

BROOKMONT CAPITAL MANAGEMENT

“A BUGG’S LIFE”

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First Quarter in the Books

When Brookmont Capital Management opened its doors this past November, the markets were already in the midst of a significant correction. Rising energy prices, falling home sales, and billions in loan losses were just a few of the major obstacles investors were facing as the year was coming to a close. Conventional wisdom would say that our decision to launch Brookmont Capital Management could not have come at a worse time.

As we entered the first quarter of 2008, the markets became more uncertain as oil prices crossed the \$100 threshold and the economy slipped into a recession. The end result was a 9.45% loss in the S&P 500 and a 14% drop in the NASDAQ.

On the other hand, first quarter performance for the *Brookmont Dividend Equity Strategy* was very encouraging as it outperformed the major indices and its respective benchmarks during each of the first three months of the year. The Dividend Equity Strategy was down 2.35% during the first quarter, which compares favorably to its respective benchmarks: the Lipper Large Cap Value Index (-9.54%), the Russell 3000 Value (-8.55%), and the Dow Jones Dividend Select (-9.44%).

The Strategy's March performance stood out the most as it gained 2.3% versus a 0.4% loss for the S&P 500. Several stocks contributed to last month's performance, including Lance (+17%), General Electric (+12%), Sara Lee (+11%), and AT&T (+10%). General Motors posted the largest decline during the month (-18%) as the outlook for U.S. auto sales continued to deteriorate (GM has since recovered this loss). No other Strategy holding fell by more than 5%.

During the first quarter, we added two new names to the Dividend Equity Strategy. In January, we sold **Huaneng Power (HNP)** and swapped into **McDonald's (MCD)**. McDonald's has been hitting all cylinders of late with same store sales rising more than 11% in the U.S. and more than 15% in Europe. The two stocks have moved in opposite directions since the swap was executed in January with Huaneng's stock price falling 27% and McDonald's gaining nearly 21%.



In February, we added **Microchip Technology (MCHP)** to the Strategy and it represents our first holding in the Technology sector. A dominant player in the microcontroller market, MCHP has also risen 21% since it was added to the Strategy in mid-February. A financially strong company, Microchip Technology has increased its dividend by 105% over the past three years and currently offers a 3.6% dividend yield. Microchip Technology was added to the Strategy to replace **SunTrust Banks (STI)**. We sold this Super Regional Bank holding when concerns about the Home Equity Loan sector became apparent. The stock has fallen 7% since it was removed from the Strategy.

The Strategy's year-to-date return has crossed over into positive territory with a 5.5% gain during the month of April (as of April 28). Several holdings have reported better than expected first quarter earnings and their stock prices have moved higher as a result. April winners include Sonoco Products (+17%), Royal Dutch Shell (+19%), National Fuel Gas (+11%), General Motors (+15%), JP Morgan (+12%), and Microchip Technology (+13%).

The Strategy's sector allocation remains underweighted in Financials, Technology, and Health Care. Sectors that carry an above-average weighting include Consumer Staples, Durables, and Materials. While many Financial Sector companies have reported significant losses during the past 6 months (which has also led to reductions in quarterly dividends), the Strategy has been able to avoid both issues. Financial holdings in the Strategy have posted a 7% average gain for the year, versus a 7% loss for the overall Finance Sector in the S&P 500. Just as important, dividend payouts from the names that we own appear to be very secure.

Brookmont Capital Management

Dividend Equity Strategy

The Brookmont Dividend Equity Strategy consists of individual stocks that provide an average dividend yield that is significantly higher than the S&P 500. Stocks are screened by current dividend yield, free cash flow, credit quality, and history of dividend increases.

Sector Allocation %



Health Care	8%
Consumer Durables	16%
Consumer Staples	16%
Energy	6%
Finance	15%
Technology	3%
Industrials	11%
Materials	11%
Telecom	6%
Utilities	8%

Quarterly Performance First Quarter 2008

Brookmont Dividend Equity -2.35%

(January -1.80%; February -2.82%; March +2.30%)

S&P 500 -9.45%

Lipper Large Cap-Value -9.54%

Russell 3000 Value -8.55%

Dow Jones Dividend Select Fund -9.44%

Firm results are net of fees. Performance returns are calculated from discretionary accounts that hold each Strategy holding. Non-strategy holdings are excluded from performance calculations.

