Mid-Year Earnings Report

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Like the summer in general, earnings "season" is drawing to a close. In baseball terms, as of August 4th, we are in the eighth inning of the quarterly earnings reporting season. In general, only the major retailers (which have January fiscal years as opposed to December fiscal years) have yet to report results. Earnings season provides investors with a picture on how companies are doing. It's important to remember that although the market's short-term action often is driven by psychology and day-to-day economic statistics, over the long-term there is a clear link between earnings and price.

For the overall market, the second quarter has been strong. According to Credit Suisse, as of August 2nd, 67% of the companies in the S&P 500 reported earnings. Of those, 75% beat earnings estimates, 16% missed estimates and 9% met estimates. Credit Suisse is now looking for total second quarter earnings of $20.70 for the index and, for the full year, the consensus earnings estimate is $82.60. For 2011, the figure is now $95.14. If that $95.14 turns out to be true, the S&P 500 is selling for a reasonable 12x earnings, less than the 15% expected growth rate in 2011 earnings versus 2010.

Judging by the results of our July 31st large-cap holdings, the possibility of a double-dip recession seems remote but the possibility of a slowdown in the growth rate of earnings going forward is very real. It is just hard to believe they will keep the torrid pace of the second quarter. Revenue growth has been respectable and, lastly, management guidance about the future has been "cautiously optimistic." Of the July 31st holdings, 34 of 39 stocks beat estimates, three met estimates and two missed. In aggregate the median earnings per share growth between the most recent quarter and the same one a year ago was about 35% on revenue growth of about 14%. It is important to note that these are not companies bouncing back from weak earnings last year. Their 2009 earnings growth rate was about 13%.

Sector (No. of Stocks)	Beating Estimates	Earnings Growth	Revenue Growth
Consumer Discretionary (9)	6 of 9	49%	10%
Consumer Staples (3)	2 of 3	19%	19%
Energy (1)	0 of 1	-17%	7%
Health Care (7)	7 of 7	19%	22%
Industrials (6)	6 of 6	40%	18%
Information Technology (9)	9 of 9	87%	37%
Materials (3)	2 of 3	62%	31%
Telecom (1)	1 of 1	92%	11%

As you might expect in a recovering economy, consumer discretionary stocks showed good growth. Six of the nine stocks in that sector beat earnings estimates, the other three matched. Earnings growth ranged from 7% for Nike to 195% for DirectTV for an average of 49% on revenue growth of 10%. Leaving DirectTV out, earnings growth was still an impressive 31%. Revenue growth for the consumer discretionary stocks ranged from 4% to 53%.

If there were a weak group in the second quarter, it was the U.S.-based consumer staples firms, General Mills and Colgate. Both firms had earnings in-line with expectations, but light revenue growth and tepid guidance with management expressing concern about pricing power and margins. On the other hand for its last reported quarter, our non-U.S. based consumer staples stock, Brazil's AmBev, had earnings growth of 45% and revenue growth of 39% as that country's economy recovered.

The one energy stock we owned on July 31st was Newfield Resources. It reported slightly worse than expected earnings of $1.06 per share, two cents below estimates. In addition, its Q210 earnings were below the $1.28 earned in the Q209. However, cash flow was higher than expected and oil and gas production growth was higher than expected. Many analysts and investors view cash flow as more relevant to energy companies such as Newfield, and our sole telecom services stock American Tower, due to the high non-cash charges such as depreciation in their respective businesses.

The seven health care stocks had earnings growth ranging from 4% to 33%. The low figure came from distributor McKesson whose Q209 numbers were bolstered by the one-time distribution of swine flu vaccine while the high number was reported by Express Scripts which benefited from a large acquisition. The average earnings growth for our companies in the sector was 19% on revenue growth that averaged 22%, again Express Scripts posted the highest revenue growth number of 105% due to its acquisition.

Nowhere did the economic recovery make itself more evident than in the industrial sector where average earnings growth for the six companies reached 40% on average revenue growth of 18%. The strongest growth in both earnings and revenues came from Union Pacific Corp with earnings up 73% and revenues up 40% on the double-play of higher utilization of its rail cars and higher fees paid by its customers. The company's second quarter earnings number was 16% higher than analysts following the company expected.

Technology stocks were the portfolio's stars in the quarter. In aggregate they beat estimates by 11%, had earnings growth over Q209 of 87% and revenue growth of 37%. The most recognized companies in the group, Apple and Microsoft, were especially strong. Driven by its array of new products such as the I-Pad and new I-Phone, Apple's earnings jumped 75% on revenue growth of 61%. With earnings growth of 42% on revenue growth of 22%, Microsoft proved to be no slouch either. Revenue growth for our tech investments ranged from 13% to 68% while earnings growth ranged from 13% to 263%.

Results from the two mining stocks, Newmont Mining and Barrick Gold, reflected the strong rise in the price of gold over the past year with earnings growth of 79% and 65% respectively on revenue growth of 34% for each firm. Newmont, however, missed its estimate due to somewhat non-recurring events such as excessive rain in one area and weaker than expected copper prices. Additives maker Lubrizol had earnings and revenue growth of 43% and 26% respectively.

Lastly, the one Telecom Services stock we own, American Tower, had 11% revenue growth but 92% growth in earnings. More importantly, free cash flow for the company was up 200%. The company operates towers necessary for wireless communications.

In conclusion, our companies showed substantial earnings growth in the most recent quarter with decent revenue growth as well. Given the economy, there was some caution about the future. What we generally prefer to see is a company beating earnings and revenue estimates, then suggesting future results will be stronger than expected as well. We got some of that this past quarter, but with the still tenuous recovery in the U.S. coupled with the economic softness in Europe, caution about the future was still the name of the game.

Note: Our Tax-Exempt large-cap composite companies were used for table above. Sources: S&P, Value Line, Wm. O'Neil, company data.

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