# Great Companies, Inc.

# Quarterly Review 1st Quarter 2008

## DEFEATING FEAR

First of all, we understand that the stock market is a very scary place for most of you right now, and realize that it's difficult for you to be confident about your investment future. However, in the same vein, it's critical that we remain strong and steadfast, as it is the only action that will provide you the desired result. Unfortunately, many people when faced with this kind of pain will panic and sell. This usually happens near the bottom. Running from a bear market is just as perilous as running from a real bear. You will surely get what you fear the most – eaten by the bear. We recognize that this is easier to say than do, yet it must be done. For numerous reasons, we believe investors will look back a few years from now and will be kicking themselves for not adding money to their equity portfolios. Our goal with this quarter's newsletter is to provide you the will and courage to overcome your fears. We intend to accomplish this by empowering you with a more level perspective, based on truth and fact.

This is not meant to imply a Pollyanna or cavalier attitude towards the real issues that the financial markets and the economy are dealing with. The problems are real and for some sectors severe, however, they are far from terminal. Our otherwise very healthy economy does have a severe cold, but it will soon get better. The Federal Reserve and government have begun doctoring our "dis-ease" with strong medicine that is beginning to take hold. Clearly, in due time, the patient will be well again. Once better, we can again look forward to the growth and prosperity we need and desire. Even better, we can also expect a stronger immune system to protect us from a relapse. With this metaphor in mind, let's move on to the truths, facts, and historical realities of investing with a focus on your specific investments.

Let's first address the general economy. Outside the crisis in the financial sector, which will eventually correct itself through a combination of free market forces and some federal assistance, the U.S. economy is resilient and healthy in many areas. Interest rates are low thanks to a very accommodative Fed. Inflation is a worry, but still low and although the dollar is weak, it's generating an improving trade deficit from improving exports of U.S. goods. Also, industrial demand remains strong globally and productivity continues to increase. All in all, there is more positive than negative and Armageddon is nowhere in sight. When you consider that most of our portfolio holdings derive half or more of their business and profits outside the U.S., this diversity also lowers the risk.

However, with the above said, it is becoming increasingly evident that we may already be in a mild recession. Since the "R" word frightens people, let's put it into perspective. The definition of recession is as follows: A period of general economic decline; specifically a decline in Gross Domestic Product (GDP) for two or more consecutive quarters. Since WWII, my lifetime, we have had ten such events. However, as the following table illustrates, stock market returns have been weak the year prior to

**Truth About Recessions**

| | | | S&P 500 PERFORMANCE | | |
|---|---|---|---|---|---|
| START DATE | END DATE | MONTHS | DURING RECESSION | PRIOR 12 MONTHS | NEXT 12 MONTHS |
| Apr.1, 2001 | Nov. 30, 2001 | 8 | -1.80% | -22.57% | -17.83% |
| Aug. 1, 1990 | Mar. 31, 1991 | 8 | 5.35% | 2.91% | 7.59% |
| Aug. 1, 1981 | Nov. 30, 1982 | 16 | 5.82% | 7.60% | 20.11% |
| Feb. 1, 1980 | Jul. 31, 1980 | 6 | 6.58% | 14.24% | 7.60% |
| Dec. 1, 1973 | Mar. 31, 1975 | 16 | -13.13% | -17.89% | 23.28% |
| Jan. 1, 1970 | Nov. 30, 1970 | 11 | -5.28% | -11.38% | 7.79% |
| May 1, 1960 | Feb. 28, 1961 | 10 | 16.68% | -5.59% | 10.28% |
| Sep. 30, 1957 | Apr. 30, 1958 | 7 | 2.40% | -6.47% | 32.57% |
| Aug. 1, 1953 | May 31, 1954 | 10 | 17.91% | -2.53% | 29.84% |
| Dec. 1, 1948 | Oct. 31, 1949 | 11 | 8.76% | -1.60% | 21.76% |
| | **Average** | **10.3** | **4.33%** | **-4.33%** | **14.30%** |

Data Prepared By Citigroup

a recession (this most likely has already passed), rather benign to slightly good while we are in a recession (most likely where we are now) and generally superb to great the year after the recession ends (our immediate future). Consequently, as bizarre as this sounds, recessions have actually been very positive for stock investors.

Once investors realize we are in recession, stock prices tend to bottom in anticipation of economic recovery. This is the great dilemma posed to investors; when your fear is highest, prices turn higher and you refuse to participate because the headlines remain scary. If you wait for the news to be good, prices are already much higher. This is why trying to time the market is usually a fool's game. The periodic bear market and the strong sense of fear it creates are the price that equity investors pay for ultimately achieving long-term returns higher than other asset classes. Success means **defeating fear.**

Drilling down to the more specific attributes of the great companies we own, excluding financials of course, paints a very exciting and bright future. First on a pure basis, the following updated earnings report card clearly establishes the following fact. Our companies individually and in the aggregate had an awesome most recently reported quarter. The average earnings increase is outstanding and some of the individual results are mind-boggling. When you contrast this against the 20% drop in earnings of the S&P 500, an accepted proxy for the stock market, our portfolios results are even more extraordinary.

Even the financials we own have strong recovery potential from the tremendous hits they have taken from investors, much of which is based on fact, but some also based on fear and misunderstanding. Clearly, Citigroup and American International Group are huge global franchises and are not at risk of going out of business. Obviously, we have had more difficulty with bond insurer, Ambac, where its insuring of mortgage-backed securities created such fear that the rating agencies forced it to raise dilutive capital at a very low stock price to maintain its AAA credit rating. This is an important point: Ambac still maintains the highest credit rating possible by Standard & Poor's and Moody's. This has never been a question of solvency as Ambac has $16 billion in claims paying ability, far in excess of any actual loss imaginable.

