

Miller Wiggin Investment Letter

Miller Wiggin & Associates, Inc.

Second Quarter 2007

During times where economic indicators are confusing, investors who try to read the economic tea leaves can be easily whipsawed. So far, 2007 seems like one of those times.

There are no asset classes priced at bargain levels. But on a relative level there are two areas we continue to be excited about: large-cap domestic stocks and emerging markets short-term bonds.

The lack of bargains on an absolute basis does not mean that markets are overpriced. Today, many things are fairly valued. It's not exciting but it doesn't suggest that we should be defensive.

Quarterly Investment Commentary

After an uninspired first quarter, stocks around the world surged in the second quarter. Domestically, bigger was better, with larger companies delivering the highest returns, followed by mid-caps and then small-caps. It was also a good quarter for growth stocks. Fueled by the second quarter's returns, growth indexes have now out-performed value indexes for the year to date in all market-cap segments. International stocks had another strong quarter and out-performed the U.S. market again.

Non-equity asset classes were mixed. Emerging-market short-term bonds (PIMCO Developing Local Markets) performed very well and added a lot of value relative to the U.S. bond market, which was slightly negative for the quarter and only slightly positive for the year. Commodity futures were negative for the quarter though still positive for the year. REITs suffered a sharp correction, losing 9% during the quarter and have now experienced an 18% decline since peaking in early February.

So far this year our model portfolios have outperformed their benchmarks. The fixed-income allocations were big contributors to the relative performance with PIMCO Developing Local Markets, Loomis Sayles, and FPA New Income overcoming PIMCO Total Return's underperformance. Performance of the equity funds was mixed. Funds that beat their benchmarks included Longleaf Partners, TCW Select Equities, Laudus Rosenberg U.S. Small Cap, and Thornburg International Value.

Investing Without Bargains

In every economic cycle there are points where the indicators are particularly confusing. During these times investors who try to read the economic tea leaves can be easily whipsawed. So far, 2007 seems like one of those times as investors vacillated between fears of economic weakness (driven by the housing market) and strength (driven by the buyout boom and a strong global economy).

We've never believed that we could add value using an investment strategy that relied on accurate forecasts of the economy over the near term. Instead we focus on identifying tactical opportunities in which asset classes are fundamentally mis-valued. When we find them, in most cases it means a

superior return opportunity. At the same time it means we believe we have a significant margin of safety to protect us from the many risks that are always present. Even when there are no bargains, we can generally assess valuations in the various asset classes so we can form an opinion about the degree to which there is (or isn't) a margin of safety. Coupled with our scenario analysis, which allows us to stress-test our portfolios for a variety of potential economic and market environments, this is how we make prudent investment decisions in an uncertain world.

At an absolute level, there are no asset classes priced at levels that make us confident that we are likely to capture big returns over a several-year time horizon. On a relative level there are two areas we continue to be excited about: large cap domestic stocks, and short-term emerging market bonds.

Large-Cap Domestic Stocks: From November 1999 through February of this year, large-caps (S&P 500) had a total cumulative return of only 9.6% (1.5% annualized) compared to 72.7% (9% annualized) for small-cap stocks (Russell 2000 Index). This sizable performance discrepancy leaves large-cap stocks bargain-priced compared to stocks of smaller companies. Moreover, stocks of larger companies tend to do better when the dollar is weak (their foreign earnings are worth more converted back to dollars and U.S. exports become more competitive), which is partly why mega-cap stocks are now experiencing stronger earnings growth than smaller companies. They also tend to perform much better than small-caps late in the economic cycle. We may or may not be late in this cycle but we are clearly past the early stage.

A reasonable question to ask is whether large-cap stocks are cheap on an absolute basis, or only a less-pricey segment of an overall market that is expensive. Whether the overall market is expensive is a good question, especially after its very strong second quarter. Our short answer is that we believe domestic large-caps are reasonably valued and therefore attractive, though not so attractive that we would pound the table over them.

There is risk to our view. We've just experienced the greatest earnings boom since World War II, thanks partly to profit margins hitting a 40-year high. So the question is: While the stock market looks reasonably valued or even undervalued based on earnings, if profit margins were to move back to "normal" levels wouldn't the overall stock market then be overvalued?

There are really two questions here:

- 1) Are profit margins likely to decline significantly?
- 2) If they do, will stocks be overvalued without a price decline?

It does appear that profit margins are likely to decline in coming years:

- Labor costs are a big part of the equation. They have been the biggest driver of declining margins. The massive growth in the global labor market from China, Eastern Europe, and other parts of the developing world, along with technology-based productivity increases have made it difficult for labor to grab as big a piece of the economic pie. However, labor's lack of leverage may stop deteriorating and gradually reverse, increasing labor costs and putting some pressure on margins. But a big jump in labor costs doesn't seem likely in the foreseeable future.
- Depreciation expense, also a big factor, will also increase given the pick-up in capital investment the last few years.

- Interest expense is beginning to increase because of new borrowing and rising rates.

So, some margin pressure seems likely as the drivers of widening margins lose their momentum. However, it is not clear that margins will suffer a huge decline. Top-line growth has been healthy, and given a very strong global economy, revenue growth could stay reasonably strong. And though productivity is slowing and labor costs may not be as much of a positive, there is still an abundant supply of labor around the world and will be for years to come. China still has a long way to go in its transformation from an agrarian to an industrial economy. So, while we expect profit margins to decline and earnings growth to slow, we are not assuming that the slowdown will be alarming unless there is a recession.

