market. The "spread" in valuation reliably increases at times of major distress, such as 1973-74, the recession of early 1990s following the S&L debacle, and the earnings collapse that occurred in the recession that began in 2001 following the tech bubble bursting. More recently, this measure showed stock valuations were widely spread last fall as the crisis unfolded, roughly as wide as they'd ever been during the 50-plus years in Empirical's data set. Our common sense and experience suggests to us that those types of environments would favor our stocking picking discipline and active managers in general.

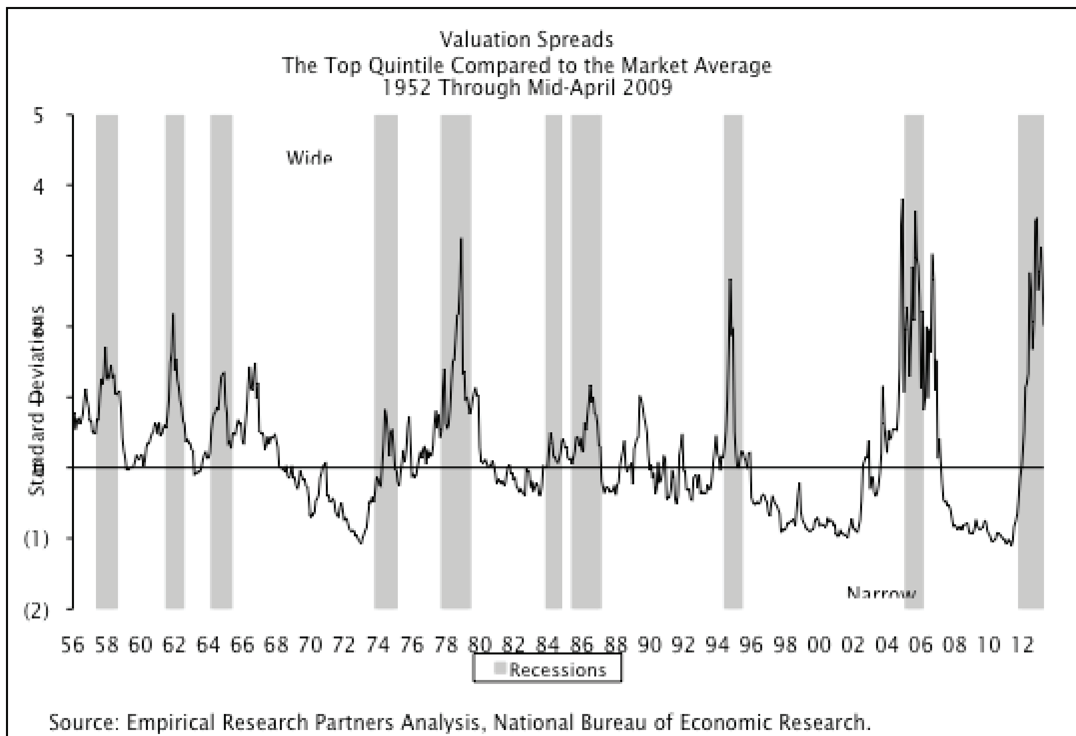

Chart 1 –The differential between the cheapest stocks and the broader market became very wide in late 2008 and remains historically wide.

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We are of the opinion that some stock valuations have become completely disconnected with their underlying fundamentals (even admittedly bad fundamentals). We have believed for several months now that one reason for this disconnect was that as highly stressed financial institutions (including hedge funds) were forced to reduce their leverage, they sold any liquid assets they could to raise capital. Some stocks were being dumped at any price. Supply and demand imbalances can create pricing anomalies in the short term, and with a temporary glut of supply as hedge funds and other investors dumped stocks, and a lack of demand as investors hunkered down to weather the storm, leading some stocks we follow to trade at what we considered to be ridiculous levels. Since then, we've questioned our assumptions to make sure they are factoring in a sufficiently negative overall environment at the company level, and we continue to see what we believe are some of the most compelling individual stock opportunities of the past couple of decades.

As a reminder, our stock selection process focuses on three main areas: 1. great companies with sustainable competitive advantages; 2. good management teams that are share holder friendly; 3. finally, the companies need to be trading at good valuations. Over the past few months, we have been able to find a lot of companies that meet our stringent criteria, and we remain confident that our disciplined investment approach will add a lot of value in this environment. One of my favorite quotes is from Shelby Davis and goes something like this… "Investors make the most money during a bear markets, they just don't realize it yet," meaning that future returns come from buying great companies at bear market prices. We will continue to work tirelessly on your behalf to uncover those great investments that will lead to superior future returns.

- CB&T Investment Team 5/2009

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