CLARK & STUART, INC.

Investment Counsel

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"By 1995, Alderson had created a new baseball corporate culture around a single baseball statistic: on-base percentage. Scoring runs was, in the new view, less an art or a talent than a process. If you made the process a routine – if you got every player doing his part on the production line – you could pay a lot less for runs than the going rate."

Moneyball
Michael Lewis

Dear Friends,

Rarely has the world seemed more dangerous, chaotic, and hostile: natural disasters unlike any before; a nuclear crisis with unknown consequences; uprisings across the Middle East; European governments on the brink of default; Governors in several states fighting with legislators and public employees; and Washington politicians squabbling over petty cash cuts to the current budget. At the risk of sounding flip and insensitive, here is some good news: the major league baseball season starts today.

It is easy to be distracted by issues and events which, however tragic or violent, may have only a modest and temporary impact on the economy and the financial markets. For investors, it is essential to remain focused on what matters most. Baseball, however, is a *good* distraction which offers many similarities between the investment process and the responsibilities of a general manager – e.g. scouting and player evaluation (research), determining the true value of a player (company), trading players (stocks), balancing offense, defense and pitching (diversification). Most important, the general manager (investor) must have a sensible and durable strategy which, over the course of a very long season, will accomplish the primary objective – scoring runs (making money).

In Moneyball, Michael Lewis tells the story of the Oakland Athletics. After great success in the 1970's and 80's, a change of ownership in the mid-90's forced the A's to operate with limited resources. Other clubs spend tens-of-millions on unproven prospects and popular-but-overpriced free agents. The A's rely on proven-but-undervalued ballplayers. Billy Beane, Oakland's general manager, and his predecessor, Sandy Alderson, largely dismissed the gut instincts of scouts and coaches in favor of the unconventional-yet-quantifiable approaches to player evaluation advocated by writers like Bill James and Eric Walker. As Walker wrote, and Lewis quotes:

"Analyzing baseball yields many numbers of interest and value. Yet far and away – far, far and away – the most critical number in all of baseball is 3: the three outs that define an inning. Until the third out, anything is possible; after it, nothing is. Anything that increases the offense's chances of making an out is bad; anything that decreases it is good. And what is on-base percentage? Simply yet exactly put, it is the probability that the batter will not make an out. When we state it that way, it becomes, or should become, crystal clear that the most important isolated (one-dimensional) offensive statistic is the on-base percentage. It measures the probability that the batter will not be another step toward the end of the inning."

Like the Oakland A's, we try to score runs (make money) by not making outs. We too emphasize a high on-base percentage in the form of companies which produce consistent profit and dividend growth. Also, because many other investors try to hit home runs with unproven companies and popular-but-overpriced stocks, we are usually able to purchase the shares of companies we want to own at a discount to their true (intrinsic) value. Thus, we *"pay a lot less for runs than the going rate."* Having a sensible and durable investment strategy, an approach to making money based on what matters most, is always a good idea. In a dangerous, chaotic and hostile world, it is essential. Play ball!

The Equity Market -- What Matters Most?

Obviously, the violent uprisings in the Middle East, the related spike in the price of oil, and the earthquake/tsunami/nuclear disaster in Japan were not among the factors we cited in January as risks to the global economy and financial markets. The Standard & Poors 500 Index had risen nearly 7% before the weight of these events and other ongoing risks triggered a correction in stock prices -- eliminating those earlier gains. Nevertheless, share prices recovered over the last few weeks and the S&P 500 posted an increase of 5.4% for the first quarter.

As you know, our strategy is focused on the *longer term* rewards of common stocks. We do not alter our approach to fit current market trends. However, we monitor the critical variables which comprise the fundamental economic backdrop, and which drive stock prices in the *short term*, in order to be prepared for abrupt and significant changes. Moreover, competing voices and current events can be a great distraction for our clients – especially in a dangerous world.

Predicting the short term direction of the stock market is a hazardous exercise. As we have said many times, even when you may be right the market will make you humble. Over the years we have benefitted greatly from a continuous conversation with our wise friend (and Michael's former colleague), Bob DeLucia. With Bob's guidance we have developed the Equity Market Checklist – a framework for assessing the market outlook. Our purpose is not to predict stock market returns over the next 12 months, but rather to provide readers with insight to the variables which matter most.

