

## **“Simple” Helped Improve Valuation— Not Just Earnings**

### **August 2009- Market Outlook**

All but a few of the companies in our portfolio have exceeded/met 2Q earnings expectations. However, earnings don't explain fully our July 9.0% return vs. the 7.4% market return. Our returns may have started to benefit from a fundamental valuation for financial sector companies with simple products, and simple investment portfolios.

**Improved Valuation in July:** The improved price/book value for a portfolio of “simple” insurance companies is shown below. Positive earnings results helped, but more important the 2Q results were driven by easy-to-understand basics such as higher-than-expected premium revenue, or lower-than-expected claims. The market may have finally begun to re-focus on fundamentals rather than the need to determine capital adequacy (see July “*Shift from Fear to Fundamentals*”). In fact, few conference call questions were directed at capital adequacy, which stands in stark contrast to last quarter's conference calls.



**More to Go— Especially Reinsurance:** Over the past 5 months we have gravitated towards certain reinsurance stocks (see March, *Bring on 1Q Results*). We like the opportunity to select smaller companies that sell specific products, or cater to a certain type of customer. Certain companies have benefitted from 1) favorable price trends, 2) problems with two large competitors, 3) demand for reinsurance to address capital constraints.

**Improved Pricing- Yes or No?** Once again, certain companies indicated product pricing trends improved, while others stated prices had not improved/deteriorated. Pricing trends in the insurance world have important implications for stock prices, so direction is important.

In the end, both companies might be correct. The disparity arises because pricing depends in a big way on product mix, and client mix. Companies sell many different products to many different types of clients. The difficult part for an investor is to determine which company is aligned to benefit from a proper mix of products, and clients. From our standpoint, there has now been enough improvement to pick-and-choose winners from losers.

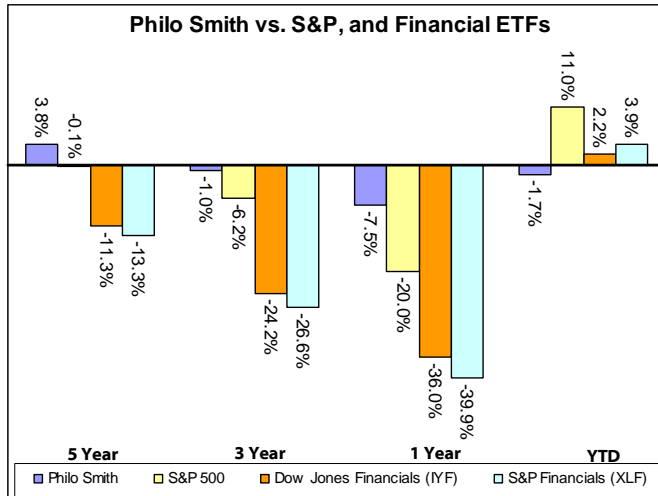
**Get Back to Fundamental Valuation:** Several of the reinsurance companies we own still trade below book value, yet already produce double-digit returns. We have in the past highlighted that a company with a 12% ROE has historically commanded a price/book value of about 150%. The implication for investors is that significant upside could materialize if fundamental valuation continues the comeback we may have seen in July.

If you have questions regarding the financial services sector, or would like to discuss our investment approach, please contact us at the phone number below, or visit our website.

**E. Stewart Johnson**  
Portfolio Manager

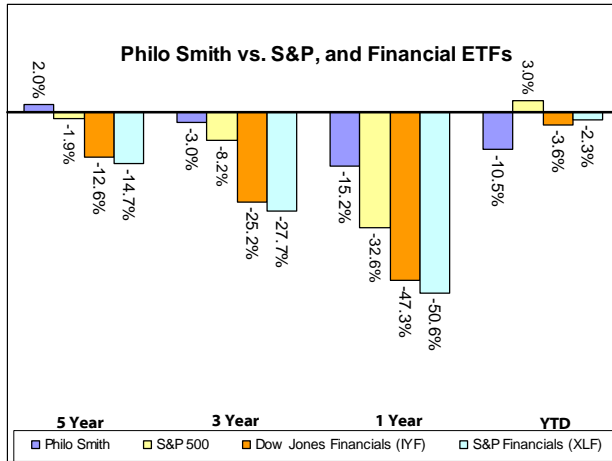
# Performance

Year-over-year through July 31st, 2009



# Performance

Year-over-year through May 30th, 2009



Year-over-year through June 30th, 2009

