

Monthly Investment Commentary



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The large-cap S&P 500 (as represented by Vanguard Index 500) is up 15% year-to-date through August. This gain is more impressive when considering that at the end of February, that benchmark was down about 18%, and nine grim days later the year-to-date loss stood at about 25%. August returns contributed to the impressive rebound, with Vanguard's S&P 500 proxy gaining about 3.6% for the month. The small-cap iShares Russell 2000 ETF was up 2.8% for the month, bringing year-to-date returns to 15.8%, while mid caps continued their strong run with a 4.9% gain for the iShares Russell Midcap ETF; that benchmark is now up over 25% in 2009. Value stocks outperformed growth for the second month in a row across all market caps in August, but continued to trail growth by large margins for the year to date. Developed market foreign equities saw returns roughly in line with their large-cap U.S. counterparts (though foreign stocks remain well ahead year to date), while emerging-markets equities (based on Vanguard Emerging Market Stock Index Fund) saw their torrid run interrupted in August with a 0.6% loss; however, they remain up almost 50% in 2009. Vanguard Total Bond Market Index Fund was up 1% in August and is now up 4.6% for the year, while high-yield bonds (based on the Merrill Lynch U.S. High Yield benchmark) gained 2% in the month, bringing year-to-date returns to over 40%.

Investment Update

After a brutal 12 months, it would have been nice to relax just a little this summer. But the environment remains as interesting and challenging as any we're likely to see in our careers (at least we hope this proves to be the case) and we remain in analytical overdrive mode as we try to balance numerous potential opportunities amidst a wide range of possible outcomes. Below is a summary of a couple of asset classes we have been following closely this year:

High-quality U.S. Stocks— We review a lot of research and spend a significant amount of time thinking about where are the best opportunities to invest our clients money. All of our work leaves us confident that U.S. high-quality stocks still represent a good buying opportunity and are likely to out-perform the broad U.S. stock market by a decent margin over the next several years. As an example, one of our trusted research providers, GMO, estimates that the broad U.S. stock market is likely to return only 5.2% over the next 7 years. However, they estimate high-quality stocks should return over 12% during that time-frame. At CB&T we're not sure what the differential will be between low and high-quality, but we do agree with their conclusion that high-quality will do better. If you're not familiar with GMO's work please visit their website at GMO.com; they have a long history of being very accurate on their forecasts and much of their commentary is free. The challenge, of course, is that "high-

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quality” is a nebulous concept and is often in the eye of the beholder. Here is a brief summary of what high-quality means to us:

Most importantly, we want to invest in companies that have an economic moat. In other words, they possess some kind of sustainable advantage over their competitors. Investing in companies that have a strong moat improves the odds that our companies will survive the difficult times and produce market beating returns for investors over the long-haul; here are some of the qualities we look for to determine if a company possesses a competitive advantage:

- Dominating economies of scale or low-cost production
- Unique intangible assets such as patents, trademarks or a strong brand name
- High switching costs for existing customers
- Barriers to entry for new competitors

Another factor we look for in companies is the ability to consistently generate a high return on equity (ROE). In our experience, a firm that year-after-year produces a high ROE (i.e. >15%) usually possesses one of the competitive advantages mentioned above. Simply defined, ROE is a company’s annual net income after tax, divided by shareholder’s equity (total assets minus total liabilities). Essentially, ROE indicates the amount of earnings produced by each dollar of equity. All other things equal, high ROE companies will produce more earnings and free cash flow which can be used to support a higher level of growth and keep their companies financially strong, and provide cash returns to shareholders. ROE, like most financial measures, has limitations and should not be used in isolation; however it can be a powerful tool to identify quality companies.

Lastly, the financial health of a company is an important aspect of finding high-quality companies for investment. Firms that are financially strong are able to meet their obligations, invest for future returns and return capital to shareholders in the form of dividends and buy-backs. In the midst of a financial crisis it is the financially strong firms that are able to survive, grow market share and build for the future. Criteria we look at include balance sheet strength, earnings stability, debt coverage, margin stability and earnings growth relative to industry.

The three areas mentioned above are a good starting place to look for quality investments that can provide market beating returns. Also, keep in mind that low-quality stocks tend to recover first after a recession, so we expect the best relative performance to lie ahead for higher-quality stocks.

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High-Yield Bonds—below is a review of performance and our current outlook for high-yield bonds.

- High-yield bonds have rebounded sharply in 2009, with the Merrill Lynch High-Yield Master Index gaining over 40%, well above last year's -26% debacle. Performance is poised to surpass the 39% record return in '91. Because many companies with high-yield debt are less financially stable than their peers, they are also more sensitive to the economy, and clearly the economy is improving right now.
- Moody's forecasts a scenario where speculative grade bond defaults could be higher than any time in history, including the Great Depression! Default rates are high and are at similar levels seen in the 1990 and 2001 recessions, not nearly the 15% default rate anticipated. Default rates (annualized) were at around 10.7% in July, vs. 14.9% expected.
- In late 2008, both absolute yields and spreads versus Treasuries and investment-grade bonds were far above prior peaks. A worst-case scenario was priced into the market. Peaking at around 2000 bps, the current spread level (800) is more indicative of prior recessionary spread levels.
- Potential average returns over the next five years are likely to be in the low to mid-teens. At roughly 10%, yields are in line with longer-term averages while spreads are roughly 2% higher. Economic and high-yield-specific risks are not to be forgotten, and if they resurface, losses over a 12-month time period are possible but seem remote.
- The high-yield asset class looks fairly valued given the economic uncertainties that remain. We have enjoyed a tactical overweighting in our model portfolios as an equity alternative. From here, we think this continues to be a defensive stance vs. equities.

—CB&T Investment Team

- CB&T Investment Team 9/2009

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