THE Equity View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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Market Meltdown Creates Opportunities in "Recession-Resistant" Equities

Q: Are we going into recession?
A: We're not sure, but after close to a 17% drop in the S&P 500 over the last month, it's clear to us that the market is now increasingly pricing in one. According to our colleagues on RiverFront's Investment Strategy team, the market started pricing in a likelihood of recession around the 1150 level on the S&P 500. At current levels, US large-cap stocks are approximately 30% below their 150-year price trend on RiverFront's Price Matters℠ framework, a condition that has historically produced excellent entry points for investors who have longer than a 12-month investment window. (Past performance is no guarantee of future results.)

Could the market go lower? In the near term, absolutely. While markets are generally "slow to overreact," once panic mode sets in, things can fall farther and faster than rational thought would otherwise suggest. However, investing is a probability game, and at current levels, we believe probabilities are in patient investors' favor. The truth is, no one really knows for sure whether we're headed for recession at this stage. **Perhaps the more useful question equity investors can be asking themselves is: which securities might already be pricing in recession-like earnings expectations?** We believe that the probability of success will be highest if one bets on the equities most likely to make it through a recession and still demonstrate some level of growth and margin stability. We call these "fire-resistant stocks"; acting like a Nomex suit for firefighters, they can provide crucial protection in dangerous situations. While these stocks can reside in several different industries, they generally have two or more of the following traits in common:

Fire-Resistant Factor #1: Solid Balance Sheets. In an economic dislocation, the first stocks that get sold are often those for which investors are forced to price in some risk of bankruptcy. Consequently, investors are starting to place a premium on balance sheets, after two straight years of not really caring about solvency risk.

Fire-Resistant Factor #2: Cheap Valuations. Armageddon won't necessarily affect a stock whose valuation is already pricing it in; market moves are related to expectations, not necessarily reality. Right now we are finding stocks of some US companies whose current valuations are implying growth rates well under historical levels, and under levels that they experienced during the last deep recession.

Fire-Resistant Factor #3: Dividend Growth. As long as dividends aren't cut (and 2008 was a great litmus test for a company's ability to pay a dividend in tough times), then the powerful compounding of reinvested dividends can create portfolio growth even when there isn't any in the markets. We also believe a long-term track record of paying and growing dividends speaks volumes about a company's stability of business model. *Dividends are not guaranteed and are subject to change or elimination.*

Fire-Resistant Factor #4: Low-Volatility. While large-cap low-volatility stocks generally have been out of favor up until recently, on a long-term basis we believe low-volatility stocks generally offer more attractive risk-adjusted returns than the average stock. In addition, we believe there's an "arbitrage" opportunity that exists as we think the average large-cap manager tends to be more focused on shorter-term absolute returns, versus longer-term risk-adjusted returns.

Image from www.textilescience.ca

Taking this analysis a step farther, we used a discounted cash flow tool to attempt to "back into" a company's expected earnings-per-share growth, which is implied by its current stock price. We compared that to analysts' growth expectations, the company's historical growth rate, and the company's earnings performance in the last deep recession (the first quarter of 2008 through the second quarter of 2009).

We were able to find stocks within our portfolio holdings with valuations that are currently pricing in lower future growth than they did during the last recession, a pretty pessimistic assumption, in our opinion. Not surprisingly, most of these companies also have strong balance sheets, and many tend to have lower volatility and/or pay healthy dividends as well, all in keeping with our "fire-resistant" stock theme. Our holdings that meet this criteria include the following:

Apple Inc (AAPL-NasdaqGS-$374.10)*	Dollar Tree (DLTR-NasdaqGS-$64.70)
Henry Schein (HSIC-NasdaqGS-$61.84)	Int'l Business Machines (IBM-N-$170.61)*
McDonalds (MCD-NYSE-$85.96)	Pfizer (PFE-N-$17.60)
PSS World Medical (PSSI-NasdaqGS-$23.01)	United Technologies (UTX-N-$71.57)

** Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.*

Ticker	Expected Long-term earnings growth rate implied by current price*	Operating earnings growth over recession period (Q1 08-Q209)	5-year average operating earnings growth	Beta* (52-week)	Current dividend yield	5-year average dividend growth
AAPL	**6%**	**16%**	66%	1.09	0.0%	N/A
DLTR	**11%**	**21%**	28%	0.29	0.0%	N/A
HSIC	**11%**	**14%**	15%	0.85	0.0%	N/A
IBM	**7%**	**19%**	17%	0.75	1.8%	26.3%
MCD	**10%**	**18%**	18%	0.44	3.0%	29.7%
PFE	**<0%**	**3%**	1%	0.82	4.8%	3.7%
PSSI	**10%**	**18%**	14%	0.87	0.0%	N/A
UTX	**7%**	**6%**	9%	1.13	2.8%	15.4%

Source: chart data courtesy of Intrinsic Research and FactSet Data Systems; "LT" implies 3-5 yr expected growth

**Implied growth rate calculated using Intrinsic Research's "Intrinsic Value" tool, consensus data as of 8/8/11*
** Beta measures a portfolio's volatility relative to a benchmark. A result greater than 1.0 implies that the portfolio is more volatile than the benchmark; a result less than 1.0 suggests that the portfolio is less volatile than the benchmark. Betas may change over time.*

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