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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: *Cheap Insurance*

By: David A. Jaffe, M.D.

One morning last spring I heard a seasoned Wall Street trader comment on CNBC (paraphrasing a bit), “If you’re betting on the end of the world, you better be right ... because it only happens once.” As we launch into the New Year, we can say with the confidence of perfect 20:20 hindsight that the financial world did not end in the spring of 2009. But it sure looked like it was heading that way, didn’t it?

Measured by the Dow Jones Industrial Average (DJIA), the market dropped from an October 9, 2007 peak of 14,164 to a thirteen-year low of 6,547 on March 9, 2009, a decline of 54%. During those gloomy days early in 2009, the market was “pricing in” *Great Depression II*, including nationalization of the biggest banks. Of course we know today that a replay of the 1930’s was averted, as the economic fallout from the bursting of the credit bubble was limited to what many have labeled the *Great Recession*. Thanks to a flood of cheap money, government guarantees for sectors from the auto industry to money market funds, and some pretty good policy decisions, the U.S. recession which began in the fourth quarter of 2007 came to an end with modest economic growth returning in the third quarter of 2009. The stock market, forward looking creature that it is, reversed course after setting the dismal March low and never looked back. The DJIA ended 2009 at 10,428 up 22.7 % for the year (with reinvested dividends), its best return since 2003 and fully 59% above its March 9th low.

At this point, the attentive reader is likely puzzling over the above numbers, which offer a striking illustration of the perils of volatility for investors. If the DOW dropped 54% from peak to trough, then recovered 59% from trough to 2009 year-end, why is that index still 3,736 DOW points below its 2007 high? The simple answer is that with less capital after a decline, it takes a bigger percentage gain to “get back to even.”

Consider an investment account beginning the year with \$10,000. If one suffers a 25% loss that first year, it takes a 33% gain the following year to get back to \$10,000. This is a stark reminder of the prudence of a conservative investment structure, with emphasis on preservation of principal

as well as growth, something we strive to accomplish by balancing a diversified portfolio of quality stocks with a percentage of stable and hopefully boring investment grade bonds.

As the government pumped money into the economy, credit markets healed, and a few “green shoots” of economic growth began to appear. Investor’s appetite for risk grew and lesser quality stocks outpaced the more staid holdings of the PASI portfolio. In fact, the 50 best performers in the S&P 500 from 2008 gained just 9% in 2009, while the 50 worst 2008 performers doubled in 2009. The 50 biggest stocks rallied 22%, while the 50 smallest jumped 113%. But even for conservative stock pickers, worry and uncertainty among investors last spring created great opportunities for those with discipline and a long-term outlook. We picked up a number of new holdings at what we judged to be bargain prices. Our portfolio ended the year trailing the market averages by a very modest margin – the S&P 500 gained 26.47% in 2009, while the composite PASI stock portfolio returned 24.94%, a cost we view as “cheap insurance.”

Applying the math for the last two years to the S&P 500 vs. the PASI composite stock portfolio, our clients remain far ahead. The chart that follows shows the history of a hypothetical investment account beginning the dismal year 2008 with \$100,000, comparing the returns if those dollars were invested in an S&P 500 index fund vs. PASI management. At the end of 2009 the PASI account is better by \$8,107. (Higher fees for active management vs. an index fund would reduce the PASI advantage by about 0.75% per year).

	S&P 500		PASI Composite	
	Pct change	Year-end \$	Pct change	Year-end \$
2008	-37.0%	63,000	-29.7%	70,260
2009	26.5%	79,676	24.9%	87,783

The remarkable stock market recovery of the last three quarters has led to widespread complacency on Wall Street, the prevailing psychology shifting from a bearish “end of the world” mentality to a stampede of bulls now calling for another 20% gain in 2010 (no complaints from us if that becomes reality). But there is a definite disconnect between Wall Street and Main Street. While the picture is slowly improving, we must remember that unemployment remains at 10%, people are losing their homes, businesses are closing, and though money is cheap, credit is tight. Banks are only willing to loan money to those who don’t really need it.

Further, the Federal Reserve has yet to ease off the monetary accelerator. The stock market celebrates every decline in the value of the dollar, making U.S. exports cheaper short-term but threatening inflation and the dominance of our currency as a store of value long-term. As Congress spends taxpayer dollars on programs worthy and otherwise, our national debt explodes and foreign creditors (China) grow restless. The Fed faces a difficult balance when they begin to withdraw the liquidity that has helped rescue the financial markets, and ultimately raise interest rates, a move that stock investors won’t view kindly unless offset by strong economic growth. Suffice it to say there’s still a lot of risk out there. We’re not giving up that cheap insurance anytime soon.

