

Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors

March 10, 2010

Stocks finished about flat yesterday. Volume was up sharply from Monday but the increase was concentrated in just a few old has-been names like AIG, Citigroup, and Fannie Mae. Tech stocks had another relatively good session.

Today marks the anniversary of the start of the bull market. Over the past 12 months the Dow has risen by more than 60%. Yet it is still 25% below its October 2007 all-time high. In fact, the market is still 8% below the level it was at the Friday before Lehman Brothers failed and Merrill Lynch was taken over.

I am not going to spend much time this morning trying to make a bull or bear case for stocks. Suffice it to say for the moment that the economy is clearly improving, earnings are headed toward record levels, the liquid alternatives to stocks (bonds and cash) are not particularly attractive, and the wall of pessimism is still sufficiently high that I think the path of least resistance remains higher.

But today I want to look back and see what we can learn looking in the rear view mirror. I will quote from letters I wrote at the beginning of March last year and have chosen to attach to this e-mail a copy of my Special Report I wrote on March 10, 2009, the exact bottom of the market. Looking back a year, three overriding themes are evident.

- Fear was rampant and was the dominating influence of the moment.
- Seeds for improvement had already been sown and there were early signs some were sprouting. Within weeks, the phrase “green shoots” would be on everyone’s lips.
- If one could strip away the emotions of the moment, values were incredible.

Let’s start with the fear. When the bear market began in October 2007, the Dow was over 14000. Right after Lehman folded on September 15, 2008 it fell below 11000. By the end of 2008, it was down to the 9000 range. And despite all the hope the President Obama brought to the table, fears relating to the transition of administrations pushed the Dow down to almost 6500 on March 9. Americans were frozen in place spending only on necessities. Senator Dodd spoke of the possible necessity to nationalize some banks. Barney Frank was blasting banks for holding conferences in Las Vegas and sponsoring golf tournaments. February 2009 was the worst month for stocks since the previous October and early March only saw the panic accelerate.

But there were positive steps being taken. By early March, Treasury had invested TARP funds in major banks and was on the brink of beginning its stress tests. Monthly job losses were peaking. GDP growth was at its nadir. Housing activity in states like California was beginning to pick up. A \$787 billion stimulus bill was being enacted. The Federal Reserve was providing maximum liquidity. LIBOR spreads were coming down and some markets, like the commercial paper market were beginning to reopen.

While all this was happening, the black box quant funds were hemorrhaging, forced to sell assets to meet liquidity needs and margin calls. That only accelerated the downturn. I noted this on March 4, 2009 with the following paragraph:



“Right now stocks sit almost 33% below their 200-day line. That is technical gibberish that says things have fallen apart too fast. The pendulum has swung too far no matter how bad the news. Getting it moving in the other direction won’t be simple. Selling begets selling. We are back in that pattern of huge late afternoon selloffs, a sure indication that hedge funds and mutual funds are trying to meet liquidation requests. But when it turns, you will see all those chanting doom and gloom Monday evening telling you why prices today are a bargain of a lifetime.”

One could see the values emerging but the emotion of the moment made us all resemble a deer focused on the headlights.

In the same letter I made the following “bold predictions”

1. Whatever the rate of Q1 GDP decline may be, it will be the worst number of 2009.
2. Several very large banks may disappear but the banking system will remain in tact. Banks today have plenty of money to lend. It is fear, not lack of funds that is stalling lending.
3. Federal stimulus, beginning soon, will stimulate economic activity. We can argue by how much later.
4. No matter what happens to Obama’s budget, the health care and energy sectors will continue to make excellent profits for many years to come.
5. The Federal safety nets put in place after the Great Depression will prevent a second coming of the Great Depression.
6. The next significant move in stocks will be up but it should be viewed strictly as a bear market rally until demonstrated otherwise. If I had to put a round number on it, I would say that Dow 8000 might be a reasonable target. Watch for emerging leadership and whittle away positions that fail to rally.
7. While the recession may or may not end before the start of 2010, the mood will be much more hopeful by the end of this year. If stocks reflect mood and expectations more than reality, it means the bear market should end in 2009.
8. We will have to traverse several more big potholes before the all clear siren can sound. These potholes will be where expected (e.g. the auto and banking industry) and where they are not expected.”

