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**Portfolio Manager**

## Quarterly Review

It was a risk-off quarter for the market, as investors rotated into defensive sectors amid fears about the economy. The three top performing sectors were Healthcare, Utilities, and Consumer Staples. This skittishness about the economy has become a rite of summer, this being the third consecutive year of such a phenomenon. Each of the prior two times, the fears of an economic downturn proved unfounded, the market rose, and cyclical stocks recovered. There is no guarantee things will play out the same way again this time, but there are some encouraging signs.

Corporate profitability remains high and growth in profits strong. This tends to lead to increases in capital spending (capex) and hiring. Capital spending has already picked up dramatically, and employment has been increasing, if not at the rate many would like to see. Research firm ISI conducts a semiannual survey of chief financial officers on their capex and hiring plans, and there has been a remarkably high correlation between the survey results and the subsequent economic data. The recent survey results indicate that corporations plan to ramp up their spending and employ more people. This bodes well. Capital spending and employment are keys to a sustainable economic recovery.

While the Federal Reserve's quantitative easing program is set to end, monetary policy remains very accommodative. Along with this, the yield curve remains upward sloping, historically a sign that the economy will remain healthy.

One reason employment has been slow to return is that many of the jobs lost were in real estate, an industry that experienced a bubble. There was a misallocation (to that industry) not just of capital but of labor. It takes time for that to be worked off. In the case of employment, it takes time for those workers to develop skills in other areas. Additionally, employment is always slow to return in an economic recovery, as companies prefer to be sure that the economy is on sound footing before committing to the fixed expense of a new employee.

The recent economic pause may have been caused to a large degree by a few temporary factors. The Japan earthquake, which affected demand as well as the global supply chain; the spike in gasoline prices; and the unusually poor weather in the US have likely contributed to the recent slowdown. As these subside, economic activity may pick up. In our management of the funds, we are looking to take advantage of temporary dislocations in sectors and individual securities, but remain mindful of the risk that things won't necessarily play out the way they have before. We maintain a long-term perspective, a willingness to go against the crowd, and a commitment to concentrating our portfolios in our best ideas.

Overall, we feel optimistic about the long-term prospects for domestic equities, thanks to strong corporate profits, American ingenuity and the back-drop of demand from international markets. One of our largest areas of concern, as it relates to the macroeconomic environment, is the federal budget deficit. Frankly, there are no actionable investment decisions that we would make immediately. But it's a risk that we monitor and give a great deal of thought to. At Oak, our decisions are driven in part by our top-down view of the economy. If at any time we believe that the economic picture is fundamentally changing, we'll adjust the portfolio in a way that we think will best serve clients and shareholders. As always, we make portfolio management decisions with the intent of investing in a company for not just a few quarters, but for several years.

Best regards,

