December 2011

Core Growth Equity Investment Strategy

Be fearful when others are greedy and greedy only when others are fearful. - Warren Buffett

Most people get interested in stocks when everyone else is. The time to get interested is when no one else is. You can't buy what is popular and do well. - Warren Buffett

The future is never clear, and you pay a very high price in the stock market for a cheery consensus. Uncertainty is the friend of the buyer of long-term values. - Warren Buffett

These quotes from Warren Buffett reflect his well regarded wisdom about buying and selling stocks. It's simple, right? Everyone knows the object of investing is to buy stocks when they are low in price and to sell them when they are high. But surprisingly, very few investors actually accomplish this. Most get caught up in the enthusiasm of a rising market or the pessimism of a falling market. More often than not, investors let the attitude of the day drive their long-term investing decisions and eschew these time-tested disciplines of investing.

Without a doubt, it is very easy to fear the world of investments these days. It seems like financial news is now on television and radio 24 hours a day, seven days a week. The financial media know that viewership increases when news is bad. Indeed, in 2008, in the heat of the financial crisis, viewership almost doubled. This is why they hope to create such concern when reporting the news.

Undoubtedly, the financial future is particularly murky at this point. First, there are many disconcerting events taking place in the world of economics. As of this writing, unemployment remains high at 9%. This is an ominous sign that too few people are working and bringing home paychecks. Second, the number of new houses sold is staying stubbornly low. The slow pace of sales negatively affects the price of homes generally. Given that houses represent the biggest asset most of us own, lower prices cause the wealth of the average American to decline. Adding to this bleak economic picture are high consumer and government debt levels both here in the U.S and in Europe.

Beyond economics, the political debate in Washington seems to be out of control. Our leaders have chosen a path of confrontation instead of cooperation with regard to the government deficit and the high level of government debt. Twice in the past six months, legislative committees simply chose to bypass a deadline and instead "kick the deficit can down the road" without coming to grips with the real issues.

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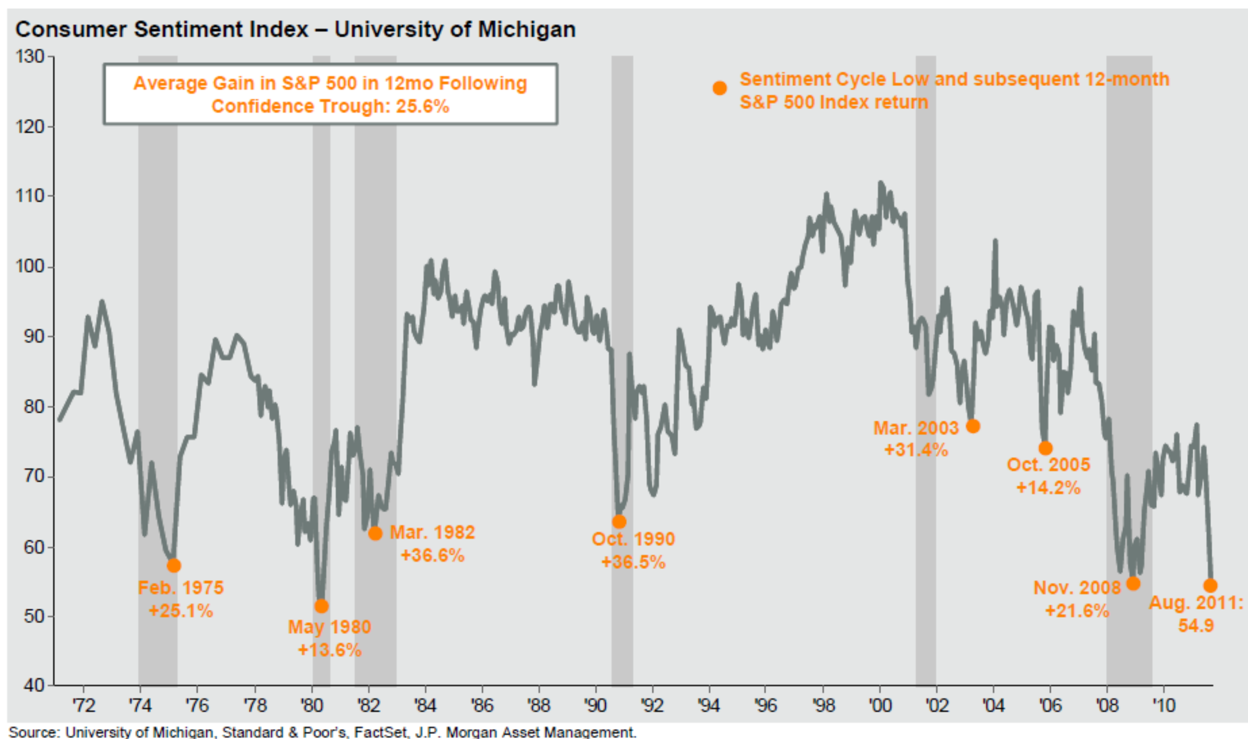
Preserving And Growing Capital Since 1969

This does sound bad for investors, doesn't it? But let's remember that we have survived difficult periods in past. For many investors, however, it is difficult to remain optimistic during such periods. Indeed, it is common during these periods for measures of consumer confidence, or sentiment, to decline along with stock prices. One such measure of confidence is the University of Michigan Consumer Sentiment index. This index surveys individuals regarding their feelings about their specific financial situations, their confidence in the overall economic picture, and their expectations for the future. It provides a good measurement of the level of optimism or pessimism that is evident among consumers.