Strategy Characteristics

	<u>Strategy</u>	<u>S&P 500</u>
Dividend Yield	3.60%	2.10%
Beta	.91	1.00
P/E Ratio	14x	18x
Average S&P Rating	B+	B
Exp. Earnings Growth	11%	7%
Return on Equity	21%	17%
Investment Style	Value/Core	Core
Market Cap. Average	\$54 billion	\$92 billion
Number of Holdings	37	-

Representative Holdings

Abbott Labs
 AT&T
 Chevron
 U.S. Bank
 McDonald's
 Microchip Technology
 Johnson and Johnson
 Microchip Technology
 Kellogg
 J.P. Morgan
 National Fuel Gas

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Earnings Are Better Than They Seem

With all the doom and gloom that has surrounded first quarter earnings announcements, you would think that U.S. companies were losing money right and left. Truth be told, all of the negative news has been contained to the Financial and Consumer Discretionary sectors. Financial companies are projected to report a 70% decline in year-over-year earnings growth as profits decline from \$59 billion during the first quarter of 2007 to \$19 billion during the first three months of 2008.

Remove the Financial Sector from the equation and the prognosis for corporate earnings looks entirely different. Analysts expect first quarter earnings growth to end up around -14%. That number jumps to a positive 8% growth rate ex-Financials. A similar outcome is expected during the second quarter of 2008 as earnings growth is forecasted to be -6%, but rises to a positive 6% when Financials are ignored.

The biggest concern is that expectations for earnings growth during the rest of the year are too optimistic. There were several negative preannouncements last week that indicate analysts will have to reduce their projections for the second and third-quarter of 2008. Warnings came from sector leaders that include Apple, Microsoft, Kimberly-Clark, Texas Instruments, and VF Corporation.

This week brings another heavy schedule of first quarter earnings announcements. Reports are expected from Verizon, Royal Dutch Shell, ExxonMobil, Chevron, Kellogg, GM, and Southern Company.

S&P 500 Sector Returns

<u>Sector</u>	<u>April</u>	<u>YTD</u>	<u>1- Yr</u>
Energy	11.80%	3.39%	26.33%
Materials	9.23%	5.35%	12.10%
Industrials	2.04%	-2.52%	2.22%
Consumer Discret.	4.84%	-1.71%	-18.66%
Consumer Staples	-0.49%	-3.25%	2.10%
Health Care	2.46%	-9.78%	-12.33%
Financials	8.29%	-7.60%	-27.90%
Technology	7.65%	-8.90%	0.57%
Telecom	2.35%	-12.54%	-11.24%
Utilities	5.85%	-5.45%	-5.06%
S&P 500	5.79%	-4.21%	-6.53%

(as of 4/26/08)

Have We Reached the Bottom?

Historically, the S&P 500 reaches a bottom when our economy is 60% of the way through a recession. Recessions, on average, normally last about eleven months. As many economists believe that our economy entered a recession during the fourth quarter of 2007, the timeline would seem to indicate that the stock market is experiencing a rebound that is more than just a dead-cat bounce.

Before we conclude that the recent gains in the market are permanent, we must remember that no recession is exactly alike. Some are short and shallow, others are deep and prolonged. The 2001 recession was short in duration and consumer spending growth barely declined, but the S&P 500 fell another 40% after the recession had officially come to an end. The difference was that the 2001 economic recession was the result of an implosion in corporate earnings and capital spending, not rising inflation or poor decision making in Washington, D.C.

On the other hand, a recession in 2008 has similar traits to the recession of 1973-75 in that consumers have suffered from rising food and energy prices, and the U.S. dollar has suffered from a significant decline in value. The major difference between them, however, is that inflation pressures have not extended into other areas of the economy as they did in the 1970's. Prices for autos, housing, and clothing have either declined or remained flat as supplies are running well ahead of demand.

So have we reached a bottom? Perhaps. If that is the case, then the overall stock market did not suffer much at all from an economic downturn. Over the past year, the S&P 500 has only declined by 6% as strong performance from the Energy and Materials sectors were able to offset the dramatic collapse in many financial stocks.

