



**Volume 34 - Number 2**

**Summer 2010**

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## **Market Update: *A Shift in Sentiment***

By: David A. Jaffe, M.D.

*The real puzzle is why the stock market continues to advance in the face of widespread economic uncertainty, including weak consumer demand, high unemployment, escalating national debt, troubled European economies, and sticking gas pedals. In fact, corporate earnings reports have surprised on the upside and there is a growing consensus that U.S. economic growth has staying power.*

Thus I concluded our Spring Newsletter *Stock Market Update*. Three months later sentiment has shifted 180 degrees. Talk of a “double dip recession” is common and whispers of deflation and even depression have slipped back into the noise emitted from CNBC on a daily basis. So what changed?

Not much, really. It is often said that the stock market is an “averaging machine.” The views of millions of investors, covering the spectrum from the most gloomy bears to the most effusive bulls, are digested by this amorphous system and ultimately expressed as a *net* change in the price of its underlying assets, often denominated in pennies. When the bulls outnumber the bears, as was the case in the first quarter, demand for stocks results in higher prices. Add a disappointing economic report to the mix and the averaging machine shifts from forward to reverse, sellers outnumber buyers, and prices fall.

In the first quarter, the averaging machine decided that the bad news (Greece, for one) was outweighed by growing corporate profits and the perception that stocks, at least in the U.S., represented a good value when judged by anticipated growth, price-earnings ratios, and dividend yields. The risk-free competition looked pretty feeble in this era of near zero money market rates and two-year CD yields averaging 1.9%. April was a quiet month, but then growing worries about Greece and other debt laden European economies sent the Euro plunging against the U.S. dollar, a shift that hurts the competitive position of U.S. exporters. At the same time, China announced measures aimed at slowing its economy, one of the few existing bright spots. Then on May 6<sup>th</sup> came the “flash crash”, an eight minute 700-point swoon in the Dow that left many investors convinced the stock market was nothing more than

a casino with the computers in control. So much for rebuilding confidence in the financial markets!

Sentiment is a funny thing. When the bulls are in control, good news is celebrated and bad news taken in stride. When sentiment turns, good news is discounted and investors focus on everything that can go wrong. Fear of market declines leads to selling, and selling leads to market declines. Market rallies such as one triggered by China's mid-June revaluation of their currency fizzle, leaving investors even more convinced that stocks will do nothing but decline and that they are better off sitting on the sidelines with their cash earning next to nothing in money market funds.

The S&P 500 lost 11.43% in the second quarter, erasing first quarter gains and leaving it down 6.66% for 2010 through June 30<sup>th</sup>. As investors sought shelter from the storm, they bought fixed income and gold. The high quality companies typical of PASI stocks held up better than the indexes, with our composite portfolio down 5.95% year-to-date. Our average balanced account, 60% stock and 40% bonds, shows a decline of 2.43% for the year.

Barring new surprises (and it seems there are *always* new surprises), the near-term direction of stocks will depend on how the averaging machine judges the known risks vs. prospects for economic recovery and growth. Released in early July, the government's employment report for the month of June was discouraging. Key to a lasting recovery will be job creation, and most economists judged the report as anemic. Business leaders are reluctant to hire workers due to uncertainty over new regulation, taxes, and the strength of demand for their goods and services. Meanwhile, a political battle is brewing over the balance between government stimulus and our exploding budget deficit. Reduced spending and increased taxes won't help a fragile economy; this was proven in the U.S. in 1937 and in Japan in the early 90's, and may be proven again in the U.S. in 2011.

Our investment committee debates these issues and their implications for deployment of your assets at virtually every meeting. Our goals are simple: safety, liquidity, and a reasonable rate of return over time. The fact is there really aren't that many options. Beyond investing in your own business and paying down your debts, the common choices include stocks, bonds, commodities, and real estate. Commodities including gold are volatile and if bought at the wrong time can take years, if not decades to recover. Investors who bought the yellow metal in 1980 at its inflation adjusted peak of \$2,251 per ounce remain far from break-even, if they are still holding the asset. And while there are no doubt great opportunities in the real estate market today, with that investment comes taxes, insurance, maintenance, and as many investors know, liquidity issues.

Time and again we come back to the advantages of our investment structure, a diversified portfolio of high quality stocks with a bond allocation chosen to fit the individual client. It is valuable to remember what stock ownership means – you own a piece of a business and are entitled to a share of future cash flows. As long as it is a healthy business and well managed, and the business grows with time, the investment will appreciate in value. Granted, stock prices fluctuate and are influenced by a multitude of factors on a short term basis (and we've

all been reminded during this generational economic slump that “short term” is a relative concept). Collecting cash dividends while waiting for the market environment to improve helps foster patience. If you own the right companies, eventually the business will grow and the value of the stock will be so compelling that demand for the shares will drive the price higher. It is *our* business to be sure that *you* own the right companies.

