

Finding Opportunity Amidst Volatility

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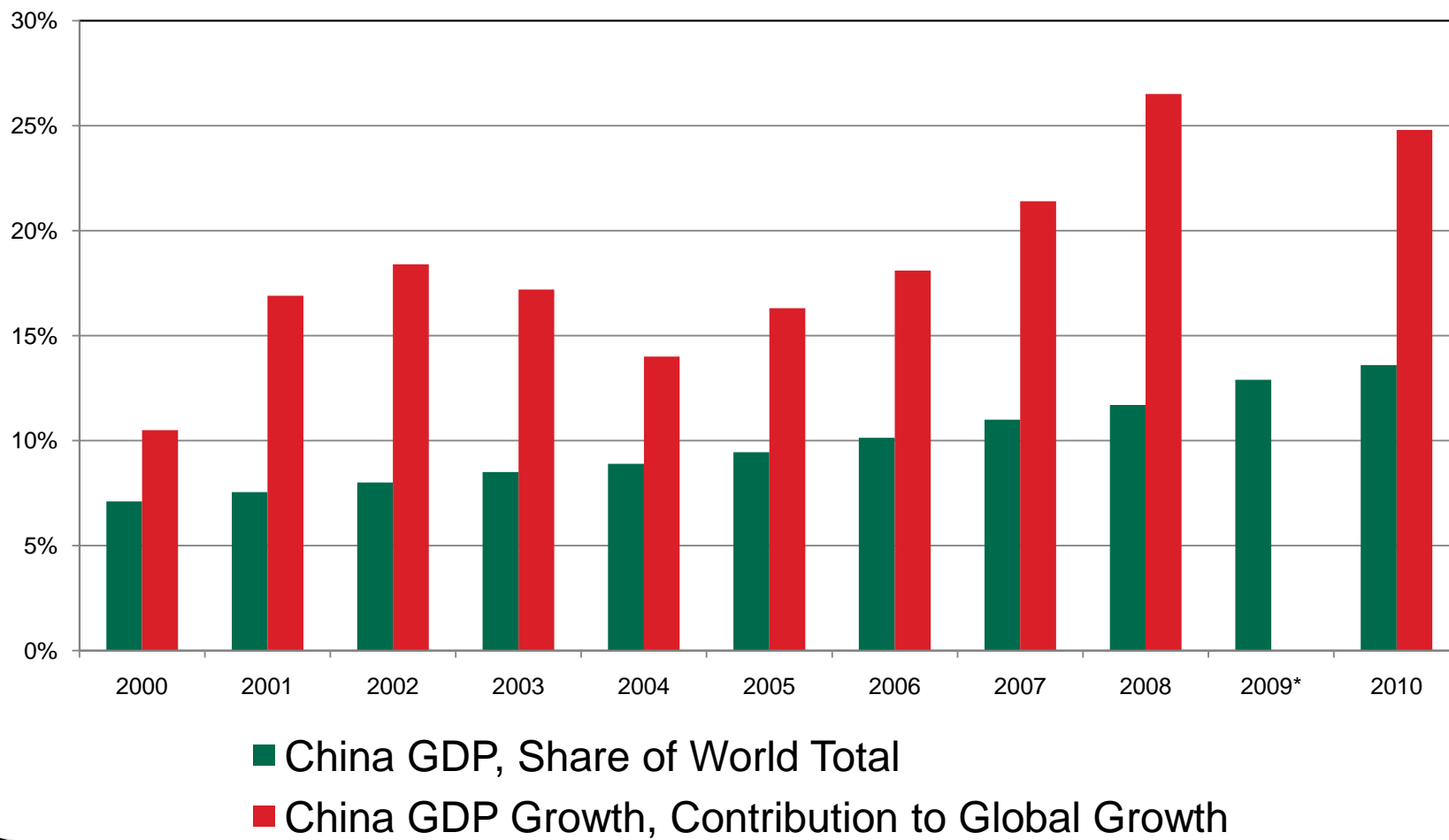
Key Themes

1. Global growth is slowing, including China.
2. Europe is a mess, but not a global disaster.
3. The domestic debt threat is real, but not imminent.
4. U.S. equities are attractively priced.
5. Non-U.S. equities are downright cheap.
6. “Safety” is trading at a high premium – we prefer non-traditional sources for income when appropriate.

