

# 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 5% in the country for one year and among the top 25% for the ten years ending June 2009 according to the PSN Database of Large Cap Growth Managers!

## DID YOU SEE US?

Michael K. Farr's current book, *A Million Is Not Enough*, is in bookstores and on Amazon.com now! Michael is a



CNBC Contributor and appears regularly on CNN, NPR, and Associated Press Radio. He is quoted in



The Wall Street Journal, USA Today, Forbes and many others. Readers

may now subscribe to our free weekly market commentary by visiting our website [www.farmiller.com](http://www.farmiller.com).

## View From A Farr

- Fed Funds are .25%; they were 2% last year.
- 1 year Treasury bills closed the quarter at .38%.
- The 10-year Treasury note closed at 3.30%. It was 3.82% last year.
- Investor psychology is bullish.
- Earnings growth seems to have bottomed.
- The Russell 1000 Growth Index was up 13.97% in the 3rd quarter.
- The S&P 500 Index was up 15.61%.
- Financial woes continue to be severe.
- Expectations for the remainder of 2009 are optimistic.

## “Stupidity has a knack of getting its own way.” Albert Camus

We worry when things don't make sense. The lofty valuations of the broad stock indices don't entirely make sense. The Standard and Poor's 500 Index is up well over 50% from the March lows. Investors willing to pay \$11 for every \$1 in earnings per share in March are now willing to pay over \$19 for that same dollar per share. Peter Lynch points out that earnings growth is the best indicator of stock price performance over time. On that front, it seems that market participants have abandoned market skepticism in exchange

for full-throttle optimism. The consensus estimate is now calling for S&P 500 operating earnings to grow 28% in 2010. A pipe dream? Maybe, but if this earnings growth does indeed materialize the market is trading at a much more reasonable 15x earnings for 2010.

Our worry is simply this: remarkable amounts of government stimulus have been effective, but the economy and markets may very well have become dependent on this stimulus. In classic recoveries, government stimulus improves the economic environment enough to encourage consumers and investors to return to the party. As demand returns, government stimulus is removed. We call this process “taking off the training wheels.”

While investors have clearly returned emphatically, the anticipated return of the consumer remains hotly anticipated. Stock buyers are firing with abandon while the whites of consumers' eyes remain a phantasm. Will the current level of home sales continue in the absence of tax credits, low down-payment FHA loans, and artificially low mortgage rates? What will auto sales look like next year now that “cash-for-clunkers” has expired? Will \$11 trillion in lost wealth finally encourage consumers to save more for retirement? In a hunky-dory world, all of this will turn out just fine, but we're worried about investing real dollars hoping for hunky-dory.

*Continued*

To learn about the services that we provide, please contact us:

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Our long-standing mantra is to always sacrifice opportunity rather than sacrifice clients' money!

### Market Timing

Among things that don't make sense is market timing. Clients sometimes ask me, "Michael, if you think that share prices are too high, why don't you sell everything?" Well, the answer is that if we thought we had perfect and complete information, we would. But alas, that is impossible. Moreover, the analysis we perform on individual companies continues to suggest that valuations are reasonable for high-quality, defensive

companies with realistic growth expectations. Furthermore, the view becomes incredibly more complicated when one tries to anticipate the outcome of exogenous issues like Iran's missile testing, and the wars in Afghanistan and Iraq. While we're anticipating, we might as well cover emerging health care reform, capital gains taxes and increasing income taxes.

The bottom line we continue to reach is that the latter stages of this rally have been fueled by speculators hoping and praying that the government has orchestrated a flawless plan to resurrect demand and remove stimulus at exactly the right time. Investors are increasingly

abandoning high-quality, defensive investments in favor of those able to provide the most octane in a goldilocks recovery. For our part, we'll continue to do things the way we always have.

### History Lessons

On September 30, 1929, the Dow Jones Industrial Average (DJIA) traded at 381. Two months later, at the end of November, it traded 198. By the end of April, 1930, it had regained considerable ground, almost 50%, to trade at 294, and from there things got ugly yet again. The 1929 stock market crash was just the beginning. Following the April, 1930 recovery, the DJIA followed a one-step-forward, two-steps-back pattern until it bottomed in July 1932 at 41. The years 1932-1937 were very good to investors, and then share prices moved lower until the beginning of World War II. The Federal Reserve misjudged the 1932-37 recovery and removed stimulus before sustainable end demand materialized.

Following the initial years of the Great Depression, the country went through the feel-better stimulus period similar to the one which we are enjoying now. However, the Federal Reserve's Open Market Committee (FOMC) removed the training wheels before the toddler economy was secure, and the economic contraction was renewed. Chairman Bernanke is a great student of the 1929 Market Crash and Great Depression. He knows the downside of stepping back too early, and Central Bankers the world over know the inflationary ramifications of keeping stimulus around too long. There is not a lot of room for error. Stock investors seem to expect that the FOMC will get

## 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.

this timing just right. We certainly hope they do, but we're worried...and skeptical.

### Federal Reserve

Federal Reserve Vice Chairman Donald Cohn said in the first week of October, "we must begin to withdraw accommodation well before aggregate spending threatens to press against potential supply, and well before inflation as well as inflation expectations rise above levels consistent with price stability." So, they're reminding us that they appreciate the precarious balance. My favorite line came from Chairman Bernanke himself last week when he said, "Accommodative policies will likely be warranted for an extended period. At some point, however, as economic recovery takes hold, we will need to tighten monetary policy to prevent the emergence of an inflation problem down the road." Well, that certainly clears things up. Later, Bernanke said that the Fed would look to remove stimulus when, "the time was right." Wow, again!

