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The second quarter of 2010 was a reminder that any recovery would not be a steady affair. After rising around 5% first quarter, the S&P500 fell more than 11% during the second. Half of this decline came in the last five days of the month. As I write this note, the S&P 500 is up about 5% from month end, reversing the damage from the last week in June.

In order for the stock market to rise over time, one or both of the following must happen. Earnings must go up and/or the price that people are willing to pay for a given stream of earnings must go up. I say this because I still feel that earnings will be healthy as we move through earnings season over the next few weeks. I am becoming concerned, however, about where the PE multiple may be headed in the future. This PE ratio is the price that people are willing to pay for a stream of earnings. It is derived by taking the price of a security and dividing it by the earnings. One way of looking at the PE ratio is that it tells you how long investors are willing to wait around for a return of their capital. This is an oversimplification, but I think it will convey my point.

Company A is expected to earn $5.00 per share this year. What would you be willing to pay for a share of this stock? If you paid $5.00, you would receive 100% of your purchase price in one year. This seems like a good deal. You might be willing to pay 3 times earnings or $15. This would represent an expected return of 33% per year. How about 10 times earnings (a PE of 10)? The annual earnings would amount to 10% yearly return. Determining how long a stream of earnings will continue for any company requires predicting the future. If you had a high level of confidence that an earnings stream would last for 10 years or longer, you can see why you might be willing to pay a higher PE multiple for the stock. If you had great difficulty in figuring out what earnings would be tomorrow, you might not be willing to pay as much.

Changes in PE ratios can be a result of growing or worsening confidence of investors. Sometimes if investors have gotten too euphoric, and they think that earnings will grow to the moon forever, and are willing to look out 40 years, they can move the PE up far higher than it should be. The market correction that began in 2000-2001 was one that addressed the PE ratio, not collapsing earnings. If exposure of some of the silly business plans of the internet economy were not enough to temper the euphoria, a terrorist attack on our soil and the subsequent economic slowdown did the trick. Investors that were willing to look out 40 years in 1999 were, in 2003, only willing to look out 4 quarters. The reason the overall stock market went nowhere over the last 10 years is due primarily to the PE of the market coming down.

At the end of 2000, Emerson Electric sold for just under $40 per share. Its earnings were $1.65 that year, so the PE ratio was 24. Today, Emerson sells for about $45 per share.

Its earnings expectations are $2.53 per share for their year ending this September. So, even after the recession earlier this decade, and the economic mess of the last few years, Emerson has been able to increase their earnings per share by over 50%. The stock price has only moved from $40 to $45. The PE ratio has moved, however from 24 to 17.8. Based on next year's earnings, the PE ratio is 14.3. You can see then that in periods when PE ratios are moving down, it is hard to make a lot of money in stocks. Put another way, you could have correctly forecasted 10 years earnings gains of 55% and not made much money because the market demanded a more conservative multiple of 17 or 15.

As a side note, one reason we like dividend paying stocks is that they pay income even during periods when the PE of the market is moving down. This same investor in Emerson during this period would have received over $9.00 per share in dividends over this period.

Why do PE ratios change? There is some linkage between high PE ratios and low interest rates and again between low PE ratios and high interest rates. I think that PE ratios can be expressions of confidence and hope on one hand and fear and uncertainty on the other. In periods of greater uncertainty, PE ratios can move down. Investors are not willing to look out as far into the future, or they might not like what they see. Rising interest rates can be a source of uncertainty. So can policy changes out of Washington.

The huge moves in the market can occur when you have rising earnings and rising PE multiples or falling earnings and falling multiples. A large downdraft in the market could occur, then, if earnings expectations came down and there was a great deal of uncertainty causing investors to demand lower PE multiples as well. If the market multiple (the PE ratio for the market) were to drop from 16 to 12, but earnings stayed the same, the market would fall 20%. If earnings also fell 20%, the market would fall 40%.

Again, I don't think that the primary risk factor in today's market is earnings. I do worry about the market demanding a lower multiple due to the growing level of uncertainty about the impact of the various fiscal and regulatory policies coming out of Washington. It is true that these policies could have an impact on earnings, but I think that the bigger impact might be on multiples as they can negatively affect confidence in the markets and expectations.

How low could the multiple go? I don't have a scientific answer for this. I think that 7 times earnings is too low, but that 10 times to 12 times might be realistic if things get difficult. This would suggest 25% to 30% downside in the market.

As my thinking on this issue continues, I want to let you know how I might respond. The accounts managed by us have a long term objective or benchmark as part of the investment policy. In normal times, an account would typically be allocated consistent with this benchmark. The policy does allow us to deviate from the long term weightings

if we feel that there are opportunities or risks present that call for doing so. I can reduce the weighting to equities a certain amount and remain consistent with the parameters of the policy. I don't anticipate going beyond this level. If I did, we would have to have a conversation. If you have any questions about this, let me know.

In an effort to keep this letter on the shorter side, I will wrap up. I am happy to share some of my specific concerns with you if you would like to chat. I may communicate again with a more specific note at an appropriate time.

As always, please feel free to call me with any questions or comments.

Sincerely,

Peter B. Harre, CFA

Enclosures

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