



# FAYEZ SAROFIM & CO.

*Investment Counsellors*

**A Consistent Discipline for Fifty Years**

**2ND QUARTER  
2009**

## **ECONOMIC & MARKET UPDATE\***

The US economy continues to contract, but the worst of the crisis appears to be over. The severity of the downturn, which intensified so alarmingly in late 2008 and early 2009, has eased as massive policy actions have gained traction. The 37% rally in the S&P 500 Index from the lows this spring reflected relief that the worst-case outcomes had been averted and reinforced greater optimism about near-term prospects. The recent stalling of market progress, however, re-focuses attention on the pronounced crosscurrents in the economy and raises questions about the timing and sustainability of the upturn.

There is accumulating evidence that cyclical forces for recovery are gaining strength. Commodity prices have rebounded, and bulk shipments of commodities have increased. Although the June payroll report was disappointing, layoff announcements seem to have peaked, and initial unemployment claims are stabilizing. Indexes based on surveys of manufacturing purchasing managers have registered improvement. Inventories, which have been slashed to their lowest level since the 1980s, are positioned for a replenishment cycle later this year that is likely to coincide with the maximum impact of the fiscal stimulus.

Even the most depressed industries are registering a pulse. Sales of both new and existing homes are stabilizing. First-time home buyer tax credits, improved affordability and the lagged impact of lower mortgage rates earlier this year are helping to prop up the housing market even as house prices continue to decline. Auto sales have bounced from depressed lows in May and should receive a boost when the “cash for clunkers” auto rebate program is enacted this fall. Furthermore, the scheduled ramp up in vehicle production as shuttered plants re-open should provide a lift to second-half growth. Manufacturing is a small part of the nation’s GDP, but as the most volatile sector, it often signals the trend in the overall economy.

***Once depressed cyclical industries snap back, a self-sustaining recovery depends more fully on an improved backdrop for the consumer.***

Once depressed cyclical industries snap back, however, a self-sustaining recovery depends more fully on an improved backdrop for the consumer. Debt-burdened consumers, coping with numerous challenges from declining home values and portfolio losses to deteriorating job prospects and higher credit costs, have been spending less and saving more. Over the year ending in mid-2009, inflation-adjusted consumer expenditures dropped an estimated 1.8%, the deepest decline in 58 years. Meanwhile the savings rate, which was near zero as the recession began, has increased rapidly, reaching 6.9% in May. The surge in savings and debt repayment has muted the impact of tax cuts and higher government transfer payments and pressured spending. The pace at which these consumer adjustments continue to occur is a key factor shaping the nearer term outlook. If, as confidence builds, savings are increased more gradually, growth in consumer spending could resume at a rate more nearly in line with increases in disposable income—a more tempered pace to be sure than the spending increases in the debt-fueled spree of the last cycle. Consumer deleveraging, then, does not preclude a recovery, but it does seem to dictate that it will be sub-par and bumpier than is typical following a severe recession.

Businesses in this downturn have been aggressive in cutting costs and successful in realizing productivity gains. Consequently, as demand begins to firm, corporate profits are expected to rebound solidly, particularly against easier second-half comparisons. Furthermore, equity market valuations appear reasonable on what is assumed to be trough earnings in 2009. A rebound in depressed financial stocks, assisted by short-covering, led the spring rally. We believe new leadership with fundamental strengths will be required to drive the market higher from current levels. In our opinion, the well-capitalized companies in our portfolios, with their solid balance sheets and strong free cash flows, are prime candidates to lead the next up-leg. Their competitive advantages and ample financial resources equip these industry leaders to sustain earnings increases in an environment of more restrictive credit, higher capital costs and sluggish demand growth. In addition, these globally dominant multinationals are poised to benefit as faster growth resumes in developing markets. The uncertainty that has been a salient characteristic of this downturn is likely to overhang the recovery as well. We believe the high quality companies that are the focus of our strategy are positioned to sustain superior growth however the recovery unfolds.

\*The views expressed herein are those of Fayez Sarofim & Co.’s investment professionals at the time the comments were made and may not be reflective of their current opinions and are subject to change without prior notice. Neither the information contained herein nor any opinion expressed shall be construed to constitute investment advice or an offer to sell or a solicitation of an offer to buy any securities mentioned herein.

