First Quarter 2012 Commentary

The gains experienced by the stock market in the fourth quarter of last year spilled into 2012. On the home front, corporate earnings have been growing at a satisfactory rate and the job picture has been slowly but steadily improving. Worries about Europe, which had dominated the news cycle in recent quarters, have dissipated for now, as Greece's debt restructuring was completed and the European central bank provided stimulus to the region.

After all was said and done, the S&P 500 index was up 12.6%, marking its best first quarter percentage gain since 1998 and its best ever first quarter point gain. The Dow Jones Industrial Average advanced 8.8% and is now less than 7% from its all-time high of 14,164.53, reached on October 9, 2007.

Interestingly, the recent stock market rally has not translated into much enthusiasm from retail investors. U.S. stock funds have continued to experience cash outflows. So far in 2012, through the end of the first quarter, U.S. stock funds saw $15 billion in net redemptions, according to the Investment Company Institute trade group.

A Tale of Two Companies

We would like to present, for your investment consideration, two companies which are available for purchase in today's stock market. We will briefly describe each and let you decide which one is the more attractive candidate.

Company A

Over the last ten years, Company A has grown its revenues by an average of 7% per year, its book value by 9%, and its earnings per share by 10%. It is the owner of some of the most trusted and long-lived consumer brands in America, it generates billions of dollars of cash flow year in and year out, and its stock is currently selling for a price that is about 12 times its expected 2012 earnings.

Company A is diversified both geographically and by product, with over 50% of sales coming from outside the U.S. and several different blockbuster brands with annual sales over $1 billion. It is consistently listed in the top 20 companies in Fortune's annual Most Admired Companies list, and it is one of only four AAA-rated companies in the U.S.

Finally, Company A has increased its dividend each and every year for the last 49 years, and it is expected to make it 50 in a row next month. Its current dividend yield is 3.5%.

Company B

Company B's stock is currently languishing, in part due to its weak profit outlook for 2012. While the S&P 500 has raced ahead 28% over the last six months, Company B's stock price has gone up only 6%. Over the past ten years, its stock price is essentially flat. Even so, its CEO is stepping down soon and will receive a very generous "golden parachute" package as he leaves.

Over the last few years, Company B has issued a substantial number of recalls for some of its iconic brands. It is the subject of ongoing investigations and inquiries by various government authorities, partially related to its product recalls.

Company B spends billions of dollars each year acquiring other companies. Its most recent acquisition was for a whopping $19 billion, using up almost two years' worth of cash flows.

Which Company Would You Rather Invest In?

So which one did you decide to buy? As you may have guessed, Company A and Company B are one and the same. Both descriptions refer to Johnson & Johnson, the global health care giant.

The Lesson: Consider the Entire Story

Looking only at the Company A side of Johnson & Johnson's scale, an investor may want to buy as many shares as she possibly can. Or, looking just at the Company B side, an investor might be expected to sell any stock he owns as quickly as possible.

As analysts, we try to consider every facet of a possible investment, both good and bad. We then decide which side of the scale deserves more weight, and act accordingly. For our clients, we have judged that the Company A attributes of J&J currently outweigh the Company B attributes, and we have made it one of our major holdings.

We believe that the troubles J&J has been facing over the last few years, while serious, are not insurmountable. There is a reason this company has been not only existent, but growing and profitable, for more than a century, and we believe it will continue on that course once it regains its footing. With the current bargain price offered by the stock market, we believe an investor will eventually be rewarded for the foresight and patience necessary to purchase J&J right now.

FELIPE

Aaron

Felipe Garcia, CFA
Chief Investment Officer
INKWELL CAPITAL LLC

Aaron Byrd, CFA
President
INKWELL CAPITAL LLC