



Fourth Quarter, 2008

Five Points to Remember

It is always a worthwhile year-end practice to review the current investment environment and its relationship to longer-range trends. Looking at the big picture keeps today's headlines in perspective and key investment factors in focus.

As 2008 began, a number of issues were on the horizon. By year's end, though, one topic was dominant -- the meltdown in worldwide financial markets. Although it was several years in the making, the collapse of the subprime mortgage market in the U.S. spawned a financial crisis affecting institutions, businesses and investors around the world.

For the year, the Dow Jones Industrial Average registered its worst performance since 1931, falling almost 34% in price. The Standard & Poor's 500 had its worst year since 1937, declining over 38%. And the Nasdaq Composite Index had the biggest drop in its 38-year history, down over 40%. Overseas, the results were much worse with many formerly "hot" investment areas falling by 50% or more.

Not surprisingly, global economic growth has slowed and the U.S., Japan and Germany, the world's largest economies, are officially in recession. Uncertainty and fear are looming large in the minds of many investors and the media is filled with stories of gloom and doom and the hard times ahead.

In our last Letter, *The Importance of Common Sense*, we noted that over the years there have been many periods where business was slack, profits were squeezed, and the stock market was down sharply. While last year's events were unsettling, the fact is that no one can predict what the outcome will be.

We have had many challenging times in our nation's history and new problems are nothing new to us. In fact, our growth has been based on facing and solving a long succession of problems, beginning with surviving that first winter in New England. We survived, and went on to accomplish great feats, including landing on the moon, eradicating smallpox, and winning the Cold War. Each of these was deemed impossible in an earlier era.

It is important to note that the situation is never all black or all white. We believe the following observations are pertinent in assessing the current investment environment:

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1. *Important long-range trends have not changed.*
2. *The earnings and dividend progress of many high-quality companies, as well as their underlying fundamental characteristics, are intact.*
3. *The appraisals of many superior stocks are now lower than their average level of the past decade.*
4. *We have had a succession of bad news in recent months, but news seldom stays all good or all bad for long.*
5. *The stock market is always unpredictable and its major turning points almost invariably occur for reasons that are obvious only with hindsight.*

These observations suggest that it would be foolish for investors to think and act as if the end were nigh. This becomes more evident when perspective is added and the facts are examined in greater detail.

Long-range Trends Have Not Changed

As we have discussed in the past, it is important to concentrate on what we know about the long-term future rather than get sidetracked by what is unknown about the near-term outlook. No one can accurately or consistently predict over the next few quarters what stock prices will do, which government policies will work, how much the Gross Domestic Product will rise or fall, or where the next big international crisis will occur.

However, there are some important longer-range trends that can be predicted with confidence. The renowned long-term growth investor, the late David L. Babson, noted nearly 50 years ago that some trends could be predicted with a fair degree of certainty. He christened these "The Predictables." They are listed below:

- *The population, including those of working age, will continue to grow.*
- *More people will need more goods and more services.*
- *Research will develop new products and new techniques, and in the process will create higher demand, additional jobs and greater productivity.*
- *The dollar's buying power will keep on shrinking.*
- *Well-managed companies with favorable long-term investment characteristics will continue, as a group, to provide their shareholders with above-average progress in earnings and dividends.*

Although the current situation seems uncertain, none of these long-term trends has changed. To date, the financial crisis has caused hardship for some and discomfort for all, but it is just the latest in a series of financial messes we've had to work through.

For example, the panic of 1819 was the first financial crisis in our history and it resulted in widespread foreclosures, bank failures and unemployment, as well as a slump in agriculture and manufacturing. Four more financial crises followed before the 19th century

was over: in 1837, 1857, 1873 and 1893. In each case, the panics consisted of spectacular growth in the money supply, rampant speculation, and a bursting of an asset bubble.

In the 20th century, the U.S. has worked through the panic of 1907, the stock market crash of 1929, the Savings and Loan Crisis of 1989 and the implosion of a major hedge fund in 1998. The international arena has not been immune -- a number of major crises took place in just the last thirty years: the Latin America debt crisis of the 1980s, the collapse of Japanese assets in the early 1990s, the 1994 economic crisis in Mexico, the 1997 Asian financial crisis, and the 1998 Russian financial crisis, to name just a few.

We will emerge from this current crisis, as we have from all the others, and the stock markets will resume their long-term upward progression. Meanwhile, investors should focus on the predictable trends that have the greatest impact on their investments.

Throughout the world, population growth will continue and these people will need more goods and services. Efforts in research and development will continue to meet these needs with new technologies and new products. As a result, demand will continue to increase as will jobs and productivity.

