



RIVERPOINT
CAPITAL MANAGEMENT
INVESTMENT ADVISORS

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CAN MEASURING THE AMOUNT OF WATER IN A GLASS BE THIS DIFFICULT?

Looking up from the bottom, the glass appears half-full. From above, the glass looks half-empty.

Investors are continuing to ask if the “glass” is half-full or half-empty. Before diving into the particulars, first imagine a glass of water, filled at half-capacity (staying neutral here – don’t want to say which half is occupied by water) sitting on the edge of a table. If you were to crouch down next to the table and look up at the glass, I bet that you’d find the glass appears more full than empty. If you looked at the glass from above, it would probably appear more empty than full. In essence, this basic exercise gets to the crux of the debate – should investors be looking at the markets from the bottom-up, focusing on company fundamentals? Or is a top-down view more appropriate, with global economic issues hogging the spotlight?

In the broadest sense, the debate is primarily among those who feel that the domestic (and global) economy is going to continue to grow, and those who believe that we are on the cusp of a new recession. Both sides have plenty of data to back up their arguments. The growth side can point to solid second-quarter corporate earnings, upbeat management comments, improving macroeconomic data points (recent industrial production and capacity utilization rates were better than expected), and continued low interest rates as support for their side. A recent spate of large corporate mergers also supports the “growth” side, as big-ticket acquisitions usually signal increased confidence at the executive level. The recession camp, however, also has plenty of evidence to back their case, with continuing disappointments in the jobs market, a housing market that continues to struggle, as well as tepid outlooks for the second half of 2010. Troubled municipalities and a debt-burdened Federal government also serve as fodder for the “recessionistas.”

Alongside the “growth versus recession” debate is that of “inflation

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versus deflation.” While this contest will take longer to play out than growth versus recession, it is no less fierce or important. In general terms, the debate is focused on whether prices are set to rise (inflation) or fall (deflation) in the future. Each scenario has its own set of effects on the economy and financial markets.

Deflation characterizes a period of falling prices. Deflationary periods happen when consumers, believing that prices will decline in the future, stop spending in the present in order to hold out for cheaper prices down the road. As consumer spending slows, companies scale back production to match the decline in demand. This leads to less hiring and fewer wage increases, which in turn can lead to an economic slowdown and lower prices. Interest rates, in this scenario, would remain low as consumers look to park their cash in savings vehicles rather than consumable items. The main arguments for deflation are that prices simply won't be able to increase with a struggling economy, no consumer demand, and limited ability for more stimulus. If we can't afford any more stimulus and unemployment remains near 10%, why would prices do anything BUT fall? Who's going to be spending money in that scenario? While these concerns do have some merit, there are two main knocks against the deflation argument: 1) there have only been two periods of extended deflation in modern times (the Great Depression and Japan in the 1990's), and 2) neither of those deflationary periods were preceded by massive fiscal and monetary stimulus actions.

Inflation, on the other hand, characterizes a period of rising prices. The belief that prices will rise in the future leads consumers to spend their money now since each dollar will be worth less in the future. As consumers spend more, economic activity picks up and the economy grows. Investors, in this case, would seek out higher returns in order to keep up with inflation; selling Treasuries and buying riskier assets (i.e. stocks) has historically done the trick. This shift towards riskier assets causes interest rates to rise. The case “for” inflation is that sooner or later all of that government stimulus money will be put to good use, creating demand and driving prices higher. Rates would *have* to rise since there isn't much room for them to fall further, and economic growth will pick up again.

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We expect that deflation will not be a problem, given that central bankers around the world are aware of the risk and appear willing to take the necessary actions to fight it. Prices are more likely to rise in the future, though exactly when is unclear due to the slack in the economy and weak consumer demand. The uncertainty that exists, however, is significant

enough to merit taking out some “insurance” on our portfolios to guard against either scenario.