Over the *long term*, the two most critical variables which determine total returns from stocks are ***(1) corporate profits*** and ***(2) equity valuation.*** The link between profits and capital appreciation is unambiguous. Over the last 20 years pretax profits of U.S. companies increased at an annual rate of 6.8%. Over the same period equities provided annualized total returns of 9.1%. The average annual return from dividends was 2.14%; implying a contribution from capital appreciation of 6.96% -- essentially in-line with the rate of profit growth.

However, equity returns can vary significantly from the long term profit trend because of changes in valuation. For example, in the 1990's corporate profits grew 6.6% annually – well below the 17.5% total return of the S&P 500. Over the last ten years the reverse has been true -- profit growth of 7.1% has exceeded equity returns of 1.4%. Still, valuation is a weak predictor of short term returns because share prices often go to extremes. For example, stocks were expensive throughout 1999 and, yet, became wildly overvalued in early 2000. Also, stocks were cheap in late 2008, but became extremely undervalued in early 2009.

In the *short term*, the three most important variables which drive the stock market are ***monetary policy & liquidity conditions, the outlook for sustainable economic growth, and corporate profits***. There is no better evidence for the critical role of these three factors than the powerful rally in stocks over the last 24 months.

From March 2009 through March 2010 the Federal Reserve purchased $1.8 trillion of mortgage-backed securities, U.S. Treasury securities and bonds issued by Fannie Mae and Freddie Mac. Given sluggish economic growth and weak private sector demand for capital, quantitative easing created a massive supply of excess financial liquidity -- much of which found its way into stocks and bonds. However, shortly after QE1 ended the stock market declined 16% because the economy had not made the transition from fragile recovery to self-sustaining expansion. Fears of a double-dip recession were widespread in the middle of last year. The rally in stocks resumed in late August after FED Chairman Ben Bernanke hinted at another round of quantitative easing (QE2) -- confirming that liquidity conditions would remain highly positive. The recovery in stocks has also been helped by surprisingly strong profit growth. Full year pretax profits in 2010 were 29% higher than 2008 while the S&P 500 was 39% higher at year end 2010 versus year end 2008.

Along with ***equity valuation***, the remaining variables to consider when assessing the outlook for the stock market are ***inflation, fixed income alternatives, corporate balance sheets, government policy, investor sentiment and global/systemic risks and imbalances.***

Here are our positive (+), neutral (o) and negative (-) assessments of these key variables today.

- *Monetary policy & liquidity conditions* (+/o) Investors know that the Federal Reserve will conclude QE2 at mid-year and this fact should be discounted in current prices of stocks and bonds. Thus, monetary policy will become a neutral variable later this year. However, policy may become a negative for stocks in 2012 when the FED is likely to be raising short term interest rates and draining liquidity by selling the securities it purchased under QE.

- *The outlook for sustainable economic growth* (+) This is, perhaps, the most critical variable at present. At this time last year an improving job market was the missing link between recovery and expansion. Today, private sector job growth is improving and may be even stronger than indicated by the Labor Department's monthly payroll reports. A sharp fall in the unemployment rate, declining weekly unemployment claims, and higher new job data in the monthly report of Automatic Data Processing all suggest that recent government data may be revised upward. Stronger job growth will also help bring stability to the still weak housing market.

- *Corporate profits* (o) Profits of non-financial U.S. companies rose almost 32% in 2010, but the fourth quarter increase was under 22%. A steady deceleration to the normal single-digit pace is likely over the next year.

- *Equity valuation* (o) Stocks, in total, are neither cheap nor expensive. Many cyclical issues are selling at high valuations; anticipating that above average profit growth will persist. Yet, many consistent-and-sustainable-growth stocks are selling at relatively low prices compared to their current profits and dividends.

- *Inflation* (+) The costs of food and energy have been rising rapidly, but core inflation remains very low. However, inflation is a significant problem in developing countries (including China).

- *Fixed income alternatives* (+) Bonds are overvalued and offer little competition to stocks. Low yields on bonds are one of the strongest arguments in favor of stocks. Assuming the economy continues to strengthen, a stampede out of bonds and back into stocks is possible.

- *Corporate balance sheets* (+) With high cash and low debt, non-financial companies have never been stronger.

- *Government policy* (o) President Obama understands that the private sector is the primary engine of job creation and recent personnel changes may signal a more business-friendly White House heading into the 2012 election. Still, many business leaders remain skeptical and, therefore, cautious about increasing payrolls and capital investment. The debate over minor cuts to the current federal budget is, unfortunately, a political side-show which obscures the real financial challenges facing the country. (see below)

- *Investor sentiment* (-) Growing optimism for stocks, particularly among those who sold equities and bought bonds over the last two years, is negative from a contrary perspective.

