

# THE FARR VIEW

A QUARTERLY NEWSLETTER FROM FARR, MILLER & WASHINGTON



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Farr, Miller & Washington's Growth Equity Composite ranked among the top 25% of firms in the country for the ten years and since inception to March 31, 2010 according to the PSN Database of Large Cap Growth Managers. Turnover averaged 26% per year while realized capital gains averaged less than 5%!

## DID YOU SEE US?

Michael Farr will Host Squawk Box on July 9th and is a regular Contributor on CNBC. He frequently appears on CNN, NPR, Associated Press Radio, and The Nightly Business Report. He is quoted in The Wall Street Journal, USA



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## View From A Farr

- Fed Funds are .25%: they were .25% last year.
- 1 year Treasury bill closed the quarter at .37%.
- 10-year Treasury note closed at 2.93%.
- Investor psychology is turning cautious.
- Earnings growth will moderate on tougher higher comps from 2H 2009.
- The S&P 500 was down 11.43% in 2Q.
- Volatility returned.
- Expectations for the remainder of 2010 are for a more tempered economic recovery and modest returns.

*Do I dare  
Disturb the Universe?  
In a minute there is time  
For decisions and revisions  
which a minute will reverse.*  
T. S. Eliot

Second quarter returns for stocks were pretty bad: down almost 12%. The last full week of the quarter saw a decline of 4.5%. Bond returns were excellent: +3.49% in the quarter. Interest rates dropped sharply (the 10 year Treasury yield fell from 3.83% to 2.93% over the course of 2Q 2010) as investors flocked to the perceived safety of bonds as stock markets tumbled around the world. The clergy and choirs leading the faithful followers of a V-shaped economic recovery have been silenced. Our long-held, oft-articulated view that this recovery would be difficult, gradual and lasting seems accurate. Our primary concerns - that this contraction was more severe

than those of recent memory, that government intervention, while necessary, prevented markets from clearing and finding their natural level, and finally that there would be further weakness when the government's money was withdrawn - all appear to have been spot-on as well.

## Jonah Had It Tough

It's hard to feel good as a prophet of unpleasant things. As investors are telling us they dread another decline and that they don't think they can take it, we gently remind ourselves that this is not "another" decline. This is all a part of the same decline that began in early 2008. As much as everyone would like to quickly tear-off the Band-Aid and be done with the current unpleasantness, this will indeed be a slower and more tedious peel.

Forecasts, positive and negative, are helpful. Even when low pressure systems build over warm water and howling winds begin to rotate, cautious, disciplined homeowners are able to board up windows and head to higher ground. Our advice has been naggingly consistent, and we hope that your investment decisions have been appropriately defensive and that you were not swayed by the momentum's siren call. Bonds are boring, especially in this low interest rate environment, but once again proved very useful in providing clients protection in these volatile markets. Looking forward, we hope that you will, as successfully, ignore the panicked alarms of decline.

Economic indicators have become lackluster. Forecasts for GDP growth in 2010 are being

*Continued*

reduced. Cautious banks, businesses, and consumers are in saving mode. All are holding cash as insurance against future weakness. This Paradox of Thrift (what's good for the individual is not good for the economy at large) indicates expectations for future returns, and those expectations are less than robust. The pendulum of sentiment often swings to excess, and President Nixon's nattering nabobs of negativism may indeed overshoot. That they may overshoot is precisely why a more middle-way, thoughtful approach to one's investments is essential.

In any recovery, top-line revenue growth is crucial. One cannot cut expenses forever. Forego revenue growth, and forego your future. Revenue growth or expansion is driven by demand. Demand is tepid, consistent with a period of contraction. Julian Robertson predicted that we were in for a "doozy" of a recession, and he was right. We suspect that we are also in for a "doozy" of a recovery.

### End Of The World?

Amid such consistent flows of negative noise, it is important to spend some energy focusing on what isn't being said. We don't hear much talk about the positive parts of the recovery. The crashing declines have largely stopped. Yes, we suspect that real estate prices have not bottomed and that the banks are not in the clear quite yet, but overall, the economy is not collapsing and is showing springtime buds of promise. Our great friend, John Whitmore, who was CEO at Bessemer Trust, wisely reminds us that most all of the predictions for the world's end have fallen somewhat short, and he guesses that this time won't be different.

In March and April we were writing about market gains of 60% and 70% relative to the sub-7000 March 2009 lows. Sentiment was ebullient and investors were in a mood to take on greater risk. As the Dow Jones Industrial Average crossed the 10,000 mark (going the unhappy way), investors

headed for the exits and sought the safer shores of bonds. A recent weekly market commentary discussed the implications of a sub-3% 10-year Treasury note. Warren Buffet says that "Americans are funny; they love stocks when they're up and hate them when they're down." We suspect that Americans feel the same way about bonds.

