ANALYST SPOTLIGHT

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"Why Mega Caps?"

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America's addiction to all things grandiose and excessive seems to have come to a head in recent months.

This multi-decade long generational shift in personal and societal preference was apparent through many different samplings of human lifestyle choices. When McDonald's opened in 1955 the largest soda was 7 fluid ounces.

Today, a small soda is 16 ounces, and a child's soda is 12 ounces. And what was once considered a normal adult meal is now a child's portion. Additionally, American's historic obsession with the automobile migrated to become a decade-plus long love affair with beastly SUVs. Hummer's entrance into the mainstream more or less called a top in this market, of which our society now scorns those earth-hating, tree-killing, ozone-depleting, environmentally-ignorant SUV drivers (including yours truly).

Fast-forward to today.

Declines in home prices and retirement savings, increased uncertainty, decreased investor confidence and the sudden realization of the debt burden held by many individuals will surely lead to an extended period of belt tightening and frugality. With "austerity and financial prudence" replacing "luxury and extravagance" as the new cultural mindset, a realignment of "excessiveness" will surely occur. Moderation is the new Mega.

Nevertheless, we encourage you to make one exception. No, I don't mean the 44-ounce Super Big Gulp or Super-Sizing your McDonald's Fries. We're not talking food servings, cars, credit card limits, or the size of your house. That's so 2008. We're talking about your investment portfolio – specifically, the size of companies in which you invest. And we don't just want you to go big. We want you to go Mega – as in Mega Caps.

Super Size Me

What is a "mega cap" stock? Typically, stocks with market caps (shares outstanding multiplied by share price) above $50 billion.

Mega Cap stocks are probably the most recognizable stocks to the general public. These companies have brands which transcend sociological class structures, income levels and geographical regions. Take a quick gander around your environment – there's a high probability that the items in your immediate vicinity were produced or sold you buy one of these companies.

For the Baby-Boomer readers, the "Nifty Fifty" investment strategy from the 1960's and 70's may ring a bell. This investment tactic encouraged investing in the 50 popular large cap stocks on the New York Stock Exchange, with a buy and hold mindset. But that was a different period, as investors were chasing growth, strong balance sheets, and industry leaders.

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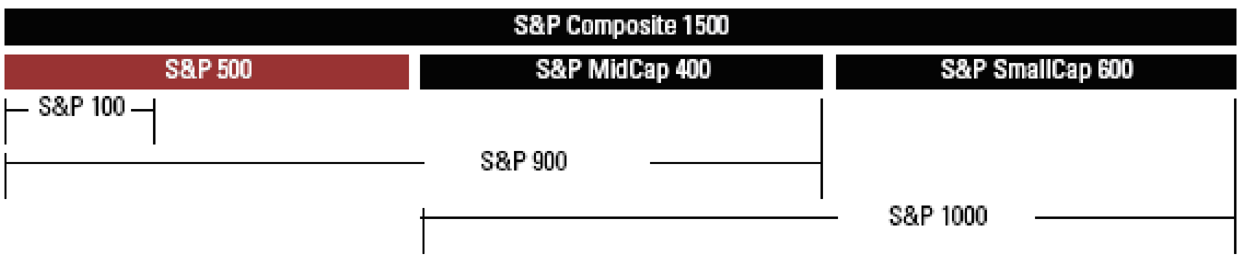
Today, we are also attracted to mega caps for their strong balance sheets, but also for the attractive valuations they sport. Considering the current environment, and in a somewhat contrarian viewpoint of typical recession-rebound plays (small caps), we think these industry giants will be best poised to lift our economy, and your portfolio, out of the market's downturn.

Land of the Giants

The popularly followed Standard & Poor's 500 Index, for example, is really just a subset of a larger index, the S&P 1500. The following graphic shows the full breakout of each of the seven main S&P indices ranging from the S&P 600 (small caps) to the S&P 100 (large/mega caps)

S&P U.S. Indices



http://www2.standardandpoors.com/spf/pdf/index/SP_500_Factsheet.pdf

Too often investors look at the market through a singular lens, with the greatest level of differentiation made between stocks and bonds. But it's important to have an appreciation of the sub-sectors of the market, as there can be large performance, valuation and growth differentials between various groups.

Today, there are 29 stocks in the S&P 500 with market caps above $50 billion mark, accounting for just under 6% of the index on an equal weighted basis. That said, if you sum the market cap of these 29 companies, they account for 42% of the entire S&P's market capitalization. It goes without saying that a small subset of the index can heavily impact its performance.

As mentioned, there can be significant performance differentials between these indices. As valuations between small, mid and large cap companies shift with in the marketplace, due in part to investor risk appetites and other macro-driven factors, these return differentials can be significant.

