

# BROOKMONT CAPITAL MANAGEMENT

## “A BUGG’S LIFE”

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### Moving on....

The past year was stressful for investors as volatility returned with a vengeance. The Dow Jones saw more than twenty-five trading sessions where the market advanced or declined by more than 200 points. Based on the first trading days in 2008, it appears that will continue in the New Year.

Contrast that to 2005 and 2006, when the Dow Jones only saw daily swings of 200+ points on one and four days respectively. The sudden volatility in stock prices can be summed up in one word: uncertainty. The deterioration in the sub-prime mortgage industry brought the housing market crashing down, billions in write-downs by financial companies, negative earnings growth during the past six months, and the fear that the U.S. economy will slip into a recession. This new uncertainty not only brings investor fear, it also leads to rotation out of specific asset classes and individual investments.

In 2007, it meant that stocks underperformed long-term bonds and gold, as well as a rotation out of value and into growth stocks. It was actually a text book lesson in market cycles. Investors sought safety in Treasury bonds, an inflation hedge with gold, and liquidation out of economically sensitive stocks and into stocks that demonstrate consistent earnings growth.

In the end, the fact that stock prices did not collapse under the weight of several negative market drivers should be viewed with guarded optimism. While we are far from being out of the woods regarding sub-prime mortgages, Wall Street is coping with the problem on a daily basis. Several individual sectors were able to post significant gains during the year. Rising prices for crude oil and the decline in the U.S. dollar pushed shares in the energy and materials sectors higher, and the tech sector rose as earnings growth remained healthy in 2007.

That does not mean that certain areas of the market did not perform poorly in 2007. The chart on page two indicates that financial and consumer durables stocks posted double digit losses during the year. This should come as no surprise as the sub-prime meltdown impacted the entire finance sector, and subsequently impacted consumer spending on new housing, autos, retail apparel, and housing related



items. These four industries comprise the bulk of the consumer durables sector.

But all in all, the market advance in 2007 was extremely wide in respect to sector participation. Referring to the table on page two, sectors within the S&P 500 performed very well during the year. The obvious exception was the finance sector. Since it carries the largest weight in the Index, its 21% decline masked an otherwise good year in the stock market.

Looking into 2008, we would expect to see continued pressure on finance stocks during the first part of the year as banks continue to write-down their loan portfolios. Consumer durables will also be a story for the second half of the year as growth in consumer spending remains weak. Stocks in the energy and materials sectors will not have the benefit of a strong wind at their backs (energy prices and the falling U.S. dollar should reverse course), and investors will begin to take profits as these two sectors run out of steam.

### Labor Market Blues

The economy ended 2007 with a thud as employment growth was well below expectations. The December job report demonstrated weakness in factory jobs, real estate, and the finance industry. The unemployment rate hit 5% for the first time in more than two years, and the gain of only 18,000 jobs in December was the weakest monthly performance in more than four years.

December's employment report indicated further weakness in the U.S. economy and the risk of a recession in 2008 has increased. Higher energy prices,

higher mortgage payments, and lower job growth do not paint a nice picture for consumer spending growth. As the consumer represents 2/3 of the U.S. economy, the Fed has no choice but to take this economic risk into consideration...even if inflation starts to rise.

And what about inflation? It should come as no surprise that the price for crude oil has risen 79% over the past year, or that natural gas prices are up 29%, and that the price of gold has jumped 39% (due to global credit concerns, declining U.S. dollar, and inflation fears). But other consumer products are witnessing escalating prices: dairy prices were up 27% in 2007, hospital services rose 8%, tobacco prices jumped 9%, airline fares rose 10%, and health insurance premiums were 10% higher. With inflation inching towards 5% year-over-year, the Fed does not have the luxury of cutting interest rates much further. If the Fed goes too far, the consequences could include higher consumer prices and continued declines in the U.S. dollar.

That said, the Federal Reserve will continue to lower short-term interest rates at its next meeting on January 29-30. We expect the Fed to cut by 50 basis points.

## Corporate Earnings Growth

The primary driver behind stocks prices is the outlook for growth in corporate earnings. Between 2003 and mid-2007, U.S. companies posted double-digit earnings growth during twelve consecutive quarters. It was only a matter of time until that pattern came to an end, and the streak was broken during the 3<sup>rd</sup> quarter of 2007.

Investors will suffer through another dismal round of earnings announcements that get underway this week. Earnings estimates have significantly declined over the past three

months as warnings from the financial sector have become a daily event. On October 1, analysts were predicting a 12% growth rate for fourth quarter earnings. Three months later, fourth quarter estimates have dropped to an expected 11.5% decline in year-over-year earnings growth.

