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Professional Advisory Services, Inc.
2770 Indian River Blvd. – Suite 204 • Vero Beach, FL 32960
(800) 847-7274 • (772) 778-0552 • fax (772) 770-2979

Market Update: *"Upside Volatility"*

By: David A. Jaffe, M.D.

While investors have vivid memories of October market crashes, historically September has actually been the cruelest month of all. This year is no exception, except that the market wrath has targeted the doom and gloom bears in 2009. Defying most expectations, the market ended the month and the quarter on a (deliriously?) gleeful note. On the 40th anniversary of the Woodstock Music Festival, one could reasonably ask "what are they smoking on Wall Street these days?"

Marking the best quarterly return since 1998, the S&P 500 posted a 15% gain in the 3rd quarter of 2009, ending September up fully 19% for the year (including reinvested dividends). Growing confident that the recession which began in late 2007 was finally coming to an end, investors bid up stocks in general and economically sensitive and formerly distressed companies with gusto.

Much has been written about the divergent performance between "quality" stocks and "junk" stocks. Volatility can be a two-edged sword – the shares of fragile companies plunge when investors fear for their survival, only to rocket skyward when they are rescued by easy credit and economic growth. Emblematic of this phenomenon is AIG, which saw its stock almost double in the third quarter, despite the widely held belief by conservative investors that the shares are likely worthless.

The PASI portfolio has trailed the market modestly in this environment, posting a 12.9% gain for the third quarter and standing up 15.9% YTD. We experienced significantly less volatility on the downside in 2008, and likewise see less volatility on the upside in the current market environment. Confirming Aesop's wisdom that "slow and steady wins the

race", from the beginning of 2004 through the end of the current quarter, the *cumulative* return for the PASI stock portfolio totals 25.2%, vs. 6.5% for the S&P 500.

While it is always hazardous to make market predictions, we are confident that we will not revisit the panic lows of February and March when the stock market was discounting "Great Depression II." Less clear is whether the current rebound is overdone. Stocks are no longer cheap relative to reasonable growth expectations, and more importantly, while the recession is likely over, economic growth will be anemic for the foreseeable future. Consumers are learning to live without home equity loans, big credit card balances, and eager banks. Unemployment, always a lagging indicator, is likely to remain elevated for the foreseeable future. As the economy is weaned from government intervention (low interest rates and fiscal stimulus for starters) much uncertainty lies ahead.

The expectation of slow economic growth leaves us feeling cautious, and our stock portfolio is structured accordingly. We have modest exposure to very sound economically sensitive companies such as Lowe's, 3M, and Nike, and a handful of the top tier technology companies. This is balanced by our broad exposure to steady solid consumer businesses like Proctor & Gamble and PepsiCo, and diversified exposure to the health care industry such as medical device maker Medtronic, generic drug manufacturer Teva, and new portfolio holding CVS. While our conservative portfolio structure may lack some of the exciting *upside* volatility seen this year, we take great pride in the protection we provide our clients from the *downside* volatility of this unprecedented economic environment.

The Way We Live Now

By: Nathan Polackwich, CFA

A party of greater opulence had never been given, at least as far as anyone could recall. The veranda had been "converted into a conservatory, covered with boards contrived to look like trellis-work, heated with hot air, and filled with exotics at fabulous prices…The house had been so arranged that it was impossible to know where you were, when once in it. The hall was a paradise. The staircase was fairy-land."

This was the scene in Anthony Trollope's *The Way We Live Now* where the reader first meets the fraudulent financier Augustus Melmotte. The foreign-born Melmotte gives this extravagant ball to gain entrée into late 19th century London's most elite social circles. The ploy succeeds, and Melmotte parlays his high social standing into a successful stock offering for a newly formed railroad company. He then uses the soaring stock as collateral for large loans to finance other ambitious projects as well as his own lavish lifestyle. The only problem is that the railroad doesn't exist, and once this truth is revealed the stock plummets, Melmotte's loans are called, and his house of cards collapses.

