

Bradley, Foster & Sargent, Inc.

Quarterly Market Commentary

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Do All Good Things Come to an End (Sooner or Later)?

I've come to see institutional decline like a staged disease: harder to detect but easier to cure in the early stages, easier to detect but harder to cure in the later stages. An institution can look strong on the outside but already be sick on the inside, dangerously on the cusp of a precipitous fall.

How the Mighty Fall: And Why Some Companies Never Give In, Jim Collins, 2009

This quote was written by Jim Collins, author of the business classics *Built to Last* and *Good to Great*, which are perennially on the nation's best seller lists. Collins is also a renowned consultant and former professor at Stanford University's Graduate School of Business. While the quotation could easily be applied to the enormous challenges facing America at the moment, his book, *How the Mighty Fall*, addresses the decline and fall of great U.S. corporations. It also celebrates several companies such as IBM, which have flirted with disaster but engineered great comebacks. In scanning the corporate landscape in America, it is truly remarkable to count the number of iconic companies which have disappeared, been acquired, reorganized, or declined almost to irrelevance over the past four years. The following is a partial list of these corporate disasters:

Federal National Mortgage Assoc. (Fannie Mae)	Bear Stearns	Circuit City
Federal Home Loan Mortgage Corp. (Freddie Mac)	Lehman Brothers	Linens 'n Things
Washington Mutual	General Motors	AIG
Merrill Lynch	Chrysler	

How did these great corporations collapse? In *How the Mighty Fall*, Collins analyzes modern corporate failures to determine whether it is possible to discover recurring themes and patterns in these disasters. The conclusions he draws are valuable not only for corporate executives but also for investors. Are there patterns which can be discerned to help investors sell shares in great companies before a precipitous decline in the stock occurs? And, on the other hand, what signs can be detected by investors in great companies whose fortunes have declined but are on the mend?

At the moment, there are numerous large capitalization, global companies which have prospered for many years yet are selling at valuations of less than 10 times earnings. These include Hewlett Packard, Intel, Microsoft, J.P. Morgan, Travelers, Merck, and Pfizer – each one a component of the 30 blue chip companies which make up the Dow Jones Industrial Average. It takes great vision, leadership, drive, and time to create a company with a strong brand, billions of dollars in revenues, strong cash flow, and global outreach. So why are these companies currently viewed so skeptically by investors? Is it because the longer that a company grows its revenues and earnings at 15% or more annually, the harder it is for that corporation to perpetuate this growth? Mighty companies are brought down by fierce competition, technological change, regulatory pressures, paradigm shifts in the culture, and geopolitical forces. They are also damaged by internal mistakes. As Collins so perceptively writes, "Whether you prevail or fail, endure or die, depends more on what you do to yourself than on what the world does to you." Ultimately, even if a company overcomes all challenges, the law of big numbers makes it difficult to show robust

growth when annual sales hit \$50 billion. Most of the companies which were part of the Dow Jones Industrial Average before World War II were dropped long ago. The only five survivors are the following:

Company & Year Added to Dow Jones Industrial Average

General Electric	1908	Procter & Gamble	1932
DuPont	1922	United Technologies	1939
Exxon Mobil	1928		

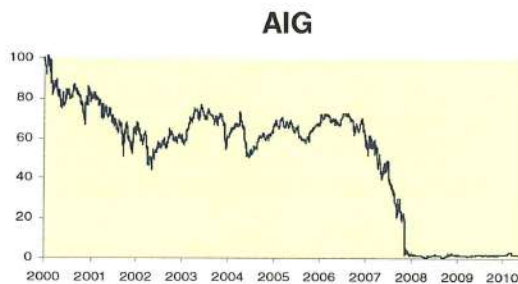
The Five Stages of Decline

In *How the Mighty Fall*, Collins lays out the following five-stage framework that he and his colleagues identified in the decline and fall of great companies:

