

## OAK ASSOCIATES, *ltd.*



Mark Oelschlager, CFA  
Portfolio Manager

### SECOND QUARTER MARKET COMMENTARY

The second quarter of 2010 was a period of de-risking for the market. Economic data disappointed investors, the BP Deepwater Horizon drilling rig exploded in the Gulf of Mexico and spewed oil for months, and the Obama administration continued its tough talk on business. All of this contributed to a flight to safety, and the market declined by over 11%.

The energy sector was hit particularly hard during the quarter, as President Obama placed a moratorium on all deepwater offshore drilling on the Outer Continental Shelf for a period of six months. A judge has since issued an injunction, which has set off a legal battle between industry and the White House. While the BP disaster will likely have effects on industry regulation, we believe the reaction has been overdone. Many oil stocks recently traded at valuations seen only (in the last 15 years) when oil was \$10 per barrel or at the height of the global financial crisis in 2008/2009.

But the main story of the quarter was renewed economic angst. Coupled with a pullback in some leading indicators, the stubbornly high unemployment rate led many to question the sustainability of the recovery. We believe this concern is misplaced. The fear early in a recovery that GDP growth is poised to decline is common, even though such an event is rare. Why is it so common? One explanation is that each cycle has unique characteristics that make it feel different than previous ones. Another possibility is that economic data never shows improvement in a perfectly linear fashion, so when there is a setback, investors get worried. We believe that is what is happening right now. Despite some worrisome issues (increasing regulation, fiscal deficits at the federal and state level, lack of employment growth), we don't share this bearish economic view, given historical precedent, the upward sloping yield curve (which is auguring economic strength, not weakness), and our belief that people tend to underestimate the self-reinforcing nature of a recovery. As a result, and because they are still trading at attractive valuations, we have maintained a healthy exposure to cyclical companies in our portfolios, even after the risk-reducing trades we made early in the year. That said, we remain long-term investors, focusing on compelling businesses that will prosper through an entire cycle.

An interesting aspect of the recent market action is the high degree of correlation between stocks. Stocks are moving in lockstep with each other to an almost unprecedented degree. One explanation for this is the growing popularity of exchange traded funds (ETFs), in which investors buy and sell baskets of stocks. Another is the intense focus on the macro

picture by market participants. The host of macro issues is dominating investors' minds, even though the micro picture is very encouraging - Corporate America is prospering, profitability is good, and balance sheets and cash flow production are strong. The latter is the fundamental driver of enterprise value, and the low multiple that investors are putting on these cash flows is an indication that they don't believe it is sustainable.

Getting back to the issue of elevated correlations: historically, when correlations between stocks were high, as they are now, subsequent market returns have been above-average. This is not surprising, since market returns tend to be strong following periods of fear, and high correlations likely represent fear. Furthermore, recent surveys of investor sentiment indicate widespread bearishness, a positive sign.

Best regards,

A handwritten signature in black ink, appearing to read "Mark", is positioned above the typed name.

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