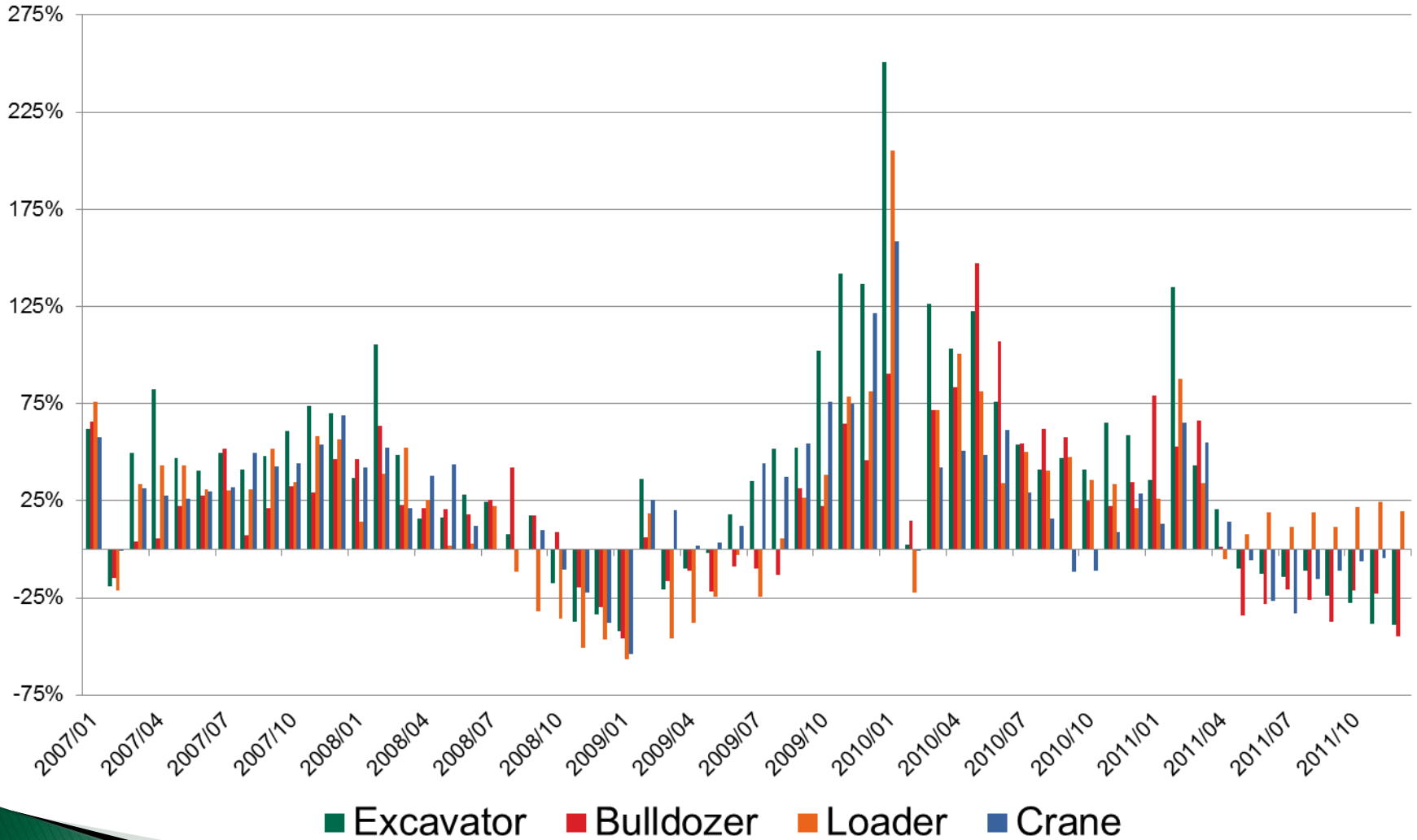
A Decelerating World

- ▶ Global growth is slowing
 - ▶ Europe is in a recession, possibly a bad one.
 - ▶ China's GDP growth is slowing.
 - ▶ Domestic growth is slowing, though it will still be better than Europe.
 - ▶ U.S. corporate profit growth will moderate as a result.
- ▶ U.S. exports to Europe are ~20% of total. Even a moderate slowdown would have a material impact on our exports.
- ▶ Exports to China are about 8% of total U.S exports.

