HS MANAGEMENT PARTNERS, LLC

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

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Volatile...irrational...unpredictable...three adjectives often used to describe the recent stock market turbulence. Below we share our perspective on the current equity market environment...

The Sun Also Rises

Secular Illumination amid Cyclical Dim

The early 1980's lay juxtaposed in the minds of the partners of HS Management Partners ("HSMP"): seemingly not so long ago, yet so far away. As individuals, we began our respective investment careers with Paul Volcker presiding as Fed Chairman, mortgage rates at 18%, and the Dow Jones Industrial Average struggling to sustain a level above 800; a 10 point Dow move was considered a volatile day. We have lived the elation and pain of financial markets since: the easing of credit market conditions that heralded the mid-1980's recovery; the October 1987 crash; the 1989 mini-crash; the nascent early 1990's recovery following the thrift crisis and the formation of the Resolution Trust Corporation (RTC) – a period that arguably most closely mimics our present state of financial affairs; the Asian currency dislocation; the meltdown of Long Term Capital Management; the March 2000 bursting of the Internet bubble; the aftermath of the 9/11 tragedy; the complacency attendant to real estate lending practices; the boom/bust of commodities; the imprudent and globally infectious use of leverage that has, to date, conservatively resulted in $500 billion in capital write-downs, with $1 trillion a distinctly realizable threshold. Institutions that survived the Great Depression – Bear Stearns, Lehman Brothers, Merrill Lynch, A.I.G. – together with New Deal institutions formed expressly to ensure liquidity/facilitate home ownership among U.S. households following the debilitating economic conditions of the late 1920's – Fannie Mae and Freddie Mac – exist no longer. While our experiences span three decades, the events of 2008 are unquestionably the most dramatic we have ever witnessed.

And yet, as difficult as the past year has been to endure, our belief in our core investment philosophy and conviction in what we own on behalf of clients has never been greater. As stated in our Second Quarter Investment Review, this is indeed a market that tests your will as an investor – unmerciful, indiscriminate, and laden with fear. And while investment styles and asset classes come in and out of vogue with little predictive logic, there is one tenet we know to be certain: fundamentals never go out of favor.

Our stewardship of client assets is founded on a simple (albeit not always easy to adhere to) philosophy: know what you own, avoid businesses/markets/instruments you don't understand, and maintain an intense focus on company specific fundamentals. The element that is not always easy to adhere to – and which requires tremendous resolve – is to maintain your discipline as other approaches dominate the headlines. The strength in commodity markets through June '08 is illustrative. Inherent in our definition of beautiful business models is to secure an earnings stream that offers a higher than average degree of growth, visibility and predictability. Commodity oriented businesses by nature do not lend themselves to our style, as the price of the product and therefore enterprise revenue is subject to inherently unpredictable social, economic, political, and financial market conditions. Of course, clients entrust their assets to us on the basis of a covenant that we will invest those assets in the most judicious manner, and in what we know best; opportunistically chasing the flavor of the week is not who we are, nor what we do.

While keenly aware of broad economic trends and the influences such variables will have on our portfolio holdings, HSMP does not pride itself on economic prognostication; we think of ourselves more as economic realists. We apply a Warren Buffett-like philosophy to the global economic footprint in which our businesses operate: we prefer to be vaguely right than precisely wrong. In that regard, we cannot escape what to us is a certain irrefutable logic; that once the financial crisis clouds part, the sustainable path which awaits us for the foreseeable future will yield anemic developed nation economic growth and more measured emerging economy growth. The use of leverage dramatically inflated asset values globally, and encouraged economic/financial market behavior that will not be repeated as world economies stabilize and eventually recover. Home price deflation in the U.S. is now also pervasive in many developed Western European nations, and the wealth diminution associated with the largest asset class most households possess has been further aggravated by severe and abrupt financial asset markdowns. The removal of hundreds of billions of dollars of capital availability (and corresponding lending capacity) among the ashes of fallen investment banks, the loss of employment among high wage earners, and Treasury/Federal Reserve directives favoring a substantially tighter regulatory framework point to a less vibrant global economic platform prospectively.

Within the contours of the more challenging landscape we anticipate, some behaviors will not change. The world will continue to: conduct Google searches; enjoy Kellogg breakfast cereals and the refreshment of Coca-Cola beverages/Diageo spirits; seek the affordable entertainment offered by Disney studios (together with ESPN) and Marvel Entertainment; embrace the value and convenience of Wal-Mart and McDonald's; consume the nutritional foods of Nestle' and the uniqueness of Starbucks blends; apply the cleaning solutions of Ecolab and the trusted billion dollar brands possessed by Procter & Gamble (24 in all); and employ the security and familiarity of Visa and Western Union financial/money transfer networks. Beautiful business models all, with shared attributes: global franchises, transparent balance sheets, sustainable and defensible competitive positions with meaningful barriers to entry, and significant free cash generating capabilities – a characteristic likely to be more deeply appreciated and therefore highly prized by market participants.

The financial markets are engaged in a seismic shift, one in which the sun is setting on the "art" of exotic, complex, and highly levered instruments in favor of the understandable elegance of comprehensible, self-funded, and beautiful business models. HS Management Partners welcomes the radiance of the new day.

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