



## Quarterly Commentary: January 2, 2007

Happy New Year! 2006 proved to be a good year for the markets despite the headlines detailing geopolitical threats, a slowing economy and a weakening housing market. This “wall of worry” helps to keep expectations low and presents great opportunity for long-term investors. A year ago many market prognosticators were decidedly pessimistic while we remained bullish. We maintain our level of optimism, but are a bit concerned by the near-consensus opinion that 2007 will again be a very good year in the markets. However, since the market has proven that it is anything but predictable, we focus on the fundamentals of our investment philosophy, many of which have been validated this past year, and as we outline below, we see no reason why this will not continue to result in positive returns for your portfolios.

We believe that our focus on large-cap, global, dividend-paying securities is a theme that is in the early stages of a multi-year opportunity. Large-cap stocks as measured by the S&P 500 returned 13.6% for the year and 15.8% including dividends. Over the past nine months large cap stocks significantly outperformed small cap stocks and they continue to trade at the cheapest valuations in decades. Dividend-paying stocks continue to outperform as well. With corporate balance sheets holding record levels of cash and dividend payout ratios at decade-low levels, we look for dividend increases to accelerate. Finally, our focus on global businesses positions us well to benefit from the increased global wealth that is being created as populations in eastern Europe, China and India become full participants in the global economy emerging in the 21<sup>st</sup> century.

The American economy – and by extension, the American consumer – has typically been seen as the engine of global growth. But the world is changing; the economic growth that is happening today is coming from consumers across the globe, and not just from the United States. In the past, the global economy followed the lead of the American economy. No more. Our fortunes are now more tied to other economies, and this convergence should continue for the foreseeable future. Globalization is a powerful and irreversible trend. As global wealth increases, consumers demand more goods and services from companies like Coca-Cola, American Express and McDonalds. This is a significant reason why the recent growth in profits will last longer, and be stronger, than most people expect.

While a strengthening global economy will benefit our portfolio holdings, indicators continue to suggest that the U.S. economy is slowing. Despite this slowing, the Dow Jones Industrial Average recently hit a new all-time high. Naturally, the recent market strength raises questions about how long it can last. The last time the DJIA touched these levels, valuations were far higher and business fundamentals were far weaker. In other words, the market may be hitting new highs, but this time it’s doing so for good reason. And there are still some powerful ingredients for higher valuations. Long-term interest rates are low, inflation expectations are coming back down, and low tax rates still prevail. As a result, global capital liquidity remains very high. Private equity firms alone raised \$170 billion in 2006; assuming 4:1 leverage, that effort implies \$680 billion available for investment. Thus, it’s no wonder that even large



companies like Home Depot are rumored to be takeover candidates. And while this surge in liquidity trend is not sustainable, we don't see it reversing course any time soon.

On a more fundamental basis, corporate returns on equity (ROE) have surged in the past few years, yet the price for acquiring that equity (as measured by Price-to-Book ratios) has not kept pace. As a result, we don't have to stretch our assumptions too much to see the market trading at 18x earnings instead of its current 15x. Just doing some basic math, placing an 18x multiple on a reasonable 2007 earnings estimate for the S&P 500 (\$93 per share) suggests an 18% market gain for next year. So while a mild profit slowdown may occur it should be more than offset by multiple expansion.

Interestingly, an economic slowdown also supports our current stance on technology stocks. As growth slows, businesses large and small invest more in productivity-enhancing products. These companies need technology to stay productive and profitable as their revenues moderate. At the same time, corporate managers need to have confidence that the global economy will stay strong in order to support these investments. We are just beginning to see this dynamic play out, as software, hardware and other technology investments are getting more attention from corporate buyers. Meanwhile, valuations in the sector remain relatively depressed, creating good opportunity for us as investors.

In our letter to you last quarter, we described part of our rationale for investing in dividend-paying securities. Most importantly, dividends and dividend growth are a significant part of the long-term total return of an equity security. But there are other reasons of note. First, dividends provide a buffer should an economic slowdown translate into lower capital returns. They reduce volatility in your portfolios, because they tend to be fairly stable; management teams are loathe to cut their dividend. Dividends are also not directly affected by market fluctuations. In fact, if a stock price declines, the resulting increase in dividend yield attracts more buyers, thus moderating the downside move. Finally, a dividend payment is a signal that management believes its earnings will be strong and persistent over time – a sign it has confidence in the long-term growth of its business despite changes in the economic environment.

On the surface, it seems straightforward to find dividend-paying companies. However, we evaluate a company's ability to pay and increase its dividend by analyzing its sources of cash flow. Some companies in decline pay large dividends because they cannot find good growth opportunities in which to invest. The ones we're attracted to, on the other hand, are growing companies that are also experts at allocating shareholder capital. These management teams invest their profits back into their businesses but also return some of these profits to you, the owner. Having a clear understanding of a firm's underlying cash flow makes it much easier to predict the sustainability and growth of its dividends.

We have found that success in investing requires that we be as disciplined about our decisions to sell as we are about our decisions to buy. Our sales are designed to eliminate a security whose stock market valuation exceeds what is warranted by business fundamentals, and we will sell partial interests in our holdings to avoid imprudent concentrations in individual positions. When



reason and an analysis of the facts demand it, we will not hesitate to sell even our best-performing stocks.

We have profited from substantial ownership of selected REIT shares over the past several years. The REITs in your portfolios have stood out for their competitive positioning, seasoned management teams and capital strength. Further, we have benefited from the fact that our REITs have generally enjoyed increasing occupancy and lease rates. On the other hand, REITs that could be purchased at 10-12x earnings and with 5.5% dividends in 2003 now command 16-18x earnings multiples and provide 3.5% dividend yields. We have been exercising our sell discipline and trimming positions where appropriate.

As a reminder for those of you with taxable accounts, we will be mailing out copies of Realized Gain/Loss reports in February to correspond with your 1099 reports being mailed to you from Charles Schwab.

Included with this commentary are your quarterly performance figures, management fee invoice(s), and a copy of your portfolio allocation as of 12/29/06. You are welcome to visit us online and access your account(s) at [www.golubgroup.com](http://www.golubgroup.com). Please contact us to establish a login and password if you do not already have one.

We wish you a safe, happy and prosperous New Year!

Warm regards,

The Golub Group

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