

## IT'S NOT THE ECONOMY, STUPID

October 4, 2011

It has now been nearly 20 years since some great political strategist identified the key issue of a presidential election by uttering these now famous words: "It's the economy, stupid." Since that utterance, the economy has taken the lead role amongst the cast of prevailing worries, including, those concerning the stock market. While the market swoon over the last few weeks has echoed the drumbeat of "double-dip," we believe there are other worries, perhaps more serious and long-lasting, that are taking the spotlight in investors' minds.

One for sure, is the status of the "Euro." This currency is backed by an initial agreement of all members to financially support the currency on a "more or less" pro-rata basis. Given the fact that all member-nations are different societies with different fiscal issues, a healthy, growing economy made the agreement easy to honor over the first 15 years of its existence. Once the current financial crisis hit, however, the fiscal disposition and difference of each member-nation came into focus. The well known problems in Greece, Italy, and Portugal have created a cloud over the Euro and all participating banks involved in the financing practices in each of these countries. With over \$200 trillion worth of derivatives existing around the world, it is impossible to know where specific risk exposure lies, but the risk of overall contagion is clearly quite high. This is the primary reason why we have avoided investments in the financial services industry. While government regulation and interference plagues this industry, the risk of contagion is our primary concern. In short, the European situation looks like the inevitable train wreck yet to happen.

The financial plight of our nation also ranks high on our worry list. We are near the end of the third highest-ever year of deficit spending, behind the deficits of 2009 and 2010. Currently, for every dollar of tax paid, the federal government borrows another 56 cents. These deficits are not the by-product of stimulus packages...those have been replaced by increases in Medicare, Medicaid, defense, and other "entitlements." Simply put, the biggest spending items are not subject to budgeting at all, but rather are open-ended. Short-term monetary stimulus has helped forestall the inevitable, but the Dollar is heading for a crisis unless the Federal Reserve stops printing money and unless we address the spending increases inherent in our entitlement policies. The down-sizing of the bureaucracies that manage these programs could be quite painful, but continuing down the road without a fix could be much worse. The role and scope of government is our largest single concern...the increase of government control and regulation has rendered several sectors of our economy to the "discount price bin," as historic rates of return have been lowered for many financial, healthcare and defense companies. Oil companies are currently being threatened, and with each passing day, new tax proposals and regulations threaten to dilute profits and lower the after-tax returns to investors. The monetary policies of the Fed have created a potential bond market bubble that, if corrected, could seriously exacerbate our deficit situation and trigger a severe recession.

The stock market always discounts the future growth of earnings and dividends, and does so through a prism of expected interest rates. These valuations are always compared to relative values in other parts of the world and a compensatory "risk discount" is applied where risk is perceived to be higher. In that regard, the U.S. is trading at a 65% premium to Europe compared to a normal historic 15% premium. Our current 16.5 multiple for the S&P 500 is at the median multiple of the last 80 years. Given the aforementioned problems addressed in this communication, it seems reasonable to expect investors to begin demanding more of a risk discount when investing. Such a change in perception would cause

prices to fall in order to get to the appropriate risk discount. This is why we are holding such high levels of cash.

The good news is that many American corporations have learned to operate effectively in this uncertain environment. Identifying these special companies, capable of growing and prospering on their own, continues to be our main focus, along with the discipline to acquire them at an appropriate risk discount.

For the short term, we expect the Dollar to strengthen, benefiting from more foreign concerns. Between now and the election next year, we see a more volatile market reflecting each poll change, each tax proposal, and each foreign crisis. Accordingly, we remain liquid, hoping to take advantage of large risk discounts that are likely to occur.

\* \* \*

Defensively and patiently yours,  
Harlan J. Cadinha  
Chairman and CEO