

## WEDGEWOOD VIEW. 3rd QUARTER 2005

### IN SEARCH OF PROFITS

In our previous client letter, entitled *In Search of Growth*, we examined how difficult it is for any company to maintain double-digit (much less +20%) growth, even over a period of a few consecutive years. In this 3<sup>rd</sup> quarter commentary, we will examine the profitability and growth of corporate America in the aggregate and what it may portend for the near future of profits, growth and stock prices. But before we delve in to this quarter's commentary, we would like to make another comment or two on last quarter's subject matter – the elusive matter of corporate growth.

Last quarter, we highlighted a study by Bernstein Investment Research and Management that analyzed the corporate growth of members of the S&P 500 Index (from 1991 to 2003). The highlights, if you recall, were that not a single company could consecutively grow earnings every year at a +25% rate for more than eight years. Furthermore, just a single company grew earnings by at least 10% every year during the time frame of the study.

Morningstar recently published a similar study entitled *Consistent Corporate Track Records Few and Far Between*. Similar to Bernstein's findings, Morningstar's study is once again illuminating (and sobering) for investors – particularly “growth” investors such as ourselves.

Morningstar's database of study contained 1,920 firms with sales history of at least ten years. Firms were filtered by maintaining *any* level of growth above zero on sales, earnings per share and free cash flow. Even Charles Darwin would have been surprised by the lack of survival of the fittest. By the end of year ten, only 16% of the original 1,920 firms posted an increase in sales every year. Furthermore, only 3.2% of the firms increased earnings each

year. A scant 0.2% increased free cash flow each and every year. Morningstar freely admits that they did not account for survivorship-bias in their study. If they did, the results would be even worse.

OK. “So what?” you might say. Well, we would counter that extrapolations and forecasts of rose-colored growth forecasts are more often, just that. Every investment cycle has a handful of growth stock darlings that even the casual stock market observer could name. Of course, the adroit trick is to buy them well before too many of your neighbors brag about how many shares they own at the neighborhood party. The lesson we have learned – at times profitably and, admittedly, at times not so profitably - is that exceptional corporate growth is, well, *exceptional*. The higher the expected growth rate, the higher one’s skepticism must be.

As surely as investors should understand the limits of exceptional corporate growth, investors must understand the cyclicity of corporate profits. The rest of this missive will address that subject.

Since the stock market bottomed in late 2002, two key fundamental factors have changed, albeit slowly, but nonetheless, significantly. The first factors, profits, have sharply rebounded and now exceed the record level set in 2000. The second, the yield curve, with considerable help from Greenspan & Co., has gone from steep and stimulative, to flat and restrictive.

The profit recovery during the current economic cycle has been nothing short of extraordinary. Even though the recession of 2001 was relatively mild, the drop in corporate profits could be considered a collapse. The ensuing rebound has undeniably been one for the record books. The recent close of the third quarter marks the 14<sup>th</sup> consecutive quarter of double-digit profit growth. Over this time span, S&P 500 profits have increased more than 70% (which is a new record). In addition, unlike most bull markets that have been driven by improved valuations (typically lower interest rates); the current bull market has been predominantly driven by earnings increases.

Well, that's the good news. The bad news is that profit cycles are of course interrelated with the business cycle and the economic cycle. Keep in mind, a derivative of *cyclical* is cycle. And the economic cycle is getting a bit long in the tooth. InvesTech Research reports that at four years, the current economic expansion is already older than three-quarters of all recoveries over the past century. Furthermore, if the current expansion extends into 2006 it will be the fifth longest since *1900*.

In addition, corporate earnings have a long history of lackluster future growth after a period of record growth. Hussman Funds succinctly spelled out this cyclical reality in a recent report. Hussman reports that:

***Since 1950, when the S&P 500 earnings have been at record levels, earnings have grown just 1.6% a year over the following 3 years and 2.1% over 5-year periods, compared to a long-term average growth rate of about 6%.***

In fact, the decline in corporate profit growth has begun in earnest. Not only have corporate profits begun to decelerate from record levels, but surprisingly one-quarter of S&P 500 companies are currently reporting *negative* year-over-year profits.

Given that corporate profit margins are at 40 year highs, corporate profits as a percent of GDP are at 40 year highs and the ratio of corporate profits to employee wages and salaries are at 50 year highs, we think profit growth over the next three to five years could well be *less* than as depicted in Hussman's study.

We at Wedgewood are not economists (as we do not spend hardly a moment trying to forecast the myriad of economic variables that economists must contend with). That said, we do pay special heed to the yield curve. Of all of the economic series that we are familiar with, the yield curve – particularly changes in the yield curve - has a long and significant history of informational relevance. Concurrent with this writing, the yield curve is nearly “flat.” The difference between the 2-year Treasury and the 10-year spread is now only 20 basis points.

(Another common measure includes the difference between the 3-month Treasury bill and the 10-year Treasury note.)

With the combined effects of a vigilant Federal Reserve trying to contain inflation with measured hikes in short-term interest rates, along with economic weakness associated with the still unfolding energy shocks, hurricane sisters Katrina and Rita and the deflating housing market (bubble?), we could well witness a stubbornly flat and the growing possibility of an inverted yield curve (i.e., short rates higher than long rates). The current flattening of the yield curve is significant, given that every flat or inverted yield curve has preceded a meaningful economic slowdown, if not a full blown recession.

Back to Hussman once more on the yield curve:

***Since 1950, when then spread between the 10-year bond and the 3-month bill has narrowed to less than 100 basis points, the 3-year average earnings per share of companies in the S&P 500 has been 2.3%. The 5-year average growth has been 3.8% a year.***

Furthermore, and more critical for the stock market, *every* inverted yield curve since 1965 has led to a profits recession (i.e., S&P 500 Index earnings growth turns negative).

For investors to persevere in the changing profit and interest rate environment, we believe stock selection should emphasize companies with the following attributes:

- Market share takers
- Organic growth
- Rich pipeline of new products and services
- Cash rich balance sheet
- Reasonable, but preferably attractive valuation

Conclusively, we believe a portfolio of *high quality* growth companies is ideally suited for the years ahead. We believe that our current portfolio fits that mold.

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