



Brookmont Capital Management “A Bugg’s Life”

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Update on the Brookmont Dividend Equity Strategy

The Dividend Equity Strategy continued to perform during a very difficult market environment. Our core portfolio rose 3.05% in August, compared to a 1.45% return for the S&P 500 and a 1.70% return for the Russell 1000 Value index. The Strategy’s performance was widespread as it outperformed the S&P 500 in eight of the ten economic sectors.

	<u>September</u>	<u>YTD</u>
Brookmont Dividend Equity	1.22%	0.80%
Russell 1000 Value	-1.67%	-13.88%
S&P 500	-2.52%	-13.63%
Dow Jones Industrials	-0.81%	-13.88%
Nasdaq	-4.21%	-14.91%
S&P 400 Mid-Cap	-4.41%	-9.15%
S&P 600 Small-Cap	-1.78%	-3.72%
EAFE (International)	-7.21%	-26.44%
As of Sept. 12		

A similar story is unfolding in the first eleven days of September. Market volatility has ramped up and stock prices are witnessing unfounded daily swings. Through September 12, the Dividend Income Strategy is up 1.22% for the month and 0.80% year-to-date. In comparison, the S&P 500 has posted a - 2.52% return for the month and is down 13.63% for the year. The Russell 1000 Value is down 1.67% for the month and 13.88% year-to-date. The Strategy is outperforming the S&P 500 in nine of the ten Index sectors.

The markets were able to rally in August as oil prices and inflation fears came back to earth and the U.S. dollar came back to life. Except for the shoe that was dropped by Fannie Mae and Freddie Mac, the month did not bring much bad news from individual companies. Perhaps the country’s focus on the Olympics, the start of college football, hurricanes in the Gulf, and Party Conventions were all a much needed diversion for investors. However, investors are now refocused on Wall Street and volatility in the stock market has returned.

Though it may seem hard to believe, the investment landscape has improved during the past few weeks. Before you roll your eyes at me, I am not naïve enough to think that it is clear sailing from here. Our attention is just now turning toward the November elections and consumers are still feeling the pressure from higher prices and stagnant wage growth. Unemployment will continue to be an issue for the economy and finance-related companies are still facing a troubled future. On the other hand, the economy has survived a tremendous run-up in oil prices, the fallout from subprime loans, plus declining home values and has not gone into the tank.

It is times like this when investors must be disciplined and have a long-term point of view. The markets are forward looking and what happens today is not as important as what might happen 12 months from now. We may not have seen the last from these market risks, but I am confident that we have seen the worst from them. This is what market rallies are made of and the beginning of the recovery is getting closer.

Here is why I believe the recovery should happen sooner rather than later. Lower energy and commodity prices will eventually boost consumer confidence and spending. Lower prices will also translate into contained inflation, which will be a boost to the economy and the stock market. As well, the Federal Reserve will have less incentive to raise short-term interest rates as inflation fears dissipate. The U.S. dollar will find a trading range that will bring comfort to investors without causing too much damage to U.S. exports. The

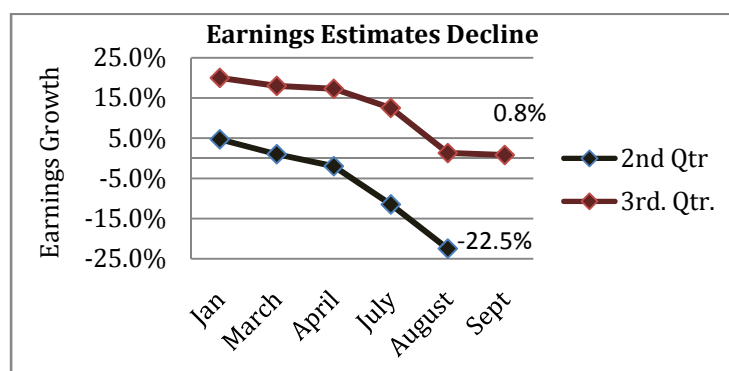
housing market will find a bottom in 2009 as home prices become affordable. The new U.S. President will do anything he can to boost the economy and stabilize Fannie Mae and Freddie Mac, which in turn adds liquidity to the housing market. Eventually, unemployment will overshoot to the upside and companies will begin to hire once again.

