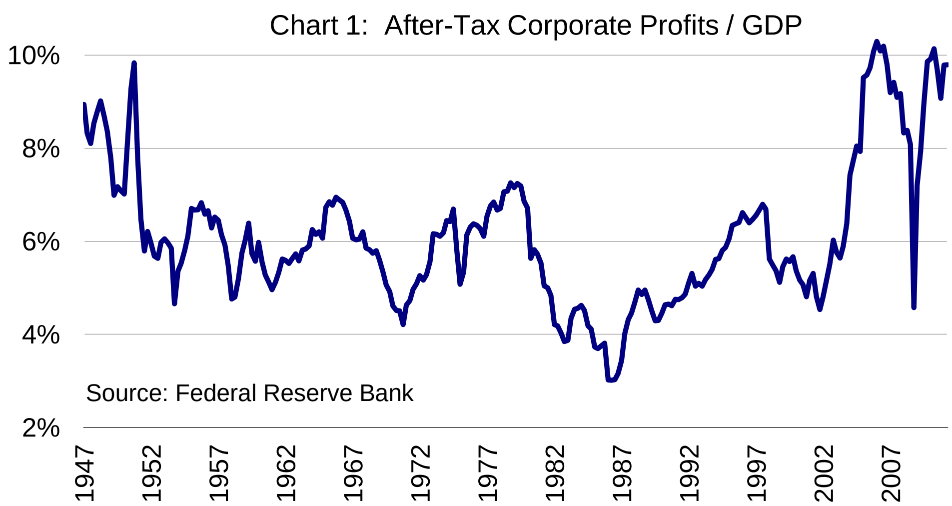
NOESIS CAPITAL MANAGEMENT

A REGISTERED INVESTMENT ADVISOR

October 15, 2011

Dear Client:

Stock markets worldwide have been selling off and extremely volatile since late July, with investors understandably anxious about the current economic situation. However, the multinational companies that we follow remain well equipped financially with solid balance sheets and strong cash flow generations. Even overall corporate profits in the U.S. are close to all-time highs (Chart 1). Corporate fundamentals remain strong, and I don't believe investors are being pessimistic about them. Instead, I think they're sending a strong message that they distrust policymakers in many Western economies.




During this time of highly volatile worldwide financial markets, I spent a few days reading Joel Greenblatt's books, *You Can Be a Stock Market Genius*, *The Little Book that Beats the Market* and *The Big Secret for the Small Investor*. Written by a successful hedge fund manager, these books are intended to teach individual investors proper thinking logic when it comes to investment. Admittedly, these books make up a basic introduction to investing, rather than an advanced technical course; however, they explain investment concepts surprisingly well and are easy to read. I was reminded that it's good to review the basics once in a while, especially in times of extreme volatility and nervousness.

1801 Clint Moore Road, Suite 100, Boca Raton, Florida 33487
561-999-9888 • Fax 561-994-2893 • E-Mail: info@noesis-capital.com
www.noesis-capital.com

### What Investment Options Do We Have?

Let's start with a simple question: If you have $1,000 today and you don't need it for the next 10 years, how should you grow the money over the next decade? The first option you have is to put it in the bank and earn, in today's market, less than 1%. Ouch! That's almost nothing.

Another option is a 10-year Treasury, yielding approximately 2.0%. Well, after accounting for inflation and tax, this could still ultimately mean a loss. Nay!

A third option is a corporate bond with less than 4% yield. Hmm, that sounds better.

Or, finally, you can choose to invest in a real business yielding returns of 6% or higher. Isn't the answer obvious? The total return of the S&P 500 Index historically has been approximately 9%, while the 10-year Treasury has stayed about 5%+ and 30-day Treasury yields hovered around 3%+.

This leads to the real question: where can we find a business with a consistent 6% return? The stock market doesn't sound stable at all—in fact, it's quite risky. Let's think about it for a minute. If you read a quote on any company, Caterpillar (CAT) for example, the trading price as I write this is $78.86, the previous closing price was $75.52 , this year's high was $116.55 (on 5/2) and the low was $67.54 (on 10/4). The price has declined more than 42% over the past five months and then jumped more than 4% in one trading session! How could CAT's value have changed so much in five months or even just one day? Did CAT's fundamentals really deteriorate 42% over the past five months and then suddenly improve 4% in just one day?

