PERKINS
INVESTMENT MANAGEMENT

CIO OUTLOOK

UNCOMMON VALUE℠

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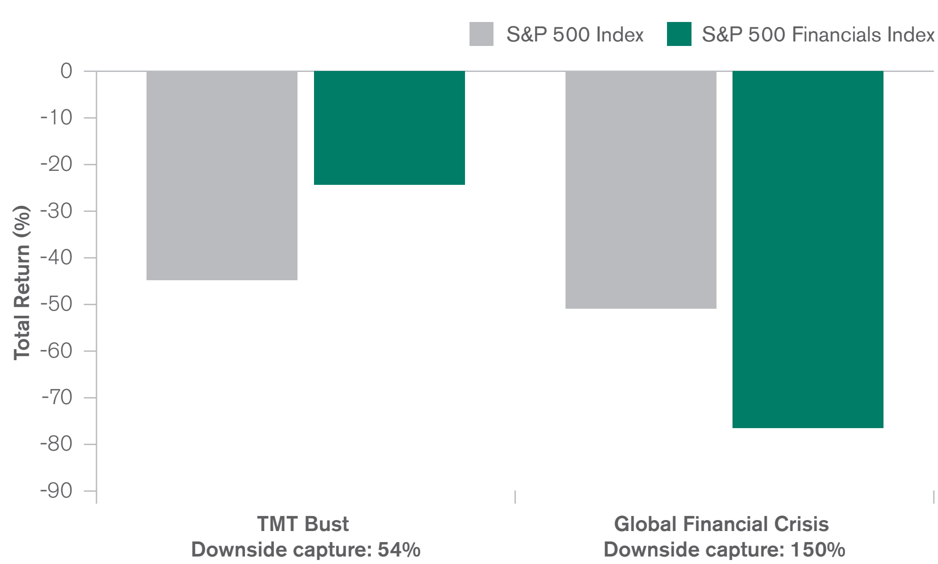
FLU SEASON, PREVENTION AND DEFENSIVE INVESTING

A recent trip to the drugstore afforded the opportunity to get a flu shot. The ease of this annual ritual belies the complexities involved in making the vaccine an effective defense against seasonal influenza. According to the Centers for Disease Control and Prevention, year-round surveillance for influenza is conducted in over 100 countries in order to provide data that informs the selection of the individual viruses which will comprise the vaccine. Since there are many flu viruses and they are constantly changing, the composition of the vaccine is updated to match the three or four viruses that research suggests will be most common. Investors may be able to learn from this dynamic: the composition of a defensively oriented stock portfolio must be updated with reference to a changing investing environment.

The performance of financial stocks during two nasty "flu seasons" in the market is illustrative of the need for updating portfolios to match the risks that are circulating. Many investors will recall the devastating losses that banks and other financial companies realized during the Global Financial Crisis, a period which saw the S&P 500 Index fall 51% from peak to trough. The S&P 500 Financials Index – which included numerous companies at the center of the crisis – fell a remarkable 76%, capturing roughly 150% of the overall market decline. Thus, a portfolio containing significant financials holdings was very much exposed to trouble in the real economy and financial markets, and unlikely to achieve a defensive outcome (i.e., a smaller loss than the overall market).

PERFORMANCE DURING TWO DRAWDOWNS: FINANCIALS VS. S&P 500 INDEX



Source: Bloomberg. Both time periods cover peak to trough for the S&P 500 Index. TMT Bust is from 8/31/2000 to 9/30/2002, Global Financial Crisis is from 10/31/2007 to 2/27/2009.

Stocks which prove defensive in one investing scenario may be anything but in a different scenario.

Conversely, the circumstances of the Tech-Media-Telecom (TMT) Bust in the early 2000s were quite different and financial stocks turned in an admirable performance. In that episode of ill-health in the stock market, the S&P 500 Index fell 45% from peak to trough, led of course by the dot-coms and many TMT companies as that period's frequently given name suggests. What may be forgotten – or not experienced at all – by many investors today is the performance of financials: they declined 24%, or roughly 54% of the overall market loss. Portfolios holding significant stakes in financial companies were therefore somewhat inoculated against the risks in the market during that selloff. Stocks which prove defensive in one investing scenario may be anything but in a different scenario. Past performance cannot guarantee future results, as the disclaimer says.

Today, many investors appear to prefer predictable earnings streams and much has been written about the positive fund flows into so-called "low volatility" Exchange Traded Funds (ETFs)/strategies. We at Perkins are often asked: are low-volatility strategies defensive? It is a good question. The MSCI World Minimum Volatility Index is an often-used benchmark for this type of fund, and has much larger sector weightings to health care, utilities, telecommunications, consumer staples and real estate as compared to its parent MSCI World Index (which is market cap weighted). Should global growth remain slow, or weaken, and interest rates persist at very low levels – a scenario which does not appear far-fetched – then the relatively less economically sensitive nature of these companies' earnings streams may well lead to outperformance. However, it is worth noting that valuations in many "safe haven" sectors have expanded dramatically in recent years to historically high levels, perhaps in anticipation of just this sort of economic outcome. Were a different scenario to unfold – e.g., if interest rates begin to rise – then the yield arguments which have supported these sectors' valuations would be vulnerable to a reappraisal in the market, and "low volatility" investors could be exposed to losses.

There are many other, more fundamental questions to consider as well when assessing the defensiveness of low volatility strategies: how can utilities achieve attractive profit growth when electricity demand growth in the U.S. has fallen below 1%? Or, are Real Estate Investment Trust (REIT) occupancy levels unsustainably high and what would be the impact on profits should vacancies rise? There is a lot to consider when making a determination of whether a given stock (or sector) will be more or less exposed during the next drawdown, and the analysis can be complicated. However, we believe it is clear that simply knowing a group of stocks performed a certain way in the past is not enough. Things change. An investor who is aiming for a defensively oriented portfolio – i.e., attempting to reduce drawdown participation well below 100% and therefore "defend" capital/savings in the event of losses in the stock market – would do well to keep this notion of change firmly in mind.

There are the basics as well, such as washing your hands often with soap and water and trying to avoid close contact with sick people. As for investing, three process elements which are routine at Perkins come to mind. First, take a careful measure of balance sheet leverage. Many companies, including those with predictable earnings streams, have increased their debt burdens in recent years to finance mergers and acquisitions (M&A), stock buybacks and dividends. Second, consider whether a company has an enduring competitive advantage. A strong moat can serve the dual purpose of protecting a business during tough times and enabling it to prosper during good times. Finally, sketch out a downside scenario. Knowing how much you could lose before buying – having a keen awareness of the negative possibilities – may be the most powerful tool when attempting to minimize downside losses.

Thank you for your continued confidence in Perkins.

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Investing involves risk, including the possible loss of principal and fluctuation of value.

There is no assurance that the investment process will consistently lead to successful investing. There is no assurance the stated objective(s) will be met.

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MSCI World Index℠ is a market capitalization weighted index composed of companies representative of the market structure of Developed Market countries in North America, Europe and the Asia/Pacific Region. The index includes reinvestment of dividends, net of foreign withholding taxes.

The **MSCI World Minimum Volatility Index** aims to reflect the performance characteristics of a minimum variance strategy applied to the MSCI large and mid cap equity universe across 23 Developed Markets countries. The index is calculated by optimizing the MSCI World Index for the lowest absolute risk (within a given set of constraints).

The **S&P 500® Financials Index** comprises those companies included in the S&P 500 that are classified as members of the GICS® financials sector.

S&P 500® Index measures broad U.S. equity performance.

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