What if margins do suffer a large decline? If it is gradual, the stock market may not be hurt too badly. This is because stock valuations appear to offer some margin of safety. Plugging in much lower “trend” earnings (that take out the huge surge of the last few years) into our primary valuation model, stocks appear to be in a fair-value range given current interest-rate levels. Most other valuation metrics we look at are also fairly encouraging. However, if there is a sharp and sudden earnings decline, as would be likely in a recession, stocks would almost certainly be hit. But, as we showed in detail last quarter, if we look out over five years, current valuations seem to suggest that it is reasonably likely that stocks will do better than bonds, even in a fairly bearish earnings environment. This isn’t all that surprising—since 1960, profits have had nine down cycles and stocks rose in five of them as P/E ratios rose. In our view, a sharp decline in earnings is possible but not the most likely scenario.

Addressing the general question of the outlook for stocks, there are several other bullish factors. One is the huge volume of money raised by private leveraged buy-out funds. According to investment firm Bridgewater, there is \$300 billion of capital committed to these funds that is yet to be deployed. With the typical levels of leverage (i.e., debt) employed by buyout funds, this could result in almost \$3 trillion of buying power. Over the last few years buyouts as well as corporate share repurchases have removed a sizable amount of stock from the market—about \$1 trillion (net of new and secondary issues) since mid-2004. Though some of that stock may come back into the market as private equity firms exit their investments by taking their privatized holdings public, this trend of sizable amounts of stock disappearing through privatization seems likely to continue for a while and is a bullish factor.

A second factor that is hard to quantify is the growth in sovereign wealth funds. These are state-run investment funds that invest a portion of a country’s currency reserves. Those countries with excess reserves to invest in this way include China and other developing countries with positive trade balances, as well as many of the oil exporting countries. According to a recent article in *Barron’s*, Stephen Jen of Morgan Stanley estimates that these funds may have as much as \$2.5 trillion and are growing rapidly. Their objective is generally to capture higher returns than those offered by government securities (such as U.S. Treasury bonds), which means investing in areas like private and public equities and real estate. China’s recent \$3 billion investment in the private equity firm Blackstone Group is an example of this.

Perhaps the biggest risk to longer-term stock returns is inflation and interest rates. The rapid growth in the developing world has caused demand for basic commodities to spike in a big way and is one source of potential inflation. At some point supply is likely to catch up with demand but that point may still be a ways off. However, there is a growing consensus among some of the sharpest fixed-income managers that inflation from a variety of sources is working its way back

into the system and that it is likely to move higher in the next cycle (though no one we know of is predicting double-digit 1970s-style inflation).

We haven't seen government bond yields of 6% since they were briefly there in the late 1990s. If we get yields that high or higher in a few years and they stick for a while, investors will require higher expected returns from stocks to justify owning them. Higher returns in that case would require lower prices for stocks relative to their earnings. If we experience an extended period of rising rates it will be an environment that investors haven't experienced since before the early 1980s, when interest rates peaked and began a 20-plus year downward trend. At this point, given the likely continued growth in the global labor force and the potential for productivity strength, a sizable (more than 1 percentage point) and long sustained rise in rates doesn't seem likely but is not something that we can rule out. A spike in inflation and interest rates is much easier to imagine now than it was a few years ago. As always we factor these possibilities into our scenario analyses.

Getting back to the question of large-cap stocks, what is the bottom line? Based on our analysis, large-cap stocks are a compelling opportunity *relative* to stocks of smaller companies. Thus, relative to our benchmarks we are significantly underweight small-caps and overweight large-caps.

On an absolute basis large-cap stocks are reasonably valued so we are in turn comfortable with the outlook over the next five years, but not optimistic enough to overweight our overall exposure to stocks. Margin compression is a risk but doesn't seem likely to be severe, at least not soon. And even if it is, stocks might still do okay relative to bonds over a five-year period. But, inflation and interest rates are something to watch.

Over the shorter-term, as investors continue to try to read the economic tea leaves in an environment with various cross currents and stresses, we wouldn't be surprised to see some news—economic, financial, geopolitical, a hedge fund or derivative-related blow-up—over the next year that spooks investors and triggers a quick stock market correction. A 10% decline would not be surprising given the performance run since February of 2003 (the S&P 500 has almost doubled). This isn't a prediction but we wouldn't be surprised. If it does happen, we think the downturn is likely to be a short-lived correction rather than the start of a bear market, unless we are heading to a recession, which is possible but seems unlikely given current global economic strength.

Emerging-Markets Short-Term Bonds: This continues to be both a currency play and a yield play. Shifts in the economic policies and fundamentals of many developing countries that have occurred over the past 10 years have had profound impacts on their economic health. Large trade surpluses and generally booming economies have allowed many emerging countries to significantly reduce their dollar-denominated debt (less debt and less of it denominated in dollars) and build very large foreign currency reserves. Despite attempts by some countries to keep their currencies from appreciating, there has been some appreciation. Nevertheless, many of these countries' exports remain very competitive. The strong growth many of these markets are experiencing is in turn luring more foreign capital. It is becoming something of a virtuous circle. Coupled with the real possibility of slower U.S. growth because of moderating consumption, the dynamics seem to be in place for further declines in the U.S. dollar relative to currencies of many developing markets over the next few years. Currency appreciation coupled with a yield of about 6% suggests the potential of very competitive returns from an asset class that also brings potentially valuable diversification benefits.

As always, we will continue to challenge the assumptions that underlie our view, consider new information as it becomes available, and stay intellectually honest in making well-reasoned investment decisions for our clients. We appreciate your confidence and trust.

Best Regards, Deborah F. Wiggin and George Z. Miller