

BROOKMONT CAPITAL MANAGEMENT

“A BUGG’S LIFE”

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Up, Down, Up, Down...

During eleven trading sessions in January, the Dow Jones Industrial Average moved higher or lower by 170 points or more. Not only have the markets seen wide price swings on a daily basis, trading volume has been very heavy since the beginning of the year. Nine days in 2008 rank among the top 20 in trading volume at the New York Stock Exchange. While this may be good news for brokerage commissions, it signals widespread uncertainty and angst among investors.

We do not subscribe to this short-term trading mentality as flipping positions is a no-win proposition...except for the IRS. Not only do you risk the chance of being out of the market at the wrong time, you also have to make several correct decisions for it to pay off. This includes knowing which stocks to sell, when to sell them, when to buy back into the market, and which stocks to buy. If you're realizing short-term gains along the way, you will pay up to 35% in taxes to Uncle Sam.

While we do not advocate market timing or high turnover in a portfolio, we do believe in lowering risk and volatility in our client accounts. How is this done?

The first point to remember is that the amount of risk in a portfolio is not the same as volatility. In statistical terms, standard deviation is used to determine the volatility within a portfolio. If your month-end market values swoon higher and lower with no consistent pattern, the portfolio's standard deviation will become quite high. Although the wide fluctuations keep investors awake at night, the volatility in market value only means "high risk" if your time horizon is short.

On the other hand, let's suppose your portfolio owns large concentrations of only four or five stocks. Let's also suppose that these stocks include a couple of banks, a telecom company, a utility, and an energy company. Sounds fairly boring, correct? Even though the portfolio is not as diversified as the one in the previous example, this investor sleeps well at night because his portfolio has shown less volatility in its monthly market values. But is this investor actually living in a state of denial and his portfolio is actually carrying a much higher level of risk?



Portfolio concentrations are probably the largest purveyors of risk that are quiet time bombs just waiting to be lit. Think back in time and consider which stocks were once darlings on Wall Street and were viewed by investors as "blue-chip" names. That list would include Enron, WorldCom, Citigroup,

Consider a third portfolio that has a standard deviation (volatility) that is somewhere between the two previous examples. The account is well diversified among the ten sectors of the S&P 500, holds an average weighting in small-mid cap stocks, and has a 15% allocation in foreign stocks.

Which portfolio would you think carries the least amount of risk? A portfolio with high volatility, a portfolio with minimum volatility and invested in four or five blue-chip stocks, or a portfolio that is invested in numerous "style" and Market cap" boxes?

The answer is not as clear cut as you might think. A volatile portfolio is only considered to be "risky" if you have a short-term time horizon. The stock market, in general, is volatile and somewhat random when the investment horizon is viewed in months, not years. When the time horizon is stretched out to ten years or longer, a volatile portfolio will see its risk profile drop significantly and is why younger investors can be more aggressive with their portfolio.

The third portfolio (widely invested in sectors and styles) may seem to be the less risky, but may not be the case. If the holdings are highly correlated with each other, the risk in the portfolio may be a stealth danger to long-term performance. This type of portfolio lulls investors into a false sense of security. However, if an investor's time horizon is short (3-years or less), this portfolio would hold the least amount of risk.

The portfolio that has no volatility, but is only invested in four or five stocks, holds the greatest amount of risk regardless of the investor's time horizon. As we have seen in recent years, individual stocks can tumble during one session of trading, or can slide over a few weeks without much notice. It is this portfolio that must be monitored on a day-by-day basis.

There are several reasons why an investor would allow his portfolio to carry so much risk. The first would be that he does not understand the true basics of the stock market and how he can insulate his investments from this amount of risk. Second, it is possible that the low level of volatility has him convinced that his portfolio is not in risk. He could also be "in love" with the few stocks that he owns, or terribly averse to paying any taxes on the long-term gains he would realize.

The lesson to be learned is that many investors have convinced themselves that a volatile portfolio equates to high risk. As well, many investors believe that a portfolio that is invested in numerous market sectors, or one that has shown little volatility in the past, carries a low risk profile.

Fed Gets Aggressive

Back during the Greenspan era, the Federal Reserve was notorious for its Chinese water torture quarter-point interest rate movements. Call it conservative, practical, or rational. The thought of cutting interest rates by 125 basis points during a nine-day period never entered Greenspan's stream of consciousness.

