

October 2008: Widespread and Indiscriminate Losses

- October was a devastating month of performance as the average stock declined 23% with widespread losses across sectors, geography, and valuation levels
- Among the various methods for calculating estimated earnings, stocks look to be about 25% cheaper than their longer-term average
- Taking Warren Buffett's advice that now may be a good time to buy sound companies that will participate in long-term U.S. prosperity, we peruse the S&P 500 Dividend Aristocrats index to identify stocks that appear undervalued

The average stock in our EquityCompass universe declined 23.2% in October in a devastating month of performance across all market-caps, industry groups, investment styles, and global markets. All of the S&P 500 sectors declined 10% or more with the overall index down 16.9% for the worst month of performance since the 1987 stock market crash. There was little discrimination in the selling based on stock attributes of expected earnings growth, valuation level, short interest, dividend versus non-dividend, and analyst opinion. The only sub-industry group showing a gain for the month was Educational Services as the apparent cost and difficulty of obtaining loans at conventional colleges is driving increased interest in distance learning (online) alternatives.

The relative performance advantage that was evident last month favored larger, higher quality, and lower beta stocks. These attributes are more characteristic of an index such as the DJIA which declined 14.1% in October versus the equal-weighted S&P 500 that declined 21.1%. This performance spread is abnormal and indicative of the collapsing breadth in the market. We should note that October's performances did show some emerging price momentum from the many broken trends of the last three months. The sub-industry groups with distinctly better relative price momentum include Biotechnology, Packaged Foods, and Educational Services.

Earnings Confusion

Depending on your perspective, there are different methods to analyze company earnings. For analysts assessing intrinsic value, future operating earnings or cash flow, are the major input for discounting back to present value. Other investors focus on trailing earnings inclusive of non-operating items for an apples-to-apples comparison to past valuation levels. And from here, there are still other variations that include operating earnings exclusive of writedowns, core earnings that exclude various adjustments such as pension expensing, cash or non-GAAP earnings that exclude non-cash amortization items, bottom-up earnings that aggregate analysts for a consensus estimate of earnings, and top-down using broader economic factors to generate earnings estimates. Given the financial crisis and downward earnings pressure, the various earnings calculations are producing widely different numbers.

The EquityCompass uses consensus analyst earnings estimates for the next 12 months. We do this for two reasons. The first is philosophical, based on the notion that stocks are an investment best analyzed looking forward rather than behind. Secondly, we believe it is the change in future earnings expectations that is a major driver in the change in stock prices. Full year earnings estimates for the S&P 500 for 2008 are anywhere from \$40 to \$85 depending on the version. The higher number is from operating earnings exclusive of what are considered non-operating write downs, which in the case of financial stocks and General Motors amount to big losses. Top-down estimates inclusive of write-downs are about \$72 for this year. As such, the S&P 500 is trading with a P/E ratio of 11.4x or 13.4x depending on whether or not you exclude or include non-operating write-downs. As for 2009, it looks like estimates are for a slight increase at best. As such, our view is that P/Es are somewhere in the 12x range for 2008 and 2009 earnings versus an 83 year average of about 16x. The S&P 500 were at a P/E of 7x in the late 1970s when inflation rates and U.S. Treasury yields were dramatically higher.

Identifying the Favorable Aristocrats

In his October 17 op-ed piece in *The New York Times* entitled "Buy America. I am.," Warren Buffett stated that he is buying American stocks for his personal account due to his investing rule that one should "be fearful when others are greedy, and greedy when others are fearful." According to Ned Davis Research, investor sentiment is as extremely negative as has been in the bear markets since the 1970s. Buffett qualifies his current purchasing, however, stating, "...investors are right to be wary of highly leveraged entities or businesses in weak competitive positions. But fears regarding the long-term prosperity of the nation's many sound companies make no sense." A key question for the average investor is, "How do you identify the sound companies?"

One school of thought looks at dividend policy, stating that a history of maintaining or increasing dividends is an excellent indicator of company stability over time. Standard & Poor's tracks an index of companies in the S&P 500 that have had a long history of increasing their annual dividend. The S&P 500 Dividend Aristocrats is an index of companies in the S&P 500 that have increased their dividend each calendar year for at least 25 consecutive years. The Aristocrats have increased dividends each year through this extended time period that has seen recessions, bear markets, September 11th, the '87 crash, and a myriad of other market shocks. The index is rebalanced to equal weight each quarter, and stocks are removed if they fail to increase their dividend or are removed from the S&P 500.