The story of Augustus Melmotte immediately brings to mind the fraudsters of today, particularly Bernie Madoff. But the better analogy, perhaps, is to our economy *as a whole*.

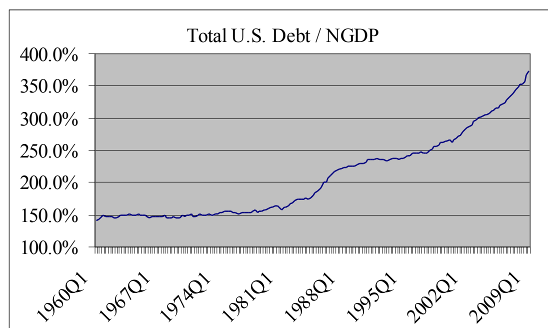
Most developed and many emerging market economies have similarly taken on too much debt. And while the assets supporting our debt aren't fraudulent like Melmotte's railroad, many – like real estate from 2003-2007 – were extremely overvalued and have also suffered dramatic price declines. Thus, our economy finds itself in a situation not unlike that of Melmotte, and investors have reacted accordingly, sending global financial markets on a rollercoaster ride unrivaled by anything since the Great Depression.

In March of this year, the stock market was hitting levels last seen in 1996. The consensus among investors seemed to be that the economy's fate would resemble Melmotte's (he committed suicide). But as the new administration announced innovative and credible financial policies, the markets regained confidence and staged a dramatic turnaround.

By summer, warily eyeing the Federal Reserve's unprecedented expansion of the money supply and trillion dollar budget deficits, investor's fears shifted from economic Armageddon to inflation. The sharp rise in interest rates from March to June (the 10-year U.S. treasury rate jumped from around 2.5% to almost 4%) and the 75% increase in the price of oil appeared to confirm these fears.

But over the ensuing months talk of inflation began to subside as interest rates retreated and the price of oil held steady. Moreover, with economists now predicting positive third quarter GDP growth and the stock market up more than 60% from the March lows the inflation theme has been superseded by a new theme – this time a more cheerful one – that a strong, self-sustaining recovery is imminent. The wildly shifting mood of investors this year lends credence to renowned investor Jim Grant's observation that "markets make opinions, not the other way around."

So do investors finally have it right? Is everything returning to normal? We're skeptical. In the same way that Augustus Melmotte's affairs couldn't simply "return to normal" once his loans were called, years not months will be required for the global economy to fully recover from the bursting of a massive debt bubble three decades in the making.



The chart above shows the ratio of total U.S. credit market debt (household, business, and government) relative to the size of the U.S. economy defined as Nominal Gross Domestic Product, or NGDP. Back in 1960 the country had $750 billion in debt vs. $525 billion in NGDP. That 150% ratio of debt to NGDP remained relatively unchanged until the early 1980s. But total debt then began to grow at a much, much quicker pace than the overall economy. Fast forward to today and our total debt amounts to $53 trillion vs. just $14 trillion in NGDP, a ratio of 378% or almost four dollars of debt for every dollar of economic output.

This debt gave our economy a tremendous but artificial boost. For instance, at the peak of the real estate bubble in 2005, households were extracting $1 *trillion* a year from the equity in their homes through cash-out refinancing, home equity loans, and housing turnover. This represented a shocking ten-fold increase over the $100 billion a year homeowners were taking out in the late 1990s.

Economists at Goldman Sachs have estimated that about half this money was spent with the rest reinvested in real estate and securities. This estimate suggests that without mortgage equity withdrawals, the U.S. economy would have grown less than 1% a year from 2003-2006 rather than the 3% annual growth that actually occurred. And that's just from mortgage equity withdrawals! How much more did rising credit card, business, and government debt add to growth?

