



The Sub 6% Dilemma

Gregory A. Nejme, CFA
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On any given day, important market influencing headlines vie with those less significant for a piece of our investment mindshare, challenging us to sift and store what matters. And so it was that a seemingly unimportant piece of information managed to capture our attention. Perhaps we had, at least on this occasion, seen the proverbial forest through the trees.

With the release of earnings in late June, General Mills announced its decision to reduce the discount rate used to compute pension expense to 5.85% from 7.5%. In so doing, General Mills was compelled to raise by \$100 million its estimate of 2011 retiree pension expense. Of course, the soon to be 30 year anniversary of the virtually uninterrupted rally in Treasury bonds has led to dramatic reductions in the assumed discount rate applied to plan liabilities. Tomorrow's liabilities are much closer to today's stated balance sheet amounts; indeed, the gap between net present value and present value is much lower than this generation of investors has ever known.

Concerns regarding disinflation/deflation have fostered a climate which simultaneously reduces yields on fixed income securities while effectively inflating liabilities – the dilemma. Tepid global economic growth expectations and investor risk aversion have proven a boon for fixed income instruments, with strong appreciation and attractive yields producing outsized returns. However, even assuming a gradual recovery from here, the conditions so favorable to advantaging fixed income instruments would appear less conducive. As our gaze in the rear view mirror dims and we focus on the road ahead, we believe quality growth equities are particularly well positioned. (We define quality growth businesses as those possessive of: high and rising market shares; wide and defensible moats; recurring revenue streams; pricing power; abundant cash flows; global platforms balanced between developing and developed markets; and meaningful - albeit attainable - growth opportunities matched with management teams capable of judiciously capitalizing on such opportunities.) And while a selective discipline is vital to identifying the best businesses, those attributes shared among common stocks in a concentrated portfolio can produce a much lower risk profile than the homogeneous risk perception commonly ascribed to equities.

Financial decision makers including institutional CIO's, consultants, CFO's and advisors of all types are confronted with a similar conceptual framework as General Mills: the common theme of lower rates of return and higher levels of assumed liability is producing a shared, collective anxiety. And the big headlines of the day – weaker company revenue growth, stubbornly high unemployment, rising developed market deficits, Euro fragility, slowing China – only serve to validate what conventional wisdom now regards as THE big headline: the world as we know it post financial market contagion is responding much differently (read: slowly) to central bank tools than we've witnessed historically. In just the last few weeks, record issuance in the high yield market, as well as the decision by the state of New York to reduce its assumed rate of return on pension assets to 7.5%-7.75% from 8% (assumed for the past 10 years), offer evidence of the mounting pressure to satisfy increasing liabilities in a world of low returns.

From Relief (high beta, low quality won) to Reality (quality growth takes the lead)

The well documented recovery in global equity markets dating to March, 2009 in the U.S. was led by high beta, low quality equities as investors exhaled following “The Great Recession.” The HSMP senior investment team, consisting of Harry Segalas, David Altman and myself, started in the business in 1981/82. Over the course of our professional careers, the pendulum contrasting fear and greed was never more pronounced than was true in 2008 and 2009. In the wake of greed returning, quality equities were largely dismissed (Chart 1). (The relationships in the following three charts, provided by BernsteinResearch, remain largely consistent when analyzing the data series through the end of July.)

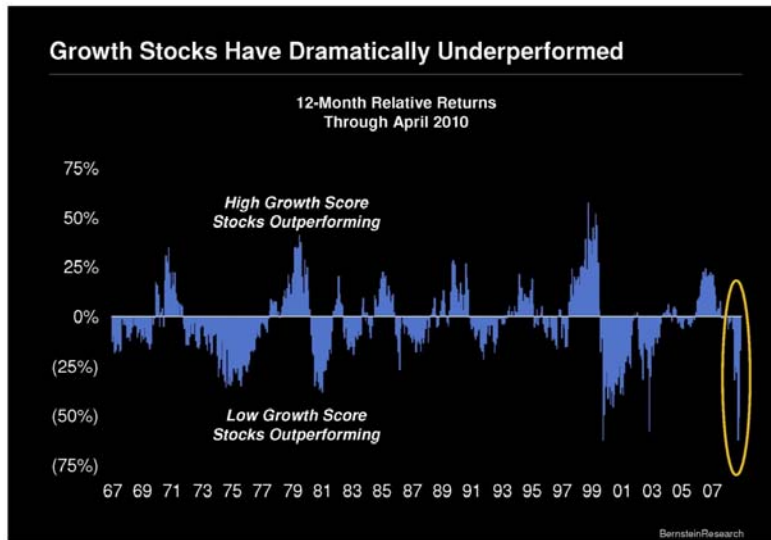


Chart 1

The relative underperformance of growth equities as shown above extended a pattern dating to the beginning of the millennium, creating meaningful opportunities within the quality growth continuum. In fact, and amidst the tempered view of global economic growth and assumed returns on various asset classes, quality businesses capable of securing a larger piece of a less expansionary global pie offer a solution to the sub 6% (pick a number) dilemma.

