

Market Commentary *September 1, 2010*

The path of economic growth in the coming quarters can best be described as an ongoing battle between monetary policy, which remains very stimulative, and fiscal policy, which could well become more restrictive. Although there is several hundred billion dollars of stimulus still to be spent, **the additional costs of recently enacted major legislation on healthcare and financial reform, combined with the distinct probability of higher taxes in 2011, has caused fiscal policy to turn the corner from being accommodative to being restrictive.** Monetary policy is a stronger economic lever than fiscal policy, which is why we continue to believe the economy will not experience a double-dip recession, but rather continue to muddle along at a punkish and below-average rate of growth. The steepness of the yield curve also suggests the economy will continue to expand -- not double-dip.

The equity markets have been range bound for most of 2010. After peaking in late April at 11,205, the Dow Jones Industrial Average corrected 13% by early July; equities then rose into August only to pullback over the past three weeks, resulting in the worst August performance since 2001. The ceiling on prices can be blamed on the petering-out recovery as evidenced by a continued spate of economic data that has come in below expectations: unemployment claims, manufacturing, housing etc. **The floor of the market's range is set by the fact that earnings (as well as revenues!) continue to beat expectations and valuations are as cheap as they have been in the past 25 years. Equities also appear extraordinarily attractive given the low levels of interest rates and non-existent inflation.** In addition, M&A activity is picking up, which is a reflection of exceptionally strong balance sheets and an increase in corporate managers' appetite for risk.

What are some of the factors that can cause the market to break out of its range?

Obviously, stocks may decline further if the economy in fact goes into a double-dip recession. But we view that probability as low: 15 to 20%. One has to acknowledge this risk exists because in a slow-growth environment the economy is more susceptible to an external shock, such as the one we experienced on 9/11, that could push the economy into a recession. On the upside, the market could break out if economic data started beating expectations, giving rise to the view that a double-dip is less likely. Also, if the elections in November result in a split government, the markets will likely react positively as the probability of additional regulation diminishes. Gridlock in government has in the past been very positive for the markets.

Historically, below-average economic growth has been good for high-quality companies that can still deliver decent earnings and dividend growth in a slow-growth economy (e.g. the mid-to-late 90's). This year, high-quality equities have been marginal outperformers, while high-quality with large dividend yields have been significant outperformers. Reduced yields on bonds, the uncertain economy, and a flat market have steered investors towards high-dividend payers. For instance, with Haverford's Quality Dividend Value portfolio, which

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currently yields 4.5%, investors receive half of equities' historical rate of return up front in the form of dividends, with the prospect of both dividend growth and future capital appreciation. Compare the current opportunities in stocks and bonds on a micro level: Today you can buy a McDonald's 10-year bond with a 3% yield to maturity. Every year you will receive the bond's coupon payment and in 10 years receive back par value. Alternatively, you can buy the common stock paying a 3.2% yield with a high probability they will grow their dividend by about 10% a year. After ten years, the yield on your original cost would be 8.3% - more than twice that on their bond. If the common stock remains at the same price ten years from now and assuming 10% earnings growth, the price-to-earnings (P/E) multiple will be 6.5. McDonald's is just one example that highlights the current disconnect between stock and bond pricing. IBM recently issued a three-year bond with a 1% coupon while the dividend yield on its stock is more than twice that amount! (For a list of high-quality companies with stock yields greater than their bond yields see the *Better than Bonds* chart on page 3.)

The current pricing of equities is indicative of investors' sour sentiment toward the stock market and the economy. The last time the equity market yielded more than the bond market was in 1956. Following the Great Depression, investors demanded more income from stocks than from "safe" bonds. **Today, many stocks have dividend yields that exceed their bond yields and the Dow Jones Industrial Average yields more than the 10-year Treasury**, showing you just how poor sentiment is. This year, \$33 billion has already flowed out of equities, which makes the total outflow \$233 billion since January 2008. During that time, \$559 billion has flowed into bond funds and new money continues to be allocated to bonds even at today's paltry yields. Also, there are almost as few bulls and nearly as many bears as there were at the market bottom in March 2009, and yet the market is 60% higher and the economy is in much better shape.

Many pundits are describing the bond market as a potential bubble, akin to the tech/telecom or Japanese real estate bubble. While "bubble" may not best describe the bond market, we believe "overvalued" does. Bonds have been in a 26-year bull market and have never been as overvalued relative to other asset classes as they are today. Bull markets do not last forever: reversion to the mean is a very powerful force. **True, you won't lose your principal buying a 10-year or 30-year Treasury bond today (if held to maturity!), but you may certainly miss out on very attractive opportunities elsewhere.**

Haverford's Current Portfolio Strategy

- Fixed income investors should stay within their comfort zone of maturity risk, tolerate the low yields, and, most certainly, stick with quality.
- Equity investors looking for current income should consider the dividends paid on our portfolios to be safe. These companies produce tremendous cash flows that in many cases would support much larger dividend payments. Remember that more than 70% of the companies we own raised their dividend even in the teeth of the recession.
- We will continue to focus on new investments that are benefitting from growth outside the U.S. This focus has led us to recently increase our weightings in both developed and emerging markets as well as define many stock-specific portfolio moves this year.

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High-Quality Better-than-Bonds Portfolio

	10-Year Bond Yield to Maturity	Common Stock Dividend Yield	5-Year Dividend Growth
Abbott Laboratories	3.0%	3.6%	8.8%
Altria Group Inc.	4.9%	6.3%	9.1%
AT&T Inc.	3.4%	6.5%	6.1%
Bristol-Myers Squibb Co.	3.1%	5.1%	8.8%
Chevron Corp.	2.9%	3.8%	12.1%
Coca-Cola Co.	2.9%	3.2%	10.5%
ConocoPhillips	3.2%	4.0%	16.4%
Consolidated Edison Inc.	3.2%	5.2%	0.9%
E.I. DuPont de Nemours & Co.	3.1%	4.0%	3.4%
Exelon Corp.	3.7%	5.0%	10.1%
GlaxoSmithKline PLC ADS	2.9%	5.6%	5.6%
Intel Corp.	2.6%	3.1%	25.7%
Johnson & Johnson	2.7%	3.7%	12.0%
Kimberly-Clark Corp.	3.1%	4.1%	8.5%
Lockheed Martin Corp.	3.2%	3.4%	20.6%
McDonald's Corp.	3.0%	3.2%	31.7%
Merck & Co Inc	2.9%	4.4%	0.2%
Procter & Gamble Co.	2.9%	3.2%	12.1%
Sysco Corp.	3.1%	3.2%	16.6%
Verizon Communications Inc.	3.6%	6.5%	3.5%
Average	3.2%	4.4%	11.1%

Data as of September 1, 2010
Source: Bloomberg, Factset