



investment styles ebb and flow . . . fundamentals never go out of favor

Scarce Economics

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The Song Remains the Same

Market greed succumbed to an all too familiar fear as the dog days of August rolled in, and suddenly the summer of 2011 had a déjà vu quality: September 2008 was, after all, not that long ago. Indeed, while the characters in the public and private deleveraging play changed, the cast for the sequel is a Who's Who in the evolving, omnipotent debt crisis: the U.S. government; Euro zone member countries and financial institutions large and small in Western Europe; anemic developed market economies; slowing emerging market GDP accompanied by accelerating inflation; and, of course, Standard & Poor's in the role of evil empire.

As the curtain closed on the latest staging, and given the handsome reward participants willing to embrace risk realized dating to the March '09 lows, the gathering clouds behaved in typical summer fashion, bursting metaphorically in an abrupt August equity market downpour. The drama has continued thus far in September.

The Fear Factor and the Scarcity of Safety

That fear has returned to the markets is manifest in the risk off trade gaining prominence over the embrace of riskier asset classes. Indeed, the fear of the unknown has proven a very powerful grip on investors' collective psyche, and Euro zone worries form the apex of potential collateral damage markets are struggling to fully comprehend. The coordinated policy response by U.S. and European authorities, allowing Euro financial institutions easier access to dollar borrowings, serves to highlight the underlying state of financial market fragility. In addition, Operation Twist represents the Fed's latest effort at promoting sustainable domestic economic growth. While it has always been important to understand the businesses you own and the securities underlying those businesses, that imperative has arguably taken on even greater significance given the present climate.

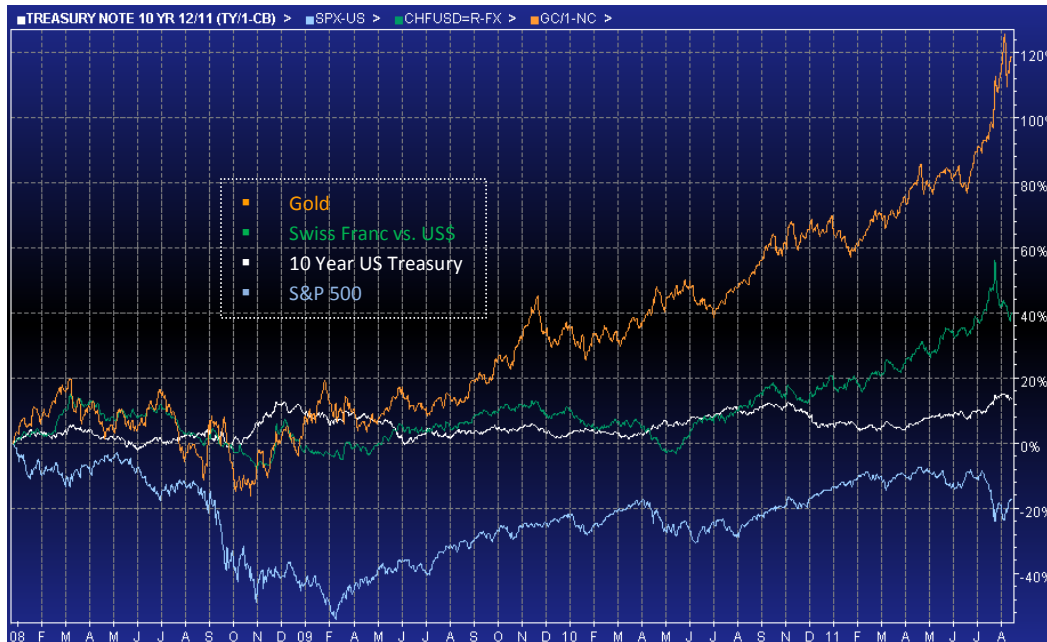
Paul Samuelson's classic economic textbooks clearly defined the laws of supply and demand and the manner in which those forces converge to influence equilibrium production scheduling, resource allocation and, importantly, the price of the product/service under consideration. A core Economics 101 tenet is that supply shortages – scarcities – can and often will produce a rising price grid for the goods and services in question, *ceteris paribus*.

