

QUARTERLY  
COMMENTARY

*A quarterly commentary on the markets and the economy from Rorer Asset Management, LLC*

10 LARGEST HOLDINGS AS OF  
MARCH 31, 2006

Large Cap Equity:

ConocoPhillips (COP)  
McDonalds Corp (MCD)  
Motorola Inc (MOT)  
AFLAC Inc (AFL)  
CVS Corp (CVS)  
L-3 Communications Hldgs Inc (LLL)  
Exxon Mobil Corp (XOM)  
J.P. Morgan Chase & Co (JPM)  
Microsoft Corp (MSFT)  
Morgan Stanley (MS)

Mid Cap Equity:

Staples Inc (SPLS)  
Fiserv Inc (FISV)  
Office Depot Inc (ODP)  
HCC Insurance Holdings Inc (HCC)  
Parker Hannifin Corp (PH)  
Laboratory Corp America Holding (LH)  
Bear Stearns Cos (BSC)  
Affiliated Computer Services (ACS)  
SEI Corp (SEIC)  
Ensco International Inc (ESV)

**RORER**  
ASSET MANAGEMENT, LLC

# THE RORER REVIEW

## PICKING OUR BATTLES

In the last issue of the Rorer Review, entitled *The Wind at Our Back*, we wrote about the twin forces of higher interest rates and energy prices slowing the U.S. economy. We illustrated how this would cool off the robust housing market, and temper the enthusiasm of the consumer. Further, we opined that all of these factors together will result in a tougher earnings environment for U.S. corporations, making continued attractive earnings growth more likely at larger corporations which possess extensive geographic reach and/or diversified lines of business. This, in turn, will likely result in the stocks of these larger companies retaking the market leadership in the months and years ahead after more than six years of relative underperformance versus their smaller competitors.

It finally appears that the U.S. economy is, in fact, cooling off, led by the housing market. Inventories of unsold houses have spiked in 2006 thus far. In February, the month's supply of unsold homes rose 25%, year-over-year to 6.3 months, the highest level since 1995. The prices for new homes fell almost 3% in the same month, while existing home prices actually rose almost 11% year-over-year. With builders of new homes getting more aggressive on price in order to sell their rising inventory of homes, it is only a matter of time before the price for existing homes comes under pressure.

The marginal buyer is beginning to feel the squeeze. In the last Rorer Review we cited the fact that roughly 50% of all mortgages originated in 2005 were esoteric instruments such as Interest Only mortgages (IO) or Option ARMs. Because the borrower often stretches financially to afford these mortgages and makes only interest payments on these instruments, sometimes at below market rates resulting in a rising balance over time, any softening in the housing market and the economy can have a profound negative effect. We recently read that fully

20% of the esoteric mortgages originated in 2005 are already underwater, meaning the house is now worth less than the mortgage! Taking this a step further, because interest rates have risen, the interest payment on many of these mortgages will be readjusted upward resulting in higher monthly payments for the borrower. In a worst case scenario, financially stretched homeowners will not be able to afford the higher payments. If the value of their homes continues to decline, marginal borrowers will find themselves in an increasingly tenuous position.

Obviously, rising interest rates have all but turned off the spigot in the home refinancing market. The incentive to refinance a mortgage lies in the opportunity for the consumer to reduce monthly mortgage payments and also to monetize the equity in his home. In 2005, refinancing resulted in the consumer extracting approximately \$800 billion in equity. It is estimated that the consumer spends roughly 50% of this amount, representing a boon to the economy in 2005 and probably early 2006.

Unfortunately, as the home refinancing market dries up and monthly payments on Adjustable Rate Mortgages rise with higher interest rates, many consumers will take it on the chin. In early 2006, thanks in part to the home refinancing mentioned above and to seasonally warmer than normal weather in January, retailers reported robust sales for the first month of the new year. Since then, there has been increasing evidence that retailers are feeling a bit nervous about their prospects. We have heard from several trucking firms that business has fallen off a bit lately thanks mostly to retailers holding off on new shipments as they reduce existing inventory. Furthermore, Wal Mart recently reported that same store sales for March came in at the low end of their 1% to 3% estimate. The company blamed two factors for the weakness versus their plan: bad weather and Easter falling in April this year rather

than March of 2005. While bad weather is certainly unpredictable, we have to believe that the company included the shifting Easter holiday in its estimates for March. Given that the marginal home buyer mentioned above is a typical Wal Mart customer and that the company is considered the bellwether for retailers in general, we will be watching the progress of these monthly sales reports with interest as the year progresses. It certainly looks like the sledding could be rough for the low-end retailers over the next several quarters.