**Great Companies, Inc. Holdings**
**MOST RECENTRLY REPORTED QUARTER**
**PORTFOLIO EARNINGS REPORT CARD**

| COMPANY | DATE | EPS CHANGE |
|---|---|---|
| 1) Aflac Inc. | JAN. 31 | 18% |
| 2) Akamai Tech. | FEB. 6 | 52% |
| 3) Amphenol | JAN. 17 | 28% |
| 4) Broadcom | JAN. 24 | 26% |
| 5) Cardinal Health | JAN. 29 | 8% |
| 6) Charles Schwab | JAN. 16 | 36% |
| 7) Cisco Systems | FEB. 6 | 15% |
| 8) Coach, Inc. | JAN. 23 | 21% |
| 9) Cognizant | FEB. 7 | 44% |
| 10)Danaher | JAN. 24 | 19% |
| 11)EBAY | JAN. 23 | 45% |
| 12)Fedex Corp. | MAR. 20 | (6%) |
| 13)Fiserv Inc. | FEB. 6 | 19% |
| 14)Genentech, Inc. | JAN. 14 | 25% |
| 15)Google | JAN. 31 | 39% |
| 16)Home Depot Inc. | FEB. 18 | (5%) |
| 17)Illinois Tool Works | JAN. 30 | 19% |
| 18)Johnson Controls | JAN. 18 | 39% |
| 19)Kohl's Corp. | FEB. 28 | (13%) |
| 20)L 3 Communications | JAN. 31 | 19% |
| 21)Manitowoc Co. Inc. | FEB. 4 | 111% |
| 22)MEMC Elec. | JAN. 25 | 73% |
| 23)NetApp Inc. | FEB. 13 | 28% |
| 24)NII Holdings | FEB. 27 | 18% |
| 25)Nike Inc. | MAR. 19 | 23% |
| 26)Staples, Inc. | MAR. 4 | 15% |
| 27)Stryker | JAN. 23 | 21% |
| 28)Teva Pharm. | Feb. 12 | 23% |
| 29)United Tech. | JAN. 23 | 23% |
| 30)Unitedhealth | JAN. 22 | 10% |
| 31)Weatherford | JAN. 24 | 22% |
| | **Average** | 26.9% |
| | | |
| 32) Ambac | JAN. 16 | loss |
| 33) American Intl Grp | FEB. 28 | loss |
| 34) Citigroup | JAN. 15 | loss |

What can clearly be gleaned from the above is that our portfolio companies had great business results last quarter that were significantly better than their stock prices reflected. As we have previously and often expressed, the stock market can be very wrong in the short run. However, it's even more important to recognize that in the long run the market always gets it right. Therefore, our only rational conclusion can be that at some point in the near future, our portfolio stock prices should rise significantly.

In summary, in this environment, it would be easy to cash out, put your box of money under the bed, and wait for things to settle down. Unfortunately a lot of people are doing exactly that and it will probably cost them dearly in lost returns over the long run. We have seen time and again that when things get tough, investors often panic and overlook the good news . . . and there is good news. First, the Fed is doing all it can to improve the situation. Interest rates have been cut, discount windows opened, etc. Eventually, these actions will result in a turnaround in the economy. No doubt over the long-term new regulations will be imposed on mortgage brokers, highly leveraged investments will be curtailed, hedge funds will come under closer scrutiny, etc. These actions will prevent us from falling into this trap in the future.

Second, Wall Street is having a fire sale as prices on many great companies and values are at very attractive levels. While prices have come down, it is reasonable to assume that earnings growth will soar as companies refinance their debt at lower rates and business conditions improve. Eventually this will result in higher earnings, which will transition into higher stock prices. While this will benefit corporations, it will have the opposite effect on conservative savers. For example, interest rates on three-month Treasury bills are yielding only 1.28%. At this rate a saver is actually losing money after inflation. Investors will eventually return to equity investments, and when they do the markets will soar. However, many of those who try to time this move will miss out on much of the upside returns. This pattern has been repeated time and again over the years, and yet few have learned that staying invested over the long-term is the key to building wealth.

Third, a weak dollar is creating enormous opportunities to increase global sales and profits. This will contribute to higher earnings growth rates. Again this will ultimately translate into higher market prices for our Great Companies, Inc. portfolio businesses, most of which get 50% of their profits and sales internationally. While long-term opportunities are enormous, the short-term volatility has shaken the average investor's faith in the stock markets. The key is to follow a strategy that has been tested over long-term market cycles, and that is precisely what the Great Companies, Inc. strategy is all about. Our strategy has worked over bull and bear markets, during periods of over-valuation and under-valuation, unlike many of the hedge funds which have blown up, or approaches that worked in some markets, but not in others.

In conclusion, we remain very enthusiastic regarding the future returns of your Great Companies, Inc. managed portfolios. During downturns, higher growth stocks, many of which we own, tend to come down harder than average, but also tend to recover much more sharply as the market improves. Our businesses are terrific and sooner or later the market must realize that fact because, as we hope you all agree: in the long run **Earnings Determine Market Price.** Always have, and always will.

Sincerely,

Charles C. Carnevale
Chief Investment Officer

*The opinions in this newsletter are for informational purposes only and should not be construed as a recommendation to buy or sell the stocks mentioned or to solicit transactions or clients. Past performance of the companies discussed may not continue and the companies may not achieve the earnings growth as predicted. The information in this newsletter is believed to be accurate, but under no circumstances should a person act upon the information contained within. We do not recommend that anyone act upon any investment information without first consulting an investment advisor as to the suitability of such investments for his specific situation.*