

Equity Investment Corporation
2009 Third Quarter All-Cap Value Commentary
October 8, 2009

The past year has been the most tumultuous for stocks in any of our lifetimes. From September 30 a year ago to this year's low on March 9, broad indices fell 40%-50%, with the Russell 3000 Value index (R3000V) falling 46.6%. Nonetheless, due to the rally since and our smaller decline during the downfall, our All-Cap Value Composite rose 0.9% over the past year, versus declines of 10.8% and 6.9% for the R3000V and S&P 500 indices, respectively (all figures exclude fees)¹.

Since the market peaked in May 2007, our All-Cap Value Composite fell 14.0%, versus declines of 33.2% and 27.1% for the R3000V and S&P 500 indices. Getting back to even versus that peak requires a further increase of 16.2% for us, versus 49.6% for the R3000V and 37.2% for the S&P 500. The reality of this simple math is why we believe it is so important to reduce the risk of loss in a portfolio.

For the quarter, our All-Cap Value Composite increased 15.8% versus 18.6% and 15.6% for the R3000V and S&P 500 indices. Year-to-date our composite increased 19.1% versus 15.0% and 19.3% for the R3000V and S&P 500.

A great deal has been written about how unpredictable recent financial events were, that no one could see them coming, that they were "Black Swans". In the main, we believe the after-effects of excessive credit and economic imbalances were about as unpredictable as a hangover after a night of binge drinking. It was only the timing of the party's end that was difficult to predict.

Even so, such predictions are the occupation of speculators. The responsibility of investors is protection and long-term growth of capital. Protecting capital requires care about inflation and insolvency risks. Growing capital requires long-term ownership of businesses that can reinvest and grow, purchased at a rational price. In 1989 we wrote about the primacy of these principals over prediction in a Guest Viewpoint for Pension World entitled "The Infallible Forecast" (enclosed). These precepts guide us now as much as then.

Protecting capital from the expected hangover from the Credit Bubble meant moving away from companies with excessive leverage or earnings driven by loose borrowing/lending. By guarding against these risks from 2005-7, we shielded portfolios from the declines of 2008-9. (For further background, please see "How We Navigated the Bubbles – Commentary Excerpts" on the Presentations tab of our website at www.eicatlanta.com.)

Protecting capital when others seem blithely unaware of risk does not mean ignoring opportunity when others act out of fear. That is why, as the market fell from September through March, we deployed all available cash, purchasing stable firms (like Pepsi, Proctor & Gamble, Brown Forman, and Intuit), as well as more volatile ones in banking, financial services, and REITs. These actions also contributed to our positive 12-month results.

From this point, we believe protecting capital means avoiding cyclical and lower quality stocks that have led the rally since the March lows. These stocks are priced to reflect higher earnings than we believe sustainable, especially given the possibility of a slow recovery or double-dip recession. Meanwhile, unusually attractive opportunities remain in the more predictable, stable companies. That is why our portfolio exposure in these stable sectors continues to be among our

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highest ever. Also, we have begun incremental steps to reduce our exposure to some financials that have rallied strongly.

Portfolio Review

During the quarter we added a new position in C. R. Bard, a leading producer of catheters and other products used in vascular, urology, and oncology treatments, and sold our position in IMS Health, where ongoing cost pressures in the pharmaceutical industry were impacting growth. We added to our position in Wal Mart, where the price did not seem to reflect the stronger underlying fundamentals, while reducing our exposure to eBay after it rallied. We trimmed various financials, including SunTrust, Duke Realty, and Post Properties, while shifting our insurance exposure slightly by reducing Torchmark and increasing Chubb. We also shifted energy holdings slightly by trimming top performers like Cimarex Energy and Nabors Industries, while adding to laggards Chevron and ConocoPhillips. Finally, we trimmed our stake in Cadbury after Kraft's acquisition bid.

Conference Call

Our Third Quarter conference call is scheduled for Wednesday, October 21 at 4:30 (Eastern Time). The audio may be accessed by calling 800-977-8002, and entering the passcode of 200414#. Further instructions for accessing the visuals for the call appear on the back of this letter. We hope you can join us.