Inflation, too, will remain a potent force. Since 1925, the average annual rate of inflation has been about 3%, although there have been periods when it has been much higher as well as significantly lower. Regardless of current concerns, investors should never discount the impact of inflation over time.

Finally, high-quality companies with top-notch management teams will continue to expand their markets, increase their revenues, and turn in superior growth in their earnings and dividends per share. Eventually, this progress will be reflected in the increasing price of their common shares, as it has in the last 80 years or so.

Earnings and Dividend Progress Remain Intact

Naturally everyone would rather see stock prices go up rather than down. But experienced investors know that the underlying characteristics of a company are key for investment success over time.

The table on the next page shows a number of companies we have recommended over the years. As can be seen, their progress in earnings and dividend growth has remained intact throughout the credit crisis. As a group, over the last three years their compound annual growth in earnings was 14% whereas the S&P 500 saw a 5% compound annual decline in its earnings for the same period.

More remarkably, for 2008 -- the year the credit crisis exploded -- each of these high-quality companies is expected to increase its earnings. Overall, this speaks to their financial strength, their conservative management practices and to the superior markets in which they operate. In short, it speaks to their core fundamental strengths.

Company	3-Year Compound Annual Change Through 2008E				Value Line Financial Strength	'08E P/E	10-Yr. Avg. P/E		
	Earnings Per Share*	Dividends Per Share*	Operating Earnings Per Share*						
	Per Share*	Per Share*	2005	2006				2007	2008E
Abbott Labs	9%	9%	2.50	2.52	2.84	3.25	A++	15x	21x
Auto. Data Proc.	8	23	1.86	1.82	2.01	2.35	A++	16	28
Becton, Dickinson	15	17	3.01	3.41	3.95	4.55	A++	16	19
Cisco Systems	14	--	0.87	1.01	1.28	1.30	A++	12	26#
Coca-Cola	13	11	2.17	2.37	2.57	3.10	A++	14	27
Colgate-Palmolive	13	12	2.64	2.91	3.38	3.85	A++	16	24
Dentsply Int'l	12	15	1.34	1.42	1.66	1.90	B++	14	19
Ecolab	15	14	1.23	1.43	1.66	1.85	A	18	26
Expeditors Int'l	15	29	0.88	1.06	1.21	1.35	A	21	32
Fastenal	20	19	1.10	1.32	1.55	1.90	A	17	30
Genentech	39	--	1.28	2.23	2.94	3.40	A++	25	50#
Johnson & Johnson	9	12	3.50	3.76	4.15	4.60	A++	13	21
L-3 Commun.	17	34	4.20	5.05	5.98	6.75	B+	11	20
McDonald's	23	34	1.97	2.30	2.91	3.65	A++	16	19
Microsoft	16	13	1.24	1.18	1.76	1.95	A++	10	30
Nike 'B'	12	23	2.58	2.60	3.23	3.60	A+	13	20
Paychex	11	30	1.13	1.33	1.47	1.55	A	16	42
PepsiCo	10	15	2.69	3.00	3.34	3.55	A++	14	23
Procter & Gamble	13	13	2.60	2.81	3.31	3.75	A++	15	23
Sigma-Aldrich	12	11	1.88	2.05	2.34	2.65	A	14	20
Stryker	17	54	1.75	2.02	2.40	2.80	A	14	31
Sysco Corp.	9	14	1.42	1.47	1.70	1.85	A+	12	24
United Tech.	17	15	3.05	3.64	4.27	4.90	A++	10	18
Wal-Mart	12	17	2.37	2.89	3.13	3.35	A++	16	26
Walgreen	11	20	1.56	1.86	2.07	2.15	A+	12	31
Average	14%	18%						15x	26x
S&P 500	-5	8	76.45	87.72	84.08	65.00		13	20

Percent in highest A++ category

56%

**All figures are based on a calendar year. #7-year average.
Sources: Standard & Poor's, Value Line, DWA estimates.*

In terms of dividend growth, these quality companies also outperformed the S&P 500 over the last three years. On average, their compound annual growth in dividends increased more than two times as much as the S&P 500 Index -- even with two of the companies being non-dividend payers.

Price/earnings ratios have contracted dramatically over the past year and all of these companies are now appraised at significant discounts to their average levels of the past decade. As a group, they are currently appraised at only two multiples greater than the market, a reasonable premium for quality. Finally, since the early 1950s the price/earnings ratio for the S&P 500 has averaged about 17 times, suggesting an expansion may be due.

In prior downturns, the turning point, where investor psychology improved, was obvious only well after the fact. Despite Wall Street's current fears and gloomy outlook, it is very likely that this time will be no different. At some point the market will turn and high-quality companies, with their superior track records and above-average growth, will resume their upward progression in share price.