

Stocks as an Asset Class

Macro headwinds are providing long-term opportunities in U.S. stocks

by Anil Kapoor, CFA



Recently, macroeconomic factors have dominated the news across all financial media outlets. Between the tough employment situation here

in the United States and the debt crisis in Europe, many investors have shifted focus from company fundamentals to the macroeconomic environment and a more “top down” way of thinking. In their defense, the current situation in Europe cannot be ignored. Yields on bonds issued by several struggling European countries have risen dramatically over the last 10 months as investors continue to demand higher rates for holding high-risk European debt. The chart shown to the right, which uses Greece as a proxy for distressed nations, illustrates this dramatic increase in bond yields. Notice that the yield on German debt has remained steady, indicating a much stronger financial position than Greece.

Many of our clients have asked why

the U.S. equity markets have reacted so swiftly to what is happening in Europe. The short answer is that European defaults could lead to a serious contraction in European GDP, which would domino into a global, economic slowdown. Additionally, in the event that Greece, Italy, Spain, etc., default, U.S. financial institutions would be left holding worthless sovereign debt. The recent bankruptcy of MF Global, a once reputable securities firm, is the first clear indication of the fallout potential for this concern.

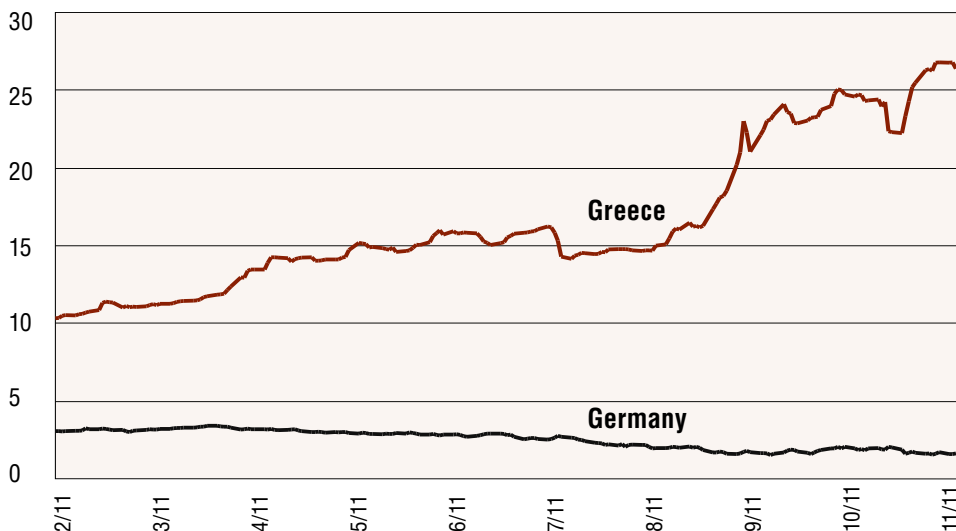
All financial companies on Clifford Swan’s approved list have been reviewed for their exposure to European debt, and we are confident that none of these companies will turn into the next

MF Global. We are cognizant that some banks may have hedged their Eurozone debt exposure by essentially buying an insurance policy on this debt from a counterparty (another bank or entity). The stability of that counterparty, and its ability to make good on the insurance policy, does add another possible layer of risk. That said, especially with the mortgage meltdown counterparty fiascos so fresh in bank executives’ minds, we believe that this “counterparty risk” is minimal.

The above analysis regarding the stability of financial companies is one illustration of a “bottom-up” approach to

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Yield on Greek vs. German Debt February 2011–November 2011



Source: Bloomberg, Clifford Swan Investment Counsel

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managing macroeconomic issues, such as the Eurozone crisis. In this case, our analysts' rigorous research into our financial companies' fundamentals, trends, and valuations provides the information we need to assess the risks each is exposed to in changing macroeconomic factors. We would never buy or sell a security based solely on the macroeconomic environment. In fact, we often find that macroeconomic turmoil presents opportunities for many of our quality companies, as is the case now.

As a result of both the current macroeconomic backdrop and a general aversion to equities, the U.S. stock market is poised for a period of strong growth. Valuations are attractive, fundamentals are solid, balance sheets are stronger than ever, and companies have cut costs to the point of maximum efficiency. The last 10 years were very unique in that we had two bubbles pop in a short period—internet companies in the early part of the decade, and the housing market in the latter part of the decade. It is doubtful that the next decade will see a similar trend. Rather, we anticipate a move back to normalcy (7%-8% equity returns). Those who have reacted to the recent market volatility by shunning equities in favor of other asset classes could be in for a rude awakening. Let's explore this in more depth.

In relation to bonds—the second most liquid asset class—equities look attractive. The biggest indicator of this attractiveness is the difference in yield on the 10-year Treasury versus the earnings yield on the S&P 500 (inverse of Price/Earnings ratio¹). The current yield spread is 6.4% while it has averaged 0%-2% over the last 50 years. The last time the spread was this wide was 1974. Subsequent to 1974, equities outperformed in the one, three, and five-year investment periods.

