Executive Summary

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Since Inception	
Hot List	168.3%
S&P 500	27.3%
Accuracy	56.4%
Beta	1.2

YTD	
Hot List	-0.6%
S&P 500	1.3%

Since Last Issue	
Hot List	-1.8%
S&P 500	-4.3%

Avg. Fundamentals	
Market Cap (mil)	$11,216
PE Ratio	34.9
5 Yr EPS Growth	27.6%
Yield	2.5%
Rel. Strength	53

Portfolio Sectors	
Services	5
Technology	3
Consumer Cyclical	1
Healthcare	1

The Economy

The markets have been shaken over the past couple weeks by the continued turmoil in the Middle East and the tragic tsunami and earthquake that rocked Japan, but the global worries have yet to quash the U.S. economic recovery.

The economy continues to be driven by manufacturing sector growth. Last week, the Institute for Supply Management announced that its manufacturing index jumped to 61.4% in February, hitting its highest level in nearly seven years. It was the 19th straight month ISM's index indicated an expansion in the manufacturing sector.

The employment index of ISM's manufacturing report, meanwhile, not only improved -- it reached its highest level since January 1973.

Overall, the economy added 192,000 jobs in February -- and, because 30,000 government jobs were cut, the private sector actually added 222,000, according to the Labor Department. The unemployment rate, which is based on a separate survey from the jobs-added report, fell only slightly to 8.9%, but nonetheless came in below 9% for the first time in almost two years. The broader, so-called "U-6" unemployment rate -- which includes discouraged workers who've given up looking for work and those who are working part time but want to work full time -- fell from 16.1% to 15.9%, dropping below 16% for the first time in nearly two years.

The weekly unemployment numbers also continue to show things are looking up. New claims are 15% below the year-ago level, while continuing claims are 21% below their year-ago level.

Retail sales, meanwhile, are continuing their impressive rebound. Retail and food service sales increased another 1.0% in February, according to the Census Bureau, and the January increase was also revised upward to 0.7% from 0.3%. Retail sales are now more than 15% off their December 2008 recessionary lows, and over $7 billion greater than their pre-recession high.

Of course, there are a number of concerns about the economy, including oil prices, which remain near $100 despite having dipped on the Japan-related economic fears. I continue to think that oil prices won't throttle the recovery, with a good deal of the price increases coming from fear, not fundamentals. As I've noted before, Libya exports only about 80,000 barrels of oil a day to the U.S. -- a pretty insignificant figure. And while it exports a much more significant amount of oil to some of our trading partners like Italy and France, the domino effect on the U.S. shouldn't by itself be enough to halt growth here.

Perhaps more concerning is the continuing surge in food prices. Producer prices for finished goods -- that is, prices paid by companies that sell the food to consumers -- jumped nearly 4% in February, the Labor Department reported this week. Crude producer food prices rose 6.7%. Weather, once again, was a big factor, with unusually cold temperatures the culprit this time. But rising global population and demand is also playing a role.

As for the tragedy in Japan, much remains unknown. The human toll has been terrible;

what the economic impact will be is unclear. About 10% of U.S. exports go to Japan; in the short-term, that figure would seem likely to decline. But looking further out, it's unclear, especially if the country takes on big stimulus efforts in order to spur a recovery. As for the fallout from the nuclear reactor trouble, I won't pretend to be a nuclear expert. We'll have to wait and see and hope for the best. But overall, despite its economic trouble in the past decade or two, Japan has proven to be a resilient nation with a strong, productive workforce. While there will be plenty of short-term impact on the markets and economy, I expect that over the longer term it will recover from these terrible losses. When all is said and done, the world's third-largest economy will remain an economic power.

For the market, the past fortnight was a volatile one. Overall, the S&P 500 returned -4.3%, while the Hot List returned -1.8%. For the year, the portfolio stands at -0.6% vs. 1.3% for the S&P. Since its inception in July 2003, the Hot List is far outpacing the index, having gained 168.3% vs. the S&P's 27.3% gain.