- Hubris Born of Success – Leaders in the firm view success as “deserved” rather than hard-earned in the face of tough odds; they get distracted by extraneous opportunities or threats, neglecting their primary flywheel; and they lose their inquisitiveness and learning orientation and become self-satisfied.
- Undisciplined Pursuit of More – Success creates pressure for more growth. This unsustainable quest for growth confuses big with great. Excellence declines as discipline is lost, and there are not enough of the right people to manage growth.
- Denial of Risk and Peril – There is a tendency inside the company to explain away negative data rather than recognize something is wrong; executives set audacious goals or bets that aren’t based on experience or the facts; huge downside risks are taken based on unclear data; blame is externalized; frequent reorganizations occur.
- Grasping for Salvation – Companies make dramatic, big moves in an attempt to force a breakthrough; boards search for a charismatic leader or outside savior; hasty, panicky behavior becomes the norm; managements overpromise and under deliver; chronic restructuring occurs; financial strength erodes.
- Capitulation to Irrelevance or Death – Continuation of mistakes in earlier phases; corporate leaders do not return to what made the company great; hope fades and options narrow; the company runs out of cash and is acquired or declares bankruptcy.

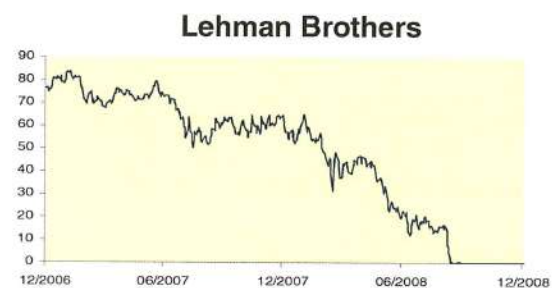
Recent Examples of Corporate Collapse

The most obvious examples of the decline and fall of the mighty are the financial icons that self-destructed during the 2007-2009 financial panic. The charts below show the precipitous fall of the stock prices of two of the mighty financial firms which collapsed in 2008:



Does not take into account 1:20 reverse split

Source: Bloomberg



Unlike industrial corporations whose demise can often take a decade or longer, one of the key patterns in the recent collapse of large financial firms and banks was the amazing speed with which it happened. Great firms like the 158-year-old investment bank Lehman Brothers, and Merrill Lynch, which built its

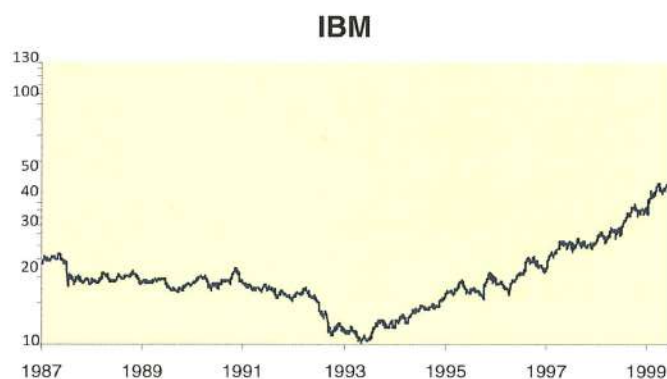
reputation on helping retail investors slowly accumulate wealth over decades, disappeared in less than 18 months. The stock of the world's top insurance company, AIG, declined 97% before being rescued by the Federal Reserve in September, 2008. In each of these firms, hubris, born from earlier success, and the undisciplined pursuit of profits (and bonuses) led the companies to take huge risks in their subprime mortgage businesses, and their losses in this sector, magnified by their huge leverage, led to disaster.

Companies with Near-Death Experiences

There are also a number of great corporations which fell from grace and appeared to be headed either for decline into insignificance or collapse, yet their managements were able to engineer remarkable comebacks. Three examples are Apple, McDonald's, and IBM.

Apple was in danger of failing in the mid-1990s. Its biggest competitor, Microsoft, seemed to be pushing Apple into insignificance. Its stock was trading at \$3 a share. In early 1997, Steve Jobs came back to the company as CEO. He focused on returning the company to profitability (after losses in 1996 and 1997), slashing costs, terminating projects such as Newton, and upgrading iMac. Jobs restored the company to modest profitability by 1998, and then in 2001 Apple introduced the iPod, which launched a new industry. Jobs's fierce commitment to technological innovation and his single-minded focus on producing well-packaged products, which would appeal to the young, transformed the company. In 2007, the iPhone debuted and began to change the cell phone market. Apple had net income of \$65 million in 2002; in 2010, Apple's net income was \$14 billion with a net margin after tax of more than 20%. It was a fabulous turnaround engineered by a man with a vision. The stock currently trades at \$330 – up 100 fold in 15 years.

