

Fall Newsletter
November, 2009

Tilting Towards Quality

A year ago, investors were impatiently cleansing their portfolios of risky assets. They were particularly quick to dump shares in companies that had a significant amount of debt. The credit markets had frozen following the demise of Lehman Brothers and highly leveraged enterprises were thought to be headed for bankruptcy because their businesses could no longer be financed and their existing debt could no longer be rolled over. Managements of many debt-heavy companies watched the market value of their stock fall 90% between August 2008 and March 2009, unable to adjust their capital structure without significantly diluting existing shareholders or refinancing their existing debt at very high rates.

A year later, the situation has dramatically reversed. Growing increasingly confident in the prospects for an economic recovery, investors have moved money back into stocks and bid up the prices of many highly leveraged enterprises. In fact, a recent study by Inverness Counsel shows that debt-heavy companies have led the stock market's rally since March. According to Inverness, of the 500 companies in the S&P 500 Index, the top 50 performers have beaten the return on the Index itself by 70% on average. Those same 50 companies the study points out have an average long term debt to capital ratio of 52%, compared to the other 450 companies in the S&P 500 which have an average ratio of only 35%. Furthermore, the Inverness analysis shows that 25% of the top 50 performers since March are expected to report a loss for the year 2009, while only 8% of the remaining 450 companies in the Index are expected to report a 2009 loss.

I point out the "low quality" nature of the current stock market rally because I believe that it is important for our clients to understand what does and does not fall into our investable universe. While we do recommend the purchase of shares in companies that have debt outstanding, we focus on well-run, profitable businesses that are not overly leveraged. We try not to overpay for the dividend and earnings growth we expect to receive and try not to over complicate the investment process by buying businesses with complex capital structures. Sticking with this "higher quality" investment strategy can, particularly in market environments like the current one, lead to underperforming the relevant benchmarks. In fact, in the "low quality" rally we have seen since March, companies with consistent earnings growth and clean balance sheets have tended to under-perform. Fortunately, "low quality" rallies tend to be brief and to eventually give way to longer periods when the consistently profitable and well-capitalized companies that we favor return to a leadership position.

The continuing price recovery of the stock market does not appear to be driven any longer by cheap valuation. In fact, the price/earnings ratio on the S&P 500 has risen to 17 times vs. an historic average of 15 times (and 10 times back in March). The lesson we can learn from recent experience may be that low interest rates and generous liquidity are

indeed more powerful positive forces than we originally thought. In any case, the market has recovered nicely from its March low and has been led by the “low quality” sector. Our job is to avoid fads, stay focused and continue to look for well-run, well-capitalized and reasonably priced stocks to recommend to our clients. We are particularly interested in dividend paying companies, not just because of the current income they provide to our clients, but because the ability to pay dividends is an attribute of a high quality company, the type of company whose stock has tended to outperform the market over the long term. As always, we’ll keep you posted on what we find. Talk to you soon.

The Standard & Poor’s (S&P) 500 Index is an unmanaged index that tracks the performance of 500 widely held, large-capitalization U.S. stocks. Individuals cannot invest directly in an index.

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