J.W. Burns & Company

Investment Counsel

Quarterly Update - July 2010

Flash Crash
or
Seeing What Matters

"It's not what you look at that matters, it's what you see."
-Henry David Thoreau

Dear Clients and Friends,

After a torrid 80% rise in the stock market from the lows reached in March of 2009, stocks corrected sharply in the second quarter mainly due to the European debt crisis, the Gulf of Mexico oil spill, and overall concerns that the global economic recovery is weakening. For the quarter, the S&P 500 was down 11.45% and almost 15% from this year's high reached on April 23. Our Equity performance was down basically in line with the broad market average, which is rare, as our high-quality equities generally hold up quite a bit better than most during market downturns. However, we had our share of hits in the quarter, specifically from BP, Monsanto, Exxon and CVS. Nevertheless, we believe our high-quality, defensive equity strategy remains a shrewd and intelligent way for our clients to generate an above-average return with below-average risk. In fact, from these depressed levels, the durable high-quality stocks that populate your portfolio offer substantial upside.

The question on everyone's mind is, "Are we heading into a 'double dip recession'?" While always a possibility, we think it is unlikely. First, double dip recessions are rare – in fact, there has only been one example since World War II of quickly recurring recessions, and that was in 1980-1982, when the Federal Funds rate was over 20%![1] Secondly, despite the spate of negative headlines, the economy has continued to show reasonable growth, with the closely watched Institute for Supply Management (ISM) data up in June to 53.9, the 12th consecutive month of growth (any number over 50 signals an expansion). In fact, in our research, all the economic data continues to point towards an economic recovery. This recovery may be uneven and slower than usual, but the fundamental case for economic improvement remains intact.

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There is no question the European debt crisis is worrisome, and represents a warning to the United States. However, the so-called PIIGS countries – Portugal, Italy, Ireland, Greece and Spain – all had huge debt burdens before the recession began and then added more layers of debt to sustain the private sector. These countries had entitlement programs that were, to put it mildly, generous. In our view, the threat to America's *real economy* from European problems remains manageable. However, the true threat would come from

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the *financial economy* (banking system, bond markets, etc.) that could then quickly spill over into the real economy.[2] At this time, we believe the systemic risk is relatively low, simply because it would not be in the best interest of the European Union to allow a financial meltdown of one or more of their members. So, at this time, we believe that the impact of the European problems will largely be a modest slowdown in the economic growth prospects of the United States and Asia.

For the record, we have no direct investments in Portugal, Italy, Greece or Spain, and only an extremely marginal position in Ireland. Most importantly, we believe that our emphasis on high-quality companies with consistent earnings growth provides a favorable backdrop for our disciplined style of investing. In other words, investors are likely to focus on companies that can deliver solid earnings even in a subpar economic environment. And, that is exactly how we have positioned your portfolio.

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In terms of stock market activity, the confidence of many investors was shaken by the "flash crash" on May 6 of this year (more on this later). However, we believe that your high-quality equities remain a very attractive investment, especially when one considers that we have exceptionally low interest rates, inflation (at present) that is non-existent, very strong corporate balance sheets with huge liquidity, easy earnings comparisons, and robust insider buying among Fortune 500 companies. Combined with the mountain of cash that investors have on the sideline, at roughly $8 trillion according to Forbes.com, we believe equities will rebound strongly from this spring's correction during the second half of this year. As of this writing, in early July, stocks are in fact recovering nicely.

Our strategy with your portfolio remains focused on high-quality, brand name companies with big profits, secure dividends, and, overall, generally defensive equity strategy. As you know, we have sold certain portions to reduce your risk exposure and have a list of excellent businesses that we are considering for purchase that we believe offer significant upside. Companies and funds such as Cracker Barrel, Deluxe Corp., J&J Snack Foods, and Vanguard High Yield Bond Fund (for fixed income positions), among others, all offer above-average earnings growth and solid dividends.

Now, on to an important question.

Q: What caused the rapid stock market plunge on May 6, the so-called "flash crash," and what has been done to prevent this from reoccurring?

A: Despite the public concern, neither the Securities and Exchange Commission (the SEC) or the Commodity Futures Trading Commission has been able to determine exactly what caused the Dow Jones Industrial Average to drop 700 points in about 15 minutes in early May. However, in a 150-page report released that same month, the two agencies said they were focused on a few key areas.