## An Update on the PASI Stock Portfolio

By: Nathan Polackwich, CFA

I've spilled a lot of ink over the past few years writing about the macro-economy – and not without reason, as the world has experienced an almost surreal sequence of events since the stock market peaked on Oct. 9, 2007 (incidentally, my birthday). Of the five biggest U.S. investment banks only two – Goldman Sachs and Morgan Stanley – remain in business and independent. Virtually overnight the so-called "shadow" banking system<sup>1</sup> disappeared, as credit markets completely seized up in the fall of 2008. In the spring of 2009 the stock market plumbed levels last seen in 1996 on fears that most U.S. banks were likely to fail due to accelerating non-performing loans and investments. But then, thanks to an unprecedented amount of Federal Government stimulus spending and Federal Reserve easing, the downward spiral slowed. Some "green shoots" began to appear, and stocks embarked on the biggest and fastest relief rally since the 1930s, recovering 80% from the March 6, 2009 bottom in a little over a year.

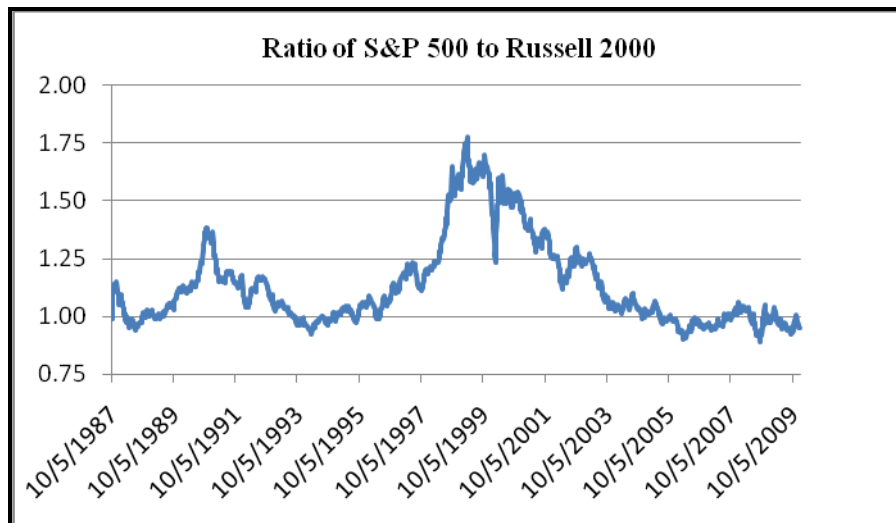
Although I will have much more to say about the macro-economy (with Europe now taking center stage), I think now is a good time to catch our breath and turn our attention to the "micro"-economy, or more specifically, the group of companies in which Professional Advisory Services is investing your money.

In general, we continue to favor the largest, financially strongest, and most competitively positioned companies. We do so for one simple reason – they are by far the most attractively valued securities we see in the investment universe. Historically, these companies have traded at a hefty premium to the overall market thanks to their low business and financial risk as well as their ability to sustain solid profit growth over long periods of time (thanks to said competitive advantages as well as international expansion). Yet today, despite these attributes, the world's highest quality companies trade at little to no premium to the average stock. The PASI portfolio, for instance, which is chocked full of the world's best companies like McDonald's, Pepsi, Intel, and Johnson & Johnson, trades at just 13.1 times this year's estimated profits vs. 12.6 for the S&P 500 overall. Moreover, the dividend yield of the average PASI stock is now 2.46%, fully 30 basis points (0.30%) higher than the overall market's 2.16% yield, and 62 basis points above the 1.84% yield on 5-Year U.S. Treasury bonds.

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<sup>1</sup> The shadow banking system pools mortgage, auto, and other loans together and slices them into different investment securities (for instance, magically converting a group of sub-prime housing loans into a AAA-rated bond to be sold to unsuspecting German pension funds). Prior to the financial meltdown in 2008, the shadow banking system was financing more loans globally than traditional banks.

How about small cap stocks? The chart below shows the ratio of large cap stock prices to small cap stock prices over the past two decades. A rising trend indicates large cap outperformance and a falling trend implies small caps doing relatively better. As you can see, small cap stocks did better than large caps over the past 10 years (though running about even since 2006). This outperformance, however, has left small caps with relatively rich valuations. The Russell 2000 Index of U.S. small cap stocks now trades at 17 times current profits and offers a measly 1.2% dividend yield.