The correlation of consumer sentiment with stock prices actually presents an opportunity for investors. To see why, let's take a look at past periods when the sentiment level was low and observe subsequent price changes in the stock market. The chart below from JP Morgan looks at the University of Michigan Sentiment Index and examines what happens to the S&P 500® Index (a widely followed index of U.S. stock market performance) in the 12-month period subsequent to a low point in confidence. Most investors quickly assume that when confidence is low, business will be bad and stocks should do poorly going forward. Surprisingly though, just the opposite is true. Looking back over the past 40 years, stocks have consistently risen after periods of low confidence readings.



In fact, looking at the last seven low points in confidence, the S&P 500® Index averaged a *GAIN* of 25.6% in the subsequent 12 months.

To understand this phenomenon better, let's recall some of our past problem periods. 1974 was certainly rotten from an economic perspective. We were in the aftermath of the Yom Kipper War and the first oil embargo. Oil prices rocketed higher. We had gasoline shortages and lines

at gas stations across the country. Politically, Nixon was implicated in the Watergate scandal and resigned in August of 1974. Nevertheless, the stock market bottomed in December of 1974, just prior to the trough in confidence reached two months later. Despite all the problems of the day, however, the stock market rose 25.1% during the twelve months that followed the low point in the sentiment index.

The period 1981-1982 was difficult as well. As you may recall, unemployment reached 10.8% in November 1982. Interest rates crested at over 20%. The tangible net worth of the entire savings and loan industry was less than zero. From the low point in confidence in March of 1982, the stock market rose 36.6% during the next 12 months.

This chart shows that what Buffet claims is true. It is better to buy when uncertainty abounds and others are fearful. But why is this true? It is because stock prices incorporate the bad news that is already obvious in the economy. Because others are nervous and are busy selling at almost any price, they then cause the stock prices to become *inordinately* cheap. Looking at each of the periods of low confidence, the common thread among them is that stock prices in fact became cheap in relation to the underlying companies' inherent values.

Buffet's third quote is particularly appropriate now. While the future is never clear, it is unusually cloudy today. The current level of pessimism and uncertainty is as great as virtually any other period in the past 40 years. This pessimism has led to what we at Goelzer believe is an undervalued stock market. If investors wishing to purchase stocks wait until they get a cheery picture, prices will no longer be as attractive.

Near-term Uncertainty, Long-term Opportunity

With such a high level of uncertainty, it is hard to predict what may be in store for the short-term market. Long term, however, we remain confident about our portfolios' reward/risk potential. The current volatility has helped us do what we believe we do best: invest in well-run companies with strong balance sheets and attractive free cash flows, trading at attractive reward/risk valuations. Too often, we think some investors ignore the risk side of this equation until it is too late. Then, they are reminded how quickly the reward component can vanish. In the current climate, we believe owning great companies with a margin of safety built in to the stock price helps limit downside exposure. In short, we buy low when the opportunity presents itself.

Not too long ago a 1% intra-day stock market move was somewhat unusual. Now it happens almost daily. In fact, as I write this letter, stock prices today are up over 3%, after falling 4.7% last week. While this level of volatility can be unnerving, it creates opportunities. Investors need to remain focused on the long-term, but also be aware of what they might lose in the short-term. This is why we advocate owning a diversified and balanced portfolio that moderates the overall risk level. Having a balanced portfolio gives one the opportunity to exchange out of low-risk assets to take advantage of negative periods when stocks go "on sale".

As part of our investment process, **The Goelzer Core Growth Equity Strategy** considers both the potential for appreciation as well as the downside risk. We do this by looking at the *value* of a whole company relative to the *price* we pay for it. We concentrate on great companies that

have unique products or services. These companies usually have an excellent rate of growth in sales or revenues. They also are typically growing earnings at a pace much faster than the average company in the stock market. Yet by considering the potential downside, we end up making purchases with a margin of safety. This distinctive investment process has helped our portfolios deliver strong risk-adjusted performance over the long term. By seeking to protect against losses in market declines and capture solid absolute returns during market rallies, we have been able to deliver attractive performance across full market cycles relative to our portfolio benchmarks and peers.

When focusing on a *whole company*, we look at Return on Invested Capital (ROIC). This is a measurement that tells us how effectively a company invests in its assets to earn each dollar of profit. Companies that have a high ROIC are highly profitable and are generally more valuable than those with lower ROIC's.