With this aggressive action by the Fed, how should investors read the tea leaves? In this case, action speaks louder than words and seems to indicate that the Board of Governors are more concerned about the economic slowdown than what they are saying in public.

The ¾% interest rate reduction on January 22 was very curious as it happened the day after the U.S. markets were closed for the MLK holiday. As we have later learned, it appears that the Fed's sudden action was precipitated by a junior trader at France's Society General. Who knew a 31-year old, mid-level trader could rock the world market's all by himself. Then again, Napoleon had the same aspirations.

On the other hand, the Fed's decision to cut interest rates after its regularly scheduled January meeting seems to be driven by more defensible logic. Almost every piece of economic news that has been announced recently has missed its forecasted number. The Fourth Quarter 2007 GDP Report was simply the icing on the cake.

In their comments, the Fed indicated that further rate cuts are a possibility as the credit markets continue to show deterioration, banks are less willing to lend to certain business and individuals, and that the labor markets have softened. In other words, their comments did not include anything that we did not already know.

Back to the GDP report. One thing to keep in mind is that any report on the GDP is always a reflection in the mirror. It only tells us what has happened in the past and not what we should expect in the future. This is also why the Economics Board waits months or years before announcing the beginning or end of a recession.

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S&P 500 Sector Returns

<u>Sector</u>	<u>2008</u>	<u>12-Months</u>
Energy	-14.39%	17.14%
Materials	-7.33%	7.22%
Industrials	-6.96%	1.58%
Consumer Discretionary	-5.26%	-18.72%
Consumer Staples	-7.19%	2.74%
Health Care	-5.47%	-3.71%
Financials	-6.71%	-25.87%
Information Technology	-17.01%	-4.48%
Telecommunications Services	-14.72%	-7.20%
Utilities	<u>-7.59%</u>	<u>6.16%</u>
S&P 500	-9.66%	-8.49%
(as of 2/06/08)		

That said, the economy did witness significant weakness during the fourth quarter of 2007. Economic growth came in at 0.6%, well below economists' expectations of 1.1%, and was the weakest report since the recession ended in 2002. Bad news for the Fed is that core inflation rose much faster during the quarter than their comfort level. However, the dramatic drop in economic growth is going to take precedence over any risk of rising inflation.

January Market Returns

The first month of the year was a rough one for the stock market. Even the Fed's two rate cuts could not move the averages close to break-even. What is interesting, however, is that the financial sector is posting its worst quarterly earnings in history, yet turned in the top sector performance. On the other hand, the tech and energy sectors are reporting the highest growth rate in fourth quarter earnings, but were the worst performers during the month. While this dichotomy may seem a little strange, investors must keep in mind that expectations for the future are far more important than what happened in the past. That said, investors were apparently pleased with the Fed's recent actions and decided that the worst may be over for finance companies. To the contrary, investors reduced their energy holdings as crude oil prices have stabilized, and sold tech shares after several companies (Apple, eBay, Motorola, and Qualcomm) warned about their future sales outlook.

The sharp decline in technology stocks also translated into underperformance from growth stocks. In 2007, growth significantly outperformed the rest of the market and a month does not signify a rotation back into value stocks. In fact, two important value-oriented sectors (energy and telecom) performed poorly in January. Surprisingly, it was the controversial financials and consumer discretion sectors that led to outperformance by value stocks. The question now becomes whether this is also the beginning of a new market trend, or merely a dead-cat bounce (see their one-year performance). Either way, value stocks have already built a 500 basis point lead versus growth stocks during the first few weeks of the year.

Corporate Earnings

It might surprise you to hear that 4Q2007 earnings growth has not been a huge disappointment. While the media has harped on the billions of losses by financial companies, other sectors of the economy have enjoyed continued earnings growth. As of February 1, the Technology sector has posted a 26% growth rate in quarterly earnings, followed by the Energy sector at 20%.

	<u>Year-to-Date</u>	<u>1-Year</u>	<u>3-Year*</u>
Dow Jones	-8.00%	-3.70%	4.40%
S&P 500	-9.66%	-8.49%	3.31%
NASDAQ	-14.12%	-8.49%	2.98%
S&P Mid-Cap	-8.61%	-7.78%	5.80%
S&P Small-Cap	-7.48%	-12.27%	3.49%
PHLX Gold	0.09%	25.60%	14.29%
*annualized			

Conversely, the Finance sector has posted a 105% decline in year-over-year earnings, followed by Materials (-17%) and Consumer Discretion (-15%).

