

## **Factors Influencing Our Current Investment Strategy**

In making portfolio decisions, we take a significant number of factors into consideration. The following are three such factors that we would like to highlight:

### **Investment Themes**

Our investment strategy often emphasizes one or more investment themes at any given point in time. For instance, long time clients may recall stock holdings in the regional banking sector from 1982-1986, the oil/oil services industry from 1986-1990, the banking sector from 1990-1997, and the banking industry again from 2001-2007 (fortunately exiting prior to the subprime meltdown). We have also had periods of time where we have concentrated on insurance and retail, among other sectors. We have found that identifying themes plays an important role in our investment process and helps us identify individual stocks for investment consideration.

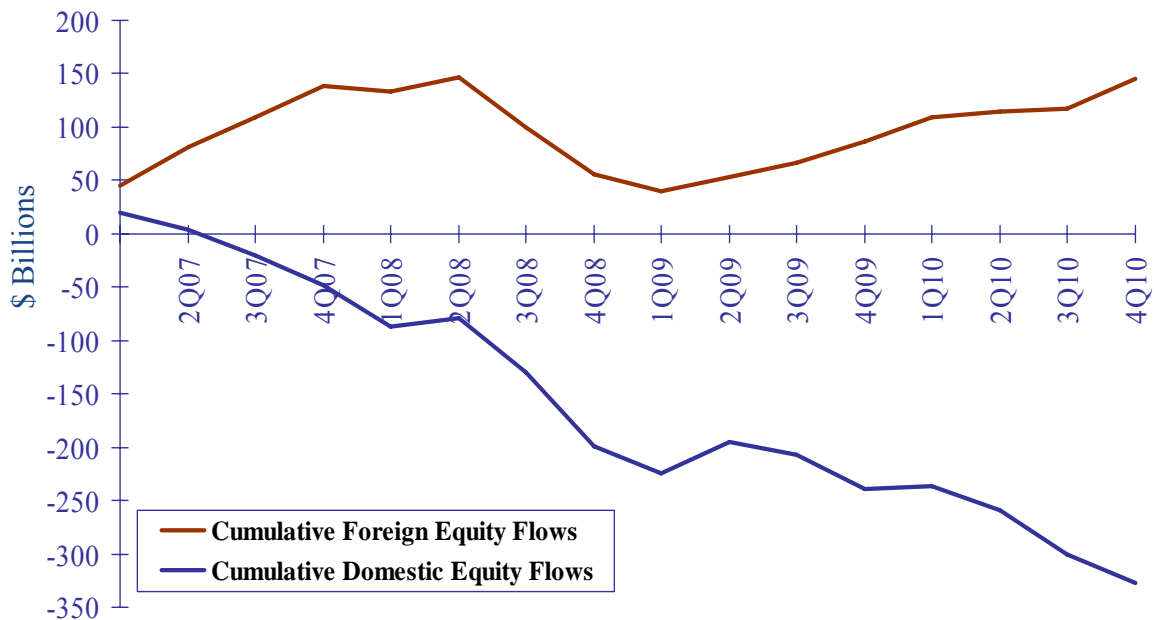
While always careful to maintain diversified portfolios, highlighting various sectors/industries has allowed our clients to outperform the general markets over time. Currently, there are four major investment themes within our client accounts:

- Technology – Technology stocks play an important role in our current investment strategy. After refusing to buy into the tech bubble that ultimately burst in 2000, we began purchasing tech stocks in more recent years as they became attractive from a valuation standpoint. As a group, we expect these stocks to maintain solid earnings, revenue and cash flow growth as the global economy continues to mend. Attractive multiples and balance sheets have these stocks positioned for price appreciation.
- Healthcare – Our current emphasis in healthcare is primarily a result of demographic trends in the United States, Europe and Japan. With aging populations in these countries and others, the demand for cardiology and orthopaedic medical devices and services is increasing. Healthcare reform in the U.S. has complicated the outlook as investors and the industry wonder what effect reform will have on device makers, healthcare providers and patients. We expect upside in our healthcare holdings as concerns over the healthcare bill continue to dissipate.
- Retail – In early 2009, we bought stocks in the retail sector which had been beaten down by the recession. We anticipated that the global financial system would work and the markets would ultimately recover. As the markets turned the corner, these stocks provided a significant lift and led to our outperformance in 2009.
- Oil and Gas – After avoiding the oil and gas industry during the speculative binge in oil prices during 2008, we recently purchased a number of integrated or “big oil” stocks. With the global economy recovering and mounting demand on natural resources from developing countries, we believe it is appropriate to participate in the energy sector. The recent turmoil in the Middle East has not been a surprise given the history of the region and it has put upward pressure on oil prices benefiting our positions.

