

On Quality

Within value circles, it has been much noted recently about how “high quality” large companies are on sale, in particular relative to a market that is likely close to fair value. “High quality” means exactly what one would think: large, stable, well-established companies with recognizable brands. Most of these names were well loved 10 years ago, but investors have clearly lost patience:

| | Price 4/30/01 | Price 4/30/11 | Current P/E |
|--------------|-----------------|-----------------|--------------|
| Microsoft | \$33.88 | \$25.92 | 10.3x |
| Cisco | \$16.98 | \$17.52 | 13.7x |
| JNJ | \$48.24 | \$65.72 | 14.9x |
| Wal Mart | \$51.74 | \$54.98 | 12.3x |
| Home Depot | \$47.10 | \$37.15 | 18.5x |
| Dell | \$26.24 | \$15.47 | 11.5x |
| Medtronic | \$44.54 | \$41.75 | 13.9x |
| Total | \$268.72 | \$258.51 | 13.6x |

The businesses listed above are some of the most storied and successful in the past three decades. Yet one share of each of these companies would have cost \$269 in 2001 and would now be worth \$258, excluding dividends. The group is selling at less than 14 times earnings, notable because these are above average businesses with below average risk. Historically the group has been valued at more than 40% above current prices.

Why have the stocks performed so poorly? Surely the businesses must have performed poorly for the stocks to have gone nowhere over 10 years. Here are the earnings results:

| | 2000 EPS | 2010 EPS |
|--------------|---------------|----------------|
| Microsoft | \$0.85 | \$2.10 |
| Cisco | \$0.53 | \$1.33 |
| JNJ | \$1.70 | \$4.76 |
| Wal Mart | \$1.40 | \$4.07 |
| Home Depot | \$1.10 | \$2.03 |
| Dell | \$0.84 | \$1.35 |
| Medtronic | \$1.05 | \$3.39 |
| Total | \$7.47 | \$19.03 |

That doesn't look so awful. In fact, earnings grew 155%, or on average 9.8% a year. The worst, Dell, grew earnings 4.8% a year, while the best, Medtronic, grew at 12.4% a year. The sub-par performance is simply the result of going from an overvalued state caused by cheery investor sentiment to an undervalued one following from a decade of disappointment. We believe attractive returns are on the horizon.

Equities

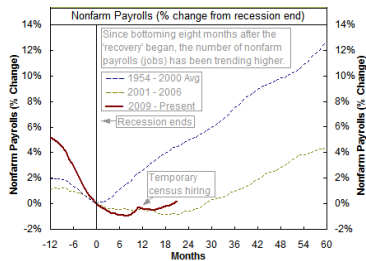
Stocks posted solid returns in the first four months of the year, with the benchmark S&P 500 rising 9.06% through April. Economic growth has been steady although below what would be expected at this point in the recovery.

We think the overall market is within the range of fair value, but are finding relative value. Many insurance names are statistically cheap due to an extended soft rate environment. Insurance comes with significant risks on both sides of the coin: the risk of the underlying investments on the asset side, and the risk that the company underprices risk or takes on too much underwriting exposure. The former was demonstrated during the financial crisis. Many insurers were forced to raise capital on onerous terms due to impairments to their

investments, particularly holdings of mortgage-related securities. We therefore believe in exercising high caution when investing in the industry. Some insurers approached the crisis with fortress balance sheets, including **Berkshire Hathaway** and our holding **Everest RE**. Both names were able to capitalize on the downturn, and remain attractively priced today.

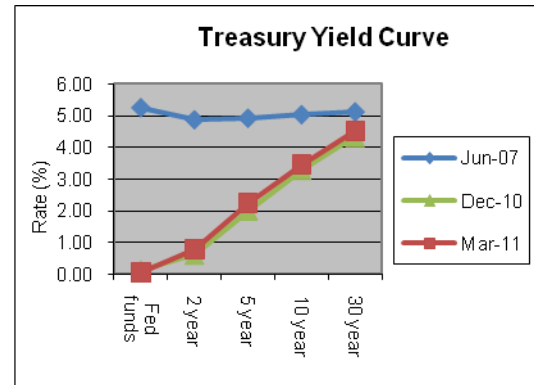
Bonds

The chief popular concern remains unemployment, which at 9% is well above the 5-6% level of most of the past 30 years. The recovery in employment has actually tracked the experience of the past decade:



The improvement in payrolls exceeds that of the 2001-2006 cycle modestly. But at 9% unemployment, many remain frustrated and politicians feel compelled to do anything, no matter the side effects, to try to improve the situation. It will correct itself but may take time.

Rates on fixed income instruments remain stingy. Interest rates ticked up slightly across maturities during the quarter but conditions were mostly unchanged. Current prices mostly fail to compensate for the substantial risks of future interest rate rises, which would result from rising inflation.



We added a **Royal Bank of Scotland** preferred in the 1st quarter at 80% of par value. Dividends should resume in mid 2012, and the bank is profitable and has healthy capital ratios.

Otherwise we are mostly sticking to the short to middle end of the yield curve to guard against inevitably rising rates.

Stock Updates

Valero and **Tesoro**, both operators of oil refineries and gas stations, surged in the quarter as refinery margins improved from 2010's weak levels. We sold both as their valuations approached our estimates of fair value.

Tellabs manufactures telecom equipment. We added a position in the first quarter as the stock became cheap due to a weak near term outlook. Tellabs has a strong balance sheet with 60% of their market cap in cash, and a history of strong cash flow generation.

CBS shares were sold as the stock has nearly doubled since last fall on improving advertising sales and rates.

We traded out **Home Depot** in mid May for **Lowe's**. We mean no offense to Home Depot, but the move makes good financial sense. Lowe's is at a rare level of valuation discount to HD, has a better balance sheet and management has been aggressively buying back shares. Bottom line: Shares are pricing a mid to high teens annual return on Lowe's over the next five years versus 10% for Home Depot.

We opened positions in **Johnson & Johnson** and **Abbott Labs** in the quarter, both quality companies on sale. Abbott has an attractive development pipeline, offering a cheap stock with good growth potential for free. JNJ earnings have grown 150% in the past 10 years, but the stock was recently available at the 2001 price.

We added a position in **Wells Fargo**. Wells has a unique, risk-averse culture. They eschewed sub-prime during the credit boom and were rewarded with Wachovia at a bargain price. They also have the Warren Buffett stamp of approval, as he has been an investor for many years.

We swapped in Wells and out **Avis Budget** as shares rebounded with the improving economic outlook. Avis retains a leveraged balance sheet and does not offer a sufficient margin of safety given their highly competitive industry.

Harper Asset Management specializes in managing capital for private clients according to a long-term, value-oriented process. We also assist clients with financial and life planning. Please contact us if you would like a review of your financial situation.

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