The decline in fourth quarter earnings growth has come swiftly as analysts were forecasting an 11.5% growth rate at the beginning of the Fourth Quarter (October 1). Four months later, it appears that earnings declined nearly 21% during the last three months of 2007. But to keep things in perspective, if the Finance sector is removed from the S&P 500, earnings grew around 11% during the quarter.

Earnings announcements are expected later this month from Hewlett-Packard, Dell, Wal-Mart, Home Depot, Lowe's, and Coca-Cola.

Interest Rates on a Steady Decline

Before the Federal Reserve began cutting interest rates in September 2007, bond yields had already declined for several months. The interest rate for overnight Fed Funds currently stands at 3%, well above the yield on a 5-year Treasury. The bond market is signaling that more cuts are coming from the Fed, which does not meet again until March 18.

If you are now holding a large cash balance in your portfolio, investing in fixed income securities is now a missed opportunity. Money market yields are now higher than those found in one-5 year Treasury Notes.

Treasury Yield History			
	<u>Current</u>	<u>Nov '07</u>	<u>Feb. '07</u>
3-Month	2.02%	3.81%	5.13%
6-Month	2.04%	3.95%	5.16%
1-Yr	1.92%	3.89%	5.09%
2-Yr	1.96%	3.77%	4.96%
5-Yr	2.67%	4.02%	4.84%
10-Yr	3.59%	4.36%	4.84%
30-Yr	4.35%	4.64%	4.93%

The President's Budget for 2009

The President's proposed budget for 2009 was released earlier this week, and here is our attempts to bullet point the important specifics of this very lengthy document:

- Anticipated budget deficits of \$410 billion in 2008 and \$407 billion in 2009
- Expected budget surplus in 2012 and 2013
- Defense spending of \$515 billion, a 70% increase since 2001
- Budget ignores spending for wars in Iraq and Afghanistan
- \$11.5 billion for Transportation, a 21% drop from 2001
- Nearly \$60 billion for education, a 48% increase from 2001
- Includes a continuation of lower tax rates on dividend income and long-term capital gains, as well as lowered marginal tax rates and phasing out the estate tax
- Anticipating three straight years of lower corporate tax receipts, offset by higher personal income tax receipts and Social Insurance and Retirement receipts, plus continued receipts from Alternative Minimum Tax (AMT)
- Budget for 2009 is based on a 2.7% GDP growth rate in 2008; the Congressional Budget Office believes our GDP will only grow at 1.7% in 2008. This gap in growth estimates could have a tremendous impact on anticipated budget receipts

Of course, the President's budget proposal is merely the first move in a long process that will include Congressional criticism from both parties. With 2008 being a very important election year, you should expect the final budget to look considerably different from today's proposal.

The Big Three (plus Chrysler)

As the Big Three continue to lose market share to their foreign rivals, recapturing sales of passenger cars seems to be elusive at a time when their cash cow products are declining in popularity. The bread and butter of the domestic manufacturers include mid-large sized SUV's and pickups, which saw a 5-14% decline in sales last year. An impressive growth rate in "crossover" vehicles was the one saving grace in the light-duty truck segment.

Auto sales are expected to fall this year to its lowest unit volume since 1993. Higher energy prices, a soft labor market, and ongoing credit concerns are to blame for the

December Auto Sales

Toyota Camry	38,831
Honda Accord	31,255
Toyota Corolla	28,452
Honda Civic	27,190
Nissan Altima	25,151
Hyundai Sonata	24,872
Chevy Impala	17,800
Ford Taurus	6,480

slowdown. Auto companies have also contributed to the expected sales slowdown, the end result from building higher quality products. Similar to furniture, audio/video equipment, and computers, cars have become a postponable purchase during a weak economy.

When it comes to passenger car sales volume, the true weakness at the Big Three becomes very clear. Twenty years ago, the Ford Taurus led annual car sales as it was considered to be innovative with a modern design. And to their credit, new domestic models at GM are winning important awards from auto magazines and J.D. Power. But how are these awards translating into actual sales?

