Portfolio Notes

July, 2002

By Gary E. Miller, C.F.P™.

Contact Gary Miller at **949-367-1961**
E-mail: **gary@walkerfinancial.com**

Vol. 2, No. 6

Mother Teresa Didn't Manage Worldcom

Bad markets have a tendency to uncover mistakes, bad judgment and wrongdoing. When shareholders were enjoying stock price growth of 20%-120% per year, few questioned the unbridled feather nesting by CEO's, CFO's, Directors, Consultants, Investment Bankers and the analysts who worked for them. There was plenty to go around at the feast. We won't spend a lot of time recounting corporate misdeeds.

The important lesson for this generation of stock investors, however is that corporate accounting is largely an art. Reported earnings can be massaged many ways, and the very nature of the capitalist system offers an incentive for management to shed a positive light on poor performance. People like Mother Teresa do not usually choose a career path leading to management of a publicly traded corporation. As Adam Smith convincingly argued in The Wealth of Nations the profit motive creates abundance but rarely nobility. This is why we have laws and regulations designed to control and punish those whose profit motive spins out of control and to see that the "game" is fair for all participants. There are plenty of honest, even noble guardians of corporate and investor integrity. It is the job of analysts and portfolio managers to ferret out and reject the snakes. Most fail in this function.

As a gatekeeper of our client's hard-earned money, it is our job to distinguish good businesses with highly competent management from average businesses with lesser management. Generally we are proud of having avoided many "train wrecks", and this, in fact, is why our discretionary client accounts are not significantly lower than they were a year ago or thirty months ago when the last bull market ended and the current bear market commenced.

Until just weeks ago, we were smugly telling anyone who would listen how most of our stock picks of the past year were up in a down market. But of late, collapsing investor confidence has spread beyond technology to nearly all sectors. Even the under valued issues we purchased for client discretionary accounts have slumped and many are trading below the bargain prices we paid. While losses on these issues are modest when compared to the summary execution meted out to big cap "winners" of yesteryear, and to technology companies, we are not pleased to see our favorites unjustly smeared with the paintbrush of paranoia incited by accounting misdeeds of others. This is proving to be a doozy of a bear market, one in which discrimination between good businesses with real earnings and those with puffed up earnings is blurred. We continue to be confident in our selections and pleased that prices for other value stocks are becoming attractive.

Validity of Free Cash Flow Standard affirmed by Worldcom Scandal

Worldcom's financial officers improperly classified current expenses as long term capital investments. From the perspective of Generally Accepted Accounting Principals (GAAP), established by the Financial Accounting Standards Board (FASB), this is a sneaky way of inflating current reportable earnings. That auditors Arthur Andersen were fooled into accepting this misclassification is astounding. To miss this sort of corporate number twisting is sophomoric, and suggests that AA's claim of error rather than complicity in the *Enron* scandal may have been true. I'm not sure which is worse, to be found guilty of a crime or guilty of stupidity!

Intrinsic value analysts would not have been fooled by Worldcom's accounting creativity. This is because we do not rely on " reported" earnings which we know to be largely an artistic rendering of the truth. The gold standard for determining the correct value or "justified price" of an enterprise is Free Cash Flow. This is the amount of actual M-O-N-E-Y that remains at year end after expenses of all sorts, *current or long term* are deducted from operating earnings. The expenses in question would have been immediately deducted from Worldcom's earn-

CERTIFIED FINANCIAL PLANNER™

Gary Miller has over 28 years experience in the financial services industry as both an analyst and financial advisor. Currently he provides service to clients as a CERTIFIED FINANCIAL PLANNER™ practitioner. Gary holds a certificate in Personal Financial Planning from University of California, Irvine; and is a Board member of the Orange County Chapter of the Financial Planning Association.

ings by an analyst who appreciates free cash flow, regardless of how the company chooses to report them. Intrinsic value analysts using free cash flow knew that the company was over valued long before the "reported" earnings were revised downward. They stayed away.

We adopted the use of free cash flow for stock analysis as our most favored approach about two and a half years ago. At the time experience told us we were in a frothy, speculative market. We wanted a means to separate the wheat from the chaff and we found it! This approach has proven its value by helping us to resist the purchase of fallen angels that were destined to fall a lot further, and to choose less glamorous but more worthy candidates for our client accounts.

Why do some stock investors panic?

As stocks, good and bad get pounded , have you asked yourself the reason for panic?

We believe it is due to the failure of many investors to diversify their holdings. As they watch their net worth dwindle, many hit the panic button, selling when they should probably be buying.

Those who own other investments in addition to stocks tend to remain cool headed. Those with substantial allocation to bonds, for example, usually see this portion of the portfolio appreciate when stocks fall.

Recently we added international bonds to our discretionary clients' holdings. The dollar has been weak relative to its major trading partners, Europe, Japan, and Canadian large part due to the unattractiveness of the U.S. stock market to foreign investors. The Euro for example has appreciated about 12% since the beginning of the year. High quality foreign government bonds are a perfect example of a non-correlating asset and healthy diversification.

Annuity Blues

Annuities are insurance products that permit tax-deferred investing. Funds placed into annuities can grow, earn dividends and compound free of income tax. When the owner finally begins taking money from an annuity, he or she is then taxed on the withdrawal. In other words, annuities are something like non-deductible IRA's. They may be appropriate for investors with high tax bills who have already fully exploited less costly tax deferred vehicles such as IRA's, employer sponsored tax deferred savings plans, municipal bonds and the like.

Traditionally, annuities were like tax deferred Certificates of Deposit, with a guaranteed yield. In recent years, however *Variable* annuities have been sold to the public as a way to earn big profits from the stock market. While enjoying tax deferral, the holder is permitted to invest in mutual funds within the annuity, known as "sub accounts". These accounts, like all stock market investments, contain risk.

What was often not communicated to purchasers of these insurance company sponsored contracts is that when the deal is closed, the sales agent is paid one of the highest up-front commissions of any investment product on the market today. That's why annuities usually have a significant penalty if "surrendered" within the first few years of ownership. The insurance company must pay the salesman at the time of the sale, then recoup its expense over time by loading the contract with inflated annual sales charges which drag down performance. If the buyer "surrenders" the contract within a few years of purchase, the insurance company would be left uncompensated for its up front sales commission expense, so it tags the investor with an early withdrawal charge.

We recently discovered an example of inappropriate variable annuity sales practices when a 70 year old retiree met with us for a portfolio review. It was learned that the gentleman had lost some 35% of his funds since investing last November, just six months before our meeting. Worse, he was stuck in the contract, or so he believed, because of the existence of a penalty clause stating that he must pay a 25% surrender charge if he abandons the contract. The penalty gradually reduces over time, but this fellow, who is not young, remains in a penalty period for 15 years!

As bad as this sounds, the story gets worse. The monies this individual invested were *already* tax protected by their status as IRA funds, therefore the tax deferral offered by investment in an annuity was not of value. In fact, this person could have purchased a no-load mutual fund to achieve his objectives and avoided the penalty and lock up situation in which he now finds himself.

It did not surprise me to learn that this investor was sold this bill of goods by a commissioned stock broker who calls himself a financial planner. It truly pains me to come across examples of investor mistreatment like this. They can be avoided by visiting a *Certified Financial Planner who is compensated only by fees for service and sells no products.*

If you find yourself in an analogous situation to this poor investor, or simply are having doubts about your current investment strategy, we offer a free one hour consultation, and hope you will take advantage of the offer.