Of course, conventional economic thought applies such theories to given industries and/or products or services. We think the same framework is easily applied on a more conceptual level, and it is within that context that we've observed market behavior.

Where do market participants perceive such scarcities to exist today?

Certainly investors regard the world in general - and global financial markets specifically - as less secure. Yes, safety is an increasingly scarce and therefore highly sought after commodity, and instruments offering security have enjoyed meaningful investment flows: think gold, the Swiss franc and yes, the instrument du jour of our thematic play, U.S. Treasuries.

The chart below illustrates the performance of these asset classes as equity markets blinked. We chose to compare the performance of each instrument to the S&P 500, and to chart the analysis effective January 1, 2008 – the calm six months before the proverbial storm. In each instance, instruments viewed as offering a margin of safety notably outperformed the S&P 500, considered a riskier asset class.



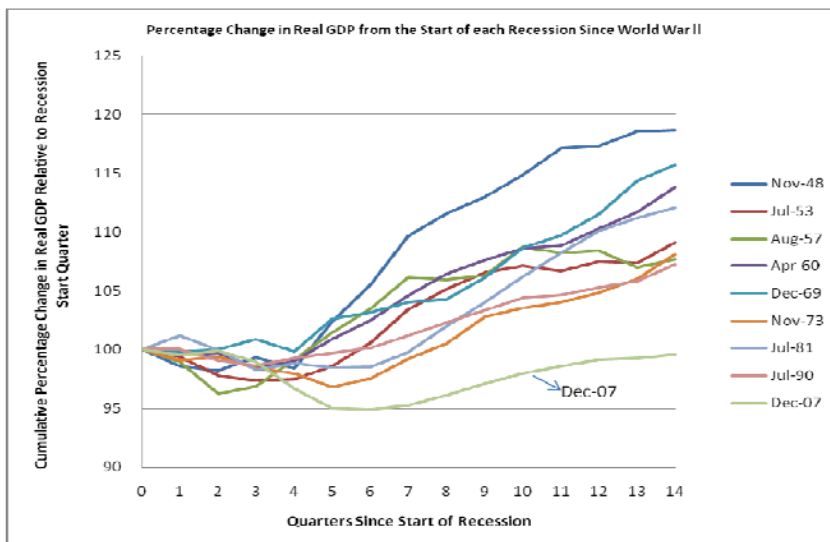
Source: ThomsonReuters

Growth Proves Elusive

Broadly speaking, we think a complementary shortage to safety exists and is likely to receive increasing market attention: the recognition and realization that growth is increasingly scarce.

Much has been written about the lethargic pace of recovery in developed markets, though most commentary focuses on short term cyclical variances to make the point. Our investment perspective is more influenced, however, by the body of work, and not the latest (and often substantially revised) data point.

When evaluating the depth and breadth of the recovery to date compared with the trajectory experienced in prior cycles, the data is indeed underwhelming. For perspective, the graph that follows considers the cumulative rate of change in U.S. real GDP from the start of the recession (as declared by the National Bureau of Economic Research - NBER) to present, and compares this cycle with the eight previous post World War II recoveries. The most recent cycle was pegged to have begun in December 2007, suggesting it is now 44 months – 14 quarters of data – since the commencement of the recession.



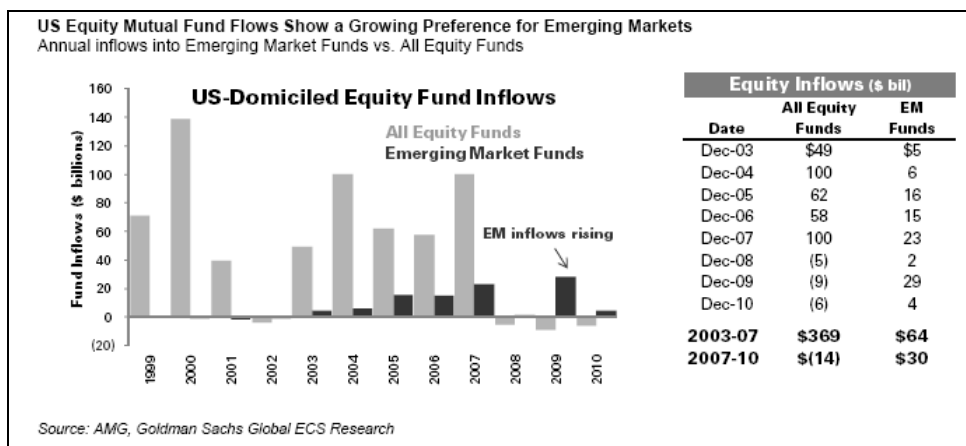
Source: US Department of Commerce, Bureau of Economic Analysis

