

CRM Market Commentary
Fourth Quarter 2011
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Summarizing the equity markets in 2011, one is reminded of part of Macbeth's famous soliloquy, "It is a tale...full of sound and fury, signifying nothing." Amid all of the turmoil that confronted investors from political incompetence to natural disasters, the S&P 500 Index ended virtually where it began. It was as if nothing had happened. Despite no change in this Index, we know much did take place with continuing implications for global markets in the New Year and beyond. After a tumultuous third quarter, the equity markets rapidly rebounded in early October on stronger U.S. economic data and the notion that Eurozone leaders could devise a plan to stabilize their debt crisis. Notwithstanding continued high volatility, the markets sustained the early October gains into year end. Constructively, the U.S. economic data continues to be indicative of 3%+ GDP growth in 4Q and housing and employment trends have been better than expected. Third quarter corporate earnings were once again robust with 70% exceeding forecasts. This figure is still impressive, but reflects a slowing trend. The pressures are varied and numerous: slowing global economic growth; raw material cost squeeze; competitive product/pricing pressures; and regulatory (FDA) enforcement/uncertainty. The stock prices of the 30% who disappointed were treated very harshly as investors shed companies exhibiting any kind of difficulty regardless of valuation or long term investment appeal. Seasonality (tax loss selling, etc.) combined with anxious markets likely contributed to the negative reaction. Stocks which declined during this time period, generally did not recover much of the depreciation as of year-end.

Unfortunately, we had more than our fair share of such stocks across our strategies during the quarter. Although we provide a more detailed stock discussion by investment strategy, we would like to provide some context. Underlying the zero return market was tremendous stock specific volatility, much of it a reflection of short term trading concerns and a lack of intermediate to long term investing foresight. Crocs had been one of our best performing stocks in the first half. The company preannounced disappointing results in October leading to an instant 40% decline in the stock price. Although management reported early spring orders are up 30% and the stock trades at 10x 2012 earnings, the stock did not recover at all during the balance of the fourth quarter. We added to our holdings and think the company is very well positioned for 2012.

After a strong start to the year, our healthcare stocks significantly lagged the market in the second half. The primary factors continue to be: low utilization trends resulting from sustained high unemployment; more consumer driven healthcare plans; the residual impact of FDA/DOJ enforcement actions; and peer medical journals/media criticism of the efficacy of some therapies. Hospira, one of our holdings, has been compelled by the FDA to remediate its quality control functions at its largest domestic plant. Hospira will spend \$300 million over 2+ years, most of it non-recurring. While near term earnings are depressed, the earnings power is not meaningfully compromised and yet the stock has declined by 40% since our purchase last spring. It trades at 9x our 2013 earnings estimate. Two other medical product companies, Stryker and St. Jude were strong early 2011 contributors, but have suffered 30%+ declines since last spring and trade at multiples similar to Hospira. Cooper, another one of our best first half performers, had a minor product recall on one of their contact lens products. The stock declined at one point by 30% from its high. After posting strong quarterly results a few weeks ago, the stock has recovered more than half the decline.

As we noted last quarter, business and investor confidence has been shaken and it will take time for business leaders to be comfortable making long term commitments. The same seems to apply to investors. We understand the trepidation when on any given day; a news headline can appear out of nowhere to dramatically upset the capital markets. These are different times. In this environment, we think institutional investors have a heightened responsibility to their clients to act like investors rather than traders and engage their companies on important matters. Corporate governance, disclosure/investor relations, and capital allocation are topics in which experienced institutional investors are knowledgeable. It is clearly easier to run rather than seek a constructive dialogue with corporate leaders, but investing requires patience, persuasion and passion. One need not become a high profile activist to make a difference.

We have encouraged managements over the past few decades to aggressively return excess capital to shareholders once all of their capital needs have been satisfied. Our preferred method was stock buybacks. We believed buybacks were a superior alternative to dividends as they were more tax efficient prior to the Bush tax cuts, they provided more flexibility to management and, assuming a stable multiple, the earnings accretion would drive a higher stock price. Over the past year, we have changed our view on the topic of buybacks and dividends and now believe managements need to reconsider their dividend policies. There has been a lot written this past year about the outperformance of high yielding dividend payers such as large pharmaceutical companies, REITS, utilities and integrated oil companies. These subgroups and selected higher yielding dividend stocks did well, regardless of the underlying fundamentals. Institutional and retail investors, both here and abroad, were willing to pay up for yield. There were “yield products” being created by packaging some of these securities and even adding leverage to further boost the potential returns for yield-starved investors.