In comparison, the recession of 1973-75 saw the S&P 500 drop by 48% and it took seven years for the market to recover its losses. The "mild" recession of 2001 brought a 43% decline in the S&P 500, and seven years later it continues to trade below pre-recession levels.

Sector Focus – Defensive

Conventional market wisdom says that “defensive” sectors outperform during times of uncertainty, declining earnings growth, and a slumping economy. If this thesis is true, then it comes as a surprise that several “defensive” sectors are trailing the overall market.

Health Care- (underweight in the Dividend Equity Strategy)

The sector is more than just drug manufacturers. Managed care companies have had a rough 2008 with WellPoint dropping 44% and United HealthCare down 40%. While these stocks should be outperforming during uncertain times, they are getting hit from numerous directions. Rising medical costs are eating into their net profits and the political environment is always an issue when a Presidential election is around the corner. Several drug makers have also seen significant declines in their stock prices in 2008, including Schering-Plough (-31%), Merck (-37%), and Bristol-Myers Squibb (-17%). Pfizer, once considered the king of the drug companies, is currently trading at an 11-year low. The pharmaceutical companies continue to be plagued by patent expirations of blockbuster drugs with nothing in the pipelines to replace the lost revenue.

The sector has significantly underperformed in 2008 and during the past twelve months. For all of the talk about aging baby boomers driving health care stocks through the roof, we have yet to see any evidence that this is true. We currently own three pharmaceutical names in the Dividend Equity Strategy, but our allocation to the Health Care sector remains 30% below its weighting in the S&P 500.

Consumer Staples – (overweight in the Dividend Equity Strategy)

During times of economic trouble, we can always rely on American consumers to buy groceries, soft drinks, and beer. As a result, stocks in the Consumer Staples sector are generally viewed as defensive names to own when the economy is in a recession. This time around, an economic recession is accompanied by rising prices at the consumer and wholesale levels. While food prices at the consumer level are up 5% during the past twelve months, foodstuffs and feed prices are rising 10-11% at the crude and intermediate stages of productions. The result is lower profit margins for food companies as they are absorbing 50% of higher input prices. While the Staple sector is underperforming the market during the month of April, several names in the sector are beating the S&P 500 year-to-date, including Heinz, Kellogg, and CVS Drugstores.

One More Round for the Fed

Just one month ago, it looked like the Federal Reserve would cut short-term interest rates by another full percentage point before calling it quits. Since then, inflation fears have increased as food and energy prices continue to climb even higher. Coupled with the belief that the Financial Sector has now gotten the worst behind it, expectations are for the Fed to cut short-term rates by another ¼% during their meeting next week and that will be it.

Central banks around the globe are considering a change of course to thwart off inflationary pressures. The European Central Bank, the Bank of Japan, and the Reserve Bank of Australia are expected to either raise short-term interest rates, or at least keep them steady, as rising food and energy prices threaten to derail global economic growth. In return, that places additional pressure on our Federal Reserve to bring an end to its successive rate cuts, or risk the chance that the U.S. dollar sinks further against foreign currencies.

The markets have already built this new forecast into yields on U.S. Treasuries. In the past two weeks, the yield on a two-year Treasury Note has risen from 1.73% to 2.41%, and the yield on a five-year Treasury Note has jumped from 2.61% to 3.15%.

This week brings a busy calendar for new economic data. **Tuesday:** Consumer confidence numbers; **Wednesday:** first-quarter GDP numbers and Chicago PMI; **Thursday:** construction spending and auto sales; **Friday:** April Labor Report. Throw in a two-day meeting for the Federal Reserve on Tuesday and Wednesday, and the week could get interesting for the markets.

Etc.

- Last week's Michigan Consumer Sentiment Poll indicates that only 30% of taxpayers plan on spending their upcoming tax rebate checks from the IRS. Most plan to pay down debt or add to savings.
- The same poll indicated that consumer sentiment in the U.S. dropped to a 26-year low
- Rising commodity prices probably mean the Federal Reserve will cut short-term rates by ¼ point this week, followed by one more ¼ point rate cut at their June meeting
- Existing home-sales have fallen 36% from their peak in 2005
- Economists expect first-quarter GDP growth to fall between 0% and .60%. Second quarter GDP growth could be a negative number as consumer spending growth falls below 0%.

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