China Punches Above its Weight



Construction Slowing in China



The Mess Across the Pond

- ▶ Greek default is “when,” not “if.”
- ▶ BUT, a Lehman replay is unlikely
 - ▶ Greece is not levered 30:1.
 - ▶ Less uncertainty as to scope of the problem: A handful of over-indebted countries with taxing authority vs. millions of 10:1 levered borrowers with dodgy real-estate.
- ▶ Of course, “unlikely” does not mean “impossible.” This is *terra incognita*, and we’re keeping our eyes open.

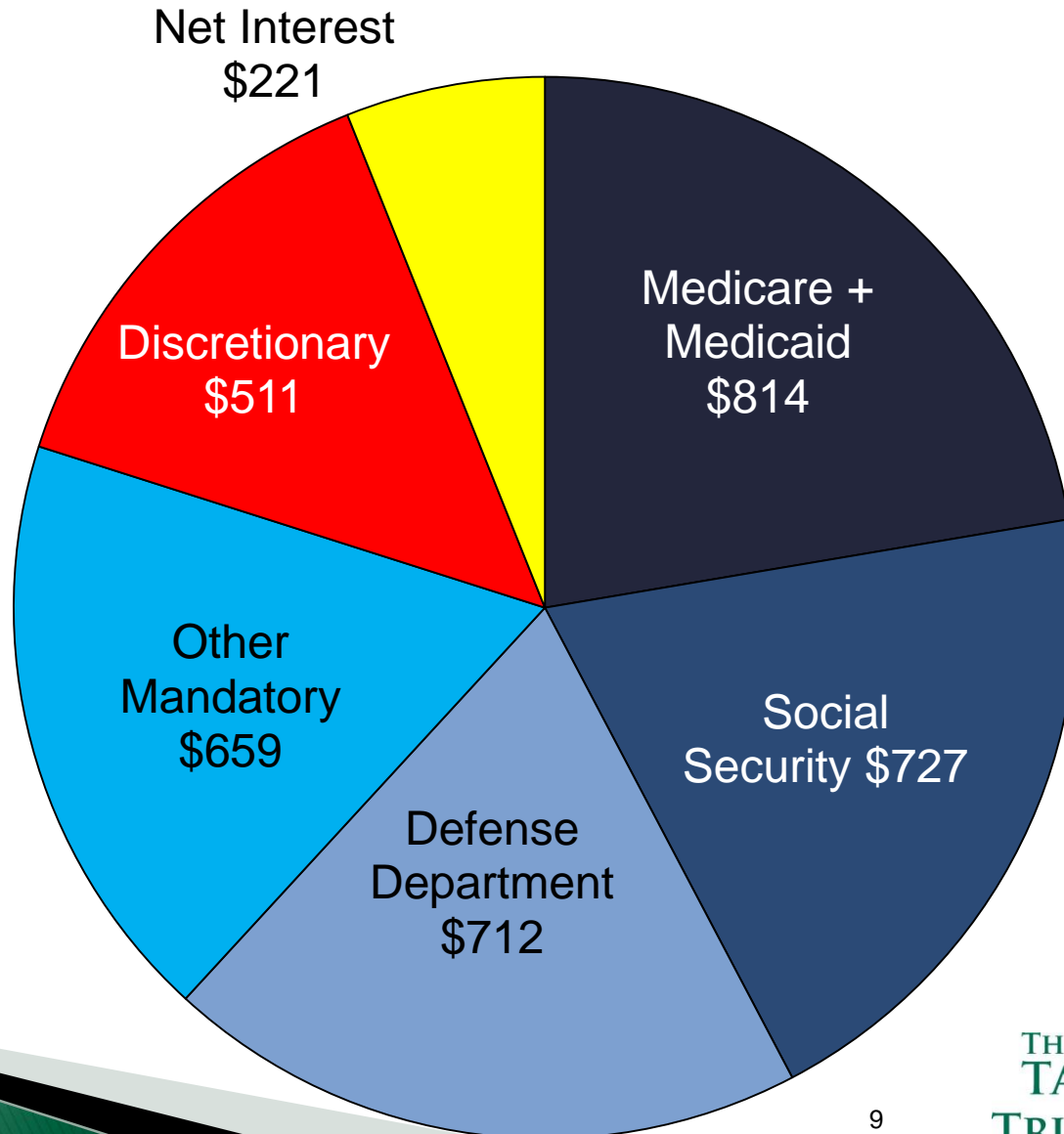
The Mess Across the Pond

- ▶ Critically, European credit issues have not (yet) affected global availability of credit.
 - ▶ European banks are nervous about lending to each other, but those jitters have so far been regionally limited.
 - ▶ Euribor-OIS spread @ 95bps, Libor-OIS @ 45 bps.
 - ▶ For global companies with good balance sheets (Nestle, Diageo, BUD, Oracle, etc) a Greek/Portuguese exit from Euro will not be a mortal blow.

The Mess Here at Home

- ▶ The Federal balance sheet is in bad shape
 - ▶ Zero political will to address mandatory spending.
 - ▶ Unless we a) raise taxes, b) cut defense spending, c) cut Medicare spending, or d) cut social security benefits, the math does not work.
 - ▶ Over 75% of spending is defense & entitlements. Arguing about pork and Medicare waste misses the point entirely.
 - ▶ Silver lining: The unique status of the dollar and the Treasury market buys some leeway. But do we really want to find out just how much?

