Alley Company Quarterly Letter
Inflection Point

April 17, 2012

We stated in our fourth quarter 2011 letter "…our belief is that today is a great time to be an investor when valuations are cheap and the news has the potential to surprise on the upside." Given that view, we were not surprised to see a strong start for the stock market in 2012. Looking ahead, while we would expect a health-restoring pause or correction in the market's upward bias at some point, we believe the aforementioned dynamics of cheap valuation with improving fundamentals are still intact.

We can all agree that the macro concerns (no need to repeat them again) have been thoroughly discussed, and to be sure, fixing these problems is important. In fact, the prospect of Israel taking action against Iran is a concern that can be added to the list, though difficult to handicap. Intellectually it tends to be easier to focus on the problems and concerns, and more difficult to imagine the positives that can occur. However, it is our view that an ***inflection point*** has been reached where it will pay to focus more on what can go right. The axiom, "people get scared fast and together, and regain confidence slowly and one at a time" is still operative today.

The first quarter was a good example of some things going right and how a more positive tone can develop. Unemployment continued to trend favorably as non-farm payrolls rose on average by over 200,000 jobs per month and have now risen for 24 consecutive months. Most banks successfully passed the government stress tests and as a result were able to raise their dividends. Fourth quarter profits continued to trend higher with full year 2011 S&P 500 earnings reaching an all-time record high. Additionally, corporate balance sheets and cash levels have probably never been in better shape.

In our last letter we published a list of potential positive developments that could be upside surprises to the marketplace in 2012. The list included:

- Europe develops a broad plan to deal with its sovereign debt problem and support its banking system.
- The U.S. finally adopts a credible long-term debt and deficit reduction plan at the insistence of the electorate as compromise becomes the only means to survive in office.
- The U.S. housing market not only bottoms but begins to pick up as apartment rents are back to all-time highs and housing affordability has significantly improved.

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- Deleveraging at financial institutions and among consumers continues to be an economic headwind, but to a lesser degree, unleashing better economic growth prospects.
- The U.S. unemployment rate continues to trend lower in self-reinforcing fashion as the moderate U.S. economic recovery continues.
- China is successful at slowing economic growth from double digits to high single digits, and engineers a soft landing.
- The extraction of oil and gas from shale begins to be a game changer as the U.S. becomes a net exporter of energy products for the first time in decades. This keeps a lid on oil and gas prices.

The relevance of examining this list again is that most of the points are viewed as serious challenges when assessed statically or as if frozen in time. But when viewed in the context of making progress with reasonable solutions over time, a positive trending bias can develop. This is the inflection point that the marketplace may be facing. Our belief is that as these potential positives unfold, bit by bit in some cases or more rapidly in others, the P/E ratio for stocks can rise. Investors who wait for the coast to be clear will likely end up paying significantly higher prices for stocks.

Currently, the S&P 500 trades at approximately 13x prospective 2012 earnings which is below the average P/E of 16.8x for the past twenty years. Most equity asset classes around the world are trading at similar discounts to their twenty year history leaving plenty of room for P/E expansion as macro concerns subside.

Valuation must also be looked at in the context of the current interest rate environment. The earnings yield for the S&P 500 (the inverse of the P/E) is 7.65%, while the SEC yield for the iShares investment grade corporate bond index (LQD) is currently about 3.65%. This disparity is indicative of a cheap stock market relative to bonds, as corporate bond yields have tended to be equal to or greater than the earnings yield in modern history. The table below highlights some of the individual company earnings and dividend yields compared to their ten-year bond yield.

Company	**Industry**	**Earnings Yield**	**Dividend Yield**	**Ten-Year Bond Yield***
Philip Morris Int’l	Consumer Goods	5.90%	3.50%	2.80%
McDonald’s	Restaurants	5.90%	2.90%	2.60%
Intel	Technology	8.70%	3.00%	2.70%
Merck	Health Care	10.10%	4.40%	2.40%
Conoco Phillips	Energy	12.00%	3.60%	2.50%
BCE	Telephone Utility	8.00%	5.50%	3.60%

All yield data as of 04/13/2012

*Closest corporate bond to ten year maturity

Source: Thomson Reuters, Charles Schwab

This relationship shows the significant valuation disparity favoring stocks over bonds. A specific example that we like to cite is Merck, where its ten-year bond yield is about 2.40% compared to its common stock dividend yield of 4.40%. We'd opt to own the stock, not the bond given a choice between the two.

Our conclusion is that there is a lot that can go right, much of which is already in motion, and that valuations are set to rise as more positive developments unfold. We are struck by the cheapness of blue chip American companies with great balance sheets, strong cash flow, and attractive dividend yields. While negative investor psychology concerning the macro environment will undoubtedly cause continued volatility, we are very comfortable owning stocks, especially given our belief that an inflection point has been reached where investors will be rewarded for focusing on what can go right.