While not perfect, the general theme of these predictions proved to be accurate. The first quarter of 2009 was the worst of times, Federal stimulus did begin to turn the economy around, there was no second coming of the Great Depression, and a year later the outlook for the economy is indeed much brighter than it was a year ago. A few days earlier, Warren Buffett issued his annual letter to shareholders. In it, he suggested that 2009 would be more miserable than 2008 but made it clear that was an economic forecast, not a stock market prognostication. Indeed, he quoted investing icon Benjamin Graham who said, “Price is what you pay; value is what you get”.

In the short run, emotions will run roughshod over reality but over the long run, reality and rationality win. I closed my letter of Friday March 6 with the following two sentences.

“Yesterday, the front page of the Internet version of the Wall Street Journal offered a video projecting a Dow of 4000. Is that a sign of a bottom or what?” With hindsight, Dow 4000 would have meant a P/E on depressed earnings of just over 7 and a dividend yield of just over 7.5%.

The bottom would come exactly one trading day later.

That brings me to our Special Report of Tuesday March 10, a day I don’t ordinarily publish. In that letter, I attempted to strip out emotion and show the incredible values within the Dow. I picked the Dow because of its size (just 30 stocks) and because at least the 10 largest Dow components at the time seemed to me to be companies that

had not only weathered the storm to date but had weathered all other bad storms for decades. I used the numbers, focusing on dividend yields and dividend growth, to make the case that the top 10 Dow components were much more attractive conservative long term investments than U.S. Treasury bonds. They provided a better yield, had a long term record of dividend increases, and were likely to grow into the future notwithstanding the effects of the recession in place. I even put in a couple columns making a subjective judgment on the probability of near term increases or decreases in the dividend.

Since we are looking backward, I will stay with these same 30 companies even though the Dow has been changed a bit in the interim. Despite my conservatism at the moment which focused on the best of breed companies, it will come as no surprise to anyone that the bottom tier had the best one-year performance rising by 126%. The middle tier rose by 91%. The top tier only gained a mere 44%. 29 of the 30 stocks are up today. Only General Motors, which filed for bankruptcy, declined.

What I find truly compelling is the dividend actions taken by the 30 companies. Dividend payments are generally a function of corporate free cash flow and forward looking projections. A year ago, I think it is safe to say that cash flows were at their worst levels and no one had a very clear or attractive crystal ball. Yet, over the past 12 months, every one of the ten companies in the top tier of the March 10 report has raised its dividend. In four cases, the increase was at least 10%. In the second tier, there were three increases and seven left unchanged. In the bottom tier, there were two increases and two cuts.

As I noted a year ago, “At some point, probably sooner rather than later, a sudden sharp rally will ensue for two reasons. First, no one expects it. Second, as I just showed, valuation fundamentals support it.” That was to be quite an understatement. In the long run, value always trumps emotion. Repeating the Ben Graham quote, “Price is what you pay, value is what you get.”

On March 10, the selling finally exhausted itself. In an internal memo to employees reported that morning in the press, Citigroup Chairman Vikram Pandit said the bank was making money once again. That was all investors needed to hear. They never looked back. On Friday the 13th, I said, “I think there is a reasonable chance that what we are experiencing this week is the market bottom.” But even in my rose colored glasses, I wasn’t contemplating 10500 plus a year later. It feels a lot better than it did at this time last year.