### Farr, Miller & Washington's Posture

Portfolios are positioned defensively. This is the result of our adherence to our fundamental, long-term discipline that emphasizes balance sheets, consistent earnings growth, and seasoned management teams. While we are very pleased with your portfolios' performance year-to-date, experience has taught us that chasing short-term momentum is a mortal sin, and the consequences

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of impetuous impatience could indeed be most substantial. The current run may last a good while longer. Rest assured that you are participating in the market's strength and, more importantly, that the prudence that protected portfolios during 2007 and 2008 is in force and maintaining our solid foundation.

Portfolios are diversified but are concentrated in four broad industry groups: technology, consumer staples, healthcare, and industrials. Again, this allocation is the result of stock picking that begins with balance sheets and income statements and not our broad view of the economy. In the Stocks Section of this letter, we review three names we find interesting now. Two have been recent purchases. Our discipline directs us to buy when the numbers are right for the company in question, and our decisions are not driven by the direction or condition of the broad indexes overall.

### Exciting News

Christopher Pusak joined us in September as a Senior Vice President and Director of National Sales. Chris joined us from Rorer

Asset Management in Philadelphia where he was the head of sales as the firm grew from \$150 million to over \$12 billion. Chris has been in the financial services industry since 1983, including stints with Merrill Lynch, Attalus Capital, and his most recent position at Rorer where he spent thirteen years. Chris lives in the Philadelphia area with his wife and two children.

In May we foreshadowed that even more good news was on the way. After a very competitive and lengthy process, Farr, Miller & Washington was selected as a finalist and ultimately the sole manager of a new mutual fund for the Touchstone Investments portfolio of funds. The **Touchstone Capital Appreciation Fund** is an open-ended fund that will be distributed through brokerage firms and banks throughout the country. This is a great way for smaller accounts and 401K plan investors to benefit from Farr, Miller & Washington's management, normally reserved for much wealthier investors. We are delighted to welcome Touchstone and all of our new mutual fund investors. Please know that our only job is to manage the money as if we had just one additional account with no marketing or client service responsibilities.

## Shares In View

This section of The Farr View describes a few stocks that 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 October 9, 2009.

### Rockwell Collins (COL - \$50.99)

Rockwell Collins provides design, production and support of communications and aviation electronics for commercial and military customers worldwide. The company's sales are split equally between products and services sold to government entities and those sold to commercial customers. Various branches of the US government accounted for 38% of total sales in 2008. Financial performance at COL has held up very well throughout the commercial aerospace downturn due to outstanding results at the company's Government Systems division. While we do not expect this strength to last forever given budgetary concerns, we believe that the company's dual-market approach serves as somewhat of a natural hedge. Furthermore, COL has been able to command high margins and generate superior returns on capital due to its leading market share and the technical expertise inherent to its product suite. And finally, the company's balance sheet and cash flow are very strong with free cash flow totaling over 100% of net income since the company became publicly-owned in 2001. At a P/E multiple of 14.0x the consensus estimate for calendar year 2010 (representing a 7% discount to the market multiple), we believe COL offers solid value for long-term investors.



### Procter & Gamble (PG - \$57.56)

Procter & Gamble is one the largest and most diversified household and personal products companies in the world. Due to the "staple"-like nature of its products, the Company has posted year-over-year EPS growth for 18 years through F2009, resulting in a compounded annual growth of 11%. For fiscal 2010 (year ends June 30th), PG is forecasting a modest 3.5% decline in EPS due to a confluence of macroeconomic and company-specific issues. Our assessment of the company-specific issues (i.e. too many premium priced products) is that this is a fixable problem in the short-term. In the longer term, we believe this is a high class problem to have as second tier brands/products continue to face significant competition from private label penetration. The rare blip in PG's track record has resulted in the stock selling



at its cheapest absolute and relative multiple in 18 years. PG currently trades at 14.2x calendar 2010 EPS, or a 6% discount to the market. Historically, PG has traded at an average multiple of 21x and 116% of the market multiple. We find the prospect of multiple reversion to the mean, combined with an above-average dividend yield of 3.10%, attractive for client portfolios.

### Accenture (ACN - \$39.07)

Accenture is a global management consulting, technology services and outsourcing firm.



Accenture's two business segments are consulting/ technology services (59% of revenue) and outsourcing (41% of revenue). These two business segments service the following five industry verticals: communications & high technology (22.8% of revenue), financial services (20.3% of revenue), products (25.8% of revenue), public service (13.1% of revenue) and natural resources (17.8% of revenue). In addition to being well diversified in business function and client exposure, the company is well diversified geographically. As of fiscal year end, Accenture generated 43% of its revenue from the Americas, 47% from EMEA and 10% from APAC. We think Accenture is a well above average company as evidenced by its consistent track record of EPS and cash flow growth, well above average ROIC, and debt-free balance sheet. From 2002 through 2009, EPS have compounded at an annual rate of 17% driven by an 8.5% CAGR in revenue, relatively stable EBIT margins (12 – 13%) and a 4.5% reduction in shares outstanding. ROIC has averaged 78% over this time period. This compares to an average ROIC of ~8.5% for other publicly-traded IT consulting firms, and we think this metric speaks volumes about the higher value nature of Accenture's services and management's decisions to turn away value/low margin work and avoid large scale acquisitions. The Company has a pristine balance sheet with no debt and \$4.0B (\$5.10 per share, or 15% of its market cap) in cash. At today's price, the stock trades at 14.2x calendar 2010 EPS, which is a wide discount to its historical average P/E of 17.5x and also a discount to the S&P 500. We think the current valuation offers an attractive risk/reward proposition for client portfolios.

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