



Hillman Capital Management  
2Q 2010  
Market Commentary

At Hillman Capital Management (HCM) we take a long-term approach to investing, focusing on the identification of companies with sustainable competitive advantage. Our goal is to purchase securities of advantaged firms when they sell at a discount to our estimates of intrinsic value. We believe that our approach offers a prudent way to control risk and outperform the market over time.

During the second quarter, U.S. equity markets declined as concerns regarding potential sovereign debt defaults in Europe, a massive oil spill in the Gulf of Mexico, unease on the Korean peninsula, a “flash crash” in U.S. equity markets, and a series of disappointing economic reports instilled a bearish sentiment in the market. Many market pundits forecasted a “double dip” recession and investors continued to favor the perceived safety of U.S. Treasury securities to equities. Given heightened fears of a double dip recession in the market, we believe that it is beneficial for investors to focus on the distinction between the economic forces at the outset of the financial crisis and those faced today. Though many conflicting points exist surrounding the longer-term sustainability of economic expansion, we believe that structural factors are likely to encourage growth in the near-term.

National economies tend to falter when faced with supply-demand imbalances, fiscal crises, political turmoil or exogenous shocks. The decline in the housing market during 2007 is illustrative of a supply-demand imbalance. At that time, new home construction caught up with high levels of speculative demand. When the excess demand dried up, the resulting imbalance sent shock waves through the economy. This type of imbalance was also evident in the broad economy when consumer demand fell sharply as a result of the financial crisis in the fourth quarter of 2008. Due to significant retrenchment in the private sector and a firming demand environment, we believe that the near-term supply versus demand balance for consumer goods continues to foster a healthy environment for business expansion. A recent study focused on the domestic production of consumer goods relative to real consumer goods purchases suggests that consumers are currently purchasing more than is being produced.<sup>i</sup> Real manufacturing and trade inventories have continued to grow at a rate below that of real final sales.<sup>ii</sup> With demand currently exceeding production, output appears likely to expand further in the coming months. We believe that this statement is supported by data such as the 56.2 reading on the June Purchasing Managers Index, a level consistent with continued manufacturing expansion.<sup>iii</sup> Personal income is the principal driver of consumer demand. We therefore believe that continued modest expansion in private sector employment is likely to be supportive in the near-term.

Changes in aggregate housing activity have historically influenced the economy and have been considered a predictive variable in assessments of future economic growth. Recent history has codified a relationship between the health of housing markets and economic stability in the minds of many market participants. Equity markets therefore reacted poorly to a 30% month over month drop in the National Association of Realtors’ Pending Home Sales Index for contracts signed in the month of May. Though market bears have latched on to the decline as evidence of an imminent double dip in housing, the timing of this assertion appears premature. Weak home sales in May were likely attributable to the expiration of a large federal homebuyer tax credit. The recent dip in home sales was not accompanied by a significant drop in home values. Record low mortgage interest rates may help to support home prices going forward.

When assessing the broader implications of a potential further decline in home values, it is important to understand that the relationship of home values to both employment and consumer spending has changed. Rising home values had a significant impact on both consumer spending and employment during much of the prior decade. Throughout this time, many homeowners treated newfound home equity as a slush fund and used it to augment their purchases of consumer goods. Conversely, tightened lending standards and an erosion of home equity values in recent years have not supported excessive purchasing behavior. Though negative from the perspective of the “wealth effect”, a further decline in home values is unlikely to have the same degree of impact on consumer purchasing behavior as it did in the past cycle.

In addition to its effects on consumption, inflated home values directly impacted employment through much of the last decade. Exceptional profit opportunities incentivized homebuilders to increase production, resulting in over two million new homes in 2005 alone.<sup>iv</sup> During that year, residential building accounted for nearly 1% of U.S. private employment.<sup>v</sup> In sharp contrast, May housing starts represented a five hundred ninety thousand seasonally adjusted annual rate, just 41% of its twenty year average<sup>vi</sup> and residential building now accounts for only 0.5% of U.S. private employment.<sup>vii</sup>

We believe that inflated inventory levels are likely to constrain home values in the near-term. However, if the pace of supply entering the market were to increase, price declines may ensue. From today’s cyclically low economic levels, in the absence of a significant shock, potential further negative impacts to the economy from home price declines are likely to be relatively subdued. Longer-term, the housing market is likely to contribute to economic growth, pricing should remain stable and construction activity will likely revert to more normal levels as inventories are depleted.

Through the second half of 2010 and into 2011, the U.S. economy will face many challenges and several headwinds may come from the public sector including: declining fiscal stimulus, state and local government budget cuts, and tax increases in 2011. We are bullish on the prospects for U.S. equities despite these factors. Recently, many firms with competitive advantages have proven an ability to adapt through business cycles and are now benefitting from increased profitability. We believe that reductions to debt and other fixed costs have mitigated business risks. Many firms are accumulating higher cash balances so as to be prepared in the event of a second liquidity crunch. Geographically diverse operations help numerous firms to endure difficulties that may crop up in a single country or region. At the outset of the financial crisis, many companies were caught off guard by a rapid contraction in credit availability and sharp declines in demand. We believe that in light of today’s uncertain economic climate, business leaders are positioning their companies more conservatively, thereby reducing the likelihood of another widespread panic.

We continue to focus our energies on the financial prospects of companies that we view to have sustainable competitive advantage and sufficient financial flexibility to weather troughs in economic activity. We believe that competitively advantaged companies will outperform their peers through market cycles. Our goal is to invest in great enterprises at attractive prices. We will continue to invest according to this precept for the long-term interests of our clients.

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<sup>i</sup> Citi, “What leading indicators are really saying”, 06/28/2010

<sup>ii</sup> Citi, “What leading indicators are really saying”, 06/28/2010

<sup>iii</sup> June 2010 Manufacturing ISM, Report On Business

<sup>iv</sup> Census Bureau

<sup>v</sup> United States Department of Labor Statistics

<sup>vi</sup> Census Bureau

<sup>vii</sup> Department of Labor Statistics

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