All the Debate, but 15% of the Budget



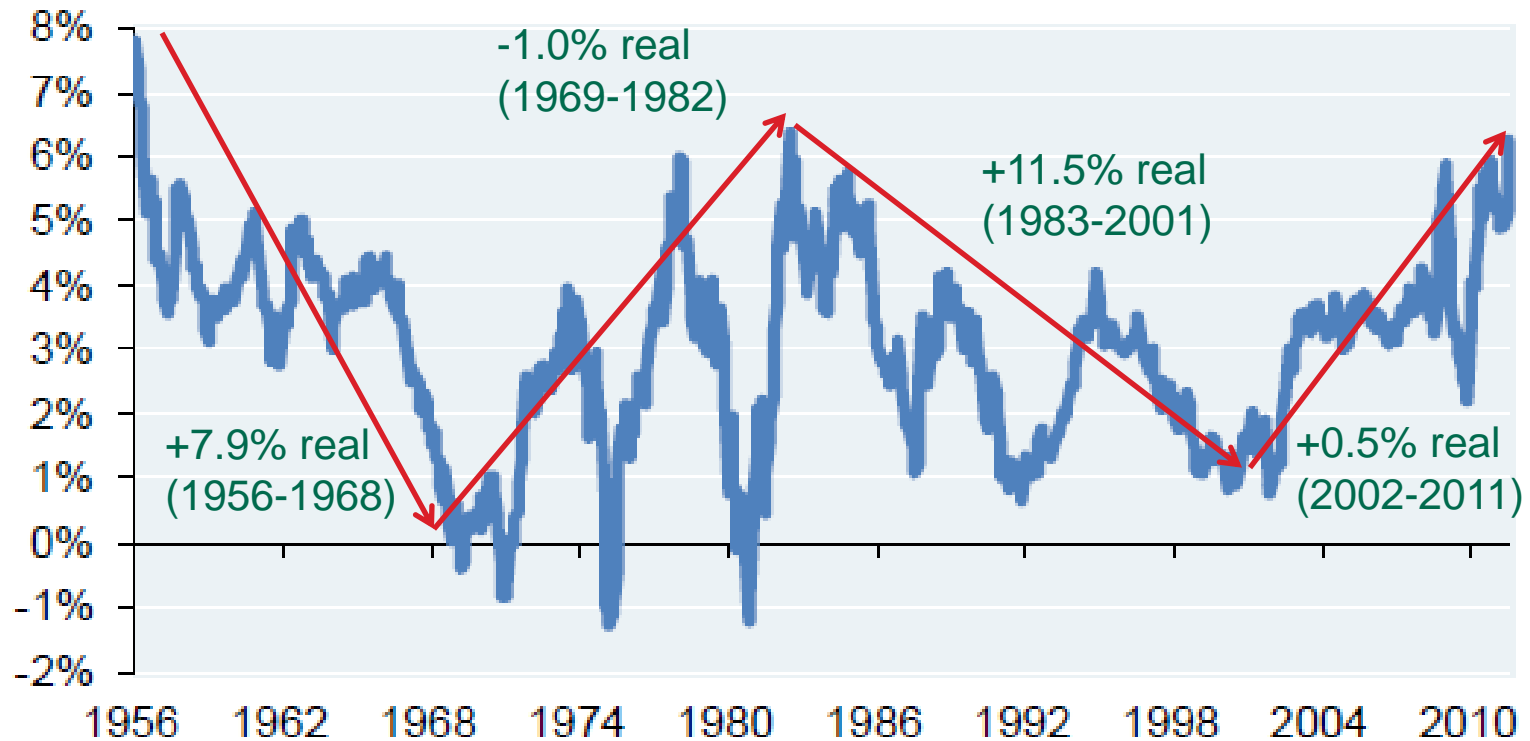
Now for the Good News

- ▶ U.S. stocks are very cheap relative to bonds, and pretty inexpensive on an absolute basis.
 - ▶ S&P 500 is at ~13x 2012 earnings and 14x 2011 earnings.
 - ▶ Expectations are reasonable: Consensus is 6% growth for 2012
 - ▶ A 14x price/earnings ratio = 7% “yield”...and earnings grow over time. Very attractive relative to a fixed 4% in corporate bonds.
