



KPCM 2009 REVIEW AND 2010 OUTLOOK

As we enter 2010, we are finally closing the book on what many will call the worst financial and economic market of the modern day era. The good news is that the U.S. and global economies are clearly showing signs of recovery.

Given the wide swings in investor sentiment and the subsequent huge price volatility in so many financial instruments, we were very pleased with our overall performance, the asset allocation, and our specific equity investments. During the financial panic, we went on the “offensive” to identify appropriate, risk-adjusted investments to add value in our portfolios. This led to our purchasing extremely attractive short dated investment grade bonds in early 2009. Additionally, while many market participants reduced or eliminated their equity exposure during the first quarter of 2009, we maintained and, in some cases, increased our exposure. As a result, our clients participated in the subsequent 60+ % rally.

So, what do we think about 2010?

Of course, we are very cognizant of the many hurdles that must be overcome to obtain a sustainable economic recovery. A few examples are:

- Budget deficits and overall global debt levels are large and growing. Both have had a very negative impact on the value of the U.S. dollar. A significantly weaker dollar from this point could be counterproductive to any sustainable economic recovery.
- Job losses continue, although at a slower pace than in prior months. Realistically, we must have sustainable job growth to create a long lasting recovery.
- Mortgage delinquencies remain a problem due to unemployment and, as such, banks continue to be reluctant in offering possible credit to consumers and small businesses.
- Both interest rates and personal income tax rates are likely to rise within the next year (depending on the speed of the recovery). Unfortunately, in the short-term, both act as deterrents to increased equity valuations. Additionally, new government regulations and the Fed’s desire to drain excess liquidity from the financial system in the coming months will act as short term deterrents.

Despite all these negatives, it is clear that the U.S. and global economies are on the upswing. Credit spreads have substantially tightened to pre-crisis levels, companies are reporting stronger consumer demand through higher sales and earnings, and many banks have repaid outstanding TARP balances. Moreover, many corporations are reporting a modest improvement in their outlook for the coming months.

In this context, we expect the U.S. economy to continue with a steady, albeit slow and inconsistent, path to recovery over the next 12 to 18 months. We expect that job growth will move on a similar path during this time.

Indeed, if economic (gross domestic product) growth can achieve a 3 – 4% rate in the next few quarters, although anemic, job growth is likely to emerge by the 2nd half of 2010. More importantly, this could set the stage for an acceleration of growth during 2011 and beyond.

Thus, while our short-term outlook for the equity market is more muted than many of our peers, we are very upbeat when we view the next 12-18 months. Moreover, we focus on management and companies. Our analytical process is done from a bottoms-up basis. The companies that make up our core portfolio are **well researched, show meaningful revenue growth, enjoy category dominant positions, and are very attractively valued.** Our research gives us the conviction “of why we own what we own” during difficult market periods. Importantly, we believe that many of our core companies are more attractive today than when we initiated the positions months, even years, earlier.

We are also very focused on tax rates; specifically long-term capital gains. As mentioned previously, it is clear that rates are likely to go higher. We find the frantic trading that seems to characterize the market today as being very unproductive for most investors.

We continue to identify companies that will weather the short-term storm and will provide superior returns as the U.S. and global economies recover. Thematically, we have focused on global multinationals that generate significantly more than half of revenues and profits from overseas markets, and enjoy a large presence in developing-nation markets.

With this in mind, we have expanded our research and asset allocation to include more emerging economies since relative growth and valuation remain more attractive. In addition, we have increased our exposure to select companies that are positioned to significantly accelerate earnings as global (and domestic) economic growth accelerates.

We continue to be mindful of valuation and have maintained our discipline by focusing our core portfolio in companies that have valuations at or below the market averages. Currently, our expectations for corporate profits suggest the U.S. market (as measured by the S&P 500) is selling at approximately 15 – 17 times projected earnings; a valuation which can be maintained with a less accommodative Fed and slightly higher interest rates.

Finally, we again point out that good management teams at many U.S. companies have cut costs and inventories very rapidly during the last eighteen months. Balance sheets in Corporate America have significantly improved during this period. Thus, many companies are poised for dramatic earnings growth as the economic recovery takes hold. We believe that our portfolio is well positioned to take advantage of a slow economic recovery in the U.S. and a faster one in developing nation markets. This underscores a continuation of our investment theme discussed in our previous report.

In closing, we want to re-emphasize that our long term perspective allows us to make investment decisions that transcend the short term issues of the day. This has allowed us to successfully emerge from the carnage of the last year and a half. We continue to focus on capital preservation and long-term growth of our client assets.

As always, should you wish to discuss any part of your portfolio, do not hesitate to give us a call at your earliest convenience.

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