This significant drop in corporate earnings growth is coming almost entirely from the finance sector. According to Thomson Financial, during the past three months, analysts have lowered their fourth quarter estimates for this sector by \$33 billion. If the financial sector was excluded from calculations, the S&P 500 would see an 11.5% earnings growth during the fourth quarter.

On the other end of the spectrum, the technology sector is expected to post a 22% earnings growth rate as year-over-year comparisons are easy to beat. You may recall that Microsoft's Vista operating system was delayed until 2007 and consumers waited to buy new computer hardware. The tech sector better enjoy it while it lasts. The next round of earnings announcements will be face more difficult comparisons.

The strong fourth quarter earnings growth that is expected from the tech sector is just one example of how year-over-year comparisons can be very misleading. The finance sector is expected to see earnings growth drop by 66% during the fourth quarter of 2007, making comparisons easy to beat during the last three months of 2008.

To smooth out these anomalies, comparing earnings growth based on the preceding quarter (and not year-over-year) offers a more realistic snapshot of the

### S&P 500 Sector Returns

<u>Sector</u>	<u>December</u>	<u>4Q2007</u>	<u>2007</u>	<u>2008</u> <u>(as of 1/16)</u>
Energy	7.28%	4.07%	32.38%	-9.21%
Materials	0.87%	-0.44%	19.98%	-6.69%
Industrials	-0.87%	-5.12%	9.83%	-7.94%
Consumer Discretionary	-4.95%	-10.49%	-14.32%	-8.06%
Consumer Staples	-1.25%	3.26%	11.60%	-3.02%
Health Care	-3.10%	-0.46%	5.39%	1.98%
Financials	-5.73%	-15.04%	-20.84%	-6.82%
Information Technology	1.48%	-0.08%	15.54%	-11.30%
Telecommunications	3.08%	-5.79%	8.45%	-7.78%
Utilities	0.04%	6.76%	15.81%	-0.75%
<b>S&amp;P 500</b>	<b>-0.69%</b>	<b>-3.33%</b>	<b>5.49%</b>	<b>-6.40%</b>

economy. For example, earnings growth in the third quarter of 2007 declined 5.1% when compared to the third quarter of 2006. However, when third quarter earnings are compared to the second quarter of 2007, corporate earnings actually declined by 13%. The same mathematical illusion will occur during the fourth quarter of 2008. Currently, analysts are predicting 4Q2008 earnings to grow by 38% (based on year-over-year). However, when expected 4Q2008 earnings are compared against the third quarter of 2008, the growth rate drops below 5%.

Important earnings reports for the rest of the week include Merrill Lynch, PNC Bank, General Electric, and AMD Devices. Next week, earnings reports are due from Bank of America, Johnson and Johnson, Wachovia, eBay, Pfizer, AT&T, and Microsoft. With the markets closed on Monday, it will be a busy four-day week of trading activity.

## Market Sector Weights

In the past, I have addressed how individual sector weightings in the S&P 500 Index will fluctuate over time. In the short-run, sector weightings will move higher or lower due to the business cycle or Wall Street's love affair with a sector at any given time (think technology stocks in 1999). Over the long-run, sectors will see their Index weighting move in a certain direction as it becomes more (or less) important in the U.S. economy (for example, the downward trend in the material sector weighting as manufacturing moved offshore).

Whatever the reason, the trend in sector weighting is important as you manage your investment performance. In retrospect, the weighting in the technology sector rose from 6% to 29% during the 1990's, and this should have been a major "sell" signal at the time. Likewise, unless you believe the America consumer is going to hibernate in a cave for the next two years, the drop in the weighting of consumer discretion stocks should signal potential buying opportunities. This sector has been hit with the fallout in the housing sector

### Index Returns as of Dec. 30, 2007

	<u>4th Qtr</u>	<u>2007</u>	<u>3 Yr</u>
S&P 500	-3.32%	5.49%	8.62%
S&P Mid-Cap	-2.73%	7.97%	10.27%
S&P Small-Cap	-6.45%	-0.30%	7.32%
NASDAQ	-1.82%	9.81%	8.80%
Dow Jones	-3.91%	8.83%	7.20%
S&P REIT	-13.37%	-16.80%	7.85%
EAFE (World)	-1.91%	8.60%	14.10%

and the problems that persist in the auto industry. Companies like Home Depot, Carnival, Whirlpool, and Harley Davidson have been hit hard during the past twelve months and are potential rebounds when the economy turns around.

Unlike sector weightings, the largest companies in the S&P 500 have not changed that much over the years. The following ten companies ended 2007 with the largest market capitalization in the S&P 500: ExxonMobil (4% of the total index), General Electric (2.9%), Microsoft (2.5%), AT&T (2%), Proctor and Gamble (1.7%), Google (1.6%), Chevron (1.5%), Johnson and Johnson (1.4%), Wal-Mart (1.4%) and Bank of America (1.4%).

