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DAVIS HAMILTON JACKSON & ASSOCIATES

The Have's and the Have Not's

In an investment letter at the beginning of this year, we highlighted several factors in favor of large cap growth, including better relative expected earnings growth, a slowing economy, and attractive relative valuations. As we pointed out at that time, the Value Index was 70% more expensive than the Growth Index on a PE to expected growth basis. And indeed, as illustrated below, growth stocks have been outperforming significantly this year.

As of 11/23/07	Russell 1000 Growth	Russell 1000 Value
1Q07	1.19%	1.25%
2Q07	6.86%	4.93%
3Q07	4.21%	-0.25%
QTD	-3.12%	-7.72%
Year to Date	9.16%	-2.21%

Profit cycle decelerating more than expected.
This strong performance has come despite the deterioration in the overall profit picture. A slowdown in overall profit growth has been widely anticipated for some time. However, the deceleration in the third quarter appears to have been much greater than expected, with financials and housing-related stocks making up the bulk of the earnings falloff. With 90% of the companies in the S&P 500 having reported, third quarter operating profits are expected to decline 8.5%, the first decline in five years. Moreover, it is only in the last month that fourth quarter estimates have begun to turn down sharply, falling from an expected 8.8% in July to about 1% currently. While the estimate reductions have been ongoing for the financials and housing stocks, they have recently spread to other areas of the market. It's very likely we'll start to see more cuts for next year.

Better earnings and improving expectations driving Growth.
However, these gloomy statistics obscure the more positive earnings dynamics within individual sectors, which help to explain Growth's strong performance. Based on results reported through mid-November, the Growth Index experienced 10.4% earnings growth for the third quarter versus a negative 7% for the Value Index. The table below shows expected 2007 growth by sector for the Growth and Value Indices as of the end of June and currently. Overall estimates have actually been rising for the Growth Index, driven by increases in staples, healthcare, industrials, technology and materials.

As of 11/23/07	R1000 Growth	6/30/07	Current	R1000 Value	6/30/07	Current
	Current WGT	Proj. 07 EPS Growth	Proj. 07 EPS Growth	Current WGT	Proj. 07 EPS Growth	Proj. 07 EPS Growth
Consumer Disc.	12%	13%	10%	7%	-9%	-21%
Consumer Stpls.	10%	6%	7%	9%	4%	6%
Energy	9%	22%	20%	15%	-3%	0%
Financials	7%	16%	7%	30%	6%	-11%
Healthcare	16%	16%	18%	7%	5%	5%
Industrials	13%	18%	37%	11%	7%	13%
Info Tech	28%	18%	22%	3%	-15%	-21%
Materials	3%	19%	27%	4%	1%	-3%
Telecom	1%	58%	22%	6%	4%	6%
Utilities	1%	9%	19%	7%	6%	7%
Avg. % $ Wgt.	100%	16%	19%	100%	3%	-4%

Weightings shift reflecting growth opportunities.
The three largest sectors in the Growth Index—technology, healthcare and industrials—have the highest growth rates, currently 22%, 18%, and 37%, respectively. It is interesting to note that consumer discretionary has now been replaced by industrials as the third largest sector in the Index. Healthcare remains the second, but with the slower growth and underperformance of large cap pharmaceuticals over the last few years, this sector has declined from representing about 28% of the Growth Index in 2002 to around 16% today. With the slower growing pharmaceuticals shifting to the Value Index, the healthcare sector in Growth now has a more attractive profile.

Foreign sales have been driving a large part of U.S. profit growth. Thus it is not surprising to see larger representation in the Growth Index of those sectors where foreign sales represent a large part of revenues, specifically tech, industrials, energy and materials. The two latter sectors were less than 1% of the Index at the market's peak in early 2000.

Financials hurting the Value Index and the S&P.
The high weighting of financials in the Value Index explains a large part of the recent decline in that index's overall growth rate. This weighting had been over 35% as of June 30, and has now fallen to 30% as those stocks have underperformed. The S&P 500 Index (not shown) has also experienced a significant downward revision to 2007 estimates. Keep in mind that the S&P also has a significant weighting in financials, currently about 18% down from about 25% earlier this year.

There still appears to be good value in Growth!
The table below shows the PE to growth ratios in February of this year and more recently for the Growth and Value Indices. Even though the Growth has dramatically outperformed, the 2007 growth rates have risen for the Growth Index and fallen for the Value Index and the S&P. Thus growth remains relatively attractive, despite its recent outperformance.

As of 12/31/07	Calendar P/E 2007	Consensus EPS Growth 07 vs 06	P/E to Growth
Russell 1000 Growth	18.9	17.1%	1.1
Russell 1000 Value	14.4	8.2%	1.8
S&P 500	14.9	9.0%	1.7
As of 11/23/07			
Russell 1000 Growth	19.1	19.0%	1.0
Russell 1000 Value	13.8	-4.0%	NM
S&P 500	15.8	3.0%	5.3

Currently the market has been adjusting to the more recent earnings announcements and the cuts in fourth quarter earnings, with the S&P experiencing another significant correction. While market <u>sentiment</u> has backed off from its highs, it remains too bullish to expect significant upside near term. Both <u>monetary</u> and <u>valuation</u> factors remain positive; but the key to the direction of the U.S. equity market will be whether earnings estimates for 2008 remain too high. We continue to focus on attractive growth stocks that can deliver above average earnings growth in the current environment.

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