Another great comeback story is McDonald's. Ten years ago, McDonald's faced problems on many fronts. It came under attack in the U.S. by nutritionists and public policy leaders for its unhealthy food offerings, which allegedly caused obesity and other health problems. In France, activists campaigned against McDonald's in anti-American attacks. And finally, the mad cow panic caused consumers to stay away from McDonald's in droves. Earnings per share dropped by more than 50% from \$1.47 in 2000 to only \$.70 in 2002, and the stock dropped from \$48 to \$12. McDonald's did not panic. They chose a new CEO from within the company. They listened to their clients. In 2003, they began to offer healthier menu items including salads with Paul Newman's Own dressings. This was followed several years later by low calorie snack wraps, premium McCafe coffee, and more recently smoothies and frappes. 2011 EPS are estimated at over \$5.00, while the stock has gone up sixfold since it bottomed in 2003.



Source: Bloomberg

The stock chart of IBM above shows one of the greatest comebacks in modern times. From 1926-1972, IBM beat the major stock market indices by more than 70 times; \$1,000 invested in IBM stock in 1926 (with dividends reinvested) would have turned into \$5 million by 1972. However, by the mid 1980s, IBM began a steady decline, and then in the early 1990s, IBM posted its first loss in more than 70 years.

Between 1991-1993, IBM lost more than \$15 billion. The board brought in Lou Gerstner, formerly Chairman & CEO of RJR Nabisco, to turn things around. Gerstner did not make rash, panicky decisions. He didn't seek game-changing acquisitions. He avoided the media. He spent his first 90 days listening and learning – from staff and clients alike. In his first weeks, he also concentrated on getting the right people in key positions. As Collins writes, he wanted people who understood that “they don't have jobs; they have responsibilities.” He then confronted the brutal facts about IBM's products, its pricing, and its declining market share. They dramatically chopped the price of mainframe processing power by over 90% during the next few years, cut costs by \$7 billion to survive, and regained market share. IBM refocused on the client and saw that their clients desperately needed someone to integrate all the disparate pieces of information technology. Gerstner resisted advice to split up the company. He consistently under promised and over delivered. Importantly, he reinstilled a culture of discipline with a framework of eight principles of IBM performance. Also, IBM executives received stock options only if they simultaneously bought stock with their own cash. From losses in 1993, IBM's net income soared to \$8 billion in 2000 and in 2010 achieved more than \$14 billion in profits. Its stock has climbed tenfold since 1993 to an all-time high this year.

Value Stocks or “Value Traps”

At Bradley, Foster & Sargent, Inc., one of the key tenets of our investment approach is to seek to moderate risk and achieve strong capital appreciation in equity portfolios by buying quality growth companies at reasonable prices. When the price of what appears to be a great company is falling, how does one know whether it represents a great bargain or a signal to sell? How do investors distinguish between compelling value stocks and “value traps”? First, there is no formula which provides the right answer every time. Well-known institutional investment firms bought or held on to their shares in AIG, Fannie Mac, and Washington Mutual all the way to the bottom, in the belief that their managements would succeed in turning these firms around. Second, it is vital to understand whether a company's management is tracing Collins's five stages of decline or following the path that Lou Gerstner took at IBM. At Bradley, Foster & Sargent, Inc., we strive to know a company inside and out by analyzing its financial statements, reading research reports, and trying to understand the company and the industry. Then we visit the company or attend management presentations and break-out sessions at conferences, listen to quarterly investor conference calls, and talk to analysts at investment banks and brokerage firms. In short, we do everything we can to understand a company's business and management strategies. This helps us determine whether external threats are eroding a company's moat as well as gauging whether arrogance is leading to the undisciplined pursuit of growth (including poorly thought out acquisitions or expensive new projects which distract management from its primary business). Finally, if we initiate positions in a potential turnaround as we did with IBM in 1995 and 1996, we generally build incrementally larger positions in our clients' portfolios, as we see the company's strategy bear fruit, rather than take large positions at one time. If the price of the stock moves significantly in the wrong direction, we generally will exit quickly, believing that the first loss is the best one. In summary, we believe that paying attention to Jim Collins's approach helps us build and maintain a portfolio of quality stocks which will preserve capital in adverse economic conditions and deliver strong appreciation in buoyant periods. And finally, we try to remember that most good things, sooner or later, do come to an end.

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