## PORTFOLIO COMMENTARY

### 2nd Quarter Attribution\*

The three-month period ended June represented the strongest quarter for the S&P 500 Index in more than a decade. The robust rally, which began in early March, continued in April and early May, followed by a largely sideways market move. The portfolio posted a double-digit gain for the quarter, but results trailed those of the Index. Lagging relative returns in April were only partially offset by the outperformance of higher quality issues in May. Relative results for the quarter as a whole were restrained by the portfolio's underweighted representation in the volatile financial sector, which led the market by a wide margin. The rebound in select financial stocks from depressed levels was propelled in part by short-covering as successful secondary equity offerings in the sector helped to ease balance sheet concerns. The portfolio's emphasis on the energy and consumer staples sectors also impeded relative returns in the quarter. Support for relative performance derived from the limited and correctly focused representations in health care and utilities, stock selection among industrial issues and the lack of exposure to the weak telecom sector. Leading issues in the portfolio included Prudential Financial, Bank America, American Express, Intuitive Surgical, HSBC Holdings, Fluor, News Corp., Apple and General Dynamics. As investors give greater consideration to the lingering after-effects of the financial crisis and the considerable challenges facing the recovery, we believe they will increasingly value the attributes of the high quality, well-capitalized companies that are the focus of our strategy.

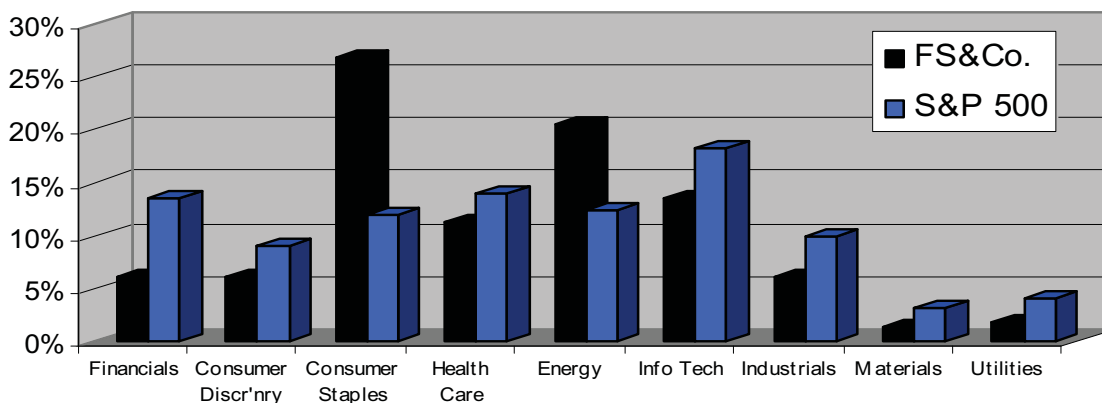
#### Top Ten Holdings\*

Exxon Mobil Corp.  
 Philip Morris Intl Inc.  
 Coca-Cola  
 Procter & Gamble  
 Johnson & Johnson  
 Chevron Corp.  
 Nestle Sponsored ADR  
 PepsiCo Inc.  
 Intel Corporation  
 Abbott Laboratories

#### Portfolio Characteristics\*

Avg. # of Holdings:	50-70
Avg. Mkt. Cap:	\$99 B
Median Mkt. Cap:	\$38 B
5-Yr. EPS Growth:	19.2%
Dividend Yield:	2.9%
P/E (2009):	14.5x
ROE:	28.6%
Debt to Total Cap:	27.2%

### Sector Weightings



*\*Based on a target model portfolio. The specific securities identified and described herein do not represent all of the securities purchased, sold or recommended for the portfolio, and it should not be assumed that investments in the securities identified were or will be profitable. We will, upon request, furnish a listing of all investments made during the prior one-year period. Data as June 30, 2009.*

## TOPICAL DISCUSSION ON FINANCIAL SERVICES SECTOR\*

### FINANCIAL SERVICES SECTOR OVERVIEW by Matthew M. Altenau, Analyst and Nick Zdeblick, Analyst

During the past two years, the Federal Reserve, Treasury, FDIC, and Congress undertook an unprecedented coordinated effort which included enhanced government programs, government capital injections, and FDIC seizures/company acquisitions designed to stabilize the financial system and renew the flow of credit in the global economy. With the benefit of hindsight, many factors contributed to the unparalleled disruption in the financial markets. Extreme levels of leverage were accepted in the financial system as years of general economic stability, excess liquidity, and low interest rates led to lax regulation and oversight. Rising asset values, particularly in residential real estate, justified loose credit standards and whetted financial institutions' appetite for risk. Lastly, acceptable banking practices such as third-party origination, securitization, and investment bank/commercial bank regulatory arbitrage allowed firms to circumvent regulations designed to prepare the systems for the inevitable storms of the business cycle. The many and varied failures that led to the financial upheaval underscore the reality that neither a quick resumption of banking-as-usual nor perfect package of new government regulations are likely. More than ever, investors need to seek quality businesses with ample franchise value that deliver attractive returns without relying on the gray areas of regulation.