### Economy

Three seminal issues have driven the recovery of the past two years: government rescue money, bank stress tests, and exceptionally low interest rates. Government included the kitchen sink in their response. Americans are expressing disappointment that the real recovery is not further along given all of the suffering and all of the response. Frustration is being directed at the government, but the frustration, in our opinion,

better illustrates the depth of the problems.

Money was the first and strongest response by our government to the current financial crisis - money and government guarantees of money. The federal government backed money market accounts, certificates of deposit, mortgage-backed bonds, and banks' overnight liquidity, to name just a very few. Dallas Federal Reserve Bank President Richard Fisher said recently that the Fed had "done quite enough" in the supply of rescue and stimulus dollars. He suggested that the failure of the policy response was due to the uncertainty created by legislators in Washington. Policy uncertainty is a constant risk. That so much has been enacted, and is in the process of being enacted, has many waiting on the sidelines trying to suss out the new landscape.

Markets began to rally as Bank Stress Tests were

### OUR SERVICES

Farr, Miller & Washington's investment management is based on market wisdom rather than market whim. We believe that stocks are the best way for most long-term investors to satisfy their financial goals, and we focus our energies on selecting the most appropriate securities for each portfolio. Our equity orientation is balanced by our expertise in fixed-income securities, which satisfies that portion of a client's portfolio requiring low-volatility, income producing investments.

In general, we believe our long-term view leads to low portfolio turnover and higher realized returns, as our diversification lends stability to returns. While our firm's principles are consistent, we tailor their application to each client. We conduct regular account reviews and are here when you need us. Clients will receive information on their portfolios in the form of monthly custodial statements, transaction confirmations, quarterly performance analysis and regular strategy conferences. By keeping the client involved in the investment process, we ensure consistency of focus and purpose.

proposed. An imploding banking system always comes down to the same thing: confidence. Alexander Hamilton wrote about the necessity of having the public's faith and confidence as essential to a successful banking system. Bank Stress tests were designed by the Federal Reserve, though they wouldn't share the findings. The Fed, after a reasonable period, declared the majority of major banks as sound, and investors and depositors alike accepted their word. Markets rallied.

Interest rates are low and have been low. The Federal Reserve has even given up on tightening threats. The strongest statement we heard recently was that a certain Fed governor was growing less comfortable with the "extended period" language. Low interest rates have meant low mortgage rates, and low mortgage rates have offered support for home prices. But rates alone weren't enough: in the first quarter of 2010, the government funded 96.5% of all new mortgages in the US.

Apart from mortgages, low interest rates keep payments on all types of adjustable rate debt in check. Higher debt service costs would add additional pressure to businesses and consumers and therefore curtail spending. Moreover, higher interest rates would lead to a surge in the federal government's debt service costs. Therefore, from this perspective, we have been fortunate that the European debt crisis has led to a "flight to quality" in Treasury bonds. However, the resulting low rates have effectively "reset" the economy to unsustainably low interest rates. We are concerned what happens when the music stops.

### Inflation Anyone?

We know that we can't precisely forecast interest rates. There is historic precedent for long-term interest rates remaining very low for years after a country begins to de-leverage as the U.S. economy began to do in 2008. On the other hand, the Federal Reserve is terrified of deflation and appears willing to avoid deflation

Keeping bond portfolios too short is risky if rates stay low longer than the consensus expects. Keeping them too short also causes clients to miss out on the steep yield curve. Conversely, investors buying primarily long-term bonds are at risk in a rising interest rate environment.

at nearly all costs. This would suggest that inflation will eventually be the greater problem. We have been buying high quality, intermediate term bonds for client portfolios. Keeping bond portfolios too short is risky if rates stay low longer than the consensus expects. Keeping them too short also causes clients to miss out on the steep yield curve. Conversely, investors buying primarily long-term bonds are at risk in a rising interest rate environment. Inflation kills long-term bond returns. We choose to take the middle road and continue to find reasonable opportunities in high quality corporate bonds, taxable municipal bonds, agency bonds, and tax-exempt municipal bonds.

### Our View

As increasing revenues are necessary to grow a business, a nation that perpetually spends more than it collects is bound for serious trouble (just ask Greece). More spending is affordable if you have more money coming in. Growth and expansion generate more cash. If expenses can be contained, growth can lead to surplus and savings. Errol Flynn said, "My problem lies in reconciling my gross habits with my net income." Though the US had a surplus just 10 years ago, it will be several more decades before it can anticipate surplus again.