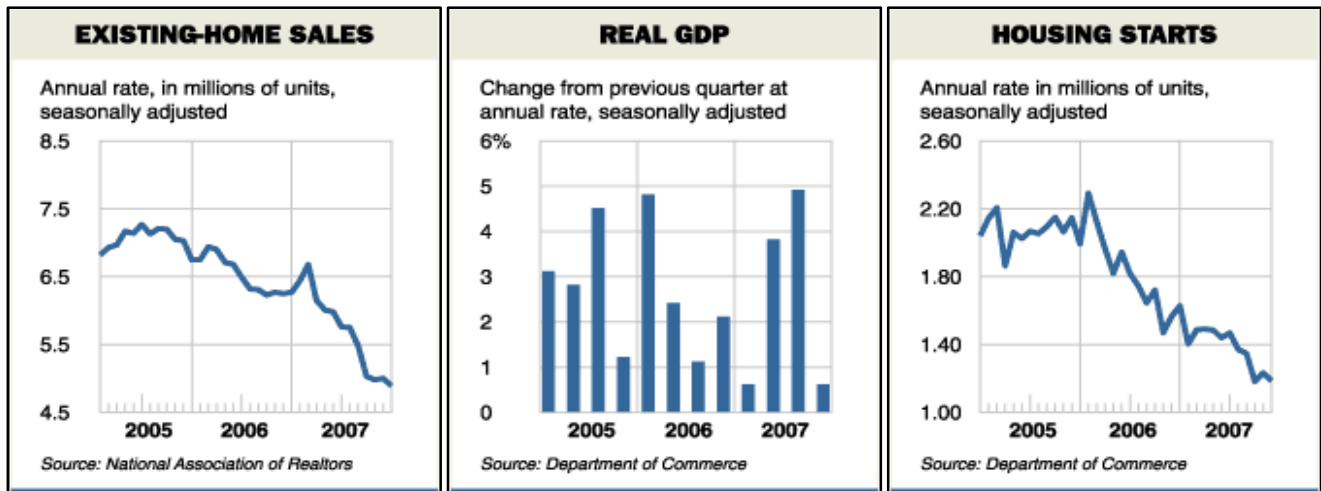
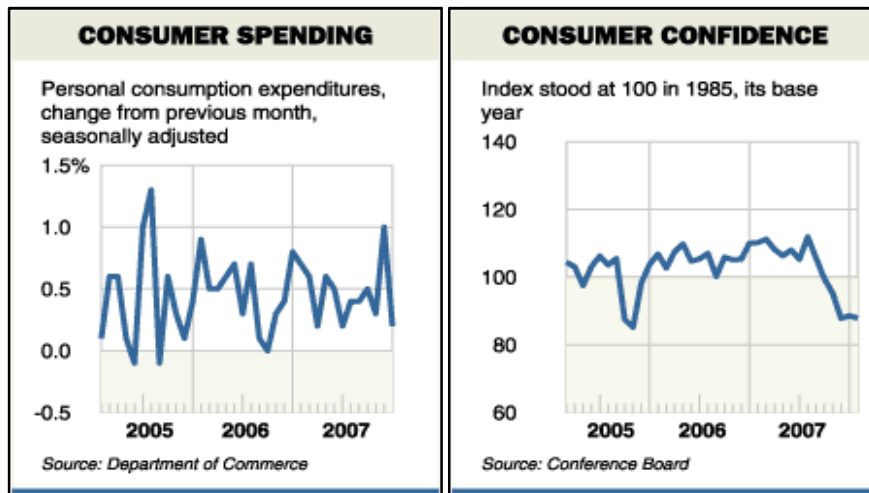
In December, the top four passenger cars sold in the U.S. were built by Asian auto companies. The Toyota Camry was once again the top-selling car with 473,000 units sold in 2007. The table below indicates that the American consumer has a neverending thirst for the Honda Accord, Toyota Camry, Nissan Altima, and Hyundai Sonata. The irony is that these cars are built in Marysville Ohio (26 years), Georgetown Kentucky (20 years), Smyrna Tennessee (23 years), and Montgomery Alabama (3 years).

A major factor in the Big Three's falling market share is their intent to reduce fleet sales to car rental companies. Not only is this a low margin business, it will eventually flood the used car market with specific models and hurt their resale value.

Market Share of U.S. Car Sales

		<u>2007</u>	<u>2006</u>
GM	↓	8.6%	9.2%
Ford	↓	4.7%	6.1%
Chrysler	↓	3.3%	3.0%
Toyota	↑	9.4%	8.8%
Honda	↑	5.5%	5.1%
Nissan	↑	3.9%	3.3%
Hyundai	↑	2.9%	2.8%

The following graphs are examples of our slowing economy, including consumer activity, the housing market, and GDP growth. Each graph paints an economy that is experiencing a tremendous slowdown.



(Courtesy of the Wall Street Journal website)

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