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Portfolio Manager

## Back to the Core

For years, Allen Trust Company's equity investment approach has revolved around a few dozen companies whose fundamental financial quality and strategic competitive advantages we've found compelling. We refer to the stocks of these companies as ATC's Core Equity List, and they've been the focus of our efforts predominantly (though not exclusively) in the domestic large-cap arena.

"Core" discipline says a lot about our ethos here: We prize quality and durability over flash and fad. Moreover, we believe that attempts at "timing" the stock market (jumping in and out of positions as short-term expectations change) are certain only to benefit brokers and the tax man, while very possibly leaving clients uninvested during those brief periods when stocks leap to their greatest gains.

The data grinders at Ibbotson Associates have calculated that \$1 invested in the S&P 500 in 1925 and held through thick and thin would be worth \$2,533 in 2004. Removing the S&P 500's 38 best months over that 79-year period, however, would result in a portfolio worth just under \$18, a performance approximating the return on T-bills! What's more, many of those stellar months came hard on the heels of major downturns, because the market tends to surge most following cyclical low points, *the very times when the broadest swath of market timers have forsaken the market.*

By targeting a more distant horizon than market timers do, and by committing to companies whose businesses can endure profitably for years, we lessen the high costs of portfolio turnover while increasing the likelihood that we'll keep our heads when others are succumbing to manias of panic or greed.

So what is "Core"? Crudely summarized, it's stuff we're comfortable sticking with. As definitions go, that falls short. Perhaps a look at the current Core portfolio's basic, equal-weighted characteristics relative to the S&P 500 will be illuminating:

ATC Core Equity List vs. S&P 500		
	ATC Core	S&P 500
Earnings Yield (fwd)	7.4%	6.3%
Return on Equity	23.2%	19.6%
Dividend Yield	2.3%	1.7%
Earnings growth (5-year forward est)	10.6%	10.6%
Average Mkt Cap	\$42.9B	\$47.1B

Source: Morningstar

Keep in mind that these are aggregate statistics, and do not represent targets or threshold criteria for Core construction. That said, you can see that the companies we gravitate towards have higher earnings yields (about 17% higher presently), higher ROEs (about 18% higher), and higher dividend yields (31% higher!), all without compromising projected growth in profits (identical, by Morningstar's calculations).

Other characteristics you'll find among our Core Equities are lower-than-industry-average debt ratios, consistent dividend growth, low cost structures relative to peers, barriers to new competition, and sustainably differentiated product niches.

What won't you find at the Core? Stocks whose high valuations are predicated on the extrapolation of blistering current growth rates (i.e. the Googles), companies with all-or-nothing jackpot potential (e.g. undiversified techs and biotech), or companies highly levered to swings in the price of non-value-added commodities (e.g. "pure play" gold miners).

In a future letter, I will describe how we work to maintain a Core portfolio that keeps its vitality and invites new opportunities for growth.

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## Firm News

Allen Trust's companion company, Allen Capital Management, a Registered Investment Advisor, is open for business and bringing on clients whose needs lie squarely in the investment management arena. The ACM team will be familiar to all of you who know ATC: the same cast of characters, albeit working within a different regulatory and custodial framework. Call us to learn more!