

The Philadelphia Trust Company

April 2011

Investment Commentary

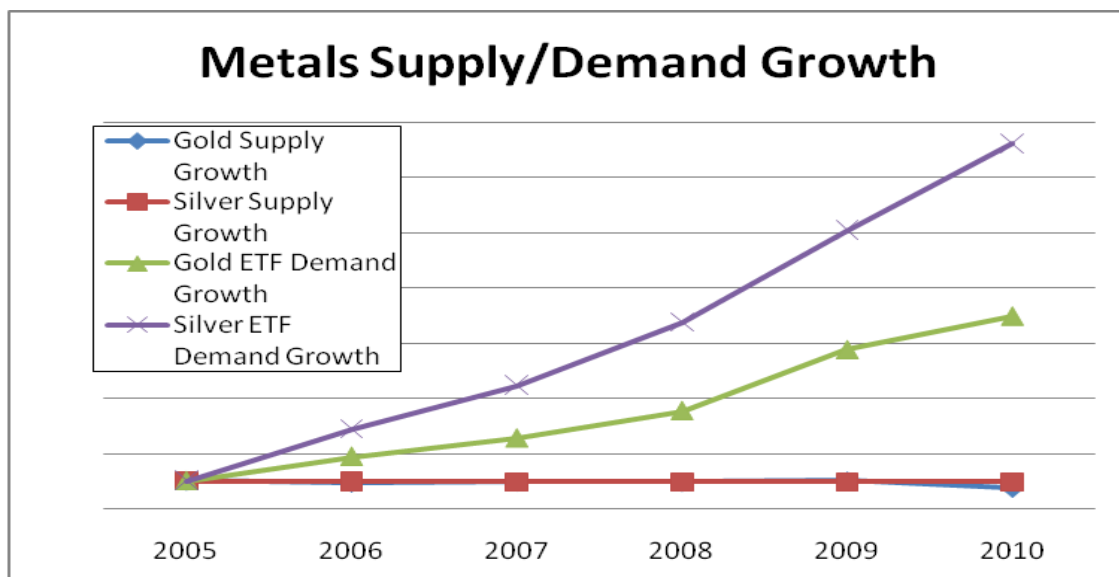
Even if one could have predicted the revolutions, earthquakes, tsunami, nuclear meltdown, and a new NATO military operation in the Middle East, it is unlikely that those events would be expected to coincide with the best first quarter performance of the S&P 500 since 1998. In fact, the strength of the market in the face of these disruptions makes one wonder how high valuations would be if these devastating events did not occur. However, closely watched, markets often provide clues about risks that are underappreciated. For instance, in the spring of 2007 a Bear Stearns hedge fund that invested in mortgage securities lost billions and was forced to close. This warning was an indication of the rapid deterioration of the mortgage market. In recent months, we have witnessed events that make us cautious about the liquidity of certain markets, and investors appear to be making assumptions that could prove costly if incorrect. The following will elaborate on what increased liquidity risk means for corporations, commodity prices, credit markets, and market perceptions.

Liquidity refers to the ease with which one can buy and sell securities. Apple stock, for example, is highly liquid. With an average of 18 million shares traded every day, it is highly likely an investor wanting to sell shares could find buyers of the desired quantity, near the market price. A house, on the other hand, is less liquid and would likely take weeks or months to sell. In the last year we have seen several instances where buy or sell orders overwhelmed the market, resulting in a massive dislocation in price. There are several implications for markets, if this expectation of liquidity is not achieved.

When it comes to operations, “just-in-time” inventory channels enable companies to hold low levels of inventory, with the expectation of readily available replacements. However, disasters in Japan interrupted the global supply chain for products like semiconductors, auto parts, and electrical components. In addition, petroleum exports were hobbled by civil unrest, which closed ports in the Middle East and threatened to shut down the Suez Canal. The disruptions seen in this quarter are impacting both the price and availability of raw materials, and reminding managers of the need for redundant and geographically diverse supply lines. This potential build-up of “just-in-case” inventories could be a short term drag on profits, but will ensure an adequate supply of inputs is readily available. The combination of higher commodity costs, declining consumer confidence, and rising inventory levels all contribute to increased uncertainty. We expect that when companies announce first quarter earnings, many will lower profit expectations for the remainder of the year. Geo-political instability and natural disasters are illuminating operational risks, and prudent managers will heed those warnings.