What exactly does this “insurance” look like in our client portfolios? First off, the best protection is a balanced portfolio that holds both fixed-income and equity securities. Generally, deflationary periods are good for fixed-income securities (bond prices rise as interest rates fall) while inflationary periods are good for equities. The fixed-income holdings provide stable income in a period of falling interest rates and declining prices. The equity allocation benefits from rising prices through greater economic activity and higher corporate revenues. Another important strategic decision is selecting shorter-term bonds that mature within five years’ time; this will protect our clients’ bond portfolios against some of the drastic price swings that rising rates can inflict on longer-term bonds.

Recent M&A Activity

BHP bid \$39 billion for Potash

Sanofi-Aventis bid \$18.5 billion for Genzyme

Intel bid \$7.7 billion for McAfee

Rank Group bought Pactiv for \$4.6 billion

Blackstone bought Dynegy for \$550 million

Hewlett-Packard, Dell in \$2 billion bidding war for 3Par

As mentioned earlier, merger and acquisition (M&A) activity has picked up in recent weeks. During the credit crisis, many companies cut costs, laid off workers and pared back on capital investment due to the bleak economic outlook. Those same companies have since recovered and now find themselves sitting on mounds of cash, with Boards of Directors and investors anxiously waiting for them to put that cash to good use. What is a company to do? Imagine that you own a company that has \$5 billion in cash – would you rather hold that cash and earn less than 1% on 2-year Treasuries, or would you rather buy a proven company that would post earnings on 10% of each dollar you invested (implying a price-to-earnings, or P/E, ratio of 10)? Companies are beginning to choose “option B.” Merger activity will continue to be a factor as successful, mid-sized companies priced at 10-12 times earnings will continue to be targeted by larger rivals. Companies like Fiserv (FISV) and Symantec (SYMC) fit the bill as potential targets. Both have market values between \$8 billion and \$12 billion, generate high levels of recurring revenue and free cash flow, have histories of consistent earnings growth and trade at attractive P/E multiples. From our perspective, M&A activity is a sign of increased corporate confidence and, therefore, a brighter economic future. However, increased deal activity may only benefit potential acquisition targets and might not be enough to push the broader market higher. At RiverPoint, we won’t buy a stock simply because we believe that it is a merger candidate, but our focus on quality and valuation may allow us to benefit from this trend if this level of M&A activity continues.

From a top-down macroeconomic view, there’s enough conflicting data to create an uncertain, “glass half-empty” view. From a fundamental,

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bottoms-up perspective, cheap stock valuations, strong corporate balance sheets and low interest rates create an optimistic “glass half-full” view. Macroeconomic trends are notoriously hard to predict, so instead of trying to do the near-impossible we’ll continue to focus on what we know – that buying solid companies with proven records of success will reward our efforts over time. History has shown that our bottom-up approach is a successful way to invest. Our balanced accounts are hedged against the risks of inflation and deflation – fixed income allocations provide income and price stability in times of recession or deflation, while equity investments will perform well in times of economic growth and inflation. Our goal, as always, is to protect our clients’ capital as if it were our own. We are confident that focusing on buying high-quality, reasonably priced bonds and stocks within the context of a conservatively appropriate asset allocation will achieve this goal.

FOR OUR CLIENTS WITH ASSETS CUSTODIED AT CHARLES SCHWAB:

We wanted to let you know that Charles Schwab will be sending a letter out with its September account statements. This letter will discuss changes that account custodians need to make regarding the way that they report investment cost basis information to the Internal Revenue Service (all other account custodians will also have to abide by these new rules – at this time we do not know if or when other custodians will send out letters to their clients). In the past, custodians only reported sale proceeds to the IRS on 1099’s. New regulations now require custodians to include cost basis in addition to the proceeds from the sale. These new requirements, which will be phased in over the next few years beginning January 1, 2011, will apply to all purchase and sale transactions. These changes apply only to account custodians and require no action on your part as account holders. If you have any questions or would like more information, please do not hesitate to call a RiverPoint professional.