My friend and colleague, Rick Santelli, is wont to shout, "STOP Spending!" We wish lawmakers would listen.

As investors consider the longer road to economic recovery, it is logical they would be cautious with the capital they commit for investment. In fact, they are paying an amount for \$1 per share in earnings that is just slightly above the amount they would pay during the dark depths of the market sell-off in March 2009. While caution is warranted, we would guide our clients to closely examine and take advantage of several emerging opportunities. Warren Buffet advises us "to be fearful when others are greedy and greedy when others are fearful."

### Forward March

Farr, Miller & Washington's caution and defensive posture have been warranted. While defense remains our strategy, we are studying an increasing number of companies whose valuations have become very attractive. Our clear investment discipline guides our decision making, but we are encouraged by this advent of greater opportunity. Balance sheets and income statements cover our desks and computer screens. Our research is non-stop, as we look for additional ways to protect and further our clients' interests.

## Shares In View

The following are companies we find interesting. They are not recommendations to buy or sell. We may be buying and or selling in portfolios under our discretionary management. If you have questions about the appropriateness of these issues for your investment strategy, please call us. Closing share prices are as of June 30, 2010.

### PepsiCo (PEP - \$60.95)



PEP is a diversified consumer staple company that has produced highly profitable and consistent growth over the past 20+ years. PEP derives approximately 50% of its revenue from the sale of food and approximately 50% from the sale of carbonated and non-carbonated drinks. Based on sales derived from food, PEP is the second largest food producer in the U.S. behind Kraft. Despite a history of consistent double-digit EPS growth, PEP's P/E multiple has contracted from a long-term average of ~20x EPS, or 130% of the market multiple, to 15x, or roughly inline with the market (based on normalized EPS). We believe part of the multiple contraction is due to the slowdown in North American beverage volumes. While carbonated soft drinks have had declining volumes since 2005 due to secular changes in consumer habits, PEP's strong portfolio of non-carbonated drinks was able to propel growth. This growth has leveled off, but we believe new product launches and a revamped Gatorade can improve results in the near future. Given the Company's product and geographic diversification, coupled with its excellent balance sheet and defensive characteristics, we think investors will once again pay a premium multiple for this high quality company. In the interim PEP has a 3.1% dividend yield which is nearly 110 basis points higher than the S&P 500.

### Abbott Labs (ABT - \$46.78)



ABT can be thought of as a mini Johnson & Johnson. The company's business segments include Pharmaceuticals, Nutritional Products, and Medical Devices. The company's Pharmaceutical business is dominated by Humira, an autoimmune agent used for rheumatoid arthritis, Crohns, psoriasis, and several other indications. Humira, which accounts for 20% of ABT's total sales, goes off patent in 2016. Humira is a biologic drug. Biologic drugs are difficult and expensive for generic companies to copy which means that

generic competition will likely be less fierce than the generic competition for a typical small-molecule drug (e.g. Lipitor). ABT is not an exciting growth company. Instead, it is a high quality, diversified, global healthcare name with a great balance sheet and a great track record (stable and above average growth) trading at a reasonable valuation (11.5x 2010 estimated EPS with a 3.7% dividend yield). ABT's business is barely impacted by changes in global GDP growth. Stable companies have underperformed the overall market quite significantly since March 2009 (ABT +14% vs. +60% for the S&P500), allowing investors to buy defensive growth companies such as ABT at very reasonable valuations.

### Exxon Mobil (XOM-\$57.07)



After holding up much better than the overall market during the recession, XOM has underperformed both its energy peers and the broader market over the past year. Investors jettisoned this name for riskier and higher beta energy names as the market began to recover last year. The BP accident polluting the Gulf of Mexico has cast a pall over the entire energy sector this year. Meanwhile, XOM should be one of the least affected by an extended drilling moratorium in the Gulf. Its recently closed acquisition of XTO will boost production growth and give the company an opportunity to be a global leader in developing unconventional oil and gas reserves. The strength of the balance sheet has enabled the Company to continue investing in exploration projects while others were forced to reduce capital expenditures. XOM is an efficient project manager and generates industry-leading returns on invested capital. The stock appears very inexpensive at current levels trading at 10.1x 2010 EPS, 7x 2011 EPS and 5.8x consensus 2011 cash flow per share. Additionally, it trades at just 2.4x book value, well below the historical range of 2.8 to 4.2x book. Finally, investors can collect a 3.1% dividend yield while they wait for the story to develop. Energy demand should continue to rise with global economic growth and XOM represents a safe way to participate.

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