Recently, Colgate (a Clifford Swan company) completed a bond deal, setting the yield on its 10-year issuance at 2.45%. This is the lowest yield on record for a 10-year corporate bond issue

“We often find that macroeconomic turmoil presents opportunities for many of our quality companies, as is the case now.”

(Bloomberg). Currently, the stock has a dividend yield of 2.6%. Given the low risk and stability of a company like Colgate, we would much prefer a little pickup in yield combined with the potential capital appreciation of the stock to the lower yield of the bond. In a nutshell, when Wall Street gravitates towards bonds in a herd mentality, we lean towards equities. Over the very long run, large cap stocks always outperform inflation and bonds, particularly Treasuries. See chart below:

Wealth Multiples for U.S. Asset Classes and Inflation

December 1802–December 2005

Asset Class	Return
Inflation	16 times
Treasury bills	4.8 thousand times
Treasury bonds	19.5 thousand times
Large-capitalization stocks	10.3 million times

Source: Pioneering Portfolio Management, Swensen, 2009

Another way to think about the attractiveness of stocks relative to bonds is to look at 10-year Treasury yields in terms of nominal GDP, which is sometimes used by investors to approximate a “fair bond yield.” In our current environment, GDP and inflation are growing at a long-term average rate of approximately 2% and 2.5%, respectively, setting nominal GDP at about 4.5%. Currently, the 10-year Treasury yields approximately 2%, which means that bonds are not keeping up with inflation, let alone nominal GDP.

In reviewing real estate as an alternative to stock investment, we believe that

stocks are likely to provide greater safety. The thought that real estate cannot lose value was disproved in the last few years, and property devaluation was dramatic in many cases. The housing market is still in disarray and distressed properties are the only inventory that has moved significantly (which, in some cases, could provide some interesting opportunities). It is important to note, however, that the real estate market is still in flux, and that it will take some time for it to stabilize before its next upswing.

Gold could be used for portfolio diversification in case of a catastrophic economic event (currency devaluation, hyperinflation, etc.). However, it is difficult to evaluate gold as a viable substitute for stocks. The very foundation of our investment process is our search for businesses that generate significant free cash flows with high returns on capital in industries with substantial barriers to entry. Gold cannot be qualified by any of these characteristics, thus we have a hard time with its valuation. As a pure investment, stocks do, and will continue

to, outperform gold or any other precious metal over the very long run.

When we look more closely at the stock market itself, we find additional reasons to be optimistic. Using the S&P 500 index as a proxy for the

entire stock market, the trailing Price/Earnings ratio (P/E) on this index is currently 12.5x, representing an earnings yield of 8%. The average bear-market bottom P/E is approximately the same at an earnings yield of 8%. This gives us some comfort that equity markets are close to, if not at, bottom, and may be nearing an inflection point signaling outperformance over a multi-year stretch. In addition, average interest rates at bear-market bottoms are close to 7%. Currently, with interest rates at 2%, it seems the earnings yield should

be higher. Some would argue that using P/E as a valuation tool is flawed as earnings drastically decline when heading into a recession. For those with that viewpoint, Price/Book might be a purer, more stable metric. Currently, Price/Book on the S&P 500 is 2.0x. Historically, Price/Book for the index has ranged from 1.5x–5.0x. So again, we are on the bottom end of that range signaling that stocks present a compelling value.

Stepping away from the index and focusing on Clifford Swan companies, we tend to invest in higher-quality companies than comprise the entire index. Thus, if we are wrong in our growth projections, and equities continue to lag, our companies should still outperform. With our focus on companies with stable business models, a strong history of paying and increasing dividends, conservative management teams, and attractive valuations, we expect our client portfolios to withstand another recession, just as they have in the past. Clifford Swan companies simply have less business risk than the average company comprising the market.

In conclusion, we believe that market psychology is far too negative right now. Investors have been burned as of late, and their recent memory is trumping any sort of rational behavior. Stocks look attractive both as a stand-alone entity and relative to other asset classes. If Warren Buffett is any indication, he put more money to work in investments last quarter than at any other time in the past 15 years. Much of that money was invested on August 8th, 2011, the first day of trading after U.S. debt was downgraded from AAA by Standard & Poors. It is during times like these when, instead of being shy, equity investors should be aggressive. As Mr. Buffett has said time and time again, “Be greedy when others are fearful.” ♦

1. The lower the P/E ratio, the cheaper a stock is relative to its earnings. Earnings yield is the inverse of P/E ratio expressed as a percentage. The higher the earning yield, the cheaper a stock is relative to its earnings.