The economic news isn't all bad, however. Indeed, foreign economies from Europe to Asia are showing signs of strong growth. Even Japan, after having been in the economic doldrums for the better part of two decades, has begun to show signs of sustainable growth. This has increased the demand for imports from the U.S. and helped to keep our factories running at high rates. Further, thanks to this good economic growth abroad as well as the increasing use of technology and the globalization of the workforce, corporate profits in the U.S. have never been higher. Productivity, as measured by unit of output per man hour worked, has grown at a healthy clip for years and shows few signs of stopping.

All of this has produced a very benign outlook for the labor market, in our opinion. Employment has increased at a healthy, but not overheated, pace for the past several quarters to the point where the unemployment rate is now well below 5%. We believe that this can continue, although at a slower pace going forward, due to increased demand for goods from growing economies abroad and even here in the U.S., despite the likelihood of slower growth. At the same time, increased productivity and global competition have helped to keep inflation in check. It is for this reason that, while we feel the consumer will rein in his voracious appetite for goods in the near term due to pressures in the housing market, we do not think that spending overall will fall precipitously in the U.S.

The wild card for the U.S. economy as well as the equity and bond markets in

the months ahead will be the action of the Fed. During the first three months of 2006, the Federal Reserve raised rates two times, bringing the overnight Fed Funds rate to 4.75%. Chairman Greenspan oversaw the first move (his last), while Chairman Bernanke presided over the second. During any tightening cycle, the debate about the ultimate ending point is always of paramount importance to the markets. Never an easy problem to solve during normal times, the fact that we are at the very beginning of a new Fed Chairman's tenure only serves to lessen the clarity of this situation. From Bernanke's testimonies thus far, it is apparent that he wants to be viewed as a hawk on inflation. If anything, this has led some economists to believe that the Fed may raise rates a bit further than it would have under other circumstances. While this may indeed be the case, we think the mounting evidence of a slowing U.S. economy and an extremely benign inflation outlook make it likely that we are very near the end of this tightening cycle.

#### THE MARKETS

In *The Wind at Our Back*, we highlighted the extreme undervaluation of large capitalization stocks versus their mid and small cap brethren. As an example of this, we pointed to Cisco Systems, which at the time was trading at a price/earnings ratio below that of the S&P 500, despite having a growth rate almost twice that of the market. Well, during the first quarter of 2006, this argument won the battle (Cisco outperformed the S&P 500 by over 20%) but lost the war (the S&P 500 underperformed both the S&P 400 Mid Cap Index and the S&P 600 Small Cap Index). Thus, despite having underperformed smaller stocks for six consecutive years as of year-end 2005, no relief was found for large cap stocks in the first three months of 2006.

Loyal readers of the Rorer Review know that we have been calling for the large cap stocks to begin outperforming for some time now. We realize at this point that you're probably asking yourself when we will stop trying to predict the end of the small and mid cap cycle. Well, you'll be

happy to know that the time is now. We are not going to point to the fact that large cap stocks as a group now trade at close to a 20% discount to small caps on a P/E basis, versus the historic norm of a premium. Nor will we harp on the fact that the mid cap S&P 400 and the small cap S&P 600 are **up** about 55% and 75%, respectively from the market peak in March 2000, while the larger capitalization S&P 500 is **down** roughly 15% over the same time frame. Furthermore, with the economy in the U.S. slowing, large cap stocks of companies that can take advantage of the growth in the international arena are likely to grow earnings at a faster pace than the rest of the market over the next several years. But we've pointed to these intriguing facts before, and we won't bore you with them again here.

What we would like to point to is our belief that with economic growth in the U.S. likely to slow over the next few quarters, good stock picking will be of paramount importance in any portfolio regardless of which market cap group outperforms the other. It is for this very reason that Rorer has employed strict quantitative and qualitative measures in its stock selection process since our inception in the mid 1980s. These disciplines have stood us in good stead over the long term, and they are why we have outperformed the S&P 500 in four of the past five quarters in our Large Cap portfolio despite the relative underperformance of the large cap stocks as a group. At some point, investors will recognize the incredible values that exist today in the large cap space and these stocks will regain the market leadership. Regardless of the ultimate timing of this, however, we at Rorer believe our time-tested disciplines will help us provide superior returns through these market cycles. One day we will win our war, but for now we are happy to pick our battles.

The views expressed represent the opinions of Rorer and are not intended as a forecast or guarantee of future results. The Ten Largest Holdings are not investment recommendations and may no longer be held in account portfolios.

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