- *Global/systemic risks and imbalances* (-) Rising oil prices. Falling home prices. The European debt crisis. Economic growth in China and other developing countries with high inflation. Unsustainable trends in U.S. government finances at all levels – federal, state and local.

In summary, most of the variables on our checklist are positive or neutral. *However, given the number of risks to the global economy, and the magnitude of these risks, a shock to the economy and financial markets is possible at any time. Importantly, there may be no single issue which could trigger a greater shock than the failure to restore America's finances through substantive reforms of spending, taxes and entitlements.* As Winston Churchill is said to have remarked – *"You can always trust the Americans to do the right thing, but only after they have exhausted all the alternatives."*

The Great American Growth Bonds

We often refer to the stocks we own as *growth bonds* – companies whose *dividends* are as certain as the *interest* on a U.S. Treasury *bond* and whose cash flows provide *growing* dividends year-after-year. Among this select group of companies are three which stand apart: 3M, Procter & Gamble, and Emerson. 3M recently increased its dividend for the 53rd consecutive year. P&G will soon increase its dividend for the 55th consecutive year. Emerson's last increase (November) also marked its 55th consecutive year. Growing a dividend for more than 50 consecutive years requires a rare combination of skill, discipline, and execution across all functions of a business. It is often said that profits are the product of accounting -- sometimes *creative* accounting. Dividends, however, are paid with cash. *"Simply yet exactly put,"* there is no better indicator that a company's intrinsic value is growing than a steadily increasing dividend.

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3M, P&G and Emerson are very different companies. 3M is a vast collection of short-cycle businesses in which sales volumes respond very quickly to changes in global economic growth. However, with hundreds of products that dominate niche markets, 3M has no large competitors who can take away significant market share. In contrast, P&G enjoys slow-but-steady growth in relatively stable markets for nondurable household goods and personal consumer products. However, some of its biggest brands face very strong competition from outstanding companies. Emerson also faces strong competition in long-cycle capital goods markets which are particularly sensitive to the global economy. The fact that these companies have demonstrated consistently superior performance in very different businesses testifies to the impact which management can have on any company. These companies also share four important attributes:

- Distinct corporate cultures and values which are the foundation of their long lasting competitive advantages.
- Diverse global operations, by industry and geography, which provide stability and consistency to financial results.
- Continuous efforts to reduce costs, improve customer service, and maximize the productivity of employees and assets. With an aversion to large one-time restructuring programs, and ongoing restructuring charges embedded in their annual results, the *quality of reported earnings* at these companies is unmatched.
- Building the *company* over the long term and not managing short term results simply for a higher *stock* price. This does not mean investors must wait many years for good outcomes. Rather, strong financial performance *today and tomorrow* are the result of decisions and initiatives taken several years ago.

		Earnings per Sh.		PE	10 Yr. Growth		Div.		Net Inc.	Non-US Rev.	
Issue	3/31/11	2010	2011E	2011	EPS	Div.	Yield	ROE	Sales	Dev.	Total
MMM	$93.50	$5.75	$6.10	15.3x	9.4%	6.2%	2.4%	29%	15.3%	33%	68%
PG	61.60	3.67	4.00	15.4	9.5	10.7	3.1	17	13.9	34	58
EMR	58.43	2.60	3.25	18.0	4.7	6.0	2.4	24	10.3	34	57

Return on equity and net income/sales for last fiscal year; P&G's ROE artificially depressed by goodwill of Gillette.
Revenues from developing markets/countries and total revenue outside U.S/North America.

3M If we could invest in only one company for the next 50 years, our choice would be 3M. It is the most diverse company on the planet with core technologies in adhesives, abrasives, ceramics, electronics, films, imaging, nonwoven materials, nano-technology, and many more. Still, 3M is a conundrum for those who like to classify companies by industry or sector and manage their exposure relative to indexes and benchmarks. Indeed, 3M is often misunderstood and its shares mispriced. As 3M's CEO, George Buckley, once said, *"If the company did not exist, you could not imagine it."*

The ultimate source of 3M's enduring competitive advantages is a corporate culture which reveres scientific innovation. However, when Mr. Buckley assumed the CEO position in late 2005 he inherited a company where resources for research labs and manufacturing plants had been limited for several years. From 2001 through 2005 spending on R&D increased less than 10% *(cumulatively)* and investment in plant and equipment was held flat. Mr. Buckley turned the focus back to innovation and investment – increasing R&D by 20% in his first year. Capital investment increased 24% in 2006 and 22% the following year. Recognizing that 3M had, over time, created 32 businesses in which it no longer competed, Mr. Buckley also implemented a Pyramid strategy in which the company now secures its high performance/high profit margin position at the top of its markets by also competing in mid-range and entry levels.