"Invert, Always Invert"

By: Nathan Polackwich, CFA

In his commencement address to Harvard, Johnny Carson said that while he hadn't found the secret to happiness, he knew from personal experience sure-fire ways to guarantee failure. Carson's "prescriptions for guaranteed misery in life" were 1) ingesting chemicals in an effort to alter mood or perception, 2) envy, and 3) resentment. Years later in his own Harvard commencement speech, Warren Buffett's long-time partner Charlie Munger added the following to Carson's list:

- 4) Be unreliable. Do not faithfully do what you have engaged to do.
- 5) Don't learn from the mistakes of others, living and dead. Become as non-educated as you reasonably can.
- 6) Go down and stay down when you get your first, second, or third severe reverse in the battle of life.

Concerning success in life and general happiness, Carson and Munger's insight was that the question is better tackled by turning the question around – that is, instead of asking what to do, they focused on what to *avoid*. Both were applying the great mathematician Karl Jacobi's maxim to "invert, always invert." A variety of paths can lead to happiness, but, as Munger observed, "How little originality there is in the common disasters of mankind."

When it comes to financial disasters, investors have displayed a similar lack of originality since stocks first began trading in the coffee shops of 'Change Alley in late 17th century London. Here too, greater clarity can be obtained by inverting the question of "How can I succeed in investing?" to "How can I fail?" Thus, in the spirit of Carson and Munger, what follows are PASI's own *Prescriptions for Guaranteed Misery in Investing*.

1. **Believe you can predict the future with near 100% accuracy.** The more confident you are in your predictions, the more risk you'll take. Moreover, those suffering from the disease of utter certainty will also ignore information which suggests they're wrong, and consequently ride their losing positions all the way down.
2. **Make sure your predictions are extreme.** Extreme events – world wars, coups, financial catastrophes, etc. – are by their very definition *rare*. They do happen, of course, as we've all recently rediscovered. But if you always bet on the rare or low-probability event you can be assured of losing money, or at the very least the opportunity to make money, most years.
3. **Concentrate your investments in the fastest growing companies, industries, and countries.** In his book, *The Future for Investors* (2005), finance professor Jeremy Siegel detailed some rather counterintuitive stock market data:
 - Since 1957, stocks with the highest dividend yields and lowest P/Es in the S&P 500 (slower growing tortoises) outperformed the index by three percent per year. Conversely, those with the lowest yields and highest P/Es (the hares) underperformed by 2 percent.

- The stocks of companies in high growth industries such as finance have underperformed the S&P 500 over the past 50 years. Meanwhile, stocks in mature industries such as energy have outperformed.
- The stocks of companies domiciled in the fastest growing countries also delivered sub-par returns over the long term while those in more mature but slower growing economies tended to outperform.

Siegel has dubbed the poor long-term stock performance of the companies, industries, and countries with the flashiest growth rates the "growth trap." As Siegel writes,

“The growth trap seduces investors into overpaying for the very firms and industries that drive innovation and spearhead economic expansion. This relentless pursuit of growth – through buying hot stocks, seeking exciting new technologies, or investing in the fastest growth countries – dooms investors to poor returns.”

4. **Invest in what you don't understand.** One of Warren Buffett and Charlie Munger's most enduring lessons is to stay within your circle of competence. Buffett once wrote that “what counts for most people in investing is not how much they know, but rather how realistically they define what they don't know. An investor needs to do very few things right as long as he or she avoids big mistakes.” Munger's advice (as usual) is blunter: “If you play games where other people have the aptitudes and you don't, you're going to lose. And that's as close to certain as any prediction that you can make.”

In what areas do investors, particularly amateurs, operate at a significant informational disadvantage? Highly complex and opaque investments like hedge funds, private equity funds, and convoluted variable insurance products are all good examples, but even the stocks of individual companies can be overly complex. For instance, the labyrinthine balance sheets of the world's biggest financial institutions confound even the most knowledgeable industry analysts and undoubtedly even the managers of the companies themselves. Thus, their stocks are probably best avoided.

As an aside and since it's timely, we also view gold as a complex investment. Gold qualifies because, unlike a stock or a bond, it doesn't throw off a dollar of cash flow. This characteristic makes it all but impossible to estimate it's inherent worth. You might say the same is true for all commodities, but we'd counter that most commodities have some use whether eaten, burned as fuel, or for industrial purposes. These commodities are actually *consumed*, and thus demand is more consistent and can be forecasted to some extent. By contrast, the demand for gold mainly reflects the whims of investors (central bankers, institutional and retail investors, and traders) and to a lesser extent fashion. That's not something we can confidently predict and therefore value. Thus, we view gold as a potentially terrific way to lose money – and especially today, since it now also satisfies PASI's 5th and final prescription.