As the graph clearly depicts, the cyclical improvement from the trough has been notably anemic. When the world’s largest and most prosperous economy behaves in this manner, the peripheral damage among trade partners, particularly those highly dependent on the U.S., is pronounced. It’s no wonder concerns regarding a synchronized slowdown/decline in global economic activity have gripped financial markets since the late April S&P 500 high was reached.

So Where’s the Growth? Opportunity Knocks Behind Three Doors...

The debt crisis may capture the headlines, though the storyline has as much to do with negligible developed market growth (and decelerating EM trends) as it does excessively levered public and private sector balance sheets. BCA Research perhaps summed it up best in their August 8th issue: “It’s All About Growth”. We agree with BCA’s fundamental premise; as well, and from HS Management’s perspective, it is also about balancing attainable company specific prospects with the disciplined use of proven valuation tools.

Certainly the market has demonstrated a strong appetite for growth when considering the capital that has been directed to emerging markets. Whether measured by the strength of the Chinese Yuan or wage pressures in San Paulo, advancing locales have experienced strong capital inflows as investors seek that scarce commodity - growth in a growth deprived world. The data below, provided by Goldman Sachs, clearly identifies the trend.



Source: AMG, Goldman Sachs Global ECS Research

Developed economy structural and emerging market cyclical headwinds notwithstanding, we have identified areas where growth exists, and where businesses satisfying our quality standards are trading at valuations we consider compelling. As such, HS Management client portfolios are populated with businesses offering a meaningful emerging markets presence; those in possession of white space opportunities; and companies positioned to sustain growth based on their own unique set of drivers.

...Emerging from Developed Profit Pools

Much has been written about the anticipated growth of the emerging markets and the tectonic shifts in political, economic, and military force that such changes may yield. We take a holistic perspective and appreciate the size and scope of developed market profit pools as a means of self funding developing economic participation.

Indeed, the shift in geo-economic influence is arguably the secular trend of the next generation, a tailwind not unlike the post World War II baby boom generation. (For more on our philosophy with regard to investing in emerging markets, see “Emerging from Developed Profit Pools” dated 3/16/2011, available at www.hsmanage.com).

Many of our portfolio companies have maintained a long standing presence in emerging markets. Diageo, International Flavors and Fragrances, 3M, ABInBev, Unilever, Nestlé, Diageo and Coca-Cola are illustrative of businesses with formidable developed market positions and accelerating emerging market platforms.¹ Today, approximately 20% of portfolio revenues and earnings are derived from emerging markets, a percentage we expect will continue to advance.

...White Space Opportunities

The ubiquity of the Web (just Google it), the digitization of content, the rapid proliferation of devices and form factors to conveniently consume content, gains in e-commerce at the expense of physical retail, and the inexorable shift in ad spending from traditional to new media highlight some of the market opportunities created by advances in technology.

Google’s Android platform, YouTube and Google+ capture white space initiatives in mobile, content consumption and social networking; Adobe’s software tools facilitate the ability of developers, marketers and enterprises to create, manage, and optimize the abundance of content being shared across multiple devices and platforms; and eBay’s efforts to re-engineer its marketplace platform is complemented by the secular gains in alternate payment systems realized by PayPal.

...Unique Drivers

The Great Recession offered many challenges, though for management teams with foresight and gumption, the 2008-2009 downturn provided opportunity to increase relevancy. Businesses that deployed capital wisely have created their own unique set of drivers with which share gains are now being realized.

Hasbro’s strategic imperative to monetize its array of branded intellectual property across rapidly growing platform mediums should contribute to the realization of higher and more consistent sales in its core toy categories. Target is a first class merchant that has demonstrated an ability to access growth from multiple initiatives (P-Fresh, 5% back Target credit card, CityTarget urban format stores, and a meaningful Canadian lease deal). Target offers reasonably predictable prospects for controlled footage growth in the U.S., and plans to open 100 to 150 stores throughout Canada in 2013 and 2014 are in process.