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¹ **Disclosures**

Not approved for presentation to wrap program clients. Such presentations should reflect EIC's wrap composite information. EIC results reflect our All-Cap Value Composite, after commissions and before EIC management fees, and are presented as supplemental information to a full GIPS® disclosure presentation, which is available upon request. EIC returns after manager fees were 15.6% for Q309; 18.5% YTD; 0.2% trailing 12-months; and -15.4% since May 31, 2007. Getting back to even, after fees, requires a further 18.1% increase for EIC All-Cap Value. All returns include reinvestment of dividends and interest. Index returns exclude fees and commission costs. Results are historical and do not imply future rates of returns or volatility for EIC or the indices, which may be materially different from the past and from one another. Individual account results may differ from those of the composite.

Audio & Visual Instructions for Conference Call – October 21 at 4:30 (EST)

Our Third Quarter conference call is scheduled for Wednesday, October 21 at 4:30 (Eastern Time). The audio may be accessed by calling 800-977-8002, and entering the passcode of 200414#. Visuals for the call are accessed by either of two methods:

- **Visuals (Live & online):** Follow 4 steps below
 - a. **Browse:** www.livemeeting.com/cc/eicvalueatlanta/join
 - b. **Scroll to bottom:** "Accept Terms and Use LiveMeeting Access"
 - c. **Enter:** Your Name; Meeting ID: [EICQ32009](#); (no Entry Code needed)
 - d. **Register:** Use your E-mail & company name
(Firefox is supported despite message to contrary)

Or

- **Visuals (off-line):** Browse: www.eicatlanta.com/presentations.htm

A replay will be posted 24-hours after the call on the Presentations Tab of our website: www.eicatlanta.com/presentations.htm. If you have any technical questions beforehand, please contact Jennifer Raeburn at 404-239-0111 or jraeburn@eicatlanta.com.

GUEST VIEWPOINT
A COLUMN

The Infallible Forecast

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There seems to be no end to the desire to uncover what the future holds, and thereby a prediction about the market's future course. Yet, before the 1987 Unpleasantness, respected forecasters were predicting the Dow would reach 3600. Afterward, some predicted a further fall to 1500. And now, in the last month, forecasts have ranged from 400-5000. Surely, experience has shown such efforts to be fruitless.

This perpetual return to the crystal ball in search of the Infallible Forecast, in spite of its poor track record, stems largely from a misunderstanding about the stock market and the capital creation process. Such predictions interest those who view the stock market as the creator or eliminator of the return on their capital. For them, a correct forecast results in a good trade, which increases their capital, while a wrong forecast results in a loss.

In contrast, anyone committed to long-term business ownership knows that the stock market does not create capital—it merely reflects the value of the capital invested in the underlying businesses. Over time, as businesses earn profits and reinvest a portion for growth, the shareholders' capital grows. This growth through the reinvestment process is the true creator of capital, and is ultimately reflected in the stock's price.

Thus, the long-term investor should look for companies that are superior at earning and reinvesting capital. With confidence in one's business's capital creation ability, an investor can wait patiently as his/her capital builds, and need not worry about the current forecasts.

Now, just as the stock market does not create capital for the shareholders, it likewise does not eliminate it. For this, investors must worry about two other threats: Inflation and Insolvency.

Inflation eliminates capital permanently by eroding its real value. Anyone who structures a portfolio without taking into account the role of inflation in the business's ability to create capital has not thought wisely about the threats he/she faces. The investor is building a house without a roof. One need not know when rain will come to know that protection against it is vital to a home's survival. Likewise, protection against inflation is vital to the survival of capital.

A shareholder's best protection against inflation is his/her business's ability to earn a high return on capital. For example, if a business only earns 7 percent on its capital, it will end up with a negative real return whenever inflation moves above 7 percent. Here, the capital creation process reverses—inflation is destroying capital faster than the business is creating it. This erosion of capital would surely be

reflected in the market's price. Would it not be better to own a business that earns say, 15 percent, since it would continue to increase one's capital in real terms?

The other threat to capital is Insolvency—which ends the going concern's ability to create and reinvest capital for its owners. While the post-war period has been fairly benign with respect to the risk of insolvency, shareholders of the 1930's whose stock certificates ended up as mere collector's items can attest to the permanency of capital elimination from insolvency. The recipe for insolvency is unstable earnings and high debt. Therefore, the wise investor restricts his/her investments to companies with stable earnings and low debt.

Thus, investors who build in protection against inflation and insolvency—by owning the right kind of businesses—remove the primary threats to their capital, and can end their search for the Infallible Forecast. □

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