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FEBRUARY 2010

Elisha Otis's "Plan B"

In 1852 Elisha Otis introduced the safety elevator – the first to prevent free fall if the cable broke. With what happened in the financial markets over the past few years, an elevator makes for relevant comparisons as we measure the ups and downs of what transpired. At Hamilton Point, we strive to limit portfolio losses by conducting research in-house, thereby controlling the quality and diversification of our investments. Our work shows that there are many "financial elevators" out there that we will not ride, but there are plenty of the Otis variety – operationally sound with opportunities for growth.

UP THE DOWN STAIRCASE

An investment question posed at times like these ought to be, "*how much must an investment portfolio appreciate in one period in order to regain losses from a prior period*?" Well, our first elevator analogy begins with two individuals on the 100th floor of a building. The first takes the elevator down 50% of the floors to the 50th floor while the second goes down 25% to the 75th floor. To return to where they started—on the 100th floor—the first must ride up 100% higher, while the second need only go 33% higher to get back to the 100th floor. Yes, it takes a 100% gain to offset a 50% loss, but just 33% to offset a 25% loss.

Moving from the elevator parallel to the investment world, you could compare the Dodge & Cox Balanced Fund to the Vanguard Wellington Fund, both of which have "balanced" investment objectives and were up handsomely in 2009. The Dodge & Cox Fund was up 28.4% in 2009 as compared to a 22.2% return with Wellington. An investor looking to 2009 performance alone might load up on Dodge & Cox without hesitation, but miss an important point about downside risk and returns. You see, Dodge & Cox was down 33.6% in 2008 while Wellington was off only 22.3%.[1] Someone who invested $1,000,000 in both funds at the start of 2008 would have just under $853,000 with Dodge & Cox at the end of 2009 versus nearly $950,000 at Vanguard[2]—presumably enough of a difference to purchase a darned nice elevator.

HOCK NOT

The moral here is to have a long-term perspective and do your best to limit investment losses during bad times while positioning for growth when markets turn positive. At Hamilton Point a number of proprietary decision-making criteria drive our portfolio decisions. One of the most important of these factors—and one that defines our investment fabric and historically helps us to limit large losses—is DEBT AVOIDANCE!

Recall that 70% of our Diversified Equity portfolio consists of shares in 35-40 companies that comprise our flagship Global Core Equity Buy List. If we are to invest client assets and take the risk of owning stock, we insist that those companies have a reasonable debt level—and in fact many Global Core stocks have gobs of cash on their balance sheets. Our objective is to invest in a diversified set of mostly unleveraged (leverage is another word for debt) future cash flows that produce sound "cash-on-cash" returns.

CONTINUED ON REVERSE >

If we make a poor investment decision (it happens), our losses should theoretically be relatively lower than if the investment was in a highly leveraged company. Other managers and Index funds that buy debt-ridden companies must be prepared to get wiped out with some investments or re-learn the elevator analogy and go looking for an astronomical gain to "catch up" again.

Incidentally, it seems that investors are more likely to steer clear of the biggest disasters related to bad business practices by avoiding companies with lots of debt. Borrowed money and fraud are often closely linked, and we honestly cannot remember an investment scandal at an organization with tons of cash—except maybe at the Federal Reserve (but that's another newsletter).

INSPECTING THE INSPECTORS

Please allow another metaphor which speaks to Wall Street and our financial regulatory system. Our society generally works well because of the monumental trust we all have in the "system." Elevators, which prominently display a comforting inspection certificate, are an example of the system giving us the confidence to ride without much concern. Hopefully those that inspect and certify elevators on behalf of the state and the Department of Labor take their responsibilities seriously when they oversee thousands of inspections annually.

We can report as well that these elevator experts report to an official "advisory board," which interestingly enough is comprised mostly of industry representatives (Otis, Thyssen and other elevator manufacturers). This system of checks, balances and certifications sounds a lot like our financial oversight arrangement where Moody's and S&P provide debt ratings (inspections) on financial products (elevators) manufactured by brokerages like Goldman Sachs, with guidance from government officials including the SEC, Federal Reserve, FINRA, Treasury and FDIC, who have advisory boards comprised of industry experts and alums from…you guessed it…the likes of Citigroup, Goldman Sachs, etc. All we can say is thank goodness the insiders that comprise and regulate Wall Street have nothing to do with elevator safety or we would all be taking the stairs or stuck somewhere.

To think that junk bond mortgage pools were packaged and resold as "AAA" rated makes one shudder (pun intended). Instead of fixing the system though, we have made most large Banks, Brokerages and Insurance companies essentially "affiliates" of the Federal Government—thus complicating an already bizarre set of incentives NOT necessarily designed to keep our financial system safe. We worry that the collective "confidence" in a system that was completely broken less than a year ago, may be a desperate attempt at creating a wealth effect which encourages consumer spending and improves (on paper) State, Federal and Bank balance sheets, without yet fixing the systemic problems facing our governments, banks and consumers.

GOING UP?

Our outlook is supported by our research and by what we learn from other truly independent sources like endowment managers—who generally share our concerns about too much government and private *debt,* but remain bullish on the highest quality multinational companies and emerging markets—neither of which are overly encumbered. Interestingly—and we are celebrating this—high-quality companies are generally priced far more reasonably now than their shoddy brethren and this gives us reason for selective optimism.

While future investment performance can never be guaranteed, at Hamilton Point we attempt to manage balanced portfolios in ways Elisha Otis probably would—with proper inspections and multiple financial safety cables like short term bonds, TIPs, Foreign Bonds, Gold, and mostly unleveraged global equity exposure… just in case we need to ride down a few floors again.

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Hamilton Point Investment Advisors is an independent and independent-minded, boutique investment advisory firm. Please contact us for a complimentary review of your portfolio. In addition, visitors to the firm's website, www.HamiltonPoint.com, can read past investment newsletters.

1. Source (tickers DODBX and VWELX): Morningstar, Inc., February 4, 2010.
2. For illustrative purposes only. Hamilton Point makes no recommendation regarding one fund or the other.

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