Economic Update

Broadleaf Partners, LLC

On Warts and Princes
Summing Up Fourth Quarter Earnings
February 22, 2007

We've just finished fourth quarter earnings reports, a season which is always busy for us as we listen to conference calls and reassess economic fundamentals at the individual company level. The results were positive, but as is always the case, there were some blemishes buried here and there. What was different this quarter, however, was not the existence of such blemishes, but investors' reactions to them.

Over the summer, earnings blemishes were frequently met by significant selling pressure -- often as much as ten to twenty percent -- and stocks closed near their lows for the day. This quarter such blemishes were often met by similar initial stock price declines, but followed up by significant intra day rallies with stocks closing flat and in some cases even up for the day. When investors are in a mood to love the market, as they are now, the dips are meant to be bought. Investors don't notice warts, they only see princes.

After a combined twenty five years in the business, Jeff and I have come to recognize that Fed policy overwhelmingly affects investor sentiment and quite often, investor preferences. When the Fed is raising rates, they are implicitly saying that there is too much growth in the economy. In no uncertain terms, the Fed's posture, in raising the cost of money through interest rates, is anti-growth. And while earnings may grow significantly during such periods as they have done recently, the pall cast by an anti-growth Fed, is a restraining factor on the markets that limits what investors are willing to pay for a dollar of earnings.

Fortunately, when the Fed shifts gears to neutral, attitudes towards growth change, and with it, investors behave differently. It is, perhaps, the absence of Fed hikes that matters the most, the magic elixir that gets investors to see past blemishes that will always be there but not always heeded.

We've written quite a bit recently on why we think growth investments will continue to do well in 2007, as has been the case so far. In addition to declining energy prices and a Fed on hold, we would add recent earnings reports and short term technical reactions to such reports as additional evidence supporting this view. Investors have clearly moved from seeing the glass half empty to seeing it half full. What investors are willing to pay for a dollar of earnings is finally on the increase – multiples are expanding.

We suspect a by product of earnings multiple expansion could be increased media attention to areas of innovation within the economy. As the ability to hit earnings targets through better pricing (and inflation) wanes, there will be increased attention to gains that can be achieved by doing things better through more productive efforts. In addition to the proliferation of video-over-the-internet which we discussed in our Cisco Update, other investment themes include on-demand software, home-based laser hair removal and

cosmetic surgery, offshore consulting services, new financial derivatives markets, and gene research.

One could argue that investors should ALWAYS be invested in the companies that have the highest levels of innovation, but it isn't always the case that such investments will outperform. This is why a diversified approach to asset allocation makes sense for the long term, with only occasional shifts in preference – and even then only at the margin – as the fundamentals warrant. As we've said before, we think it's time for investors to tilt their portfolios towards growth.

So, what could go wrong? Where are the warts and blemishes in the economy that are still there but are, perhaps, being overlooked? Right now, the biggest macroeconomic worry continues to be the state of the housing market and while we have moved past fears that it could drag the rest of the economy down with it, the emergence of troubled sub-prime loans has certainly raised some eyebrows. The troubles in Loan Land have, of course, increased regulatory scrutiny and tightened lending standards, and in this sense, perhaps the private banking sector is now exercising some of its own anti-growth policies where the Fed left off.

At the company specific level, most of the earnings concerns during the quarter related to whether or not improvements in revenues would ultimately lead to longer term improvements in earnings power and whether or not cash invested rather than distributed will actually earn an incremental return for investors. For the last few years, investors have preferred dividends and stock buybacks over corporate reinvestment activities. Are corporate treasurers changing their own growth policies just as the Fed has changed its own? I'm not sure. But I would bet that they wouldn't argue with the notion that there are plenty of opportunities worth chasing.

Finally, it's time for growth.

Kindest Regards,

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