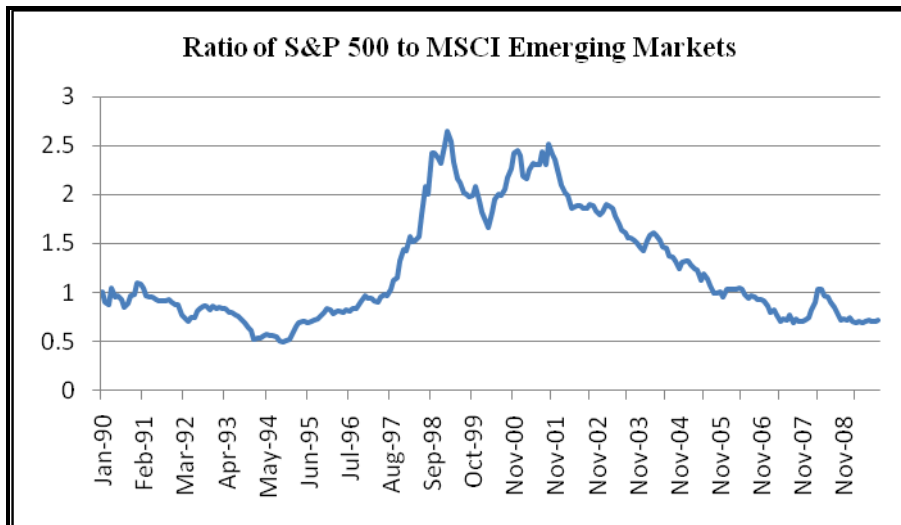
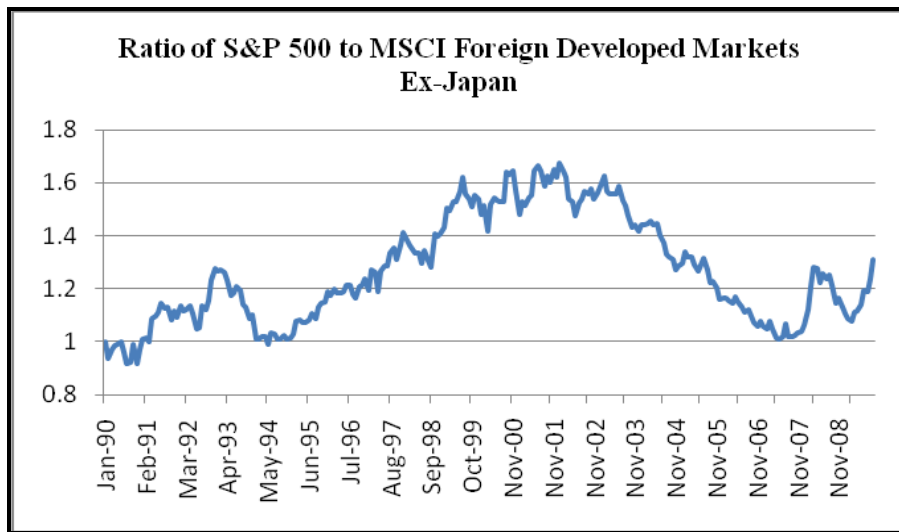


One could argue that since smaller companies typically grow faster than larger companies, they deserve to trade at a premium. The counterargument, however, is that smaller companies are also much riskier than larger companies, which suggests they should trade at a discount. Our view is that these two characteristics more or less offset each other, and that small cap stocks should trade at roughly similar valuation levels as large caps. Thus, we view the current rich valuations of smaller companies relative to large caps as unjustified.

Further, in addition to being cheaper, we think today's economic environment favors larger companies. As we've discussed in many prior newsletter articles, we foresee a lengthy economic hangover from the bursting of the global debt bubble in 2008/2009. Over the past 25 years, debt levels grew much faster than the overall economy, which provided a steroid-like boost to economic growth. But that debt must now be repaid. Thus, rather than a tailwind from rapid credit expansion, we think the economy will be sluggish for some time due to a stiff headwind from falling (or at best stagnant) debt levels. Less robust growth means a more fragile world economy that is more vulnerable to various shocks – such as a small country like Greece defaulting on its debt or even an environmental catastrophe like the BP oil spill. **With slower and lumpier economic growth, we think smaller companies will find it more difficult to obtain financing to grow their businesses and maintain their competitive positions.** Larger companies, then, should be in a much better position to take market share in the coming years. In rough waters you want a bigger boat.

So what about international stocks? Although currently only one PASI company – liquor and beer giant Diageo – is headquartered outside the U.S., on average 40% of the revenues of PASI stocks come from international markets. Thus, the large multinational corporations which mainly comprise our stock portfolio provide a great deal of international exposure. That said, at this juncture, we're far more optimistic about U.S. stocks and the U.S. dollar than foreign stocks and currencies (in the aggregate).

