Trusted Advisor

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Year End Performance Summary

In calendar 2004, discretionary client accounts rose approximately 6.7%[1], meaning we captured 2/3 of the S+P 500's gain while volatility, as measured by standard deviation was about half that of equities[2]. Individual year-end performance reports have gone out to clients. Results vary depending upon each client's risk/reward profile: we try to understand each family's willingness to accept risk and tailor the investment choices in such a way as to allow each client to sleep well at night.

U.S. equities markets provided positive returns, closely matching historical growth rates of about 10%[3]. Foreign equities, whose representation in client portfolios was significantly increased during the year, did quite well. Our weighting to energy related holdings brought forth both capital gains and dividend income. For the fifth year in a row, real estate equities were one of the strongest categories, and our holdings in particular provided impressive total returns.[4] Bonds did surprisingly well, holding their value and generating total returns that approximated their nominal yields, despite a late Spring panic based on investor fears of rising interest rates, which failed to materialize.[5] One of the year's best stock investments was First American Financial (FAF) which had sold off early in the year, under fears of a slowing mortgage refinancing market. The refi market did, in fact slow, but FAF is a diversified information company and it's other business are doing well enough to justify a price in the mid $40's. The stock was purchased for most discretionary accounts in the mid-$20's at mid-year, and we continue to hold it. In the interest of full disclosure, there were two significant losses realized last year: Corinthian Colleges and Mylan Labs, a reminder of why diversification is a must.

I'm not finding the bargains I'd like in this market, although the search is ongoing. Currently, the typical client portfolio has an allocation of about 15% to money market funds or short term deposit accounts. When the cash allocation of our mutual funds is counted as well, actual client cash holdings are about 25%. This may seem high, but is consistent with our value investing philosophy: unless there are compelling investment bargains available, we prefer the safety of short term deposits (AKA "cash"). The mutual fund managers I admire, and have therefore chosen to handle a portion of clients' money, are also holding a lot of cash, and agree that this is not a time to commit too heavily to equities. Patience is the secret weapon in a value investor's arsenal. I suspect that pressure will build to commit more funds to stocks if the market moves higher from current levels. It is certainly possible that this will happen: look at the ludicrous price earnings ratios people are again paying for companies like E Bay and Amazon and Yahoo. Sure, these are proven businesses, but there is nothing anyone can say that will convince me they deserve to be exempt from the normal range of business valuation.

Certified Financial Planner™

Gary Miller is in his 31st year of providing financial guidance to individuals and pension plans. He is a Registered Investment Advisor and a Certified Financial Planner ™ Practitioner. Gary holds a Certificate in Personal Financial Planning from the University of California, Irvine and has served as a Board member of the Financial Planning Association, Orange County Chapter.

Hole in the Donut

The extreme risk of owning over-priced stocks was recently underscored by the collapse in share price for "Krispie Kreme" (KKD). KKD began 2004 trading near $40/share but as of this writing is below $8.00. This stock was over priced from the day of its Initial Public Offering in early 2000. At the time, the hype preceding the Krispie's public stock listing was as thick as the aroma of a cinnamon donut on a cold January morning. Television's financial commentators, ever the neutral observers, could be seen munching donuts on camera. By year end the stock was trading at a price earnings ratio over 60 and at about ten times book value (by contrast, in the same year one could have purchased Cheesecake Factory (CAKE) for about five times book value and at a price earnings ratio of 32, still high by today's standards). Fast forward: Krispie Kreme stock finally fell back to earth this year, but it has taken an accounting scandal to do it, and according to at least one review[6], the company is still too expensive to attract a diversified restaurant buyer (e.g. YUM! Brands, Allied Domecq) who might want to acquire the firm.

Krispie Kreme (March 2000 -January 2005)

Character Counts

As regular readers may recall, my visit last year to the Berkshire Hathaway annual meeting provided a new insight that should have been more obvious to me years ago - when considering a company in which to invest or remain invested, looking over the people running the company is of primary importance. This brings us to Rich Kinder, CEO of Kinder Morgan Inc. which in turn is General Partner of subsidiaries Kinder Morgan Partners (KMP) and Kinder Morgan, LLC (KMR). Widely held in our client accounts, the Kinder Morgan entities have all performed well over the past two years. We were fortunate to learn of this group of related companies in early 2003 when, in the aftermath of the Enron collapse, good natural gas pipeline properties were available at bargain prices. Recently, Kinder was in the running for "CEO of the Year" at Morningstar.com. I have a lot of respect for Morningstar as they are one of the few truly independent analytical services and support the value investing approach to their stock and mutual fund reviews. Considering that they analyze hundreds of companies, it is impressive that they consider Rich Kinder to be one of the most shareholder friendly CEO's among all publicly traded firms.

KINDER MORGAN, INC. (Jan 2003-Jan 2005)

The Social Security Question

President Bush's Social Security reform proposals are stimulating a lot of public debate and this is a healthy thing. The topic of Social Security reform has surfaced repeatedly, and like another recurring challenge, energy prices, this issue has been politicized to a degree that a state of paralysis has developed among lawmakers, terrified of offending a voter constituency. Those who suggest changes are hooted down by Traditionalists who fear change. Traditionalists in this dialogue do not represent the Right or financial conservatives - rather, it is those who are convinced that "government" is responsible for our personal welfare and that Social Security as developed 70 years ago under Franklin Delano Roosevelt is an immutable, Sacred pillar of our society.

