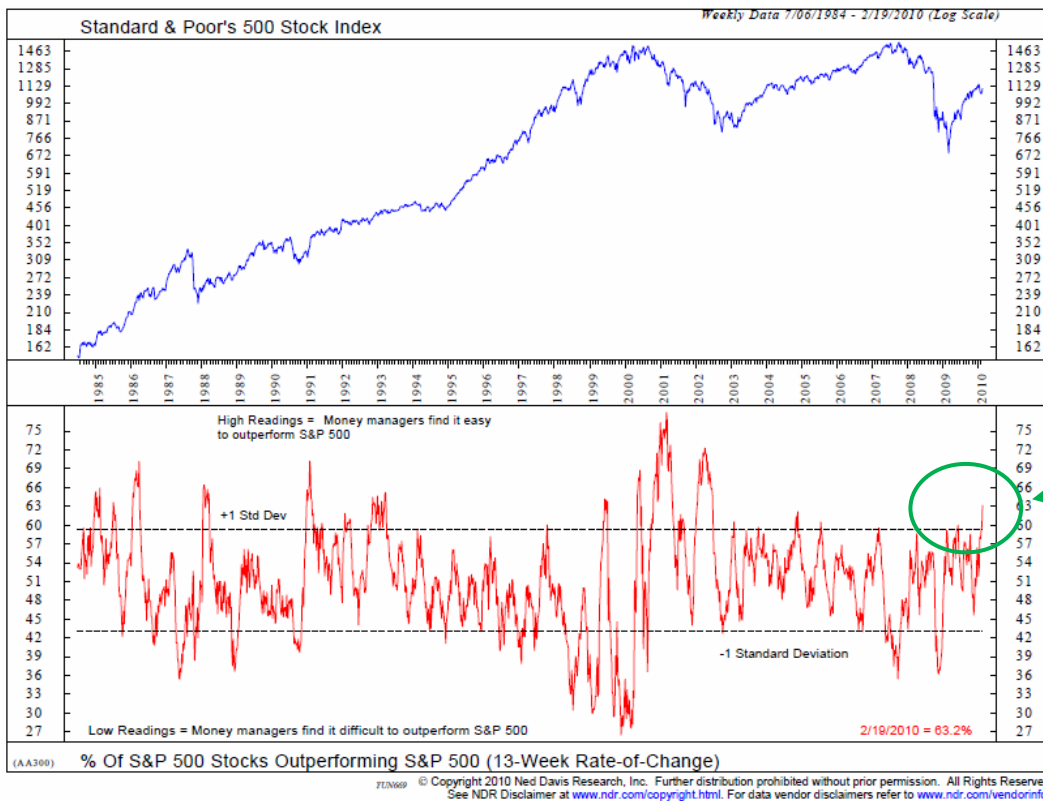




Teaching A Man To Fish: A Well-Stocked Pond for Stock Picking

We believe we are beyond the “easy money” part of the cyclical bull market, where a rising tide could be counted on to lift all boats, no matter how leaky or unsafe they might be. Simply put, we believe this is a time when stock pickers “earn their stripes” and a disciplined selection process becomes exponentially more important.

Don’t just take our word for it, however. By analyzing the change in intra-stock correlations, dispersion of returns within stocks and industries, and standard deviation¹ moves around the percentage of S&P 500 stocks outperforming the S&P 500 Index (see chart below), research provider Ned Davis Research recently suggested that the environment is likely to improve for stock pickers.



The percentage of S&P 500 stocks outperforming the S&P 500 Index has recently reached an extreme of well over 1 standard deviation for the first time since 2005, suggesting that it’s potentially a stock pickers’ market once again.

What does this all mean? We think it’s time for equity investors to use all the tools at their disposal and become more selective with their stock purchases, as they are more likely to be rewarded for their efforts. Using a fishing analogy, we describe our process for doing just that.

How to Catch Fish in Stormy Waters

1. Only fish the well-stocked ponds. We believe investors should maximize their time and effort by concentrating on industries in which the historical odds of success are stacked in their favor. Drawing on an analysis we performed last year (see our *Equity View*, 9/29/09, “When to Use a Stock and When to Use an ETF”), we looked for two specific

¹ Standard deviation is a measure of the dispersion of a set of data from its mean. The more spread apart the data is, the higher the deviation.

characteristics when trying to decide whether to dig deep into a particular company’s fundamentals or to simply gain exposure to an industry via an exchange-traded fund (ETF). First, we favor industries that have historically experienced a broad dispersion of relative performance outcomes; in other words, **the stocks within a specific industry don’t necessarily all act exactly like each other**. Second, we analyzed whether this broad dispersion primarily manifested itself in outperformance rather than underperformance; in other words, **we want industries with enough outperforming stocks to make it worth the effort**. We found “well-stocked ponds” in the following industries:

Thrifts/Mortgage Finance	Consumer Finance
Media	Pharmaceuticals
Hotels, Restaurants, and Leisure	Diversified Financial Services
Personal Products	Software*
Wireless Telecom Services	Electrical Equipment
Healthcare Providers/Services	Computer Hardware*
Retail	

Past performance is no guarantee of future results.

** Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.*

2. Use high-quality lures. As a general rule, we tend to gravitate toward companies with clean balance sheets, significant earnings stability, lack of accounting “shenanigans” (accruals, recurring write-offs, etc.), and above-average fundamental metrics, such as margins and return on invested capital (ROIC). We believe that these types of companies tend to be long-term outperformers, as well as generally providing lower volatility across market cycles. In addition, we think a consistent track record of paying and growing dividends is one of the best ways to judge a “quality” company; historically, companies that have initiated and grown dividends not only significantly outperform dividend cutters and non-payers, but have also significantly outperformed stock market averages.

3. Rely on your “fish finder”: While “fishing” in a universe stocked full of companies with strong fundamentals can significantly increase the chances for success, there can still be hot and cold spots, depending on the market cycle. Therefore, we like to combine our fundamental discipline with technical analysis tools to allow us to focus on industries with positive relative strength trends. One such model is RiverFront’s proprietary relative-strength based TMI (Technical Momentum Index) model, which helps us to illuminate “hot zones” to target, increasing our chances for outperformance.

4. Know when to cut bait. Regardless of how badly you want to land that 2000-pound marlin, sometimes the smart decision is to cut your line before you lose your fishing pole, or even your life (the protagonist of Ernest Hemingway’s *Old Man and the Sea* comes to mind here). Similarly, we believe that market participants should make it a best practice to engage in an active risk management discipline, which requires setting technically-derived stops on each position within a portfolio.

We believe that the following stocks have an attractive combination of solid fundamental scoring and strong relative strength, and generally reside in industries in which we believe odds are historically in stock pickers’ favor:

Media: Strong relative strength and media’s historical “late-cycle” status, along with a broad-based rebound in advertising has kept us bullish in media, despite our belief that media tends to be a value-destroying industry in the long term. We tend to favor media companies below mega-cap size that own what we see as attractive assets, possess motivated management and strong capital positions, and try to avoid the “conglomerate discount” that has plagued many media holding companies in the past.

- **DIRECTV (DTV-N-\$33.71)**
- **DreamWorks Animation (DWA-N-\$40.87)**
 - *Note: DWA is announcing quarterly earnings after market close on Tuesday, February 23. Therefore, the share price may be volatile immediately after the announcement. We believe the stock has positive*

catalysts throughout 2010 and 2011 and would view any significant pullback as a buying opportunity, but would caution volatility-adverse investors against buying ahead of the quarter.

- **Time-Warner Cable (TWC-N-\$46.92)**

Software/Hardware/IT Service Hybrids: Traditionally a space in which individual stock picking has made a difference, we like high margin tech's attractive blend of cyclical and defensive characteristics. In addition, two of the three companies listed below are mid-cap names that we think are in the "sweet spot" of tech; big enough to possess competitive scale, yet small enough to be able to continue to grow at an outsized pace.

- **Sybase (SY-N-\$44.17)**
- **Amdocs (DOX-N-\$29.00)**
- **Hewlett-Packard (HPQ-N-\$50.56)**

Pharmaceuticals: While no longer the top-line growth stories that they were in the 1990s, we believe pharmaceutical companies' collective valuation accurately reflects that reality, and perhaps underestimates the amount of margin expansion possible as these companies trim excessive fat via mergers and cost-cutting initiatives. Importantly, we particularly like the pharma space for its cash flow and its propensity to reward shareholders in the form of large and growing dividends.

- **Merck (MRK-N-\$37.12)**
- **Bristol-Myers Squibb (BMY-N-\$24.68)**

Healthcare Devices and Services: We believe that the valuations of the companies listed below are depressed to due ongoing fears concerning government scrutiny and reform, an outcome we think is made increasingly unlikely due to the politically divisive nature of such reform. In particular, we favor healthcare companies with leading market share and a diverse set of addressable markets, as they would lessen the risk of relying too much on any one industry.

- **Medtronic (MDT-N-\$43.66)**
- **Abbott Labs (ABT-N-\$54.40)**
- **Express Scripts (ESRX-NasdaqGS-\$89.37)**

Restaurants: While the U.S. consumer faces an uphill battle over the longer term, an improving macroeconomic picture bodes well for near-term stock performance, in our view. In addition, we favor companies in this space with discernable brands and a strong value proposition for the consumer.

- **McDonalds (MCD-N-\$64.77)**
- **Darden Restaurants (DRI-N-\$41.05)**

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