The Myth of "Normal" Times

It's been quite a month or two. So far in 2011, we've seen the downfall of multiple Middle East governments, including Tunisia and Egypt; mass uprisings in several other countries in the region, most notably Libya, where Muammar Gaddafi's forces are engaged in a violent conflict with anti-government forces; and now a horrific earthquake and tsunami that have devastated Japan, the world's third-largest economy.

The events have certainly come as a shock to most. As often happens when crises hit, these global shockwaves have sent investors running for the door. And, as often happens in turbulent times, they've led to pundits and members of the media saying that we're in a completely new era, one in which all the old rules go out the window. These are more examples of how these aren't the easy, happy-go-lucky times of the past, they say; we're now dealing with big problems and crises that very well may doom us.

Consider one article that appeared this week on Yahoo! Finance, via CNBC. It was entitled, "Black Swans Now a Regular Part of Market Landscape," a reference to Nassim Taleb's book *The Black Swan*. "For global financial markets, once-in-a-lifetime events are happening with such regularity that black swans may as well be white swans," the article stated. "Such supposedly rare occurrences have dominated the markets for more than a decade. They include the Internet explosion in the late 1990s, the ensuing dotcom bubble burst and stock market selloff a few years later, the 2001 terrorist attacks, the collapse of the real estate market that began five years ago, and now, the events in the Middle East and Japan."

Without getting into the exact definition Taleb used for a "black swan" event (and whether all the events listed above truly fit that definition), let's focus on the broader idea -- which seems to be that things are different now, and that we're experiencing shocks to the economic, political, and investing world on a level we've never before experienced. It's a scary idea, for sure, and one that probably leads many investors to consider ditching stocks and stuffing their money in their mattresses.

The problem is, it's just not true.

Yes, we've experienced some truly unexpected, remarkable events over the past 15 years or so, many of which have been anxiety-provoking, or downright scary. To the list above, you can add Hurricane Katrina, the devastating tsunami in the Indian Ocean in 2004, and the demise of Long-Term Capital Management and the subsequent fallout in the financial world.

But go back another 15 years, from 1981 to 1996. In that timeframe, we went through the Iran hostage crisis, a presidential assassination attempt that left the president wounded; the invasion of Grenada; a nasty double-dip recession and accompanying double-digit inflation; the Chernobyl disaster; the terrorist bombing of Pan Am 103; the stock market crash of 1987; the first Gulf War, the Exxon Valdez oil spill, the eruption of war in the Balkans, the savings and loan scandal, and the first World Trade Center attack. And if you think the turmoil in the Middle East is a game-changer, how about the collapse of the USSR? The world's largest country, and one of its only two superpowers, completely imploded, and soon ceased to exist. "Normal," easy times? Hardly.

Of course, the 15-year period before that was pretty uneventful. Except, that is, for man setting foot for the first time on a celestial body besides Earth; a major escalation of the Vietnam War that resulted in tens of thousands of U.S. casualties; the most widespread displays of civil disobedience that we've seen in our lifetimes in this country; the only resignation of a sitting president in American history; an oil crisis that led to skyrocketing gas prices and shortages; inflation that nearly touched 15%; the Six-Day War, Yom Kippur War, and explosion of the Israel-Palestine conflict; the Afghan-Soviet war; the overthrow of the government in Iran, and the opening up and modernization of communist China.

This is becoming dangerously close to a remake of Billy Joel's "We Didn't Start the Fire," so I'll stop here. You get the picture, though. There always have been -- and always will be -- crises in America and throughout the world. There always have been -- and always will be -- threats to our safety, security, stability, and prosperity. (Quick -- since 1900, what's the longest America has gone without being involved in a war or major, prolonged international conflict? A mere 23 years -- the period between the end of World War I and our entrance into World War II, a "calm" era that featured the worst stock market crash in history and the only depression in our nation's history.) The grass of times past has a way of looking oh-so-green, but the reality is that it's strewn with just as many weeds and brown spots as it is today.