Among the potential causes was the "severe mismatch in liquidity" during the May 6 crash; the impact of stop-loss and other market orders; and the possible link between the steep decline in stock index products, such as funds and futures, with "simultaneous and subsequent waves of selling in individual securities."[3]

These theories are neither clear nor understandable to most, so let me take a stab at it. In short, because there is intense competition among all the exchanges, from the traditional exchanges such as the New York Stock Exchange, to the Nasdaq, to the American Stock Exchange and the regional exchanges, along with many newer electronic exchanges, there is no dominant exchange to facilitate a single liquid and orderly market. And what I *believe* happened was a huge sell order on one stock – Proctor & Gamble – that was probably both a mistake (the "fat finger" theory – a trader accidently hit too many zeros on a sell order) and overloaded one of the smaller exchanges, causing many of the market participants to freeze and stop buying stocks when they saw Proctor & Gamble shares (mistakenly) drop massively. At that point, various futures contracts and sell orders hit the market powerfully and rapidly. Then, within minutes, investors realized that the market drop was electronically, not fundamentally, driven – and investors began to buy – and the market recovered quickly.

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This is what I *believe* happened; and I was right at my desk, watching the market activity when I saw P&G's stock price fall outlandishly, and I believed right away that the market drop was probably due to a trading error.

In any event, if my theory is correct, the action the SEC has taken will be quite helpful. Under new rules enacted in June, trading of any Standard & Poor's 500 stock that rises or falls 10% or more in a five-minute period will be halted for five minutes. The idea is for the trading pause to draw attention to an affected stock, establish a reasonable market price and resume trading "in a fair and orderly fashion."

The New York Stock Exchange enacted circuit breakers after the market crash in 1987. But those are based on movement of the Dow Jones Industrial Average, not individual stocks, and enact a market-wide trading halt. The halt kicks in only after the Dow drops at least 10% before 11:30 a.m. PDT. The May 6 plunge happened later in the day and did not reach 10%, making those circuit breakers useless in halting trading.[4]

We will find out more over the next few months, as the May report cited the extreme work the agencies will have to do to reconstruct the enormous trading volume of that day.

But, overall, I am confident that the SEC adjustments will be quite helpful, as were the circuit breakers imposed after the 1987 stock market crash.

And, for the record, stocks performed wonderfully over the next decade – and then some – following the 1987 debacle. Let's look for similar results going forward.

"Cautiously optimistic" is an overused term, but it does perfectly encapsulate our outlook here at J.W. Burns & Company Investment Counsel. Should the economy weaken substantially, we will take action and reduce your portfolio's risk. However, our clear investment disciplines already have us focused on high-quality businesses with durable earnings and dividend streams that should make your portfolio naturally less volatile than the overall stock market. Indeed, the desks and computer screens of our analysts at J.W. Burns & Company are covered with company balance sheets, income statements and research reports, as we continue to work very hard to move our clients' interests forward.

Back to the title - "seeing what matters" - at J.W. Burns & Company, we see that your portfolio is loaded with best of breed companies that are likely to generate healthy returns over the remainder of 2010 and beyond.

As always, please call us if you have any questions and concerns.

Enjoy your summertime.

Best wishes,

Jim

Jim

PS - Here is a piece from the June 2010 Outlook from W.P Stewart, who we have quoted previously. We couldn't agree more.

"At the current moment, equity markets offer something of a conundrum. Investors lack the confidence to push markets higher but seem only to gain confidence from rising markets. We firmly believe that equity valuations are underpinned at these levels with the S&P 500 trading at approximately 12.5x forecast earnings for 2010. This is not far away from the lows of just over 11x reached at the market's bottom at the beginning of 2009 when there were fears of a return to the Great Depression. Global growth is still expected to be solidly positive in 2010 and 2011 albeit somewhat skewed to the emerging markets. Corporate balance sheets are very robust, productivity has never been higher and earnings growth remains strong even on somewhat reduced estimates. Factoring in a slow-down in GDP growth in the mature western world post 2011 is certainly reasonable...however, even in this scenario, equities should offer significantly better returns than bonds or cash. This hypothesis may take some time to be proven as equities are only likely to grind slowly upward in the face of this challenging environment. However, we do strongly believe this is the right way to position the portfolio.

One thing is certain -- there is a lot of bad news around and many people are now forecasting a double dip recession. On the basis that the consensus has been consistently wrong over the past few months, this does suggest the 'bad news' may already be in the price."

-W.P. Steward U.S. Quarterly Newsletter, June 2010

"Should the economy weaken substantially, we will take action and reduce your portfolio's risk ."

[1] Haverford Outlook, Summer 2010
[2] David Gross, Slate, June 16, 2010
[3] Marcy Gordon, Associated Press, Thursday, June 10, 2010
[4] Jim Puzzanghea, The Los Angeles Times, Thursday, July 15, 2010

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