### Mr. Market

Market volatility doesn't stop with CAT. In fact, prices of the common shares for most public companies swing wildly year to year, month to month, or even day to day. Benjamin Graham, Warren Buffett's mentor, described the situation well. Imagine, he said, that you are a partner in a business. Unfortunately, one of your partners is very emotional. His name is Mr. Market. He will offer to either buy your share or sell you his share at a particular price every day. When he's in a good mood, he'll name a price much higher than the true worth of the business; when he's in a poor mood, he'll name a very low price. You can take advantage of Mr. Market's crazy offer to buy his share of the business at an unreasonably low price. On other days, you can sell your shares to him at an unreasonably high price. Most days, the prices are probably unattractive, either to buy or sell; you can simply choose to do nothing.

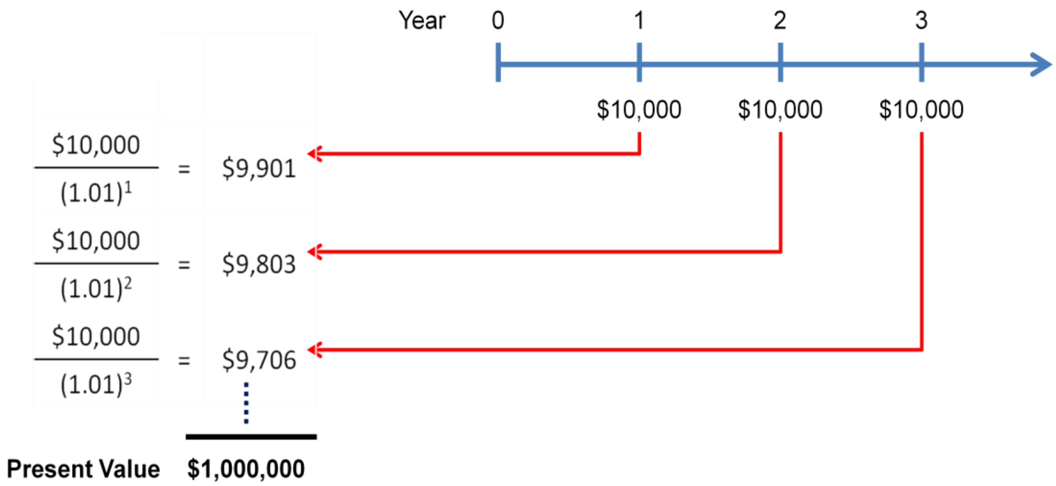
That is exactly how it works in the stock market. While stock prices can easily shift wildly over a short time period, the true value of the underlying companies likely won't change that much. Graham advised us to buy shares of a company at a large discount to their true value and called the practice "investing with a margin of safety".

### True Value of a Business

The next question is how we can assess the true value of a company. If we can determine the true value of a company, then we can make a purchase with a set margin of safety. Is it really that simple? Yes, the logic is that simple; unfortunately, the calculation is not necessarily easy.

Assume a friend of yours offers you a business opportunity, an ice cream shop in a reasonably well-established shopping plaza. She said the shop has been earning $10,000 a year over the past few years and is expected to continue doing so for the foreseeable future. What's the true value of this shop?

The answer, in fact, lies in calculating the aggregate worth of all future incomes in today's value. If we want to collect $10,000 one year from now in a bank account earning 1% interest, we need only deposit $9,901 today; for $10,000 in two years from now, we only need $9,803; $10,000 in three years from now, $9,706. As this continues, we can calculate the present value[1] of all the future incomes:




In the real world, business is much more uncertain than earning a straight $10,000 a year toward infinity. The higher the uncertainty, the higher the discount rate should be. Think about this: if a bank offers a 1% “risk-free” interest rate, what is our required rate of return to invest in the aforementioned ice cream shop? That is exactly the meaning of the discount rate.