There is a significant disconnect between which companies are the most valued by Wall Street and those that make the top 10 on Fortune's 500. While a stock's weighting in the S&P 500 is a reflection of how Wall Street values a certain company, the Fortune 500 is strictly based on annual revenues

For example, while Microsoft is the third largest weighting in the S&P 500, Fortune lists the company at #49. Likewise, Fortune lists Johnson and Johnson at #36 and AT&T at #27.

### Historic S&P 500 Sector Weightings

	<u>1990</u>	<u>1995</u>	<u>1999</u>	<u>2006</u>	<u>2007</u>
Financials	8%	13%	13%	22%	18%
Technology	6%	9%	29%	15%	17%
Health Care	10%	11%	9%	12%	12%
Industrials	14%	13%	10%	11%	11%
Consumer Discretion	13%	13%	13%	11%	9%
Energy	13%	9%	6%	10%	13%
Consumer Staple	14%	13%	7%	9%	10%
Utilities	6%	5%	2%	4%	4%
Telecom	9%	9%	8%	4%	4%
Materials	7%	6%	3%	3%	3%

On the other hand, Fortune lists General Motors at #3 and Ford at #7. In terms of true market value, Ford and GM are far down the list as each company only represents 0.11% of the S&P 500. Their respective market value puts them behind Staples, Avon, Starbucks, and Xerox. In fact, Google is now valued nearly sixteen times higher than the world’s largest auto manufacturer.

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## Economic Update

- ❖ Wholesale price inflation was up 6.3% in 2007, the highest rate in 26 years (energy prices are to blame)
- ❖ Retail sales were down 0.4% in December (energy prices are to blame)
- ❖ Unemployment stands at 5%, the highest jobless rate in two years
- ❖ Economists are predicted GDP growth at 0.9% for the fourth quarter of 2007; 1.4% for the first half of 2008
- ❖ WSJ economist poll sees 42% risk of a recession
- ❖ The same poll forecasts a decline in the inflation rate in 2008 as crude oil drops to \$78/barrel
- ❖ Housing starts will decline even further in 2008
- ❖ Though Toyota and GM’s stock prices have both fallen 24% in the past year, Toyota’s market cap is slightly above \$160 billion. This compares to a \$12 billion market cap for GM.

**Sticker Shock** – according to the College Board, a newborn attending Southern Methodist University 18 years in the future will need \$497,777 (assuming he finishes in four years) to get his degree. Add a fifth year and it jumps to \$641,000. Should this newborn decide on the University of Texas in Austin, the bill drops to \$195,000...or basically the current average price of a home in the U.S.

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## Introducing the Brookmont Capital Dividend Equity Strategy

Brookmont Capital offers customized investment portfolios for individuals, families, tax-exempt organizations, and corporations. Portfolio construction begins with each client’s specific goals and objectives, time horizon, tax strategy, and risk tolerance. A confidential client profile is developed to determine a proper asset allocation mix that may include equities (individual stocks and Electronic Traded Funds), fixed income (individual bonds, taxable or tax-free), real estate (Real Estate Investment Trusts), and short-term holdings.

The core holding in our equity portfolio is the **Brookmont Capital Dividend Equity Strategy**. The Strategy includes a list of 40 individual stocks that are dispersed among the ten sectors of the S&P 500. The holdings within the Strategy are equally-weighted and are rebalanced on a regular basis.

Foreign companies comprise 20% of the Strategy’s holdings, including GlaxoSmithKline, Royal Dutch, and Diageo. Although there are no market cap restrictions, the Strategy has a strong emphasis on large and mid-cap stocks. As well, the Strategy is not tied to a certain style, but will naturally gravitate towards value and “core stocks. Turnover in the portfolio is low as we view our stocks as long-term holdings. This allows us to keep trading costs low and invest in a tax-efficient manner.

The Strategy keeps a conservative posture with a standard deviation (volatility) that is below the S&P 500. With an average dividend yield that is close to 4%, the Strategy provides a high stream of current income with the possibility of earnings capital gains (which you might need someday to pay for SMU).

Although the Strategy carries a “market-weighting” in Finance stocks, our holdings have held up well over the past three months. U.S. Bank has dropped by 5% during the past 90 days, PNC Bank is down 11%, and JP Morgan is off by 14%. These returns compare favorably to other Finance stocks that are not in our portfolios: Citigroup (-41%), Wachovia (-36%), Morgan Stanley (-28%), Wells Fargo and Bank of America (both down 26%).