- ▶ U.S corporate balance sheets are in great shape
 - ▶ Liquidity risk for most companies is extremely low.
 - ▶ Cash as a percentage of total corporate assets at multi-decade high

The Real Story

Real S&P 500 trailing earnings yield

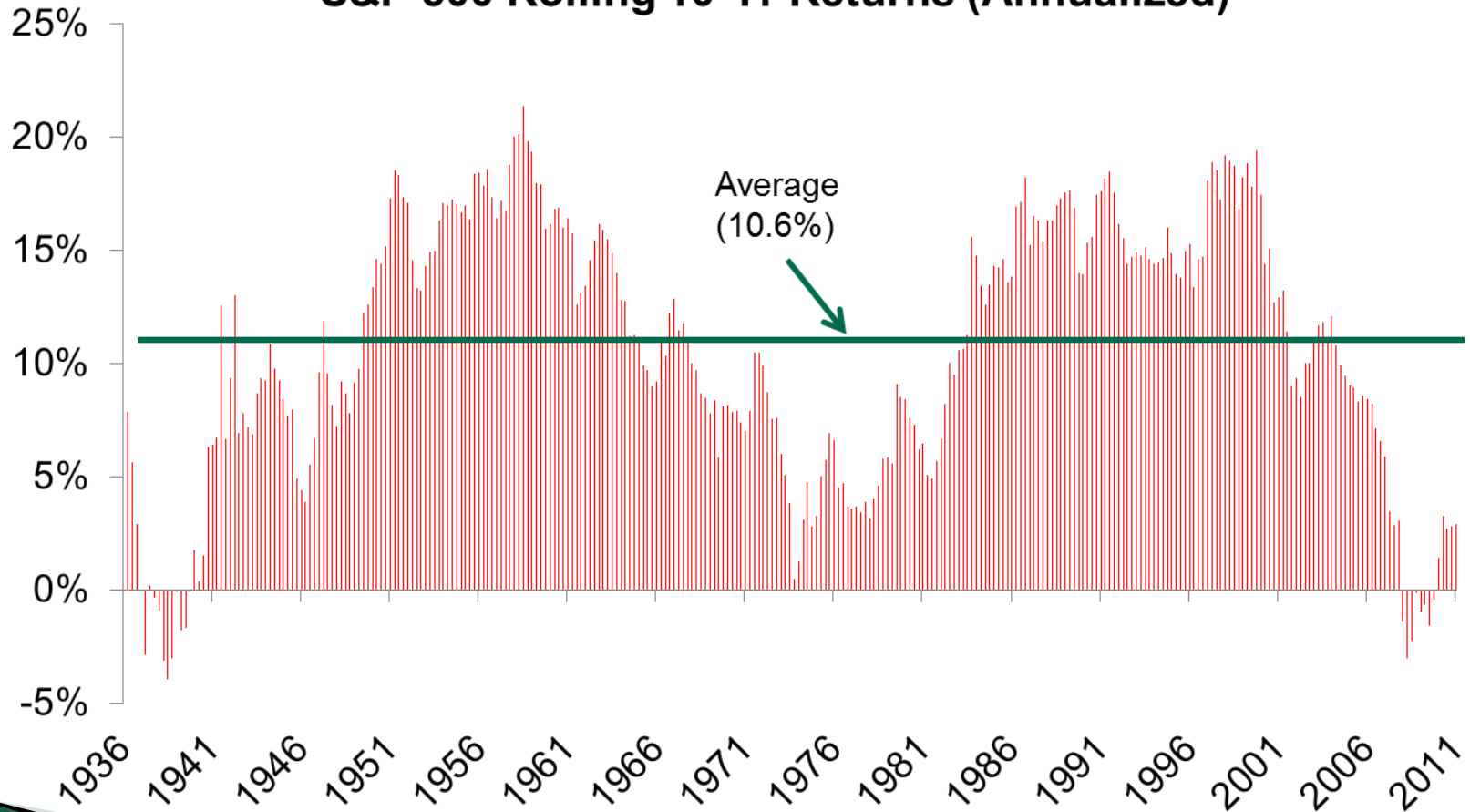
Trailing earnings yield of the cap-weighted S&P 500 less core CPI