Likewise, when purchasing *shares of a company*, we evaluate the Earnings Yield, or the rate of return that a new investor is willing to accept for each dollar of profit. Earnings Yield is the inverse of the Price/Earnings ratio, and so it is earnings divided by price. The most variable factor in determining the Earnings Yield is the price of a share. As we all know, it can change dramatically on a daily basis. Regardless of a company's inherent worth, the price of a company's shares is determined by the level at which someone who holds the shares is willing to sell them. The seller of a company that is very profitable will, when thinking rationally with no compulsion to sell, usually demand a premium in price relative to the pro rata share of the company's assets. But a seller who is nervous and needs to sell at any price might accept a discount. Part of the reason we have such volatility today is that many stock investors are anxious and focus more on how quickly they can sell their shares rather than on the real value that the shares represent. Focusing on the ROIC and the Earnings Yield calculations enables us to distinguish between real value and perceived value, thereby helping us to find opportunity when others are selling at a discount.

Our research goes further. Beyond the above numbers, we look for the reason why a potential company will be able to sustain its profitability. Typically, a company will have a unique product or service that is in great demand and offers opportunity for profitable expansion. But just as important, we want to purchase such a company at the right price. We look for situations where the purchase price offers a margin of safety so that should our estimates be off, our downside will be reduced.

Looking at stocks with a margin of safety offers another benefit. Most investors find the buy decision to be fairly easy. The problem comes with when to sell. Using a margin of safety perspective forces us to re-evaluate positions when they become more expensive. When a holding appreciates to the point where it no longer offers a margin of safety, it gives us the impetus to reduce or sell the holding and refocus our efforts on more attractive stocks.

While the uncertainty of the stock market does create anxiety, it also creates opportunity. When stock prices fall because of a lack of confidence, consider Buffett's quotes and remember that such is the time when stocks go "on sale."

The following are several examples of stocks we hold or have sold because of our focused process.

1. We initially purchased **Family Dollar Stores** (FDO) back in October of 2009 at $28. The stock had an attractive earnings yield of roughly 9% and had a return on invested capital of over 25%. At the time, investors were worried about financial turmoil and confidence in the overall economy was weak. This helped create opportunity in the stock. Family Dollar Stores is essentially a low-price retailer. The company's sales have been growing at about 8-10% annually. But its attractiveness comes from the fact that its stores require only a modest investment. Each incremental dollar spent on new stores delivers excellent incremental profit. We sold some of our Family Dollar a year and a half later at $42 and the remainder at $44. We still think Family Dollar is a great company, but that the stock no longer holds a margin of safety at the current price.

2. **Roper** (ROP) is a diversified manufacturer of technology-based solutions for customers, creating products such as radio frequency information devices, toll-road transmitters, and automated meter-reading capability for utilities. These solutions serve as a virtual cash register for customers, eliminating the need for more time-consuming methods of measuring customer usage. The company's management is very adept at generating free cash flow from its operations in order to acquire businesses that immediately add cash back to the organization. We purchased the stock in July of 2009 at $45. At the time, Roper's earnings yield was near 8.5%. In August of 2010, we sold Roper at $60 when the margin of safety narrowed.

3. **PetSmart** (PETM) is a leading retailer in the pet supply market with a 12% share of this $48 billion industry. With unrivaled product diversity and unique service offerings, the firm holds several advantages over its competition. We initially purchased PetSmart shares at $26 in November of 2007. At that price the earnings yield was near 8%. Today we still hold PetSmart and the stock has appreciated to $47 as of the time of this writing. We continue to like the stock because the earnings have gone up nearly as fast as the price. Even with the higher stock price, the earnings yield is still 7.5%.

4. **Direct TV** (DTV) is the largest satellite television provider in the U.S., with 19 million customers. It also owns satellite operations in Latin America: 93% of Sky Brazil, 41% of Sky Mexico, and 100% of PanAmericana, which covers much of the remainder of the region. These businesses serve about 9 million customers combined. We purchased DTV in February of this year with an 8% earnings yield. Despite the fact that the overall market is down 9% from the time we purchased DTV, the share price has held relatively steady. The Latin American business set yet another record for customer growth during the most recent quarter. Revenue in the region increased 46%, or 41% excluding the impact of currency exchange rates. With both the Olympics and World Cup coming to Brazil during the next four years, we expect Latin American growth to continue to be strong.

We are quite proud of the results achieved on behalf of our clients since the inception of our Core Growth Equity Portfolio. In this period of heightened economic uncertainty and increased market volatility, a well diversified portfolio of high-quality stocks, purchased with an

appropriate margin of safety, can be a solid choice for an investor seeking long-term growth. If you would like to learn more about our Core Growth Equity Strategy, please call us at 317-264-2687, or visit our website at www.goelzerinc.com.

Goelzer Investment Management is a leading investment advisory/portfolio management firm in the Midwest and one of the largest Registered Investment Advisor firms in the country, with more than $1.2 billion in assets under advisement for approximately 400 clients throughout the United States and Europe. We are an independent, fee-based firm providing comprehensive investment planning, advice, and portfolio management services. Since our firm was founded in 1969 our client base has grown to include affluent individuals and families and institutional investors.

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