Our perspective is somewhat different. We are focused on the dividend payout ratio and believe most companies have been far too conservative. While there are still some traditional growth companies in the public markets, most are now more mature. They are generating a lot of excess capital and, in most cases, have very overcapitalized (i.e., net cash) balance sheets. The dividend payout ratio for the S&P 500 is at a historic low of approximately 28%. There is some natural hesitancy over a higher payout ratio as managements’ fear having to cut the dividend in another deep recession and view it as an implicit acknowledgement that their company is no longer a growth company. Very few companies are true growth companies and this misperception by managers has created its own capital destroying virtuous cycle. Facing up to the reality of the kind of business they are managing is itself one of the great benefits of this dialogue. If there were another deep recession, any one particular company would not be singled out for temporarily cutting the dividend as most public companies took such action en masse in 2008.

We think both the absolute yield and growth rate are important. By committing to a fixed payout ratio of 50% (less than 100 of the S&P 500 companies have a payout ratio of this level), companies would still have plenty of retained capital for a rainy day and the dividend growth would equate to the earnings growth rate. The more confidence managements have in being able to sustain earnings growth, the more they should be willing to boost the payout ratio. In the event of another severe recession, managements could either maintain the dividend (thereby temporarily increasing the payout ratio) or let it fluctuate with the earnings decline. If the payout ratio was held constant, investors would enjoy the reacceleration in the dividend with the rebound in earnings coming out of any downturn. We do not believe a higher payout ratio is appropriate for all companies, but it should be for more than 20% of the S&P 500 and many small to midcap companies as well who find themselves not only overcapitalized, but continuing to generate excess capital.

Corporate managers are not fully accustomed to zero interest rates. They have refinanced existing debt and analyzed their rising pension obligations, but have they really thought about their dividend policy in

the context of zero interest rates? In spite of the current low payout ratio, the dividend yield on the S&P 500 is above the yield on the ten year treasury note which is not a frequent occurrence. In a low/no interest rate environment, there is tremendous value in dependable dividend yields and even more so if those dividends can grow over time with earnings. Our perspective is simple: the S&P 500 is trading at approximately 11x earnings. If every company adopted a 50% payout ratio, the index would be yielding nearly 5%. We believe the competition for yield would drive most of the underlying stocks back to 3-3.5% yields producing 20%+ appreciation in the equity prices. Those companies with attractive earnings prospects would appreciate even further. Many stocks in our portfolios are trading at less than 10x earnings. We do not believe they would stay at these levels with more progressive dividend policies. Our perspective is not about getting a little extra yield, it is about getting investors to invest again which would drive much greater total returns. While investors tend to associate dividend discussions with large cap companies, this allocation of shareholder resources applies across all capitalizations. Management teams are as frustrated as their investors in the undervaluation of their public stock. They can patiently wait for the market to revalue their equity or be more proactive in their capital allocation decisions, including boosting the payout ratio which will facilitate a closing of the valuation gap. We are not adverse to the continued use of buybacks as part of a capital return strategy. However, managements have not proven themselves to be great market timers and too often buy high and sell (issue) low. We would like to see more balance in capital returns leaning back in favor of dividends in this particular interest rate environment.

As business cycles remain compressed and developed economies wrestle with debt deleveraging, the investment environment will continue to be volatile. We will be subject to exogenous shocks from the Eurozone, China, Iran, Washington, D.C. and elsewhere that will temporarily impact investor confidence and result in unexplainable trading patterns for individual securities. While we are disappointed in our investment results for the second half, we are encouraged by the opportunities afforded us for the coming year. There is an abundance of companies with many of the characteristics we seek: the low growth/short business cycle is compelling managements to more aggressively manage their assets leading to many change dynamics; low free cash flow valuations are prevalent; corporations have historically strong balance sheets; and there is a significant amount of investor anxiety which often leads to behavioral overreactions/relative neglect. By employing this investment approach, we are confident our stock selections will be validated in the coming quarters.