The following two charts show the S&P 500's performance over the past 20 years relative to 1) foreign developed markets ex-Japan<sup>2</sup> and 2) emerging markets. Once again a rising trend line indicates S&P 500 outperformance and a falling trend S&P 500 underperformance.



<sup>2</sup> We exclude Japan because, following the collapse of its real estate bubble in 1990, its stock market has been on a consistent downward trend for twenty years.

As can be seen in the charts above, from 1990-1995, the S&P 500 more or less performed evenly with foreign developed markets but dramatically under-performed emerging markets. From 1995-2002, however, U.S. stocks massively outperformed both foreign developed and emerging market stocks. In fact, over that seven-year period, emerging market investors *lost* 40.2% of their investment while U.S. investors gained an incredible 248%. Of course, mean reversion being what it is, from January 2002 through June 2008, emerging markets made back almost all of what they lost from 1995-2001.

**Our view is that U.S. stocks and the U.S. dollar will outperform most foreign markets and currencies in the coming years.** Although the U.S. faces significant economic and demographic hurdles, other countries like those in Europe, as well as Japan and China, confront even bigger problems (which will be addressed in upcoming newsletter articles). The noticeable outperformance of U.S. stocks and the U.S. dollar since the Greek economy imploded is *prima facie* evidence that in times of economic turmoil, the world continues to view our currency and our financial markets as a refuge in the storm.

We expect the global economic waters to continue to be turbulent in the years ahead. The companies you own, however, have the balance sheets and competitive positions to ride out any rough weather and even use it to their long-term advantage. Equally important, their valuations remain compelling and should expand significantly once the waters calm.

### ***Cash Balance Pension Plans***

By: Ken Ligon III

With the top tax bracket slated to increase to 39.6% in 2011, we are getting a lot of inquiries from clients about ways to defer more income from taxes, especially for those subject to an additional state income tax of 7%-10%. Ouch!

One increasingly popular option that fits this need is a cash balance pension plan (CBPP). A CBPP is a form of *defined benefit* pension plan where a participant receives a promised benefit at retirement based on age, annual income and years of employment; the kind of traditional pension enjoyed by prior generations.

The difference between a traditional defined benefit pension plan and a CBPP is that with a traditional plan the benefit is defined as a series of monthly payments for life to begin at retirement. In contrast, a CBPP defines the benefit in terms of a stated annual account balance (though called a hypothetical balance because it does not reflect actual contributions, gains, or losses).

Over the past thirty years businesses have moved away from traditional defined benefit pension plans because the promises made to employees can create huge legacy costs; the auto industry is a prime example. Today most companies favor *defined contribution* plans, such as profit sharing plans including the popular 401(k) plan. With defined contribution plans,

employee balances at retirement are based solely on total contributions and investment gains or losses. The employer is not obligated to provide a fixed benefit when the employee leaves.

Recent changes in pension law, however, have made defined benefit plans much more attractive to business owners. The new law allows groups that have both a defined contribution plan such as a 401(k) and a CBPP to use the defined contribution dollars to satisfy some of the employee CBPP obligation. These "combo" plans allow the owners of a business to contribute huge dollars with very little additional funding for employees.

A 55 y.o. business owner, for example, could contribute as much as \$54,500 in a 401(k) and an additional \$147,000 to a CBPP (2010 limits). However, a younger employer with a more seasoned staff might find that the required funding for older workers skews the costs such that the CBPP advantage is negated. CBPPs don't work for all businesses – an actuarial study is important to determine whether you are a good candidate.

A key point to understand with a CBPP is that the assumed rate of investment return is a fixed amount, currently 5%. A CBPP is a liability of the corporation; the participant is owed the benefit regardless of the corporation's ability to fund the plan. Any losses must be supplemented by the business owner, while excess gains reduce the sponsor's required contribution. Most companies with a CBPP hire a professional asset manager and have a conservative investment policy to minimize risk. Plan sponsors must also pay annual premiums to the government's Pension Benefit Guarantee Corp (PBGC), which in turn insures at least a partial payment to plan participants in the event of bankruptcy.

Other positive attributes of CBPPs include the fact that these are ERISA assets and enjoy protection from creditors thanks to a 1992 Supreme Court ruling. As with any tax-deferred vehicle, one expects that taxable income will be lower upon retirement and funds in the plan will be withdrawn at a lower tax rate.

With such uncertainty regarding federal budget deficits, rising tax rates, and the viability of Social Security, high income earners may want to consider the option of a cash balance defined benefit plan to help bolster their long-term financial security.



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