

Alley Company Quarterly The Great Paradox

July 21, 2011

Lest the second quarter end without a period of significant volatility, June arrived and packed a volatile punch. The S&P 500 Index corrected 8% during May and June, but rebounded sharply during the last week of the quarter. As we have written extensively, the markets are being tugged and pulled by negative macro-economic concerns on one hand and positive company-level fundamentals on the other. United States government debt and deficits, Euro-zone sovereign debt issues, and stubbornly high U.S. unemployment continue to make headline news while corporate financial results are firmly on track to drive 2011 S&P 500 earnings to an *all-time record*. This paradox aptly explains the paranoia of investors as good company news can quickly be offset by macro trepidation.

While the macro concerns are significant, we also believe that they are in “workout mode” and given the magnitude of the problems at hand, working out of them at a measured pace may be the preferred course of action. For some, this pace of improvement may not be satisfactory; however, a more sudden fix of the problems could be accompanied by a setback in the economy. One thing is for sure, pessimism surrounding these issues runs high, so meaningful progress toward improvement would be a positive development for market sentiment.

What is perhaps most remarkable in these paradoxical times is the stellar performance of the corporate sector. Looking at the marketplace from the bottom-up unveils a whole different feeling about the economy and prospects for global growth. For example, dazzling corporate results were reported in the second quarter for technology bellwethers **Google** (revenues up 32%) and **Apple** (revenues up 82%). These great American companies are obviously seizing business opportunities around the world and not standing idly by waiting for more clarity on macro developments. Further, steady growers with long term dividend-paying cultures such as **Genuine Parts** and **McDonalds** are also producing top line momentum (12% and 7%, respectively) in the current environment. These are just a few examples from a long list of companies that quarter after quarter have been producing excellent business momentum.

As the paradox unfolds, market volatility is likely to continue. We analyze these bouts of volatility discerningly, looking for opportunities to establish or add to ownership positions in great companies at favorable valuations while paying respect to the ongoing workout of the macro issues.

Meanwhile, on the interest rate front, the 10-year Treasury spiked in price in the second quarter driving the yield down to 2.85%. On an absolute basis, bond yields are near multi-decade lows and are attractive for *issuers* but unattractive for *investors*. We currently view equities as a more favorably valued asset class relative to fixed income for long-term investors. This view is supported by our working assumption that the recent weakness in economic data represents a “soft patch” and not the beginnings of a double-dip recession.

Bridging the Gap

For investors that seek lower volatility in the stock market or for those with an investment income need/desire, we advocate a diversified portfolio of high-quality dividend-paying companies. At a time when the aforementioned paradox has created uncertainty for investors, typical alternatives in the bond market are not without risk. **High quality dividend-paying equities can “bridge the gap” between volatility/uncertainty in the stock market and low interest rates in the bond market.** Our investment philosophy focuses on *striking the balance* between attractive current yield and future dividend growth.

Conclusion

In conclusion, it is difficult to pass through a day without a negative macro headline grabbing your attention. The United States and the Euro-zone are in workout mode on many of these macro issues. Despite this backdrop, Corporate America is operating beautifully, seizing growth opportunities where they exist by staying on the cutting edge of innovation and productivity. Our view is that the stock market remains attractively valued at 13 times earnings and that the volatility that falls out of “The Great Paradox” represents an opportunity to establish or add to positions in companies with strong fundamental momentum and attractive dividend-paying qualities.

Alley Company is an investment advisor registered with the Securities and Exchange Commission (SEC). The Alley Company Quarterly discusses general developments, financial events in the news and investment principles. It is provided for information purposes only. It does not provide investment advice and is not an offer to sell a security or a solicitation of an offer, or a recommendation, to buy a security. The statements and opinions contained herein are solely those of Alley Company LLC. Certain information constitutes “forward-looking statements” and due to various risks and uncertainties, actual events or results may vary materially from those reflected or contemplated.