All bets are off if oil prices return to \$150/barrel. Energy prices not only impact consumer spending and corporate profits, they also have a tremendous impact on consumer confidence.

Earnings Update

The final report card is in for the second quarter and earnings fell 22% on a year-over-year basis. The Financial sector took a beating with earnings falling 93%, followed by the Consumer Discretionary sector with a 56% decline in quarterly earnings. Pacing the market was the Energy (+18%), Staples (+15%), and Technology (+14%) sectors. If the Financial sector is removed from consideration, the rest of the market posted an actual 5% increase in quarterly earnings.

But perhaps we have seen the worst in corporate earnings as well. Increased consumer spending and lower input costs can only mean that corporate earnings are bound to recover, even if it means waiting until 2009. Looking at expected third quarter earnings, analysts are still predicting a slight increase in year-over-year corporate profits. The Financial sector will report another three months of dismal results with earnings falling 54% compared to the third-quarter of 2007. The Energy sector will lead the markets once again with earnings jumping 60% during the quarter. The law of averages should start to kick in during the fourth quarter as earnings growth improves for financials and declines for energy companies. This might explain why energy companies have had a rough quarter in the markets while the Finance sector defies current logic and is moving higher.



Keep in mind earnings expectations come with a major caveat. Analysts have demonstrated a poor ability to forecast quarterly earnings, even when the quarter has come to an end. For example, the line graph demonstrates analyst estimates for the second and third quarters of 2008. At the beginning of the year, second quarter earnings growth was forecasted to be around 5%. When second quarter announcements came to an end, earnings had actually fallen 22% year-over-year. Comparably, third-quarter estimates have fallen from 20% at the beginning of the year to just above 0% as of today. With another month left in the quarter, and another seven weeks of earnings announcements to follow, we should expect third-quarter earnings growth to turn negative before it's over. If that should happen, it would mark five consecutive quarters (15 months) of negative earnings growth.

Sector Returns

Sector returns in September paint a very interesting picture. The Energy sector continues to sell-off and is down nearly 23% since the beginning of July. Technology is showing recent weakness as investors have become concerned about the outlook for third and fourth quarter earnings. During the past thirty days, the

decline in the Technology sector has been driven primarily by hardware companies, including Apple (-12%), Intel (-17%), Taiwan Semiconductor (-18%), and Dell (-23%).

S&P Sector	September	Since July 1	YTD
Energy	-9.34%	-22.68%	-16.40%
Materials	-6.87%	-13.26%	-13.09%
Industrials	-2.68%	0.69%	-14.00%
Consumer Discretionary	2.14%	9.77%	-5.44%
Consumer Staples	3.83%	9.90%	0.52%
Health Care	-1.01%	5.68%	-8.55%
Financials	0.03%	5.43%	-27.14%
Technology	-6.12%	-5.44%	-18.14%
Telecom	-2.75%	-6.14%	-23.88%
Utilities	-4.85%	-12.47%	-16.27%
S&P 500	-2.52%	-1.94%	-13.63%

On the other hand, history prevails as the Consumer Staples sector is outperforming the rest of the market. Typically, companies within this sector will outperform during economic weakness as consumers avoid buying apparel and major items but continue to buy food and household products. Recent leaders in the Staples sector include Pepsi, Proctor and Gamble, Diageo, Kellogg, and Hershey. Until we see a pick-up in economic growth, we should expect this trend to continue.

International Falls off a Cliff

If you think U.S. investors have had to deal with a difficult market these past 18 months, then you might find comfort in knowing that foreign investors have endured losses that are much greater than our own. The EAFE Index (Europe, Australia, and Far East) has dropped more than 7% during the month as fears over lower global economic growth have taken its toll. Investor confidence in Asia has collapsed as mainland China has seen a marked slowdown in economic activity and Asian companies, such as Hitachi and Toyota, have announced cuts in production levels as they re-adjust to a weaker global economy.