None of this is to dismiss any of the current crises. The natural disasters, political conflicts, and financial disasters we've witnessed in recent years are all very serious issues, and will require a great deal of hard work and diligence to deal with. What's important to note, however, is that we as a society have a remarkable record of dealing with crises very similar to these, and moving past them. As Warren Buffett wrote in his recent letter to Berkshire Hathaway shareholders:

"Commentators often talk of "Great Uncertainty." But think back, for example, to December 6, 1941, October 18, 1987 and September 10, 2001. No matter how serene today may be, tomorrow is always uncertain. Don't let that reality spook you. Throughout my lifetime, politicians and pundits have constantly moaned about terrifying problems facing America. Yet our citizens now live an astonishing six times better than when I was born. The prophets of doom have overlooked the all-important factor that is certain: Human potential is far from exhausted, and the American system for unleashing that potential - a system that has worked wonders for over two centuries despite frequent interruptions for recessions and even a Civil War - remains alive and effective."

In fact, in some ways, we are more stable than we were 20 or 30 or 50 years ago. Consider the way technology has improved the response time of fire, police, and military forces in terms of responding to emergencies or natural disasters. Think of how advances in transportation and communication have led to the continuing globalization of world markets, which, in turn, has made major world powers more mutually dependent -- and, perhaps, less likely to enter into major wars. Even the stability of our leadership has been greater in recent years than the past; since 1840, the longest the U.S. has gone without a president dying (either of natural causes or assassination) or being wounded while in office is 30 years -- these past 30 years.

Staying Disciplined Amid Crises

What does all this mean for investors? Well, when crises hit, I often keep in mind the work of David Dreman, one of the gurus upon whose writings I base my strategies. In his *Contrarian Investment Strategies*, Dreman wrote a lot about "crisis investing." He explained what tends to happen in a crisis: "In each case, the crisis is the major news of the day. Legions of experts are interviewed, most making dour forecasts of structural damage to the nation. A common theme is 'things will never be the same again.' Because the nation, if not the world, is focused on the crisis, the media is in its glory. A crisis sells newspapers, builds ratings, and peddles advertising."

Sound familiar? Well, with investors being bombarded with negative news, many inevitably head for the door. Such climates "let loose overreaction at its wildest," Dreman wrote. "People no longer examine what a stock is worth; instead, they are fixated by prices cascading ever lower." And, he notes, people always seem to think *this* crisis is *different*: "The event triggering the crisis is always considered to be something entirely new; nothing in our experience shows us how to cope with the current catastrophe," he writes. "'Sell, sell, sell,' the savants chorus."

The reality, however, is that we have a history of recovering from crises. And because of investors' short memories, times of crisis often actually make for good investment opportunities. In his book, Dreman looked at 11 major postwar crises, which included the Berlin blockade, Korean War, Kennedy assassination, Gulf of Tonkin crisis, 1979-1980 oil crisis, and 1990 Persian Gulf War. He showed how, one year after all but one (the Berlin Blockade, when the market dropped), the market was up between 22.9 percent and 43.6 percent, except for a 7.2 percent rise after the Gulf of Tonkin crisis. The average gain was 25.8 percent. Two years after the crisis, the average gain was 37.5 percent. It's worth noting that following the September 11 terrorist attacks, which occurred after Dreman wrote *Contrarian Investment Strategies*, it took just one month for the S&P 500 to climb back to pre-September 11 levels; a year after the attacks, however, the index had fallen below pre-September 11 levels, the dot-com meltdown no doubt being a factor.

Dreman's analysis isn't completely comprehensive, but he provides enough data to support his broader point: Bad news often gives the market the jitters, only to have it recover when the bad news turns out not to be as devastating as first feared, and the savvy investor can take advantage of that knowledge.

Does that mean you should run out and buy up every stock you can when a crisis hits? No. But, to me, it means that you should *not* cash in all your chips and head for the hills -- too often, that leads to selling low and buying high. If you have a disciplined, proven investing system, you should stick to it. That's what we'll continue to do with the Hot List, focusing on proven, solid firms with good fundamentals and financials, whose shares are selling at attractive prices. And over time, I believe that will continue to leave us far ahead of those who bail on stocks every time trouble hits.