We have selectively filtered the S&P 500 Dividend Aristocrats index to reveal a more manageable list of stocks. **Table 1** displays members of the index that have a dividend payout ratio of less than 50%. We show the average EquityCompass valuation percentile ranking since inception of the models in August 2001, as well as the highest, lowest, and current valuation rankings for the company. The

six highlighted stocks have valuation rankings below their long-term average, but higher than they have been over the past six months. We view this as an indication that, while cheaper relative to other

stocks in the context of long term averages, rising relative valuations versus short-term averages demonstrate a vote of confidence in these stocks despite turbulent times.

Table 1

Select Stocks from the S&P 500 Dividend Aristocrats Index

Symbol	Company Name	Dvd. Yield (%)	Dividend Payout Ratio*	Average Valuation Percent	High Valuation Percent	Low Valuation Percent	Current Valuation Percent
NUE	Nucor Corp.	6.60	35.69%	16.68%	63.44%	0.31%	11.33%
ADM	Archer-Daniels-Midland	2.83	19.92%	25.95%	79.62%	4.20%	20.68%
PPG	PPG Industries	4.68	40.28%	29.21%	61.58%	7.41%	23.80%
STT	State Street Corp.	2.65	19.75%	62.98%	88.56%	11.22%	28.05%
SWK	Stanley Works	4.15	34.33%	30.06%	66.37%	8.69%	29.23%
MMM	3M Company	3.26	37.27%	67.01%	87.86%	32.35%	57.22%
SVU	Supervalu Inc.	5.18	24.39%	8.94%	27.49%	0.57%	6.07%
JCI	Johnson Controls	3.43	26.78%	12.77%	44.34%	0.31%	11.61%
AFL	AFLAC Inc.	2.53	21.37%	28.84%	67.14%	5.71%	17.28%
DOV	Dover Corp.	3.76	29.30%	43.76%	72.57%	13.20%	18.37%
CB	Chubb Corp.	2.81	22.85%	13.59%	59.63%	1.69%	18.98%
XOM	Exxon Mobil Corp.	2.33	20.19%	25.13%	62.91%	1.35%	25.21%
EMR	Emerson Electric	3.88	36.70%	58.27%	73.27%	35.98%	26.91%
VFC	V.F. Corp.	4.99	38.92%	23.33%	52.64%	4.69%	31.47%
WAG	Walgreen Co.	2.02	19.28%	66.99%	88.57%	26.72%	31.73%
PBI	Pitney-Bowes	6.38	45.72%	64.25%	84.56%	28.08%	33.07%
LLY	Lilly (Eli) & Co.	6.04	44.03%	78.33%	95.45%	39.81%	33.43%
STR	Questar Corp.	1.88	13.79%	47.21%	93.38%	4.56%	42.49%
MHP	McGraw-Hill	4.26	32.53%	67.63%	90.91%	36.62%	45.37%
TGT	Target Corp.	1.90	19.00%	36.64%	69.33%	13.76%	46.74%
FDO	Family Dollar Stores	2.00	28.93%	43.02%	80.43%	1.22%	47.12%
APD	Air Products & Chemicals	3.60	33.56%	56.37%	78.59%	38.68%	47.31%
SHW	Sherwin-Williams	2.61	32.00%	23.05%	58.65%	9.15%	52.56%
WMT	Wal-Mart Stores	1.87	25.43%	47.42%	80.71%	7.53%	55.81%
LOW	Lowe's Cos.	1.96	23.50%	35.33%	72.64%	5.16%	56.66%
GWW	Grainger (W.W.) Inc.	2.28	25.95%	43.02%	66.20%	20.22%	61.34%
ADP	Automatic Data Processing	3.66	47.80%	71.43%	88.30%	38.57%	64.87%
BDX	Becton, Dickinson	1.76	23.15%	59.64%	79.21%	29.52%	67.42%
JNJ	Johnson & Johnson	2.99	39.63%	65.59%	86.36%	45.00%	69.41%
SIAL	Sigma-Aldrich	1.43	18.89%	69.53%	88.48%	52.28%	79.07%
BCR	Bard (C.R.) Inc.	0.78	12.92%	69.73%	91.49%	37.99%	79.87%
ABT	Abbott Labs	2.67	39.74%	70.23%	87.65%	46.02%	82.72%
PEP	PepsiCo Inc.	3.23	43.52%	75.72%	91.56%	53.23%	85.55%
KO	Coca Cola Co.	3.62	46.53%	86.79%	97.86%	71.65%	87.82%
PG	Procter & Gamble	2.75	38.07%	72.50%	86.17%	45.12%	88.39%
CLX	Clorox Co.	3.37	47.90%	66.30%	90.00%	45.11%	89.30%
BUD	Anheuser-Busch	2.53	41.58%	72.34%	93.02%	58.73%	89.80%

Valuation as of 10/31/08

*Payout ratio based on 12-month forward consensus EPS estimates.

Source: EquityCompass Strategies, Standard & Poor's, StarMine, Thomson One

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Additional Information is available upon request.

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