



KPCM 3rd QUARTER REVIEW AND OUTLOOK

The global stock markets continue to recover from the dramatic declines of 2008 and early 2009. Signs of economic recovery are evident in a number of foreign markets, most noticeably in Asia (China, Japan and Australia), Latin America and in Europe (France and Germany). Clear signs of economic recovery remain elusive for the U.S. and Britain. Therefore, there is a current controversy and preoccupation by many stock market commentators as to whether the U.S. stock market has run “too far too fast”.

At KPCM, we tend not to focus on the day to day economic data since much of it is subject to future revision and forecasts by most experts tend to be incorrect a good part of the time. Rather, we monitor the larger macro economic trends and relevant investment themes that can impact the underlying thesis of our asset allocation, fixed income, and core equity positions in our portfolios. This is a subtle but significant difference in our holistic approach to wealth management.

Importantly, we began to raise cash for our clients by late 2007 and into the first half of 2008. Our concern was more that equities appeared fully valued given the background of slowing economic growth. Thus, when the credit crisis exploded and pushed the global economy into a severe recession, our emphasis on cash in the asset allocation helped to cushion the downside in the portfolios.

Today, conditions are just the opposite. We find a number of very attractive opportunities for equity investment, particularly when viewed over a one to three year time frame. The U.S. economy is currently bouncing along the bottom of a severe recession. While we are not likely to guess correctly when the economy will recover or for that matter whether it is a V-shape (sharp), W-shape (double dip) or U-shape (slow long bottoming process) recovery, we do believe that the economic trend is up over the next few years. The bigger question for us is if the ultimate recovery will bring moderate or significant inflation. That is a factor to ponder as it will have a significant impact on our future asset allocation decisions. At this juncture however, we find the equity market in the U.S. and the developing economic markets of Latin America and Asia to be good places for investment.

Moreover, we continue to be impressed with corporate America’s effort to keep costs under control. Much has been said about companies cutting costs but not seeing any revenue growth. However, our view is that the aggressive cost cuts have been so successful that most of our major companies have permanently reduced their cost structures while dramatically improving their balance sheets. More importantly, these companies (many of which are our core equity investments) are growing market share at a considerable rate. Thus, these companies are generating accelerating cash flow, better returns on capital, maintaining lean inventories and are poised for economic recovery.

We think corporate profits may well be much higher than current expectations once revenue growth resumes. Whether we wait six months or one year for this to happen is not a major concern for us. These investments are poised to generate significant growth and are attractively valued at current depressed levels of earnings. Back in 2008, these equities were generally selling at higher prices, higher valuations and the respective companies were about to experience a dramatic slowdown in economic growth. Today, many are lower priced, are poised to expand profit margins and are facing a potential global economic recovery.

The high U.S. unemployment rate is contributing to investor unease. Clearly, the U.S. cannot sustain significant economic growth with rising unemployment. We believe that not enough has been done to address this issue by the government. Further, tax and investment incentives should be part of the stimulus plans going forward. Nevertheless, it has always been a mistake to assume that U.S. consumer is “never going to fully recover”. Indeed, recent retail spending data supports the argument that the consumer is beginning to re-emerge from the spending decline of the last twelve to eighteen months. In conjunction with a jobs recovery of some sort by the second half of 2010, another foundation block will come into place for a more lasting economic recovery.

Our focus is also on global developing markets. We are constantly searching for global companies that can benefit from the rapid growth occurring in developing nations. We believe consumer companies offer the most attractive opportunities to achieve these goals. Generally, a rising standard of living means that consumers are constantly seeking better products to enhance their lives. We believe that many multinational consumer goods companies have an enormous opportunity in the next ten years to benefit from this trend. We discussed this broader investment theme in our last quarterly letter as well.

Importantly we view these areas as *developing* as opposed to *emerging*. China and most of Asia, as well as Brazil and Mexico are in developing stages of growth as opposed to emerging. This is a subtle but significant difference. The emerging market is normally characterized by the need to accelerate exports of commodities in exchange for infrastructure spending on roads, power plants and factories. Developing nation economies, while still in need of power facilities etc., are also in need of office construction, residential development and adoption of programs aimed at allowing multinational companies to expand their goods and services. As the standard of living improves in these countries, internal demand for consumer goods and services must be met. Additionally, a much more sophisticated financial system needs to be in place. Our focus is to be invested in companies that will be part of this *developing* stage.

Finally, we again want to emphasize that our equity investment perspective is long term. That is not the most popular way of investing today. The rise of hedge funds, the focus on trading profits and the realization that the overall stock market has not expanded in ten years tends to underscore this current mentality. We on the other hand, believe that longer holding periods and the associated tax efficiency provides a significant benefit to our client base. In combination with focused stock selection and a vigilance to know what we own, we expect to achieve our long term goals.

Jack L. Salzman
Managing Partner

Jeffrey P. Bates
Managing Director

Steven W. McGinty, CFA
Vice President