5. **Invest today where you wish you'd invested five years ago.** Research conducted by the Vanguard Group found that from 1982-2002, a time when the stock market returned 13.1% per year, the average mutual fund investor earned just 2%. About three percentage points of the difference related to the fees and transaction costs associated with owning mutual funds. The

remaining eight percentage point loss occurred for two reasons. First, *investors shifted between stocks and bonds at exactly the wrong times*. For instance, investors shunned stocks after they had performed poorly and were cheap in the early 1980s yet exuberantly embraced them during the bubble years of the late 1990s.

Second, *investors chased returns in the market's "hottest" areas* only to suffer grievously when those sectors ultimately succumbed to gravity. Legg Mason Value Trust fund manager Bill Miller explained this phenomenon back in 2006: "5 or 6 years ago, everyone wanted tech and internet and telecom stocks, and venture capital and US mega caps. The time to buy them was in 1994 or 1995, when they were cheap. But in 1994 or 1995, people wanted banks and small and mid caps, which should have been bought in 1990, and well, you get the picture. In general, you can get a good sense of what to buy now by looking to see what the worst performing assets or groups were over the past five or six years. That is long term for most people, and long enough to convince them that the malaise is permanent and to have migrated their money elsewhere, such as to whatever has done best in the past five or six years."

As in life there are many ways to succeed in investing provided you steer clear of history's common disasters. At PASI our strategy is to build a diversified portfolio of attractively valued high quality stocks and investment grade bonds. This time-tested strategy has worked for our clients for over three decades. But perhaps more importantly we strive to ensure our clients' financial survival by helping them avoid the investing landmines described above. And as the great economist, investor, and author Peter Bernstein counseled in his 85th year of life,

"In general, survival is the only road to riches. Let me say that again: Survival is the only road to riches. You should try to maximize return only if losses would not threaten your survival and if you have a compelling future need for the extra gains you might earn."

Monsanto: *Seeds of Tomorrow*

By: Christopher M. Brown, MBA

In 1970 the average corn harvest yielded 70 bushels an acre. In 2006 the average yield was 150 bushels an acre. And by 2030, yields are expected to reach 300 bushels an acre. The driving force behind this amazing feat is Monsanto (MON), the company who pioneered genetically-modified seeds.

Monsanto helps farmers boost yields by applying biotechnology and genomics to seeds and herbicides. Its flagship product, Roundup, is the world's #1 herbicide and the most successful crop chemical in history. Not coincidentally, the Company's other major product line is genetically altered seeds that can tolerate Roundup.

Although more expensive, farmers buy Monsanto's seeds for the simple reason that they dramatically improve yields. Monsanto's latest corn seed, for instance, has three distinct genetic traits – one pesticide to kill the European corn borer (a caterpillar), another to kill the rootworm (a beetle), and resistance to Roundup weed killer. Although farmers spend, on average, up to \$36

more per acre for Monsanto's three-trait corn seed, they save twice that on chemical insecticides and herbicide.

Today, more than 90% of the genetically modified seeds in the world are sold by Monsanto or competitors that license Monsanto's genes in their own seeds. Monsanto's dominance reflects the fact that it was the first seed company to widely patent its genes, gaining the right to strictly control how they were used. Moreover, Monsanto's *Roundup Ready* seeds have become the industry standard over the past decade and are nearly impossible to replace, as it takes many years of breeding and capital investment to mix Monsanto's genes into a seed company's product line.

Continuing to distance itself from the field, Monsanto is now accelerating product rollouts with seven new offerings over the next seven years starting with this year's introduction of SmartStax corn seeds and Roundup Ready 2 Yield soybeans. Smartstax corn is a next generation super-seed loaded with eight specific biological traits for fighting pests and tolerating pesticides. Roundup Ready 2 Yield soybeans promises more beans per pod and resistance to diseases such as white mold. The Company has priced these products at roughly \$20/acre above its current generation of products, which could mean over \$1 billion per year in additional gross profits.

Global demand for food and bio-fuels has made farmers eager to squeeze more yield per acre. Demand for animal feed has exploded as developing economies like India, China, and Brazil have created hundreds of millions of new middle class citizens who now eat meat several times a day. To produce 2.2 pounds of beef, for instance, farmers have to feed a cow 33 pounds of grain and 66 pounds of forage.

Although Monsanto has faced heavy opposition against genetically modified foods – particularly in the European Union – the Company has successfully deflected criticism by focusing on seeds for agribusiness like corn and soybeans used to produce animal feed, ethanol, and corn syrup. And as genetically modified foods have gained acceptance, Monsanto has expanded into new areas of agriculture, most recently wheat, sugarcane, vegetables and fruits. For example, the Company is collaborating with Dole Fresh Vegetables Inc. to improve the color, flavor, texture, and nutrition of vegetables like broccoli, cauliflower, lettuce, and spinach. Monsanto's other next generation crops include soybeans that produce omega-3 fatty acids and drought-tolerant corn.