This 30 year period of accelerating debt growth, which is all most investors have ever known, was an anomaly. It simply can't and therefore won't be repeated over the next 30 years. Consumers and businesses are already increasing savings to repair their debt-heavy balance sheets, and both political and economic realities will soon force the Federal Government to rein in spending. So rather than a tail-wind to economic growth from ever-rising debt, we now face a headwind or at best no wind.

That's not to suggest the economy won't have solid quarters like the 3.5% growth that's expected for the third quarter of this year. But absent the creation of new technologies and industries, which won't happen overnight, the economy will struggle for years to find sustainable drivers of growth.

That's the bad news. The good news is that you don't need a high-growth economy to achieve good stock returns. In fact, research by finance professor Jeremy Siegel has shown that the stocks of slower-growing, mature companies, industries, and even *countries* usually outperform over the long-run (a word of caution to China bulls). The reason? Investors consistently overpay for rapid-growth and just as consistently underpay for stocks that make them yawn.

Although the stock market as a whole now appears somewhat over-priced relative to potential earnings, the shares of steady (but not flashy) growth companies like McDonald's, Proctor & Gamble, and Johnson & Johnson remain compellingly cheap in our opinion with P/E ratios in the low teens and dividend yields competitive with 10-Year

Treasury rates. And relative to the much riskier, more cyclical stocks investors have recently been bidding up in anticipation of a strong economic recovery, they are outlandishly cheap.

The Mac is Back

By: Christopher M. Brown, MBA

While Americans may be scaling back on expensive restaurants, they're not eating away from home that much less. According to industry market trackers NPD, Americans are on pace to eat out, on average, 204 times in 2009, only three fewer meals than last year. Americans like to eat out and spend 2% of their total income in restaurants. This recession has not made us to want to cook more, just spend less per meal. Who better to turn to than McDonald's with its reputation for value, extensive menu, and convenient locations?

With more than $70 billion in system-wide sales, McDonald's is the largest restaurant chain in the world serving on average 58 million customers daily. There are approximately 32,000 McDonald's locations in 119 countries employing more than 1.5 million people. Nearly one in eight workers in the U.S. has at some time been employed by McDonald's. McDonald's is the single largest purchaser of beef, pork, potatoes, and apples as well as the largest private operator of playgrounds in the U.S. The company's signature golden arches are recognized around the world.

The business began in 1940, with a restaurant opened by brothers Dick and Mac McDonald in San Bernardino, California. Ray Kroc, who sold the McDonald brothers their milkshake mixers, saw an opportunity and partnered with them to open additional franchises. Kroc and the brothers continually feuded over control of the business and in 1961 Ray convinced them to sell out for $2.7 million, and a royalty of 1% of gross sales. After the deal closed, Ray refused to honor the royalty portion of the agreement, worth in excess of $100 million annually today, because it was not in writing.

Ray Kroc was instrumental in enhancing the original McDonald brother's successful formula by implementing Henry Ford's assembly line idea into his restaurants and utilizing standardization, a business tactic that ensures every Big Mac tastes the same whether in Vero Beach or Paris. Kroc's business model is slightly different from most other fast-food chains. In addition to ordinary franchise fees and marketing fees, which are calculated as a percentage of sales, McDonald's collects rent because the company owns or leases most of the properties on which the restaurants are located. With approximately 85% of the chain operated by franchises or joint ventures, this structure provides the firm an annuity like stream of rent and royalties, even during challenging economic times, with minimal corresponding capital needs.

Whether you prefer beef or chicken, salad or sandwiches, breakfast or desserts, there is something for every appetite at McDonald's. Recently, they introduced the $3.99 one-third-pound Angus burger to steal market share away from chains like In-N-Out Burger® and Carl's Jr.® who offer "premium" hamburgers. In each country where McDonald's

does business classic favorites are balanced with new tastes and local flavors. In the last several years, the company has capitalized on growing consumer interest in health and wellness by introducing new products such as premium salads, Southern-style chicken products, snack wraps, and apple dippers.