Today, obviously, the bargains aren’t the same but that doesn’t mean there aren’t any bargains out there. Normally, in the first year of a bull market, the more speculative names turn in the best returns, assuming of course that they survive. Citigroup (C-\$4) has more than tripled in value. Bank of America (BAC-\$17) is up more than four-fold. American Express (AXP-\$40#) is up almost as much. But other names are up a lot less. AT&T (T-\$25#), Verizon (VZ-\$30) and Exxon Mobil (XOM-\$66) are all up less than 10%. Indeed, the top tier (in the Dow that is based on price), while up almost 44% from the absolute bottom still seems to provide value. Last year, the dividend yield on that group of 10 was 3.62%. That looked very compelling versus a 10-year Treasury that at the time yielded just 2.87%. Today the 10-year Treasury yield is up to 3.72% and the yield for the 10 stocks at the top last year is now 2.76%.

But the one percentage point differential still seems to suggest that value is present. These 10 companies noted raised dividends by an average of 7.5% in one of the worst years in memory. If they could continue to raise them at a 7% rate for a decade, dividends would double over that span and the stocks would yield 5.5% based on current prices. That compares rather well against a static return of 3.72% for Treasuries. Remember that 6 of the 10 have increased dividends every year for at least 32 consecutive years. History suggests that steady increases are probable. The four

without such an unbroken series of increases are Exxon Mobil, Chevron, IBM and United Technologies. I see no barriers to dividend increases at all at least through 2011.

Let me bring this to a conclusion:

- The toughest time to buy stocks is often the best time.
- Value matters most. Trust your value judgments. One didn't have to pick the exact bottom to make a lot of money and there is no problem with averaging in once value is present.
- Try and separate the emotional from the rational. That's the hard part. Last year in early March, there were a whole lot of emotional reasons to sell but very few rational ones. Rational reasons to buy were already in place. Once the emotional selling exhausted itself (and it always does), it presented a great opportunity. It wasn't important last year whether what began in March was a nice bear market rally or the start of a new bull market. What did matter was that valuations screamed "Buy".
- Bargains like we saw a year ago may not be seen for some time. But that doesn't mean that there aren't attractively valued investments today. Find a company whose stock you want to own and determine what you want to pay for it. It is a bit like predetermining your top bid at an auction. If you get it for less, that's great but if you pay your top price and don't go any higher, you should be happy in the long run.
- Listen to yourself and to advice you trust. Don't be scared by every canary singing on your TV set. Remember this. Virtually none of the raging bulls of 2005-2008 called the downturn of 2008-2009. And virtually none of the bears who we all listened to endlessly in 2008-2009 called the turn up. For every bull there is a bear. Some make sense. Some make nonsense. Dramatics gets you on TV and grabs headlines. But the shrill voices are rarely right for long. The best investors are the least emotional.
- Understand your tolerance for risk and abide by it both in up and down markets. You can't ignore risk at the top and be risk intolerant at the bottom. That is a recipe for disaster.
- All the long term economic engines support growth. Our population grows, productivity increases, and technology offers new opportunities. America remains the best combination of economic stability and governance. Yes, we can dig ourselves a hole or two along the way and both fiscal and monetary policy matter. But all the tools remain in place today to support a very long and productive period of growth. If Washington is prudent, we will continue to grow and stock prices will rise.

It won't be a road without speed bumps. There are plenty of problems to solve. Our deficits are too big, our government pays too much for entitlements, we are still at war, and we are still too leveraged as a nation. How Washington responds will shape the economic recovery and it is quite possible it will follow the wrong path at some point in time. But in the short run, earnings are approaching record levels, consumer balance sheets are improving significantly and we are at the cusp of improving employment. The big picture problems are probably not going to surface in 2010 or even 2011. The short term path should be higher.

I am going to close by quoting Ben Graham for the third time in one letter. "Price is what you pay, value is what you get." Always look for opportunity, try and control your emotions, understand your risk tolerances and pay special attention to value. The lessons of March 2009 are the same today. It would be tragic if we forget them any time soon.

Futures suggest a flat opening again today.

Today Carrie Underwood is 27. Sharon Stone is 52. Chuck Norris turns 70.

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