Source: Robert Shiller, S&P, corporate reports, Empirical Research Partners.

Mean Reversion?

S&P 500 Rolling 10-Yr Returns (Annualized)



Even Better!

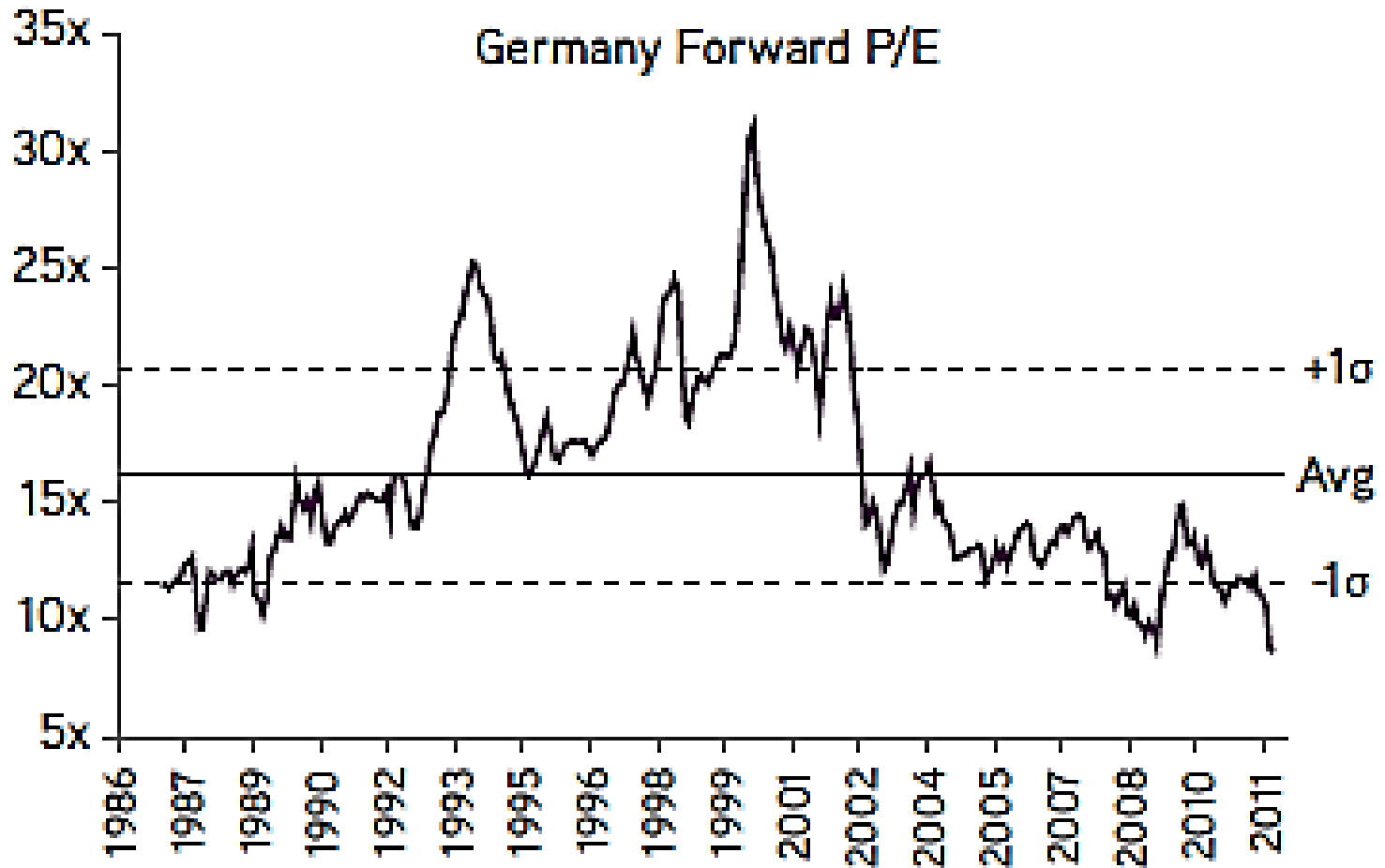
- ▶ And if you dig deeper, it gets really good.
- ▶ We can buy
 - ▶ The world's largest database provider for 11 times earnings.
 - ▶ A pharmaceutical company whose largest drug is growing at 20% per year, for 11 times earnings and a 3.5% yield.
 - ▶ A dominant tech company named after a fruit for 12x earnings.
 - ▶ The largest pipeline operator in America for a 3.8% yield -- with a dividend that's growing at over 10%.
 - ▶ One of the world's largest futures exchanges – with 60% operating margins – for 13 times earnings.