Thanks to a strong pipeline of new products, Monsanto's earnings are expected to increase sharply from \$3.30 per share this year to around \$7 by 2014. We think there's a good chance Monsanto's stock price could grow at a similar rate, providing PASI clients with a bumper crop of profits.

Roth IRA Conversions: *Part Deux*

The more conversations we have regarding Roth IRA conversion, the cloudier the subject becomes. For starters, a word of warning. There are numerous calculators available on the Internet intended to help investors decide whether they are candidates for a Roth conversion. Caveat Emptor! is the rule of the day. The quality of these calculators varies widely, and thus the advice they offer.

This is, however, a popular subject and we have been asked to address it again in the current newsletter. Here are a few specific issues which may help readers decide whether they are or are not a candidate for Roth conversion:

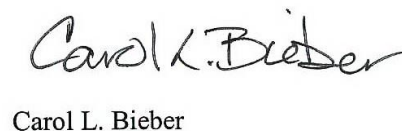
1. Payment of taxes on converted dollars – when IRA assets are converted from traditional pre-tax dollars to Roth (after-tax) dollars, taxes must be paid based upon your marginal tax rate. Unique to 2010 conversions, payment of taxes can be deferred for two years. Be aware, however, that you risk paying at a higher marginal rate if you delay the tax payment and Congress raises marginal rates, which at this time seems very likely. The simplest caveat, however, is that *if you don't have a source of funds to pay the taxes other than your IRA, the conversion is unlikely to be of benefit.*
2. Time between conversion and use of funds – the best calculators suggest that it takes about 20 years before the “cost” of paying the taxes offsets the benefit of the tax-free growth inherent in a Roth IRA. In other words, conversion is a clearer choice if you are 50 years old or younger and expect to delay spending the Roth dollars until age 70.
3. Tax bracket at time of conversion vs. retirement – with a traditional IRA you will pay taxes on distributions as though the funds were ordinary income. The tax rate is based on adjusted gross income. Now, if you knew for a fact that you would be in a *higher* tax bracket when you retire than you are while working, converting a traditional IRA and eliminating future taxes would make sense. Conversely, if you are in a higher tax bracket when you convert than you will be in when you retire, it is likely that you're better off waiting. Of course, it is probably easier to predict the weather than it is future tax rates, though higher marginal rates seem a pretty good bet right now. So ... you've been working to save and your investments have recovered nicely in 2009 and you're thinking that your IRA distributions in retirement will be close to your earned income while working, so you're in the same tax bracket, right? Well, it's not so easy. In 2009 the top tax bracket starts at adjusted gross income of \$372,950. Assuming you're going to live on 5% of your IRA annually when you retire, unless you've accumulated over \$7.46 million in that retirement account, you can expect your marginal tax rate to be *lower* when you retire than it was when you were working and stashing away those IRA dollars.
4. Estate Planning – this is the one area where conversion is most likely to be a good choice under the appropriate circumstances. First, there is *no Required Minimum Distribution* from a Roth IRA as there is from traditional IRAs (though your heirs will be required to take distributions based on *their* life expectancy). Second, taxes paid to convert traditional IRA dollars will reduce the size of your estate. Therefore, if you have a large estate with more assets than you ever expect to need in your lifetime and want to leave an attractive legacy to heirs, Roth conversion makes good sense. While the Roth IRA is an estate asset and will be counted, the taxes paid to Uncle Sam while you are alive reduce your taxable estate and the dollars in the Roth IRA can continue to grow for the remainder of your life without any government mandate that you take distributions from the account if you don't need the money.



David A. Jaffe, M.D.



Ken Ligon, III



Carol L. Bieber

S.E.C. Compliance

Pursuant to the Investment Act of 1940 and specifically Rule 204-3 thereunder, a registered investment adviser shall annually deliver or offer in writing to deliver upon written request to each of its advisory clients a disclosure statement prepared in compliance with the requirement of this rule. Part II of Form ADV complies with this rule and you may request a copy by calling or writing our office.

In February 2003, the SEC also adopted new rules requiring investment advisers to annually offer a copy of their Proxy Voting Policy. Professional Advisory Services, Inc. acknowledges its responsibility to vote proxies with respect to client holdings. Voting will be solely in the client's best interest with the primary goal of long-term enhancement of shareholder value. Records of each proxy vote will be retained for five years. You may request a copy of our complete Proxy Voting Policy by calling or writing our office.

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Additionally, the SEC issued Regulation S-P on June 22, 2000. The operating premise of this ruling is to effect compliance with the Gramm-Leach-Bliley Act which prohibits the sharing of any nonpublic personal information with any nonaffiliated third party unless the firm has provided initial notice of its privacy policies. The ruling requires we provide a copy of our Privacy Policy to our customers on an annual basis. A copy of our Privacy Policy is included with this newsletter.

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