In the 21<sup>st</sup> Century, the global industrial supply chain was shortened and streamlined yet the lending supply chain grew in length and complexity. Catastrophically, a longer lending supply chain both trapped more inventory in the chain during periods of high volatility and disabled lenders' ability to fundamentally analyze their borrowers. The longer lending supply chain was driven by securitization, which involves the pooling and repackaging of financial assets such as mortgage loans into securities and structured products that are then sold to investors. Though securitization enlarged the pool of capital that could be lent to worthy borrowers, it also enabled third-party loan originators and securitizing banks to earn fees from creating loans even if the loan would not be ultimately repaid. To grow this lucrative fee-generating business, banks sought to increase inventory in their lending supply chain; naturally, when the housing market deteriorated these loans defaulted. Additionally, because credit securities could be priced and sold at any time, regulators were convinced that the capital requirement should be lower for these securities than for loans. Not surprisingly, when residential loans began to sour, banks' capital reserves were inadequate to absorb the losses. Often securities were bought by banks' off-balance sheet special purpose vehicles. These vehicles shielded the bank from holding a capital cushion against the risk of securities losses and the purchase of these long-term mortgage assets were financed with short-term, variable rate debt. When the credit markets froze, the ability to roll over short-term funding disappeared. Consequently, many banks were required to provide this financing as a contractual backstop. In other words, banks not only had to deal with their problem assets on balance sheet, but they had to bring off-balance sheet commitments onto the balance sheet as well.

Mortgage asset and securities write-downs put significant pressure on the balance sheet of banks and depleted the equity cushion that gives banks the confidence to continue lending during a recession. Quantifying the significant loss of equity capital experienced by the world financial system is staggering: global write-downs and credit losses have totaled \$1.47 trillion since this crisis began, and \$1.27 trillion of equity capital has been raised to plug this capital hole. In June 2007, the financials sector represented \$2.9 trillion, or 21.2%, of the total market capitalization of the S&P 500 of \$13.6 trillion; today, the financials sector currently represents \$1.09 trillion, or 13.6%, of the \$8.0 trillion market capitalization of the S&P 500 as of June 30, 2009.

### Global Financial Sector Write-downs & Credit Losses vs. Equity Capital Raised (\$ in billions)

	<u>Write-downs &amp; Credit Losses</u>	<u>Equity Capital Raised</u>
Americas	\$974.8	\$738.6
Europe	\$460.2	\$450.1
Asia	\$38.9	\$83.4
<b>Total</b>	<b>\$1,474.0</b>	<b>\$1,272.1</b>

Source: Bloomberg

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Even though credit trends have been deteriorating since the summer of 2007, the health of the financial system failed its first test in early 2008 as Bear Stearns had to be saved from bankruptcy by JPMorgan Chase and the Federal Reserve in March 2008. Fearing the calamitous ripple effects that a Bear Stearns bankruptcy might have caused to the global economy given the interconnectedness of all major financial firms, the Federal Reserve saw no alternative but to intervene in March. Ultimately these fears were realized later in the year with the bankruptcy of Lehman Brothers on September 15<sup>th</sup> and the failure of Washington Mutual on September 25<sup>th</sup>, which caused a shutdown of the financing market which paralyzed the broader economy. These failed financial firms, like most other financial companies, had billions of short-term debt which was held by money-market funds that were thought to be as safe as cash. If additional firms failed, cash accounts would suffer unprecedented losses. Within two weeks of the Lehman Brothers bankruptcy, panicked investors withdrew approximately \$700 billion from money market and bond funds. As a result, demand for commercial paper plummeted, choking off the primary source of businesses' working capital and threatened the ability of the financial and economic system to conduct everyday business. While the health of the banks garnered the most significant attention during this crisis given their need for additional capital, another negative factor was the freezing and shrinking of the "shadow banking" system of money market funds, bond funds, securitized assets and structured products and vehicles that caused significant stress in the financing of the financial system. Currently banks represent only approximately 30% of the overall lending for the U.S. economy, down from over 60% share in the 1970s, and thus the non-bank lending system has steadily increased its share to approximately 70%. However, this non-bank lending declined dramatically after the Lehman Brothers bankruptcy, as many institutional and retail investors chose to not refinance asset-backed securities and asset-backed commercial paper. The balance of these funding instruments has dropped by over \$1 trillion in the last 12-18 months.