Looking Further Afield

- ▶ Outside the U.S., equities are even cheaper.

<u>Index</u>	<u>TTM P/E</u>	<u>Fwd P/E</u>	<u>Yield</u>
MSCI Emerging Mkts	10.5	9.2	2.9%
MSCI World (ACWI)	12.2	10.5	2.9%
MSCI EAFE	12.1	10.8	3.9%
MSCI Europe	10.5	9.6	4.2%
MSCI Switzerland	12.5	11.2	3.7%
MSCI Germany	10.5	9.6	3.6%
S&P 500	15.0	12.3	2.1%

What's German for "Cheap?"



Emerging Mkts Look Attractive

PRICE-TO-EARNINGS RATIOS REMAIN NEAR RECORD LOWS



Source: Bloomberg
As of 10/31/2011

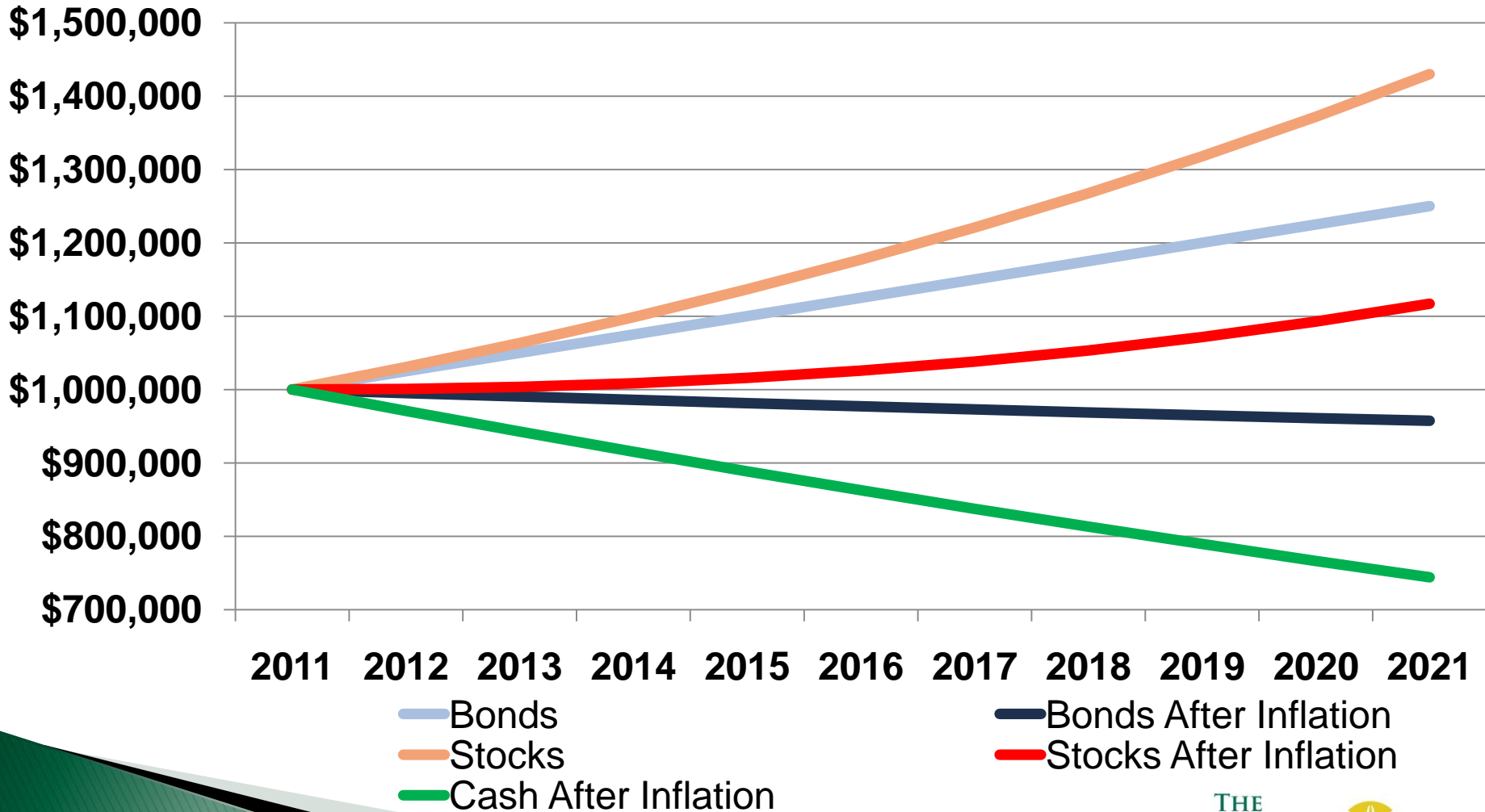
“Safety” is Very Expensive

- ▶ Investors’ concern with return of capital rather than return on capital has pushed “safe” assets to very high levels.
 - ▶ 10-year treasuries yield less than 2%.
 - ▶ German six-month notes have negative yields.
 - ▶ High-rated corporate bonds yield 3% -- or less.
 - ▶ Utility stocks rose 20% in 2011, are now at 15-17 times earnings.
- ▶ However, what seems “safe” has a hidden risk – inflation.

A Real World Example

- ▶ Investor “A” buys \$1m worth of bonds from four companies with great balance sheets and minimal risk of default. (Abbott Labs, Wal-Mart, Microsoft, and J&J). Average yield = 2.5%
- ▶ Investor “B” buys \$1m worth of common stock from the same four companies. Average yield = 3.1%.
- ▶ Over ten years, assume:
 - ▶ Inflation of 3%.
 - ▶ No change in stock prices or interest rates.
 - ▶ No reinvestment of dividends or interest.