McDonald’s unrivaled scale advantage over its fast food peers allows the firm to spread advertising and other costs over more units as well as command more bargaining power over its suppliers to ensure access to raw materials at competitive prices. These advantages fall directly to the bottom line, as the firm generates operating margins more than 60% higher than its closest competitor, Burger King.

Since 2006, McDonald's has been updating its restaurants with a more modern décor to drive traffic, the first major redesign since the 1970s. To warm up their look, the restaurants will have less plastic and more brick and wood, with modern hanging lights to produce a softer glow. They are accessorizing interiors with flat-panel televisions, Wi-Fi connections, plush chairs, and contemporary artwork. Even the playgrounds are being renovated to feature interactive game zones equipped with stationary bicycles attached to video games, dance pads, basketball hoops, and other games which emphasize physical activity.

McDonald's also recently introduced McCafé to tap into the current trend for high quality coffee and the popularity of coffee shops in general. The McCafé concept is a café-style accompaniment to McDonald's restaurants in the style of Starbucks. The rollout of its specialty coffee menu at 14,000 domestic restaurants and several international markets has turned into a meaningful sales driver as the company steals business from higher-priced competitors and sells those customers higher-margin items, such as Snack Wraps.

Even as the recession has deepened, McDonald's business continues to shine. Same-store sales have gone up every month since spring 2003, with only two lapses. McDonald's market share is growing as well. It accounts for 15.5% of all quick-serve sales in the U.S., up 0.6 points since 2003, and controls nearly half the hamburger sector, according to market trackers Technomic. The company plans to rebuild one of every 20 restaurants this year and add new locations at the fastest rate since 2002. Looking ahead, McDonald's continues to expand overseas, with China as one of its brightest prospects, along with Germany, Japan, and Russia.

After a 10 year hiatus at PASI, “the Mac is back” in the PASI Portfolio offering clients a better value than ever. McDonald’s stock trades at just 13.4X next year’s earnings estimates, a large discount to its historic average and a 10% discount to the overall market. In addition, the company recently hiked its already juicy dividend 10% this year to 3.85% (close to the yield on a 30-year treasury bond). With its unassailable competitive advantages, good growth opportunities, low valuation and high dividend yield, McDonald’s shares look as inexpensive as its fare.

Roth IRA Conversions

By: Chris Steele, CFP

Beginning in 2010, a provision of The Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005 will allow more people to take advantage of converting Traditional IRA assets into Roth IRA assets. Prior to 2010, those who made over $100,000 per year, whether filing single or married were not allowed to make a conversion. Of course there are pros and cons associated with a conversion.

Some of the benefits include:

1. The amount that you convert will grow tax free and will also be available for withdrawal tax free after an initial 5 year holding period (beginning January 1, of the year of conversion) for each conversion.

2. Roth IRAs are not subject to required minimum distributions starting at the age of 70 1/2 as are Traditional IRAs.

3. Any conversion made in 2010 will be eligible for special tax treatment. The income from the conversion can be reported on your 2010 tax return or equally on your 2011 and 2012 returns.

4. The amount that you pay in taxes will decrease the size of your estate and your heirs will never owe income tax on the assets that are in the Roth IRA.

Some of the disadvantages include:

1. Paying income tax on all deductible contributions and earnings, though you will be eligible for the special tax treatment if you make the conversion in 2010.
2. The conversion amount that is considered taxable could increase your tax bracket and possibly subject you to the alternative minimum tax (AMT).

It is important to consider all of the possible outcomes that a conversion could have on your overall financial plan. Some of the things to consider include expected tax rates, age, retirement, and the amount of your IRAs and overall estate. You should seek the advice of your tax advisor before making any decisions regarding a conversion. If you have any questions, please feel free to contact our office.

David A. Jaffe, M.D.

Ken Ligon, III

Carol L. Bieber