In addition to many government programs initiated to repair the functionality of the dislocated credit markets, the government also addressed the capital shortfall in the banking system to prevent a further contraction of credit partially driven by the banks' desire to reduce leverage amid falling asset prices. In October 2008, the U.S. Treasury, as part of TARP, implemented its Capital Purchase Program to inject \$250 billion of senior preferred capital into the banking system; over 600 banks across the country have participated in the program with \$199 billion of capital injections to date. While this program definitely aided in stabilizing the banks, it did not address the low levels of common equity available to absorb losses. Thus, bank stocks continued to sell off sharply as common equity deficient banks suffered the spiraling effect of a lower secondary stock issuance price leading to additional shareholder dilution, which led to a still-lower share price. Compounding the spiral was the threat of bank nationalization which would wipe out any equity investments made to save the banks. However, this fear began to subside as economic signals arrested their decline, the possibility of nationalization of the banks was removed, and banks were given time to evaluate their ultimate capital needs through the Capital Assistance Program, or the "stress test". This test was initiated by Treasury and bank regulators in order to quantify a capital amount that was needed by each of the top 19 financial institutions to weather a severe economic downturn.

After the many actions implemented to shore up the banking sector, investment positives include:

- The outlook for the entire financial system and the institutions within the system are much stronger with the progressive actions taken by the government.
- Significant asset write-downs and the resulting capital raises to fill those holes are primarily in the past.
- The banking system has already endured 7 quarters of rising credit losses; a lower decline rate/stabilization of housing prices and the economy would lessen future credit losses and boost earnings power going forward.
- At the end of this cycle, some firms have enlarged their core earnings power through acquisition, the removal of competition, and cost-cutting.

However, there are still many long-term risks that the industry will have to navigate as the environment has dramatically shifted from many years of low interest rates, high leverage, lax regulation, and low capital requirements to a new environment with lower leverage, increased government regulation, higher capital requirements, and higher credit losses amid a more difficult economic landscape. Given that the overall financial sector generally delivers low returns that are enhanced by financial leverage, this permanent shift will have a negative effect to long-term earnings potential. The chart below illustrates the steep drop in return on assets (ROA) that began during the recession as net income plummeted from asset write-downs, higher credit losses, and falling revenue in capital markets businesses. In addition, assets per share have also dropped sharply from the peak and will continue to fall due to a combination of deleveraging by shedding assets and the increase in the share count coming from dilutive capital raises.



The financial crisis demonstrated the importance of the funding model that each financial institution employs. The drying up of secondary markets caused long-term mortgage assets and other securities to suddenly become illiquid, causing the withdrawal of short-term funding for many institutions. This dynamic proved costly for financial institutions that primarily funded their long-term assets with short-term, wholesale borrowing instruments including jumbo certificates of deposit (CDs), repurchase agreements (repo), fed funds, commercial paper, Eurodollar deposits, and large brokered deposits. Once liquidity dried up on the asset side of the balance sheet, refinancing short-term wholesale liabilities became extremely difficult and costly. Financial institutions such as banks that possessed significant retail deposit franchises held a competitive advantage relative to peers since retail deposits represent a relatively stable source of long-term, low-cost funding that is less sensitive to market dislocations.

While the financial industry will remain challenging over the next few years, this does not mean there will not be opportunity. During the many years in which low interest rates and additional leverage drove asset prices higher, both leading firms and marginal firms were able to prosper and achieve attractive returns in this environment of secular tailwinds. However, in today's environment, the importance of distinguishing firms based on analyzing business fundamentals and identifying structural, competitive advantages is amplified in order to identify winners that will survive and thrive in a difficult economic and regulatory environment. We look for financial firms with strong brands, structural advantages, and attractive business models that can take advantage of this financial turmoil and be opportunistic in taking market share as other firms shrink businesses and sell assets to survive. However, given the challenges discussed above and the availability of better opportunities in other sectors, we will likely maintain an underweight position in the financial sector over the intermediate term.

**\* COMPANY SPOTLIGHT: JP MORGAN CHASE**

One example of the type of firm discussed above with an attractive, low-cost funding model is JPMorgan Chase, which has a deposit franchise of over \$900 billion from retail and corporate customers, and the large majority of its total funding base comes from long-term sources including deposits, shareholders' equity, and long-term debt. Led by CEO Jamie Dimon, JPMorgan Chase (JPM) was well-capitalized going into the financial turmoil and either avoided or minimized its exposure to the majority of the problem assets that caused significant write-downs. By avoiding these asset pitfalls, the company's equity and capital ratios remained strong throughout the crisis. This capital supremacy benefited the firm as depositors flocked to stable institutions such as JPMorgan Chase in a "flight to quality" during the financial crisis. These healthy deposit inflows enabled the company to

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## Company Spotlight – JP Morgan Chase (Cont'd.)