Valuation Paradox: Lack of Conviction Boosts Appeal

So how does the general malaise regarding growth reconcile with the valuation attendant to growth equities? From the perspective of market observers, the lack of conviction is captured in asset class valuation metrics for growth equities well below historic norms. (J.P. Morgan and Sanford Bernstein have published data supporting this conclusion). From our perspective, such ambivalence spells opportunity.

Equities have been broadly pressured as a consequence of the factors we've outlined. And the selloff has been rather indiscriminant, with quality businesses/equities not spared. The access to liquidity and the desire for safety has therefore yielded what we believe to be particularly attractive valuation metrics among quality businesses.

HS Management portfolios reflect such characteristics: the forward 12-month P/E stands at 12x, and is supported by a free cash flow yield of 8.1%. Clients own a dividend stream now yielding 2.0%, an obviously attractive differential to short term instruments and advantaged to ten year Treasuries now yielding 1.9% . We consider these portfolio metrics compelling against a backdrop where anticipated earnings can advance at a 10%-14% pace over the next 3-5 years. In a growth scarce environment, we believe a stream that grows at a reasonably predictable, consistent pace has the potential to be more highly prized, particularly given the low valuations now attendant to our holdings.

Financial Decision Makers and the Price of Safety

Risk aversion presents its own set of challenges, and some unintended consequences on the road to safety are likely to make for difficult choices. In September 2010, we wrote a piece entitled "The Sub 6% Dilemma". It is worth repeating certain thoughts, as market conditions in the last twelve months have only served to affirm our view.

The 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 financial market uncertainty and anemic growth have fostered a climate in which the quest for safety has been prioritized. The appetite for safety has simultaneously reduced yields on fixed income securities while effectively inflating liabilities – the dilemma.**

Financial decision makers including institutional CIO's, consultants, CFO's and advisors are confronted with a unpleasant conceptual framework. The common theme of lower rates of return and higher levels of assumed liability is producing a shared, collective anxiety.

The Walt Disney Company, by way of illustration, recently doubled (to \$900 million) its pension contribution relative to the guidance provided just three months earlier, citing the low cost of borrowing and the increasing differential between return (asset) and discount rate (liability) matching.

As financial stewards evaluate how best to resolve such funding woes, we believe the need to embrace somewhat greater risk is irrefutable. This consideration leads us to conclude quality growth equities may offer a reasoned solution to help address the burgeoning gap.

Marriage at the Debt Theatre: Safety Weds Growth

To be sure, the unfolding debt crisis will have many more sequels, and the likelihood exists that the play will run for a long time, particularly given the global audience that such theatre has captured.

We are very mindful of the difficult macro trading conditions to which all businesses are subject. In that context, we recognize we will make our share of mistakes, that our resolve will be continuously challenged, and that the world as we know it is increasingly fraught with uncertainties the likes of which few in the investment profession have experienced. One lesson we have come to appreciate over many years is that humility is an investment profession prerequisite.

Not all is glum in the Debt Theatre, however; indeed, the venue occasionally hosts festive occasions, and we were recently invited to such an affair. The proposal by safety to wed growth is truly a case where opposites attract, and we think the scarce attraction which brings the two together is destined to end in a mutually fulfilling courtship.

With world class franchises operated by seasoned management teams well positioned to effectively capitalize on growth opportunities, we are enthused by the prospects for our portfolio companies. Strong balance sheets, competitive and rising dividend payouts, and high free cash flow yields possessed by our holdings represent a store of value we take comfort in, even as opportunities to self fund growth initiatives are sustained and, in some instances, accelerated. And, unlike some large financial institutions, our portfolio businesses do not charge us – the owners – for the store of cash value generated day in and day out.

At HS Management Partners, we are encouraged that the safety of abundant cash flows is complemented by the opportunity for our portfolio companies to judiciously pursue attractive growth prospects at reasonable valuations.

The bells are ringing.

¹ Note that as an active manager, the examples given are merely illustrative, and may not be held in client portfolios in the future. The securities identified and described do not represent all of the securities purchased, sold or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable.

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