## Equity Mutual Fund Cash Flows

After becoming disillusioned by the first bear market of the decade, pension plans, endowments and individual investors sought out new investment frontiers through foreign equity and alternative investments (like private equity and hedge funds). As seen in the chart below, since the start of 2007 there has been a significant flow of capital out of U.S. domestic mutual funds and into foreign (emerging and developed) mutual funds.

### Cumulative Net New Cash Flows in Mutual Funds: Foreign vs. Domestic



Source: Investment Company Institute

These enormous cash flows have affected the valuations of individual stocks within the foreign and domestic markets. On the foreign side, these flows have pushed many stocks to unattractive price levels as fund managers have invested nearly \$150 billion of new capital. Conversely, on the domestic side nearly \$330 billion of capital has been sucked out of U.S. stocks over the last 4 years leaving many companies at extremely attractive valuation levels. As a result of this, we are focusing on U.S. stocks.

From an investment standpoint, our philosophy is to invest in approximately 20 individual stocks that each has the potential to provide a 50% to 100% return over a multi-year time frame. Unlike many investment firms, we do not allocate fixed percentages to foreign or domestic equities. Our preference is to invest in individual companies that meet our investment criteria regardless of where they are physically headquartered. Historically, the consensus has dictated that a stock's performance depends heavily on the performance of its home country. As economies of the world continue to merge toward a true global economy, country of origin has lessened in significance and the importance of where and how a company does business has increased. Our portfolios currently have a heavy U.S. domestic stock focus (most with a global presence) because that is where we are finding attractive valuations.

## Historical Perspective

Just over two years have passed since the S&P 500 touched its lowest point during the Great Recession. Investors have been through a lot since then: the European debt crisis, U.S. healthcare and financial reform, the flash crash, fear over municipal bonds, revolution in the Middle East, an earthquake, a tsunami and a near nuclear meltdown in Japan. All of these things, individually or as a group, could have derailed the current market recovery, but have failed to do so thus far. Continued progress in the wake of such unrest denotes the underlying strength of this recovery and begs the question: “how much longer can it continue?” Of course no one knows the answer, but clues may lie in the historical data:

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### Historical Bull Markets Over the Last 75 Years (% Price Return of the S&P 500)

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Bull Market Expansions		Duration	Magnitude
Trough	Peak	(in months)	
3/18/35	3/10/37	24	130.9%
4/28/42	5/29/46	49	157.3%
6/26/62	2/9/66	44	79.8%
10/3/74	9/21/76	23	73.1%
8/12/82	8/25/87	60	228.8%
12/4/87	7/16/90	31	64.8%
10/11/90	7/17/98	93	301.7%
10/9/02	7/19/07	57	99.9%
<b>Averages</b>		<b>48</b>	<b>142.0%</b>
3/9/2009	3/31/2011	24	96.0%

Source: [Investools.com](http://Investools.com)

Since 1935, there have been nine major market recoveries as illustrated in the table above. These recoveries (not including the current one) have produced an average return of 142.0% from trough to peak over an average of 48 months. How does the current recovery stack up? So far it has returned 96.0% over 24 months through March 2011. Compared to the historical average, it falls well short in both duration and magnitude - potentially suggesting more upside ahead. That being said, individual recoveries have varied in duration and magnitude. While anecdotal at best, this data provides some context to the current recovery.

We are likely in the early to mid stages of a multi-year market recovery following one of the worst recessions in over 75 years. We anticipate that the global economy and the financial markets will continue to mend, but also expect intermittent volatility (as witnessed in March following the natural disaster in Japan and unrest in the Middle East). As we have written previously, corrections in the neighborhood of 10% to 15% are the norm during market expansions. For example, since the March 2009 low, there have been four corrections in the S&P 500 ranging from -7.1% to -17.1% in the midst of an overall advance of 96.0%. As such, we do not think it is prudent to try to micro manage around such regular occurrences, although they certainly capture media headlines.

## Darrell & King News



We are thrilled to announce the addition of **John Wells, CFA**, who joined the firm in February. From 2008 to 2010, he was an investment analyst at value oriented hedge fund Defiance Asset Management, LLC, located just outside Philadelphia, PA. At Defiance John was responsible for analyzing and recommending investments in the U.S. consumer area. From 2006 to 2008, he was an investment analyst at growth oriented hedge fund Cotton Hall Asset Management, LP, in New York, NY. Cotton Hall was globally focused. John started his career at

quality of earnings/forensic accounting research firm CFRA, LLC under the tutelage of Howard Schilit. He received his B.S. in Commerce from the University of Virginia in 2001 and is a CFA charterholder. John and his wife, Christine, like to enjoy the outdoors whenever possible.

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INVESTMENT COUNSEL, LLC

410 White Gables Lane • Charlottesville, Virginia 22903  
434-977-7010 PHONE • 434-977-6313 FAX • [www.darrellandking.com](http://www.darrellandking.com)