

*With October close to setting a record for the largest stock market drop in a single month, below are a few observations and a review of Birch Hill's approach to investing in challenging markets.*

### **The Stock Market Downturn**

Through the close of business last Monday, October 27, the stock market (as measured by the Standard and Poor 500 Index) was down 27% for the month of October and 42% year to date. If the market ends the year at this level, the 10 year total return from stocks will be negative for the first time since 1938. All stocks have been subject to indiscriminate selling. Earnings, dividends, balance sheets, and price earnings multiples do not seem to matter as investors adjust to the unfolding credit crisis, pending global economic downturn, and forced deleveraging of aggressive hedge fund portfolios. We think it is quite possible that the volatility of the stock markets will continue for some time. One observer called it a bear market on steroids.

While periods of heightened volatility and sharply lower account values can prompt investors to consider abandoning their long term investment strategies, this often proves to be the most inopportune time to make wholesale changes. As noted by David Swenson, chief investment officer of the Yale University endowment:

*Human nature leads investors to overinvest in marketable equities at market tops and underinvest in stocks at market bottoms. Breaking the cycle of excessive enthusiasm and extreme caution requires investors to behave differently from the crowd....Placing...assets in marketable equities proves sensible only if investors exhibit staying power, maintaining positions through thick and thin. (Pioneering Portfolio Management, David F. Swenson. Pp.172-173)*

At times like these, when decisions are greatly influenced by emotion rather than analysis and reflective thought, we think it is helpful to review why we are long term investors in common stocks.

### **The Case for Common Stocks**

The public equity market provides investors the unique opportunity to become owners of individual companies and everything that company represents: the franchise, the service or product they provide, the reputation, and the past and future efforts of employees to use every advantage to grow their business and increase its value. Over time the earnings of successful companies will grow. While stock prices can swing dramatically over the short term, in the long run they generally keep pace with earnings growth, providing appreciation potential significantly in excess of those available from cash and fixed income investments. We believe a diversified portfolio of high quality stocks held for the long run will produce attractive returns.

Dividends are also an important reason for owning common stocks and are often underappreciated by investors. Historically, dividends have represented almost half of the total return provided by stocks. Unlike stock prices, dividend payments are usually quite stable, so even in down markets and economic contractions investors continue to receive a steady flow of income. The percentage of company earnings paid out to shareholders today is near 30% (down from the long term average of 50%) providing most companies a comfortable margin to maintain their dividend.

## **Could It Be Different This Time?**

While the current financial crisis and economic downturn may well cause profound and lasting changes in the way certain businesses operate, we believe the fundamentals of investing will remain unchanged. That is, investors will always want to share in the growth of innovative, well managed companies. The global economy has been tested many times. The facts are always different, but at the depth of every crisis, it always looks like an impossible task to climb out of the hole. These emotions are what define and create the troughs of economic cycles.

## **Asset Allocation**

For many of our clients we manage portfolios allocated between cash, bonds, common stocks and other investments. The goal of an asset allocation plan is to find an appropriate combination of expected return and expected risk that matches the client's long term needs, while maintaining cash levels for short term needs. In many regards, an asset allocation plan provides a disciplined structure to a portfolio. When one asset type performs particularly well, the asset is usually trimmed, and additions are made to an asset class that underperforms. Strategic allocation targets should be reviewed periodically and carefully revised when the long term goals of a portfolio change, and not in response to short term market volatility or headline news. This year's positive returns from government bonds and cash equivalents show that these asset classes have played their appropriate role during the recent stock market decline.

## **Portfolio Changes**

The current environment has been a challenge for all investors. We continue to evaluate individual companies to identify opportunities that may exist in the current market. In the same regard, we are also taking a closer look at the companies we own, to ensure that we are comfortable with their future growth prospects. The market decline has provided the opportunity to harvest tax losses that can be used against current and in some cases future tax liabilities.

## **Are equities attractive today?**

By many measures, equities today are priced at attractive levels. Trading at 11 times trailing twelve months earnings, the stock market today looks relatively inexpensive, matching the low for the past twenty years. Even if adjusted for a hypothetical 40% decline in earnings by 2010 the price earnings ratio of 16 times is not unreasonable. Today's average dividend yield of 3.3%, the highest level since 1991, is particularly attractive when compared to today's 3.7% yield on the 10 year US Treasury Note. An inexpensive valuation does not mean that stock prices are about to rise, however. Valuation measures can stay low for extended periods of time. The patient investor can benefit from periods of extreme pessimism when those valuation measures return to more historical levels.

## **Looking Toward the Future**

While it is impossible to predict how the market might perform over the near term, one notable investor has said he is buying:

*Let me be clear on one point: I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month — or a year — from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over. -- Warren Buffett, New York Times, October 17, 2008*

We believe that patient investors with a diversified portfolio of high quality stocks will be rewarded as this period of uncertainty dissipates and the equity markets recover.

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