

March 2010

First Quarter Commentary

Despite some modest setbacks, the market demonstrated remarkable sturdiness and resilience in the first quarter. Resilience means lively or springy. Resilience is characterized by the capability to recover or adjust easily to change. The Wall Street Journal summed it up on April 1 with a story whose headline read: “Bull Muscles Through Tumult.” The 8% intra-quarter decline in the major indexes was discomfiting. Even more unsettling were the declines in individual stocks and portfolios. As usual, the 8% market declines caused portfolio stocks to decline more. The market behaves in peculiar and unexpected ways and the January-February decline was no exception. After rallying from year end until January 19, closing that day at session highs, a downturn started the next day and lasted twelve trading days bottoming only 1.5% above the October 2009 lows. The decline fit comfortably within the range of the declines in May, July and October, all down less than 10%. Amid cries that a further, more damaging decline was at hand, the market turned around. However, January end-of-month values were the victims of the selloff. When the month ended, things looked much worse than they had at the end of the year. After significant gains, it would be reasonable to expect a meaningful setback. However, worst fears were not confirmed; a bullish reversal took place on February 5, igniting a rally. The rally attempt was confirmed on March 1 and further gains followed into the end of the quarter and beyond. On a closing basis, the January-February declines were -6.6%, -7.3% and -7.7% on the Dow, S&P 500 and Nasdaq respectively. From the lows on the 5th through quarter end, the indexes were up 10.4% (DOW), 12% (S&P 500) and 14.2% (Nasdaq). Notice that the Nasdaq declined the most and recovered the most vigorously. Since client portfolios most closely mirror the Nasdaq, accounts positively reflected the “tech heavy” index’s results and outperformed on a relative basis.

When downturns begin and especially as they gain traction, it is common that strategists, technicians, market analysts and media commentators become increasingly bearish. The frequently-asked question in a downturn is “How far down do you think we will go”? There is no shortage of opinions. The most important metrics to watch are the price action and volume on the major indexes. The market’s opinion is the only one that counts. In the same way, analyst opinions, especially downgrades, need to be kept in perspective. Frequently, leading issues are downgraded because their price/earnings ratios are at a premium, on a relative basis, to their group mates, otherwise known as laggards. Laggards are often recommended to take advantage of the outperformance of a strong and leading group move, a so-called catchup play. The market turned down in early 2009 and reignited fears that a return to the lows of late 2008 were at hand. It is difficult for a stock to fight the headwind of a downtrending market. Few stocks can buck the downtrend. However, when the market turns up, the first stocks to move are the leaders. What do leaders have in common? Three factors: a compelling story, sterling fundamentals, and something new. Analyst downgrades are often based on price-to-earnings levels, comparing the p/e of a leader to that of a laggard in the group. On March 6, 2009, six days before the follow-through day on March 12, 2009, the J.P. Morgan analyst cut his estimates on Apple and lowered his price target. The stock traded off that day to a low of \$85 indicating that some market participants agreed with his call. The basis for his downgrade were the analyst’s view that the consumer would not spend as they were fearful of losing their jobs and were witnessing home values plunge all around them.

As the market followed through, Apple shares began to rise. Then on April 22, 2009, the company announced earnings that roundly beat the analyst's reduced quarterly estimate of \$1.01. Much about the Apple story from that point forward was new as had been the case since the introduction of the iPod earlier in the decade. Then came the sleek, refreshed iMac and the new laptops. After making a series of week-over-week new highs, the stock made a new 52-week high in October. The new high was foreshadowed in May when the relative strength line made a new 52-week high indicating that the stock was outperforming the overall market shortly after the follow-through day. The iPhone, introduced in early 2007, became a leading device in the new market for smart phones. The Snow Leopard operating system was introduced late last year. The price of the iPhone was cut which, by most accounts, created new demand. Throughout the year more and more countries began selling the iPhone. The new App store became a hit and tens of thousands of downloads were made. New functions for the iPhone (cut & paste functionality) were introduced. Most recently the iPad was introduced creating a new device category, a cross between a laptop and a smart phone. Thousands of new App's were introduced for specific, unique use with the iPad. Walt Mossberg, the Journal personal technology columnist, praised the device for its many new, compelling features and ease of use. A recent newspaper article entitled "Results Made History," detailed the ways Apple's innovations have resulted in record earnings. New news, new products, new thinking, serving new markets and record earnings are and have always been the reason why stocks become leaders. Fast followers, like Palm, may make news, but rarely provide investors with sustained stock price increases. The J. P. Morgan analyst's price target, reduced when he cut his estimates last March was \$100. The end-of-the-quarter price of Apple was \$235, a new all-time high, eclipsed the next day, no fooling! A 4G iPhone is expected soon and the 3G iPad will go on sale on April 30. At some point, when the news and fundamentals can't get any better and investors have lost all inhibitions about buying the stock, even innovations will fail to drive the stock price higher. That will be nothing new as leading stocks have peaked that way forever. Who could have imagined that Intel's drive to faster and faster processors would create the conditions for its stock price decline early in the decade? Wasn't faster better?

The Apple story highlights a critical factor in the stock selection process, the "newness" factor and innovation. Companies serving new markets, providing new services, or installing new management are characteristics common not only to Apple but to each stock in your portfolio. No "entrenched maintainers" here. If you have any questions about the stocks you hold, their prospects or the selection process, please call me.

Sincerely,

John Preston
Senior Vice President