FY2008E Revenue:	\$99B
Market Cap:	\$128B
Fwd. 5-Year EPS CAGR:	48.6%
P/E (FY2010E):	12.9x
Dividend Yield:	0.6%

further increase its attractive, low-cost funding base at a time when other financial institutions had to pay much higher rates to keep appropriate levels of funding. In addition, JPMorgan Chase experienced the least share dilution compared to any of its peers since it did not have to issue new equity to replenish a capital hole caused by write-downs. Instead, the company was able to use the equity markets in a more opportunistic fashion to fund organic growth and strategic acquisitions.

JPMorgan Chase enhanced its capital markets businesses, notably its prime brokerage and commodities businesses, areas in which the firm had been relatively weak, with the acquisition of Bear Stearns for \$1.5 billion in March 2008. Partnering with the Federal Reserve, JPM was able to limit the ultimate risk of the acquisition by having the Federal Reserve finance and assume \$30 billion of problem mortgage assets. The acquisition of Bear Stearns along with JPMorgan Chase's strong balance sheet have been two of the driving forces behind its increase in market share in investment banking and capital markets. As other firms were reducing assets and shrinking business lines, JPMorgan Chase was investing and broadening its capabilities in equity and fixed income trading and investment banking. It is no coincidence that JPMorgan Chase has moved to the top of the league table in investment banking fees in mergers & acquisitions, debt and equity underwriting.

CEO Jamie Dimon had longed for many years to expand its retail banking presence in fast-growing markets such as California and Florida; he found that opportunity in September 2008 with the \$1.9 billion acquisition of Washington Mutual. With over 2,200 retail branches, Washington Mutual possessed an attractive retail branch footprint that JPM coveted, and the transaction was financially compelling with immediate accretion to earnings and significant long-term earnings potential in 2009 and beyond. Working with the FDIC, JPM acquired the deposits, assets and certain liabilities of Washington Mutual, but was able to avoid assuming a significant amount of the ultimate liabilities from the bank holding company. During a time when asset values continued to swoon, JPMorgan Chase executed two strategic transactions that significantly enhanced its earnings power for years to come, but in a fashion that protected the downside for shareholders by limiting the company's ultimate exposure to risk.

Given its relative strength throughout this financial crisis, JPMorgan Chase has been able to grow and expand its group of businesses organically and inorganically, while many of its peers are reducing asset levels. The ability to grow is especially crucial in this environment as lending conditions have dramatically improved for banks with loan spreads notably wide as more banks and non-bank lenders are pulling back from the lending market. After many years in which the "shadow banking" system took market share from banks and put pressure on lending spreads, this trend of disintermediation has dramatically reversed, benefiting the banks that have the capital to grow. In addition, the fixed income trading markets have also benefited from wide spreads partly resulting from consolidation in the sector given many competitors are either gone or acquired (Lehman Brothers, Bear Stearns, and Merrill Lynch). As a result, this is a good time to be in the banking business for a firm like JPMorgan Chase that has the capital to grow when lending and trading spreads are very high.

Illustrating the strength of its capital ratios and the health of the overall bank, JPMorgan Chase was among the first group of large-capitalization banks to be able to fully repay its funds from the Troubled Asset Relief Program (TARP). Going forward, JPMorgan Chase's loan portfolio is unique in the sense that it has a very low concentration of its portfolio in commercial real estate, relative to many regional banks that possess significant loan exposures in this area. While the downturn in the residential mortgage market has caused significant credit losses for the last couple of years, the commercial real estate market is just beginning to show deterioration in loss rates. Refinancing risk for this segment remains a crucial issue over the next several years since the decline in economic activity and employment is hurting the revenue line for commercial real estate properties, while valuations are falling with the increase in capitalization rates. The company's low exposure to this late-cycle loan segment should enable JPMorgan Chase to be one of the first beneficiaries of stabilizing credit losses in its loan portfolio, meaning the company should be ahead of its peers in reaching its normalized earnings potential.

In conclusion, JPMorgan Chase survived the unparalleled financial crisis experienced over the last few years and has successfully put itself in a position to thrive for years to come. The company's acquisitions boosted the diversification, scale, and earnings power of its capital markets and retail banking businesses, while its asset management and treasury and securities services businesses continue to be in prime position to capture the improvement in financial markets. The future prospects for JPMorgan Chase appear very bright.

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