

Alley Company Quarterly Letter

A Great Time to be an Investor

January 17, 2012

You would never know it listening to the mostly-skeptical chatter on our 24/7 cable news channels, but earnings for the companies in the S&P 500 just reached an all-time record high in 2011. Meanwhile, the price of the S&P 500 Index ended the year *20% below* its all-time high which was achieved in 2007, a period of normal market valuation prior to the financial crisis. As a result, the U.S. stock market is attractively valued at only twelve times prospective 2012 earnings, a level that is striking to us given the strong fundamental performance of Corporate America and the low level of interest rates.

It is also true that the stock market has good reason to be trading at twelve times earnings given the macro headwinds of the Eurozone and our own debt and deficit issues. If economic and political circumstances were closer to normalcy, the low inflation and interest rate environment that we now live in would suggest a stock market multiple of at least fifteen times earnings and possibly higher. We think the market is pretty much discounting what can continue to go wrong on the macro front, although more bouts of downward volatility are certainly likely as events unfold. But given the fact that the Eurozone and U.S. problems are relatively old news (three years) and that solutions are being negotiated for long-term workouts, a question that nobody is asking is, “what could go right?”

Below is a list of potential positive developments that could be upside surprises to the marketplace in 2012:

- 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.
- 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.

As we have stated before, Corporate America is performing exceedingly well and stock valuations are attractive. At the same time, news flow is negative and pessimism is pervasive. This is in stark contrast to the 1999-2000 period that preceded a multi-year bear market where news flow was positive, optimism was high, and the S&P 500 traded at over twenty times earnings. Hence, 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.

We continue to be struck by market leading companies with strong balance sheets, that trade at high single or low double digit price-to-earnings multiples, and have superior dividend yields relative to fixed income alternatives. Further, we expect dividend increases to continue as the payout ratio for the S&P 500 is 30% versus an historical average of 52%, leaving plenty of room for growth. Dividend paying stocks that provide relatively high levels of current income while allowing the upside to take care of itself in due time are very attractive to us, especially in today's low interest rate arena.

Yes, it is a great time to be an investor, especially if a few things *go right*.

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