Godsey & Gibb Associates
Research & Review
June 2010

Earnings Stability Pays Off in Volatile Economic, Earnings Environment

The economic and earnings environment has important implications for investors. In January, we identified three trends for 2010, including (1) the transition from government stimulus to organic growth, (2) mean reversion for investment returns, and (3) increased financial market volatility. As the pace of global economic growth moderates, (i.e. China growth slowing, increased risk of a "double dip' recession in Europe, continued modest growth in the U.S.) from the rapid rise from the lows of the recession, and financial markets transition from an early expansion phase to a late expansion phase, we believe these three developments will continue.

Forward looking economic and earnings estimates reflect a wide range of opinions. Based on data from Bloomberg, U.S. GDP estimates for 2011 range from 5.2% to 0.7%. Forecasts for the CPI for next year range from a high of 5.3% to a low of (0.6%). Fed funds rate estimates for 2011 range from 2.50% on the high side to 0.25% on the low side. Similarly, strategist's forecasts for 2011 earnings for the companies in the S&P 500 Index vary from a high of $97.00 to a low of $82.00. Given the above average level of uncertainty regarding both the economy and financial market, we believe fundamentals such as strong organic cash flow, solid balance sheets and operational flexibility which lead to consistent earnings generation will be increasingly important.

At Godsey & Gibb Associates, we have historically paid strict attention to fundamental analysis, including the identification of companies with stable earnings. One metric of consistent earnings generation is Value Line's Earnings Predictability, a measure of the reliability of earnings based on the stability of year-to-year comparisons. Companies with stable earnings boast higher ratings (the highest = 100) while the more volatile firms posses lower results (the lowest = 5).

As of June 2010, the average Value Line Earnings Predictability for the Godsey & Gibb Associates Equity Composite was 87.4. A total of 18 companies from the Godsey & Gibb Equity Composite earned Value Line's highest rating, 100, for Earnings Predictability. Of the 426 companies in the Value Line universe with market capitalizations of over $5 billion, the average earnings predictability measure was 64.5.

While economic and financial conditions are measurably improved from the fall of 2008 and first quarter of 2009, markets still remain subject to many risks amid a backdrop of slowing growth in China, the European debt crisis, the oil spill in the U.S. Gulf of Mexico, ongoing consumer deleveraging and a lack of significant U.S. job creation. Until the transition to a more certain, sustainable economic environment is confirmed, we expect increased uncertainty could continue to produce heightened levels of financial market volatility.

As such, the smoothing effects of a portfolio carefully constructed with consistent earnings growth companies can help increase portfolio stability given the market's expected shifts. We believe an active, fundamentally driven assessment of a company's sources and uses of cash, and its ability to navigate a changing economic and market environment can help to preserve capital and generate long-term excess returns.

For example, the standard deviation of the Godsey & Gibb Associates Equity Composite at the end of the first quarter was 15.6, or approximately 72% of the overall market's standard deviation of 21.5. Standard deviation, calculated as the square root of the variance, is a measure of dispersion from an average where a lower number indicates less volatility.

Similarly, the beta coefficient for Godsey & Gibb's Equity Composite of 0.71 implies less risk as compared to the S&P 500 Index. The beta coefficient is a measure of volatility of a stock portfolio in relation to the rest of the financial market. By definition, the market itself has an underlying beta of 1.0. If a portfolio moves less than the market, its beta is less than 1.0.

Overall, we believe the current environment represents an attractive opportunity for active investors who are focused on fundamental research. Companies that can maintain market share, keep costs contained and generate high levels of cash flow should be rewarded. Moreover, given our expectations for a modest economic recovery in the U.S., along with the higher than normal level of uncertainty with regard to direction and consistency of global growth, a disciplined portfolio construction process focused on earnings stability will remain important to protect and ultimately reward investors.

Value Line Earnings Predictability as of June 2010

	Average Earnings Predictability
Godsey & Gibb Equity Composite	87.4
Value Line Universe (market cap > $5 billion)	64.5

Sources: Value Line and Godsey & Gibb Associates

Modern Portfolio Theory Measures as of March 31, 2010

	Standard Deviation	Beta Coefficient
Godsey & Gibb Equity Composite	15.6	0.71
Standard & Poor's 500 Index	21.5	1.00

Sources: PSN Informa and Godsey & Gibb Associates

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