

In the Old World if it Walks Like a Duck...

July 2010- Market Outlook

For the second quarter (and for each of April, May, and June) we outperformed both the S&P 500 and financial sector ETF (XLF). However, two of the three months were merely less negative— June was a hollow victory similar to May. Throughout the quarter we reduced exposure to generic P&C business lines, and most recently increased positions in life insurance stocks. We were pleased this portfolio shift preceded A.M. Best's 7/15 upgrade of the life insurance sector.

Like a Duck: We were taught lessons growing up about good things: always be cautious, but a AAA rating is a sign of near-bullet proof risk. We were also taught lessons about bad things: always be skeptical if a company trades below book value, as it is very likely faced with serious, fundamental problems such as access to funding, mispriced assets/liabilities, legal issues, negative earnings, etc. In both cases -- lessons about good and bad -- the world has been turned upside down.

Lessons about Good Things: Without any room for question, the AAA rating status has been debunked numerous times. In hindsight, the reasons for the demise make it painfully clear why "AAA" no longer conveys the same feeling of safety that it did only a few years ago.

Lessons about Bad Things: Just as the AAA rating has lost some of its ability to convey safety, we would argue a company that trades at a discount to book value no longer signals the same, serious level of trouble.

World Upside Down = Opportunity: Is an appropriate *premium* to book 1.1x, 1.5x, or 4.0x? Now, what about an appropriate *discount* to book value? As Graham once wrote, "it is quite possible to decide by inspection that... a man is heavier than he should be without knowing his exact weight." Perhaps a premium valuation is not justified for a company that has for decades produced a positive ROE, provided services integral to the functioning of our economy, bolstered capital levels, and from what our trained eyes tell us do not appear to have legal issues. However, in this case Graham might agree with us -- armed with details -- that the discount is heavier than it should be.

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)

E. Stewart Johnson
Portfolio Manager

Performance through June, 2010



