Alley Company
Separate Account Investment Management

Alley Company Quarterly Letter
Market Noise

April 15, 2015

In past letters we have called out a group of market pundits and news media that we refer to as "nattering nabobs of negativism" for their inability or unwillingness to look ahead to what can go right in America instead of dwelling on past problems. Something similar is happening today with the endless dissecting of current issues that range from the strength in the U.S. dollar to the halving of crude oil prices to the appropriateness of Fed policy.

By no means are we trying to trivialize these issues (or others such as the Iran nuclear talks or the status of Greece in the European Union) – because their developments and outcomes will indeed have far-reaching effects – but the *noise* created by excessive coverage and in some cases borderline sensationalism can create unnecessary uncertainty among investors and shift the focus away from long-term investment horizons. The positive outcome from all of this noise is that it tends to create a "wall of worry" that markets typically like to climb as sentiment gets skewed too negatively.

Given the steady improvement in the U.S. economy in recent years and the accompanying recovery in the stock market, questioning of the *sustainability* of each has become commonplace. As we always suggest, a "market correction" (generally considered to be a decline in the stock market of at least 10%) can occur at any time and trying to pinpoint the near-term direction of either the market or the economy is challenging and often counterproductive. With that being said, one way to analyze the sustainability question is to focus in on two important elements: 1) potential excesses in the economy and 2) possible extremes in equity valuations.

We have had difficulty finding areas of economic excess that need to be corrected and, in fact, two important examples of lack of excess are 1) capital expenditures as a percentage of GDP are currently 27%, which is below the longer-term average of 29%, and 2) debt payments as a percentage of disposable income are down to 9.9% from 13.2% in the fourth quarter of 2007. These measurements suggest that corporations are not overextending on capital projects and that consumers have de-levered in recent years.

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For equity valuations, the following table shows that the S&P 500 is currently trading at levels that are near average over the past 25 years and thus is not exhibiting extreme valuation by historical standards.

Valuation Metric	Current Level	25-Year Average
Price-to-Earnings Ratio*	16.9x	15.7x
Price-to-Book Value Ratio	2.8x	2.9x
Price-to-Cash Flow Ratio*	11.8x	11.3x
Dividend Yield	1.9%	2.1%

Source: Standard & Poor's, Thomson Reuters. Data as of 3/31/15.

*based on estimates of earnings and cash flow for the next 12 months.

We would note that analyzing broad market valuation, while instructive, is but one variable in deciphering investment opportunities. The ultimate arbiter of value is the fundamental performance of the companies themselves, and as such is our primary focus.

The following excerpt from Warren Buffett's 2014 annual letter puts the focus squarely on the long-term opportunity as opposed to the short-term market noise.

> Charlie (Munger) and I have always considered a "bet" on ever-rising U.S. prosperity to be very close to a sure thing. Indeed, who has ever benefited during the past 238 years by betting *against* America? If you compare our country's present condition to that existing in 1776, you have to rub your eyes in wonder. In my lifetime alone, *real* per-capita U.S. output has *sextupled*. My parents could not have dreamed in 1930 of the world their son would see. Though the preachers of pessimism prattle endlessly about America's problems, I've never seen one who wishes to emigrate (though I can think of a few for whom I would happily buy a one-way ticket). The dynamism embedded in our market economy will continue to work its magic. Gains won't come in a smooth or uninterrupted manner; they never have. And we will regularly grumble about our government. But, most assuredly, America's best days lie ahead.

Noise in the marketplace is arguably elevated, which can create near-term uncertainty among investors. While the issues at hand bear watching, our conclusion is that taken together they are unlikely to derail the economic expansion cycle in the United States. Currency translation effects, while a headwind in the near term, should be transitory in nature over time; lower crude oil prices, should they persist, will ultimately be a boon for the global economy; and while the

Fed could raise short-term interest rates before the end of 2015, we expect any changes in policy to be modest and gradual at this point in time.

From a global perspective, it appears that interest rates around the world could stay "persistently low" for the foreseeable future. In this context, equity valuations should find continued support and *dividends* from blue-chip companies (especially those that can be increased year by year) should stay in high demand.