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Signal and Noise

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I'll let you in on a little secret: I've been an investment professional for about fifteen years, and I've never had CNBC in my office. As a result, I sometimes miss interviews with money managers that I respect, which is frustrating. But I also don't have to listen to talking heads filling airtime with inane observations like, "The S&P is now down for six of the last eight trading sessions."

One of the keys to successful long-term investing is separating signal from noise. Daily market fluctuations -- as well as the public prognostications of economists and strategists -- fall into the "noise" category. Whether the market is up or down on a given day means little, and the predictions of overpaid Wall Street strategists about where the S&P will end the year mean even less. What does matter when thinking about security selection and portfolio construction is a) how much cash companies are generating, b) what price you are paying for that cash-flow stream, and c) how macroeconomic forces beyond the company's control will affect the cash-flow stream, for good or for bad.

At the Trust Companies, we are focused on signal, not noise. The signals we are watching most closely right now stem from corporate America, as some companies are beginning to report that the slowdown in global economic growth is affecting their immediate outlook. Fedex, which is a decent barometer for general economic activity, was the most recent to note a slowdown, especially in the Asia-to-North-America shipping corridor. Commodity producers, from coal to aluminum to copper, have

also been quite downbeat lately. On the other hand, companies like Illinois Tool Works (a diversified manufacturer that is also a pretty good economic barometer), Oracle, and Emerson have not seen a huge slackening of demand, despite a bevy of negative macroeconomic reports.

As a result, our current thinking is that the most likely path for the world is slowing growth, rather than a repeat of the nasty credit-induced recession of 2007-2008. Critically, we are not seeing the Eurozone's sovereign debt mess spilling into global credit markets. European growth will certainly slow, and a regional recession may occur, but -- so far -- the higher interest rates that European banks are demanding of each other have not manifested globally. This gives us some confidence that a global credit crunch along the lines of what occurred after Lehman's bankruptcy is an unlikely scenario.

Our firm-wide portfolio positioning reflects this viewpoint. We own no European financials, and very few domestic lenders -- Berkshire Hathaway, Wells Fargo, and J.P. Morgan Chase represent the sum total of our financial exposure. We are also very light on deep cyclical companies like Caterpillar, as well as commodity producers that are highly levered to global (especially Chinese) growth. Instead, we have been focusing on companies with strong balance sheets, especially in healthcare, consumer staples, and technology. For income-seeking clients, we have been heavily weighted in utilities and telecom companies. We believe this positioning is currently appropriate given slowing global growth.

However, we do not intend to stay "hunkered down" indefinitely. We are starting to see some high-quality businesses being priced as if the muted growth of the coming year will be the norm for the next several years, which seems to us unlikely. We plan to cautiously deploy capital as these bargains emerge.

For clients with sufficient liquidity to get through what may be a tumultuous year or two, we think this is a great time to purchase BMW businesses at Hyundai prices. We recognize that while doing so may be intellectually easy -- who doesn't like a bargain? -- it is emotionally very difficult. And while it's impossible to take the emotion completely out of investing, focusing on the "signal" (earnings and business values) rather than the "noise" (daily price volatility) can help.

I'll finish with a quote from one of my favorite investors, the great Shelby Davis: "You make most of your money in bear markets. You just don't realize it at the time. "

We appreciate your trust and confidence. Please do not hesitate to call any member of our team at any time if we can help in any way.