	September	YTD
China	-6.6%	-60.6%
Japan	-6.3%	-20.2%
Hong Kong	-7.1%	-29.4%
Russia	-15.2%	-43.8%
Brazil	-6.8%	-19.7%
Argentina	-8.2%	-25.1%
Europe	-3.6%	-24.4%

Investors once thought that the rest of the world might escape the slowing U.S. economy and the meltdown in the financial sector. But as we have seen, our trading partners depend on the U.S. consumer and stability in the currency markets. As well, foreign banks are not immune to the debacle in sub-prime mortgages and loan defaults. European banks have also been hit with the fallout in Auction Rate Securities and were forced to spend billions in capital to buy them back.

Consumers, Employment, and the Fed

Back in December we predicted that any recession in 2008 would hurt consumers more than it would investors or U.S. companies. By and large that has turned out to be the case. Over the past twelve months, the markets have fallen between 5-11% (depending on the Index), which is much better than the 20% decline that is normally seen during a recession. U.S. companies (except Financial-related, home builders, and automotive companies) have held up fairly well as a lower dollar has spurred international sales and profits. Consumers, however, are a different story. They have been hit by rising energy prices, higher food prices, falling home values, and stricter qualifications for new credit.

Consumers have also been hit with rising unemployment. More than 84,000 jobs were lost in August, which would bring the number of jobs that have been lost in 2008 to 550,000. While it is true that higher unemployment numbers impact consumer purchases and subsequently corporate revenues, a reduced workforce will help companies lower their cost structure. As a result, the impact from lower sales revenue will be minimized and the corporation's net income will be stabilized. Unfortunately, many companies either cut too much and customer service is sacrificed, or they cut their work staff over and over and still cut some more (i.e., Ford Motor).

One thing is for certain, the weak August labor report will keep the Federal Reserve on the sidelines for the next several months. What was ignored by the markets was that the labor report also indicated lower labor costs and higher productivity. Even if oil prices were to reverse course and move higher, the Fed is going to be more worried about employment and economic growth than it is about inflation. The fact that productivity is rising and labor costs are falling, inflation will become less of an issue as time goes by.

Politics

I am going to tread lightly on this subject. Both parties should be very happy with the performances by their respective President and Vice-President nominees during the recent Conventions. It will be a very tight race up until Election Day with four or five states deciding the outcome. Look for the candidates to spend much of their time in Florida, Ohio, Michigan, Virginia, and Pennsylvania. While other states such as Colorado, Nevada, and New Mexico are up for grabs, the election is all about Electoral College votes and when combined, those three toss-up states still have fewer votes than Michigan.

Whoever is elected in November will have to face the reality of escalating Federal budget deficits. Earlier this week, the non-partisan Congressional Budget Office released its updated outlook for the next ten years and the report is sobering. The CBO expects the budget deficit to increase from \$161 billion last year to \$407 billion this year. The report blames a 15% reduction in corporate tax receipts, the recent tax rebate checks, and the government's efforts to cover FDIC deposits from failed banks. The CBO's numbers, however, do not include the bailout of Fannie Mae or Freddie Mac. Those will be added in January.

For the next ten years, the CBO has changed its outlook from a cumulative \$300 billion budget surplus to a cumulative \$2.3 trillion deficit. Revised economic conditions and approved spending for Iraq and Afghanistan are to blame for the new estimates. These estimates do not include extending the 2001 and 2003 tax cuts, or raising the annual threshold for the Alternative Minimum Tax. That would bring the expected budget deficit over the next ten years to \$7 trillion (CNNMoney).

We cannot continue bailing out foreign countries, failed banks, misguided mortgage companies, badly managed Wall Street firms, and greedy buyers of sub-prime mortgages while local school districts go broke, student loans dry up, and tuition prices skyrocket. Today, our country is a safety net for the entire world but fails to invest in its own future.

It seems like I watched too much of the Party Conventions myself...

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