Lynx-eyed readers will notice the healthy levels of outperformance enjoyed by the mid and small cap sectors of the market over the last five and ten year time frames. And even sharper-eyed readers will immediately see the rationale for this outperformance when viewing the following graphic:

	Total Return			
Name	**2008**	**3 Year**	**5 Year**	**10 Year**
S&P 100	-35.31	-6.66	-2.62	-1.54
S&P 500	-37.00	-8.36	-2.19	-1.38
S&P 900	-36.93	-8.39	-2.00	-0.95
S&P 1000	-34.67	-8.39	0.20	4.69
S&P MidCap 400	-36.23	-8.76	-0.08	4.46
S&P SmallCap 600	-31.07	-7.51	0.88	5.18
S&P 1500	-36.72	-8.35	-1.89	-0.76

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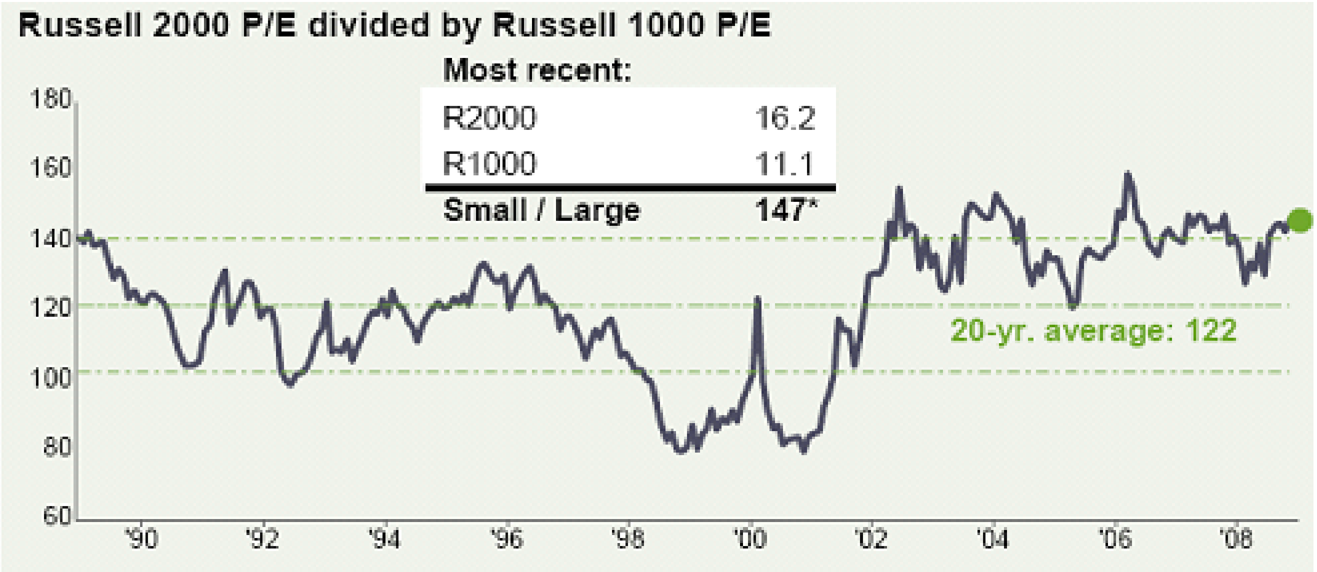

Source: Russell Investment Group, FactSet, JPMorgan Asset Management.

As illustrated above, in the 1998 time frame, mid and small cap companies were very attractively valued relative to larger cap stocks, as investors got caught up in the internet bubble – pushing companies like Microsoft, Cisco, Juniper, Nortel and Pets.com to astronomical levels, leaving small and mid cap stocks far behind.

As the dot com crash ensued, investors began seeing the attractiveness in small and mid cap stocks, and invested heavily in them over the next decade. We think that tide is about to turn.

Referencing the above chart again, you can see that large cap companies are now more attractively valued when compared to their small and mid-cap peers.

In yet another example, the following graphic (right) breaks down the S&P 500 by Mega Cap companies (with market caps above $50 billion), and compares some common valuation metrics to the rest of the index.

Market Cap Weighted	S&P 500	Mega Cap
Market Cap (median)	5,955.24	88,390.80
Market Cap (average)	15,141.46	107,303.07
PE Ratio (trailing)	15.86	5.06
PE Ratio (forward)	11.41	4.71
Debt to Equity	0.82	0.18

In addition to attractive valuations, there are a few further points that draw us to this part of the market:

- **Strong Balance Sheets**
  - Many large & mega cap companies are flush with cash, and continue to generate additional cash flow each quarter. As most of these companies are in their "cash cow" phases, the market will be attracted to these companies ability to both generate excess cash, and use that cash to take advantage of the economic downturn (grow market share, purchase smaller competitors, etc.)

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- **Relatively stable business models**
  - Large and mega cap companies are not being pressured to rapidly expand their businesses, as much as small and mid-sized companies are. Instead, investors and analysts expect these businesses to be properly managed, and provide predictable and consistent rates of returns.
- **Less of a need for external funding**
  - Considering the "cash cow" component of many of these business, many – though not all – large and mega cap companies are "self funding", meaning they don't need to issue debt or additional stock to fund their business. In the current market environment, with credit markets seized up and extremely tight lending standards, companies with the ability to self fund are extremely attractive to investors.
- **Ability to weather economic downturn**
  - Put together their strong balance sheets, stable business models, self funding business models, and you have businesses that will be able to weather the worst of economic storms.

David vs. Goliath, Round Two

Though it's a nice populist story of the "little guy" winning, we think the data presented above favor the proverbial "Goliath".

In round two, it isn't David (think small & mid caps) slinging rocks at Goliath (think large and mega caps). Now, instead, the market is throwing boulders at both of them! In this scenario, we like Goliath's chances of survival and success.

From the backlash against performance enhancing drugs in professional sports, to the sharp increase in sales of high mileage hybrid vehicles, to more health conscious servings at our local fast food restaurant, these real life anecdotes will mold together to help define a new cultural and generational shift in consumer habit and behavior.

As we all observe, appreciate and/or participate in this phenomenon, we encourage you to buck the trend in one-regard – your investment portfolio.

-- Bryan Keller, Research Analyst