Family Philanthropy

A Prescription for Holiday Happiness

by Linda Davis Taylor



As you begin to make plans for the holidays ahead, think about incorporating time to discuss your family's shared values and history as a way of building strong family ties and family continuity. Looking ahead 20, 50, even 100 years, to successfully preserve the family, individual members should understand the core principles that the family stands for—what makes the family special?

Increasingly, families use philanthropy as a way to pass on family values by working together through giving back. Important skills—research, investing, and collaborative decision-making—can all be taught through charitable giving. And what better time than the holidays to begin a new family tradition of purposeful as well as fun family gatherings!

Here are some questions to consider when thinking about whether organized family philanthropy is right for your family:

1. Do you want to create or sustain a family legacy?
2. Do your family members trust one another?
3. Do you want to strengthen family cohesion across generations?
4. Are you willing to commit time and money to this endeavor?

Do You Want to Create or Sustain a Family Legacy?

Since philanthropy is based on values, families often find that working on philanthropy together serves to sustain the family legacy by identifying the values that will define the family's philanthropic mission.

We suggest conducting a formal family survey as a first step in philanthropic planning because in sharing traditions and stories, the family's core values and philanthropic mission become clearer. By documenting the family history and understanding the “human capital” of the family through the creation of personal resumes by current family members, the family itself is strengthened.

Family philanthropy also initiates a commitment to annual family meetings, giving the family a substantive and collaborative event that carries the additional benefit of sustaining the family culture.

Do Family Members Trust One Another?

Decision making regarding which charitable causes and organizations should be supported by the family is collaborative, not hierarchical. In other words, if the family is committed to family philanthropy vs. individual philanthropy, family members must be open to differing opinions about philanthropic priorities. As the family evolves, so does its philanthropic focus as new members come to the family with different interests and passions. This dynamic process brings some of the most worthwhile and satisfying opportunities for family growth and development, so long as a commitment to collaboration and open communication is kept.

Do You Want to Strengthen Family Cohesion Across Generations?

Family philanthropy can be extremely effective in connecting different gen-

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erations of the family. By offering opportunities for dialogue around a new theme, instead of the “same old issues,” next generation family members see the family connections as interesting and dynamic.

For those with a family business, philanthropy can offer family members not working in the business a way to be involved in a substantive family project. Philanthropy can essentially become a “new family business” built from a sense of shared values, evolving as new family members contribute their own perspectives. Philanthropy can transcend the life of the family business itself—consider a few of the significant American business families who created philanthropies: Ford, Rockefeller, Gates. Philanthropic activity promotes regular contact among family members who might otherwise drift apart. Through the collaborative activity of researching causes and making visits to charitable organizations, family members learn skills that are transferable and valuable to other parts of life: finances, communication, and collaborative decision making.

Are You Willing to Commit Time and Money?

Family leaders will often ask us if they should establish a private foundation or other formal structure such as a donor advised fund in order to engage the family in philanthropy. Since any effective philanthropic activity requires some commitment of time and money, we encourage families to consider the following characteristics of philanthropy as they decide whether to become a “philanthropic family:”

- Assets that are contributed to a foundation (or other charitable fund such as a donor advised fund) are for the “public good” and are no longer available to the family for personal use.
- Annual charitable distributions of 5% are required by private foundations,

so this type of philanthropic entity is not a “one time activity.”

- Evaluating the effectiveness of charitable gifts can be challenging and often necessitates a long-term approach, requiring patience and trust in the charities’ leadership to steward the gifts effectively.
- Families should consider the level of philanthropic activity that is appropriate—in other words, will the family need the money for something else?
- Who within the family will work with the charities? Just as with other financial investments, successful philanthropy requires an effective partnership with the organizations that use the families funds to impact a project or cause.

Philanthropy Keeps the Family Vital

Philanthropic activity harnesses all forms of the family’s capital—social, intellectual, human, and financial—and invigorates the entire family system; thinking about how one’s money can impact the world broadens the knowledge and perspectives of individual family members. In the words of one family member who commented to me recently about how philanthropy has impacted the family, “we have less apathy, and more glue.”

Developing Your Family’s Philanthropic Strategy

If philanthropy sounds like an endeavor you would like to consider more carefully, consider bringing together a “posse” to explore the best options for your family. This group might include you and other family leaders, your financial advisor, estate planning attorney, and accountant. Once you determine the most appropriate structure and plan given your family’s financial situation and interests, we suggest the following steps to develop your family’s philanthropic strategy:

- Tap other family members for help (consider the next generation).
- Involve an outside expert on philan-

thropy to help develop the most effective strategy for you.

- Survey the family members for input and ideas.
- Conduct a family meeting to share survey results and get started.

As you reflect on the challenges in the world around us, consider the role of philanthropy in building ethical leaders and communities. Perhaps the sentiments expressed to me over the last year, by families who decided to pursue philanthropy together, will ring true to you as well. ♦

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