Keep in mind that the Strategy is not a mutual fund. As a client, you have direct ownership in each security, which allows full transparency and portability. It also allows year-end tax planning if your CPA recommends realized gains or losses. We have back tested the portfolio and the performance results verified our enthusiasm with the Strategy. These results are available upon request. More information about the Strategy is outlined on the following page.

# Brookmont Capital Management Dividend Equity Strategy

## Strategy Characteristics

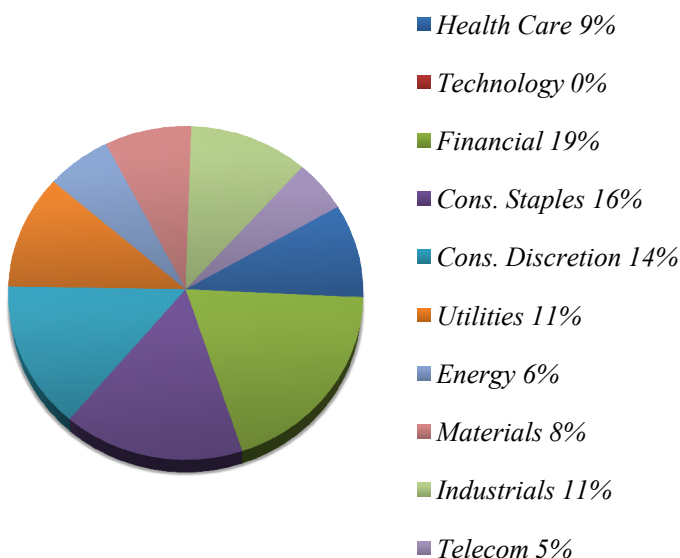
	<u>Strategy</u>	<u>S&amp;P 500</u>
Dividend Yield	3.75%	1.80%
Beta	.81	1.00
P/E Ratio	14x	16x
Average S&P Rating	B+	B
Exp. Earnings Growth	20%	7%
Return on Equity	21%	17%
Investment Style	Value/Core	Core
Market Cap. Average	\$58 billion	\$110 billion
Number of Holdings	40	-

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.

The holdings are small through large-capitalization stocks and may be domestic or foreign domiciled. The Strategy includes value, core, and growth style securities.

The Dividend Equity Strategy is benchmarked against the Dow Jones Dividend Select Index, S&P 500, and Lipper Income Median.

## Sector Allocation %



## Representative Holdings

Abbott Labs  
AT&T  
Chevron  
U.S. Bank  
GlaxoSmithKline  
General Motors  
Johnson and Johnson  
Southern Company  
Kellogg  
J.P. Morgan  
National Fuel Gas

The information above is for illustration purposes only and is not for solicitation or marketing purposes.

## Attacking Short-Term Economic Weakness

More than once this week, we’ve been asked what options are available to pull our economy through the current slowdown (and possible recession). To answer this question, we turn to a report from the Congressional Budget Office (CBO) that was released this week. Their focus was to determine which stimulus would provide the largest boost to the economy, while not busting the federal budget.

In determining the effectiveness of each economic stimulus, the CBO stressed that proper timing was a critical ingredient. During the recessions of the 1970’s, efforts to boost the U.S. economy were always too late to be effective. That changed during the recessions in 1992 and 2001 as efforts to revive the economy were perfectly timed. The CBO also stressed that any stimulus to the economy had to be directed towards domestic goods and services; otherwise any effort to boost the economy is simply exported to foreign countries.

The CBO report determined that direct transfer payments to households in the way of increased or lengthened unemployment benefits, as well as temporarily increasing food stamp benefits, were the most cost-effective available stimulus that also provided immediate results and the least uncertainty. Increasing public works spending failed to provide much stimulus and the associated costs can be very large. Lump sum tax rebates are generally cost-effective and provide stimulus to the economy in a few months, but are only effective when directed at taxpayers who will spend it. Across-the-board tax cuts provide little stimulus in combating short-term economic weakness as the wealthy receive the bulk of the benefits and are more apt to save, rather than spend, the windfall.

Keep in mind that this report focused on available options to combat short-term economic weakness, not on establishing sound fiscal policies for long-term growth.

Robert Bugg, CFA

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### DISCLOSURE

The articles and opinions in this publication are for general information only, are subject to change, and are not intended to provide specific investment, legal, tax or other advice or recommendations for any individual. We suggest that you consult your attorney, accountant, tax or financial advisor with regard to your individual situation. Although information has been obtained from sources Brookmont believes to be reliable, we do not guarantee its accuracy and it may be incomplete or condensed. Brookmont is not liable for any typographical errors or incorrect data obtained from reliable sources of factual information.

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