There is a confluence of events driving commodity prices higher. Since these prices are driven by changes in supply and demand dynamics, rather than a cash flow stream, investors are wise to monitor the events that have fueled the recent rally. Growth in industrial production in Asia has spurred global demand for industrial commodities. After drought and floods destroyed much of last year’s crop, and the EPA raised the ethanol blending limit by 50%, Congress extended the \$0.45 cent per gallon ethanol blending tax credit. These factors increased demand for agriculture products and constrained supply. To complicate matters, excessively loose monetary policy in the developed world is causing, both, volatility in the currency used to price commodities

and driving demand for precious metals as a store of value. Demand for gold bars increased 66% in 2010, and exchange traded funds (ETFs) have dramatically increased demand for precious metals at a time when mine production is flat. Financial innovations have made it much easier for investors to trade commodities, but investors should be aware that commodities are not liquid instruments, as they need to be mined, shipped, and stored. The improved liquidity is a function of financial firms using leverage and trading in derivatives markets, and the liquidity may not prove sustainable when investors begin to unwind these positions. In addition, valuing commodities is challenging because these instruments are not backed by a stream of cash flows. The arguments for higher prices make sense, but these are the same justifications that have been offered for several months now and investors have to determine the price point that appropriately reflects these assumptions. Unfortunately, it appears as though many investors assume that the current market price for certain commodities represents long term value, rather than short term supply and demand characteristics. History has shown this to be a poor method of valuing such investments.



*Data provided by Bloomberg

Since freezing up during the Credit Crisis of 2008, credit markets have thawed considerably. Fast, easy access to revolving credit has become a critical component of our economy, for both businesses and households. It is the banks that provide the funding, and it is apparent that continued deterioration in the mortgage and housing market could impair the ability of banks to provide that funding on current terms. The most recent reading of the S&P Case-Shiller Index showed that home prices, in the 20-largest metropolitan areas, declined 3.1% from a year ago. Economist Robert Shiller, who developed the index said, "Our indexes are already in double dip territory, if you use inflation adjusted data. That means they are below the previous lows of 2009, and are still declining." The vast majority of bank assets are mortgages. If home values continue to fall, it may put the value of these mortgages in jeopardy, which would impair the banks ability to underwrite new loans. Even after all of these months, the problems in housing and mortgages have not been resolved, and investors are well served by recalling the

devastating effects that frozen credit markets had on corporations and the economy. When an institution like Wilmington Trust Company fails, and is given away for 35% of its tangible book value, it is a signal that bank balance sheets are more fiction than reality.

Finally, investors in a number of markets have been conditioned to expect government bailouts. Banks and insurance companies were bailed out in 2008 and 2009, holders of European sovereign debt were bailed out in 2010, and in 2011 we have seen currency investors bailed out when there was not enough yen available to meet demand following the Japanese earthquake. Even Shelia Bair, the Chairman of the FDIC, has said, "The notion of government support has been built into market assumptions." While the "Flash Crash" in May of 2010, during which the S&P 500 dropped 7% in 15 minutes, was resolved in an orderly manner due to regulators breaking trades, it is an example of the potential problems with algorithmic trading and liquidity assumptions. These same liquidity issues manifested again in March, when the Japanese earthquake caused demand for yen to dwarf the available supply in what is touted as "the most liquid market in the world." In a number of markets, investors appear to be overwhelmingly on one side of the trade, and few seem to be considering where the buying interest will come from when everyone wants to sell. While regulators and governments have been willing to support certain markets, it is not prudent to make investment decisions with that expectation.

During the quarter, The Philadelphia Trust Company initiated a position in Archer Daniels Midland Corp (ADM), the world's largest corn processor. The company has an enduring business model that combines economies of scale with the ability to buy (corn) by the ton and sell by the ounce, profiting on the processing spread. In addition, it appears the market does not appreciate the benefit ADM will receive from ethanol legislation, as ethanol shaves about \$0.08 off of a gallon of gasoline. This becomes more important as prices at the pump climb toward \$4.00 per gallon during a period of off-peak demand. In addition, while inflation in food and energy are pressuring the consumer, we took advantage of Nike missing profit expectations, to initiate a position in the apparel maker. We remain underweight consumer stocks, but want to own enduring brands that have pricing power. Nike commands a premium in both developed and emerging markets. The product is an affordable luxury in emerging economies, and a staple in the western world where athletes own multiple pairs. With a clean balance sheet, a stable dividend, and a dominant market position, Nike should be a source of stable income and steady growth. On the sell side, our position in Urban Outfitters was sold as the stock rallied over 20% in the months after our purchase, and our valuation discipline indicated that the risk/reward profile had become more heavily weighted to the downside. Markets continue to rally higher as more investors extrapolate recent performance, enhanced by excessive policy accommodation, indefinitely into the future. While risks remain, we continue to work diligently to uncover opportunities to protect and grow your capital.

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