Further, valuations for quality growth businesses are quite reasonable. As depicted in Chart 2, one would have to go back more than 30 years to find more compelling growth stock valuations than exist at present. And in a world where growth’s scarcity will be even more highly prized, we find valuations notably attractive given anticipated earnings growth within our concentrated holdings.

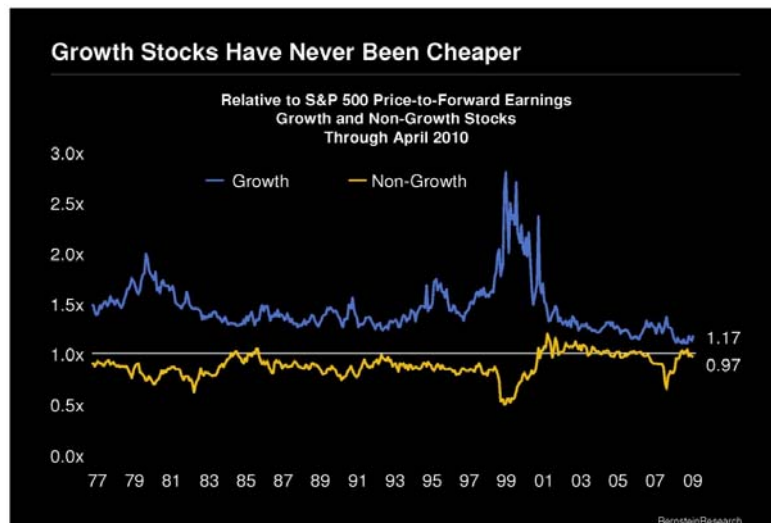


Chart 2

High free cash flow yields are a hallmark of quality businesses, as the ability to internally fund growth increases financial flexibility and ameliorates risk by reducing the dependency on capital markets to fund expansion and/or reward shareholders. With a **free cash flow yield exceeding 6.5%**, and with nearly **2% returned to us as owners in the form of dividends**, we believe an appropriate balance is being realized between a reasonable current return and the application of excess balances to fund strategic acquisitions and organic growth. Given the low return available on short term instruments, cash stockpiling is not desirable and is in fact detrimental to returns; Nestlé’s purchase of Kraft’s frozen pizza business in North America, ScottsMiracle-Gro’s doubling of its dividend and significant share buyback authorization, Scripps Networks Interactive’s acquisition of the Travel Channel, and Hanesbrands’ proposed acquisition of Gear for Sports are examples of cash flow deployment that we believe enhance the value of our holdings today and tomorrow.

Importantly, returns must be balanced against associated risks, as capital preservation – always important – takes on greater significance in a world where low returns make it even more of a challenge to restore lost principal. As shown in Chart 3, we are at a moment in time when **growth stocks possess a lower beta than value stocks** – not unprecedented, though certainly atypical.

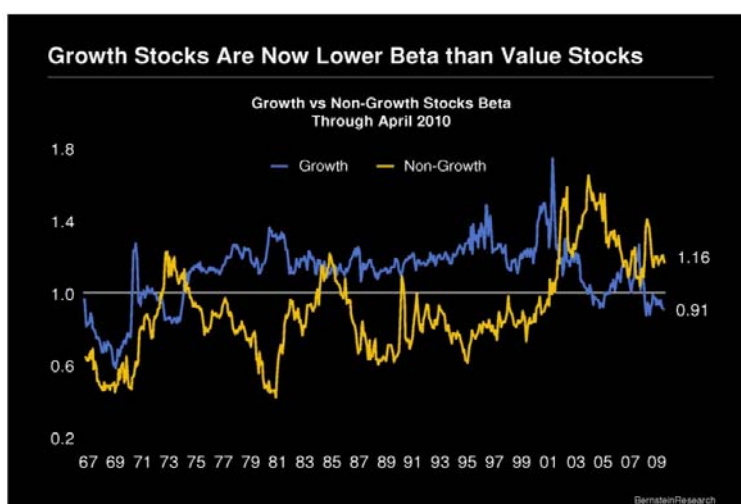


Chart 3

The Concentrated Quality Growth Solution

We appreciate the many asset classes from which financial stewards’ may choose in solving their respective dilemmas. We also appreciate that many of those asset classes – whether fixed income instruments, precious metals, or alternatives – have done quite well relative to quality growth equities. With that acknowledgement, and with high quality government/corporate debt trading at a 30+ year high, we are intrigued by the prospects for quality growth equities, trading at a 30 year low by select measures, while offering a compelling risk profile and a degree of liquidity, transparency and comprehensibility that we find a refreshing alternative.

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