Now, I don't know of anyone who would attack the idea of a backstop system to prevent the poor elderly (most of whom are widows) from destitution. Even my politically conservative clients, who otherwise dislike Big Government would never consider refusing their monthly Social Security stipend upon retirement. Yet, at it's heart, the system is a socialistic government welfare program borne in the hearts of New Dealers and so it remains.

For it's first forty five years, people erroneously considered their Social Security check to be a return of their own savings, a return of a contribution to a national savings account. In the early 1980's a Presidential commission under Alan Greenspan, now Federal Reserve Chairman, managed to educate the public to the flaw in the Social Security System: it was a pay-as-you-go creation for which no real "trust fund" existed. Rather, the earnings of the currently employed were taxed to pay for the lifestyle of the retired. When created in the late 1930's, people lived shorter lives and had larger families than in the 1970's and 1980's. In the 1930's there were some ten contributors to Social Security for every person drawing a retirement check. By the 1980's this had dwindled to about 5 to one, and demographers, noting how the Baby Boomers were failing to reproduce themselves predicted that when this large block of retirees began drawing SS checks in about 2010, there would be less than two people paying into the system for each one taking money out, an untenable proposition. The solution was clear: a surplus had to be accumulated in a real "Trust Fund" to relieve turn-of-the-century workers from the crushing tax burden of paying for a vast legion of retired Baby Boomers. In 1984, Social Security taxes were raised substantially to achieve this goal, and the target income subject to the tax was indexed to inflation.

Today, Social Security represents a flat tax of over 12%[7] on the first $90,000 of earned income, in addition to regular Federal and State income taxes. Even with this massive expansion of the tax burden on ordinary workers, we are told that the program will no longer be able to pay the current level of promised benefits by 2042. I will be age 93 at that time, and very angry if my Social Security payment is cut, because I'll be counting on the funds to pay for my annual skiing vacation!!! Worse, people now in their twenties will have a severely diminished benefit if the current system remains in place. This is a mathematically established fact. A more recent bi-partisan Presidential Commission chaired by Democrat Patrick Moynihan, the late Senator from New York, apparently advocated a partial privatization of Social Security - allowing young workers to divert some of that "pay-as-you-go" contribution into genuine personal savings accounts, invested in something more attractive than US Treasury notes.

Under proposals made by the Bush administration, workers must continue to funnel the major portion of their tax earnings into traditional Social Security, which invests only in special US Treasury bonds. But a small, optional allocation to market oriented investments will relieve the Federal Government of a major welfare burden down the road, and hopefully allow today's young workers to retire with the same dignity as have the many generations before them. While I have not yet seen the details of the new plan, to me, a more market oriented savings system is a responsible course of action - leaving the current self-destructing system in place would be like entrusting your children to a baby sitter who is a known alcoholic.

Sadly, Bush haters, and people who refuse to face reality are trying to use the President's reform effort as an excuse to take pot shots at him.[8] Moveon.org is circulating an e-mail designed to frighten current Social Security recipients into believing their benefits will be cut under the Bush plan. To the contrary, it is far more likely in my opinion, that future benefits will be endangered if Congress does nothing about this leaking boat.

Social Security is in trouble mainly because it was modified by past Congresses to expand promised benefits, without including a way to pay for these expanded benefits.[9] Those who insist the program remain 100% invested in U.S. Treasuries, have not perhaps considered that the US government is one of the most irresponsible borrowers on the planet. When all that debt has to be converted to cash Social Security payments, the government will need to raise income taxes through the roof, or worse, borrow more and more money. By 2042 it is highly possible that Japanese and Chinese bankers will be sick and tired of lending to a habitual borrower like the USA.

Enjoy the Silence

Martha Stewart is under a gag order while serving her five month Federal prison sentence. Her time is up sometime in February. The new, reformed Martha can be expected to make the television talk show rounds when she is released. Until then, it is relatively safe to leave your T.V. on! (Apologies to Martha Stewart fans, but I have no use for wealthy people who illegally profit at the expense of ordinary shareholders, something she unsuccessfully attempted.)

UPCOMING SCHEDULE OF INVESTING CLASSES:

Class Title	Location	Dates	To register call or visit...
Financial Independence for Women	Saddleback College Mission Viejo	Thursday evenings February 3 & 10	949-582-4646
How to Find High Income in a Low Interest Rate World	Irvine Valley College	Saturday Morning, March 5	www.123getsmart.com
Financial Independence for Women	Irvine Valley College	Wednesday evenings, April 20 - May 4	www.123getsmart.com

(Footnotes)

[1] Discretionary accounts size weighted, net of fees.

[2] Due to recent installation of new software, we cannot definitively report this figure at this time, but plan to discuss volatility in depth with the April 2005 edition of Trusted Advisor, at which time we will be able to present a full four year track record.

[3] "Stocks, Bonds, Bills and Inflation", ©2004 Ibbotsen Associates

[4] "Spectacular" is probably too strong a word for a value investor, but as you know we did quite well with REIT's this year!

[5] Rising interest rates cause older issues of fixed income securities to decline in price.

[6] "Krispie Kreme Seen Attracting Only the Hungriest Buyers" DJOnline Jan 5 2005

[7] Employee and employer each contribute 6.2% of W-2 earnings.

[8] As some clients are aware, I have differences with the current administration on many issues, but this is one in which I find myself in strong agreement.

[9] In the early '70's Social Security was indexed to inflation, which was the cou de gras that guaranteed the system would run into trouble. Within ten years the Social Security tax had to be raised substantially.