As Mr. Buckley likes to say, *"the magic is back."* Last year 31% of 3M's sales came from products new in the last five years -- versus just 21% in 2005. In 2010 world-wide organic volume growth was 13.7% -- well above the pace of global GDP and industrial production. Market share gains at lower levels of the pyramids have contributed to rapid growth in developing countries which now account for one-third of total sales. We believe 3M now has the foundation for a higher sustainable growth rate – perhaps closer to 12% than the 9.4% pace of the last ten years. Also, with annual sales less than $27 billion, 3M is (surprisingly) a small company; i.e. size is not an obstacle to growth. Accelerating growth, high and sustainable returns, and reasonable valuation combine to make 3M an attractive investment.

P&G Like 3M, Procter & Gamble is driven by new products. P&G has been the home of brand building and brand management for 173 years. Today the company is in the early stages of a management transition. A.G. Lafley lead P&G from 2000 to 2009 – transforming the company through acquisitions (e.g. Gillette) and divestitures into a collection of faster growing, more profitable and less asset-intensive businesses centered around mega-brands (e.g. Pampers, Crest, Tide, Pantene, Olay). That transformation continues under Bob McDonald, along with the challenges of sustaining innovation, expanding distribution, and managing through a "tsunami" of rising commodity costs.

Given strong competition (e.g. Colgate, J&J, Kimberly Clark) market shares are always moving around among consumer products companies. Also, lower-price brands typically gain share during a recession. However, increasing commodity costs are an even bigger challenge for lower-price brands and aggressive marketing of P&G's own *value brands* limited the loss of share during the downturn. P&G's profits have been distorted in recent years by gains from divestitures. Our analysis shows that per share profits *increased* 5% in fiscal 2009 (June) during the depths of the recession. Price increases and productivity gains offset commodity costs in fiscal 2010 and kept profits flat. The company is now on the verge of easier year-to-year profit comparisons. After outperforming the market averages by a wide margin during the financial crisis, P&G's stock has lagged over the last two years. The shares are very attractive at current prices.

Emerson Not surprising, the recession hit Emerson hard. Sales and earnings declined 15% and 27%, respectively, in 2009. However, like every previous downturn, the last few years provided Emerson with an ideal environment to take market share and accelerate profit growth in the recovery. The hallmarks of Emerson are its rigorous programs and processes for management training, planning, strategy, budgeting and execution. Indeed, George Buckley of 3M, who spent the middle of his career under Emerson's legendary CEO, Chuck Knight, has called Emerson *"the ultimate business finishing school."* Given the contrast between the cyclicality of its markets (e.g. process management for oil and gas, residential and commercial HVAC, industrial automation, network power for communications and computing) and its long term financial performance, Emerson may indeed be the best managed company in the world.

Until 2001 Emerson had compiled one of the most extraordinary records in corporate America – 43 consecutive years of increased earnings per share. David Farr, Mr. Knight's hand-picked successor, assumed the CEO position in late 2000 and soon shed the burden of the company's consistent earnings growth record. Mr. Farr then started a continuous process of re-making the company – divesting slower growth and lower profit margin businesses and accelerating the company's presence in international markets – which continues today. When the economic recovery took hold Emerson was well positioned. In fiscal 2010 (September) profits increased more than 15% with a sales increase less than 5%. Because demand for capital goods improves later in an economic expansion, Emerson is on-track for much stronger profit gains (20-25%) in the current year. Importantly, given its operating leverage and sensitivity to the business cycle, Emerson's long term growth rates can be misleading. For example, if Emerson achieves 2011 EPS estimate of $3.25, then its ten year growth rate will be 10.5% -- well above the 4.7% rate in the table above. We also expect bigger increases in the dividend over the next few years following increases of 2-3% the last two years. Still, after rising more than 34% in 2010 the share price looks fully valued at the moment despite a recent correction from an all-time high.