 - ▶ Dividends increase at half their recent growth rate.

Safe? We Report. You Decide.



So, What Do We Do for Income?

- ▶ We're wary of the "usual suspects."
 - ▶ Utilities
 - ▶ High-grade bonds
 - ▶ Treasuries
 - ▶ Most REITs.

- ▶ Even tobacco stocks and many consumer staples companies are quite fully valued.

So, What Do We Do for Income?

- ▶ In fixed-income, issuers at the lower end of the investment-grade spectrum offer opportunity – perhaps a 4% yield.
- ▶ Equity-income portfolios with 2.5% to 3% yields, plus mid to high single-digit dividend growth, are attractively priced.

So, What Do We Do for Income?

- ▶ To get higher yields, we go off the beaten path:
 - ▶ Master Limited Partnerships
 - ▶ Trust Preferred Securities
 - ▶ Baskets of Mortgage Backed Securities
 - ▶ Selected smaller REITs and utility stocks
- ▶ Diversified portfolios yield around 7%.

Concluding Thoughts

- ▶ We have no idea what the market will do in 2012.
- ▶ We think Europe is a manageable issue for U.S. investors.
- ▶ We think equities are pretty cheap.
- ▶ We think most bonds are pricey, especially when compared to dividend-paying stocks.
- ▶ We don't like volatility any more than you do, but we try to take advantage of it, rather than let it take advantage of us.
- ▶ Most importantly: We are thankful for your trust, and promise to work hard every day to continue to earn it.

Thank You

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