

## *Just follow the money... right to the top line*

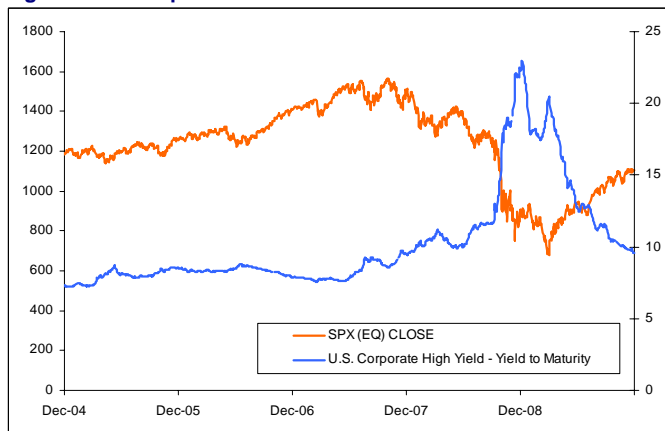
### December 2009- Market Outlook

The graph below shows interesting trends in the equity and debt markets that back up two points we have made over the last few months: 1) debt yields indicate capital concerns have abated, and 2) the equity market has not fully recovered, and our take is top line growth is needed for financial stocks resume a meaningful push higher.

Consider the dramatic shift. Last year we were rewarded for a shift towards financial stocks with simple business models, which contributed to the -9% return in our long-only, financial stock portfolio. This year the market rewarded holders of financial stocks that were badly hurt last year by capital concerns, but have now doubled from lows as these concerns abate.

Looking ahead, as the shift back towards fundamental valuation unfolds (vs. valuation based on fear) investors should be rewarded for holding financial stocks with strong top line growth potential.

**High Yield vs. Equities**



**Capital Concerns:** The blue line in the chart shows debt yields have retreated to pre-Lehman levels, which is a strong indication the market no longer extracts the same risk premium needed to compensate investors for capital concerns. What is interesting is that uncertainty remains for potential loan loss provisions faced by banks, yet the restoration of capital markets to address capital shortfalls seems to have trumped this pesky uncertainty.

**Top Lines Still Stuck:** The red line shows that equity markets still have not rebounded to pre-Lehman levels. Our take is that the initial rally in equity markets (at least financial stocks) reflects comfort with capital, but a further rally will reward top line growth— not earnings growth attributed to one-time accounting adjustments, but good ol' top line growth, such as increases in insurance premiums from the sale of more product.

**Headlines vs. Reality:** Our most recent portfolio manager presentation, which we go through in meetings with prospective investors, shows a breakdown of the products included in the notorious "pricing cycle" often quoted in headlines. We then pull specific product pricing data from a sample company's 10-Q that shows price increases, rather than declines cited in the pricing cycle data. The explanation for the difference is that data from many companies is aggregated in the single pricing cycle figure — most companies certainly show price declines, however a bit of digging uncovers true examples of top line growth, despite what headlines lead you to believe.

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. ([www.PhiloSmith.com](http://www.PhiloSmith.com))

**E. Stewart Johnson**  
Portfolio Manager

# Performance

Year-over-year through November 30th, 2009