If we are not willing to invest our $1 million in the bank to earn 1% interest, are we satisfied earning 6% from this business opportunity, or maybe even 10%? As we have seen in the graph, the discount rate is part of the denominator in calculating present value. A higher discount rate means a lower present value or, said differently, a lower true value of the business. Makes sense, doesn’t it?

As uncertainty remains high in today’s economy, investors respond by raising their minimum rate of return, making valuations appear cheap. However, if we know that a business—such as our example ice cream shop—has highly-recurring sales and is not very cyclical, then the evaluation will be easy. Let’s say the business can grow 4% per year based on population growth in the local community and we require a 10% return to offset the risk. Then the true value of the business should be $166,667 ($10,000 ÷ (10%-4%))[2]. Remember Benjamin Graham’s advice on maintaining a margin of safety? Let’s assume a 40% margin. This means that the price we are willing to pay for this business is $100,000 ($166,667 x (1-40%)).

Now you know that you own a good business and you paid less than the true value with your chosen safety margin. After you became the owner, Mr. Market asked if you were willing to sell the business to him at $120,000. I don’t know about you, but I know I wouldn’t. What if he offered you $80,000? I bet you would say no, because that’s an insult!

What if Mr. Market offered $166,667, the true value of the business? You’re probably starting to think about selling with a 67% return in only one day, aren’t you? I wouldn’t sell because I know I can gain the 67% anyway, through annual income generated by keeping the business for several years and, furthermore, I can expect to earn much more in future incomes. The point is, you should buy/sell on any investment opportunity based on thorough analysis, not based on what Mr. Market happens to offer.

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[1] Mathematically, Present Value = Cash Flow ÷ Discount Rate for fixed cash flows

[2] For constant growth rate, Present Value = Cash Flow ÷ (Discount Rate – Growth Rate)

**Conclusion**

We've highlighted above several of the key drivers for sound investment decisions: detailed financial analysis, a thorough understanding of the business, good judgment and common sense. We take a similar approach at Noesis. We favor holding good businesses with predictable earnings by paying a reasonable discount to the true values of the businesses. The higher the predictability of the earnings, the more accurately we can calculate fair value. We take advantage of Mr. Market's emotions to buy companies at very low prices. The deeper a discount we pay, the better. We also prefer owning individual companies to buying the market. As such, we are confident in buying more respectable companies during a weak market and selling expensive shares during a strong market.

**RECENT PURCHASES**

<u>HSBC</u>

HSBC (Hong Kong and Shanghai Banking Corporation) was established in 1865 in Hong Kong to finance the growing trade between Europe, India and China. This first-mover advantage has led to a strong presence in the region. Over 50% of its profit before tax is generated in Asia, 10% in Latin America and 7% in the Middle East, while Europe contributes 19% and North America 5% to the bottom line. HSBC's management recently began re-focusing on its roots in emerging markets while reducing its exposure to the US. We believe the company stands at the beginning of a multi-year process to expand on its strengths.

<u>Baxter International</u>

Baxter is a global medical equipment company. Approximately 60% of its revenue is generated overseas, and it has been recognized as one of the most sustainable, green, and social responsible S&P 500 companies. With its continuous efforts in R&D, productivity improvement, and geographic expansion, Baxter has a sustainable business model.

<u>Stryker</u>

We continue to favor the orthopedic industry in the long run, given strong demographic trends and high barriers of entry. Originally focused on reconstructive orthopedic implants such as knees and hips, Stryker has now further diversified its business into the neurovascular market, which has higher margins and is less sensitive to general economic cycles.

As always, we thank you for the trust you have placed in us and look forward to serving you for many years to come. We also greatly appreciate your willingness to recommend our services to your friends, family members and co-workers. Please do not hesitate to contact us if you wish to discuss your portfolio or have questions.

Sincerely,

Joseph Lai, CFA
Chief Investment Officer

*Our most recent Form ADV, Part II is available upon request*