The presidential election dominated the news during Fall 2012. The fate of Dodd-Frank and the Affordable Care Act depended on the election because Republicans vowed to end or curtail the sweeping regulations if they won. As momentum swung between the candidates, the stock market traded in a band waiting for direction.

In September 2012, the Federal Reserve announced QE3, in an effort to stimulate the economy. It was a highly unusual move because the Fed normally does not make major policy moves near an election. While generally viewed as supportive of President Obama, the need for QE3 indicated that unemployment was not responding fast enough to the easy monetary policy.

With President Obama’s reelection, the market initially dropped but then trended upward from mid-November through May as economic news improved and policy directions became apparent. Since the start of summer, the market has pulled back as investors took capital gains after the price run-up.

Dr. Robert Lawson, co-author of the Economic Freedom of the World Annual Report, spoke on October 3, 2012 about global economic freedom and what it means for investors. Of particular interest was his discussion on the fall of the U.S. economy from second in the world in economic freedom to the mid-teens during the last decade. One of the major areas in which the U.S. fell was property rights, which is surprising but indicates a lack of trust of the legal and government systems.

Happy State Bank generously co-sponsored Dr. Lawson’s presentation.

Dr. Terry Anderson, president of the Property and Environmental Research Center (PERC) and a senior fellow at the Hoover Institute, spoke on October 23, 2012 about the blending of environmental policy with economic prosperity. Signed copies of his book The Not So Wild, Wild West: Property Rights on the Frontier were available to attendees.

Dick Railsback charitably donated stock to the Student-Managed Investment Fund. He donated 1000 shares of Xcel stock. The students thank Mr. Railsback for his support of the portfolio and scholarships.

George Raffkind generously provided gift certificates for each Investment Series event. The students thank Mr. Raffkind for his long-time support of the finance program.

On July 14, 2012, the portfolio managers were guests on Dale Buckner’s Financial Clinic radio show on KGNC. Both stressful and fun, the students learned how important it is to present information clearly and concisely. The students thank Mr. Buckner for his continued support of the Student-Managed Investment Fund.

On August 30, 2012, the portfolio managers attended the Hodges Capital Management Investment Forum in Dallas. The managers listened to presentations from twelve different companies. The students also visited with WTAMU College of Business alumni Don Hodges, Eric Marshall, and Derek Maupin.
Milton Friedman’s famous quote of “inflation is always and everywhere a monetary phenomenon” is the rallying cry of those investors opposed to the Federal Reserve’s current easy money policy. Yet, inflation has not appeared in the economy. The Cleveland Federal Reserve Bank estimates that the market expects inflation to average 1.55% over the next 10 years. The Federal Reserve had a goal of maintaining inflation below 2% but raised the threshold to 2.5% as long as unemployment was falling or below 6.5%. While investors may worry about inflation, they are not acting in a way to bring about inflation.

Currently, the various CPI-inflation measures range from 1.4% to 2.1%, well in the target range and below the values of a year ago. Interestingly, housing attributed to a major part of the increase in the CPI. This corresponds to the spring housing market and to the recovery in the housing market.

The S&P/Case-Shiller Housing index shows housing prices increased 11% to 12% over the last year for the largest 20 cities. Housing prices are back to 2004 levels. Atlanta, Las Vegas, Phoenix, and San Francisco posted gains in excess of 20%. The jump in Treasury yields during the spring encouraged many home seekers to buy now before mortgage rates rose, which is part of the explanation for the rise in prices.

The Personal Consumption Expenditure index (PCE) measures range from 1% to 1.4%. The latest PCE figures showed divergence in the economy. Service prices rose 2.1% while food, gasoline, and prescription drugs fell. Drugs fell a surprising 1.1%. Dining-out rose 3.1% over the last three months versus an increase of just 1.3% during the last half of 2012. This indicates that households are feeling better about their disposable income. One can also make the case that with prescription drugs and gasoline total expenditures less; households substituted an extra meal or two out of the house. Of course, gasoline’s share of household income will increase during the summer driving months offsetting some of the spring savings.

The Affordable Care Act (ACA), also known as “Obamacare,” starts on October 1, 2013. Major impacts of the act include requiring uninsured individuals to sign up for insurance and providing tax credits to those families and businesses who meet certain guidelines but do not have enough income to purchase/provide insurance. A significant change will be the creation of health insurance exchanges to increase the competitive environment for purchasing insurance. The intent of the ACA is that consumers and firms have greater ability to compare insurance plans and thus, reward those plans that provide the most cost effective benefits.

Healthcare organizations and insurance companies are under tremendous pressure to eliminate waste and cut costs. Generally, this creates a need for a more efficient production process. Thus, technology firms and supply-chain management firms that offer solutions for health care organizations should gain from ACA.

Another interesting area of growth is personalized health care plans. In order to increase patient involvement, health care organizations must tailor plans and health information to individuals. This is another opportunity for firms at the intersection of technology and health care.

There has been much discussion on the impact of ACA on small business. With the recent rule changes and lack of experience under the new system, the exact impact is unknown. For investors, the concern is that the costs associated with ACA will negatively impact small firm spending in other areas such as replacement of plants and equipment, which impacts the sales of larger firms that sell these products.
The dual mandate for the Federal Reserve includes maintaining full employment. Just how to define full employment has caused debate. The unemployment rate fell below 8% in September 2012, three years after the high of 10% in October 2009. During 2013, the rate has fallen to 7.6%. The natural rate of unemployment is the rate consistent with a full employment and low inflation. The natural rate had decreased to 5%, with some estimates as low as 4%, during the 2000s. The Federal Reserve estimates the current rate to be between 5.25% and 5.5%. Chairman Bernanke stated the goal of getting unemployment below 6.5%, a full percent above the natural rate, indicating that the Federal Reserve is willing to accept a higher rate of unemployment.

The slow recovery of unemployment since the Great Recession is the main reason for the Federal Reserve’s easy monetary policy. Unemployment peaked two years after the start of the recession, which is in line with prior recessions. However, while the unemployment rate is decreasing, the economy still has a long way to go to get back to the level before the recession. Interestingly, the speed of recovery is in line, albeit a little slower, with prior recessions.

The persistently high unemployment rate is surprising considering that the labor force participation rate is at a 35-year low. In 1979, the U.S. economy last faced only 63% of the population in the labor force. The years coincide with the addition of the Baby Boomer generation into the labor market and now the exiting of the same generation. Normally, the exiting of a large generation results in a dearth of workers and a decline in unemployment.

Examining some of the sub-areas of unemployment, the economy shows some recovery. Construction unemployment is now below 10%, and the industry added 3.4% new workers in the last year. The manufacturing rate is 6.4%, less than half of its peak rate in 2010. The African-American rate is 14.3% while the Hispanic/Latino rate is 9.3%. Both rates are still about twice their pre-recession rates.

At $17 trillion, the U.S. federal debt is over 105% of GDP. On the positive, the share of privately held government debt is about 75%. This indicates that other areas of the government are holding significant levels of debt and are unlikely to rapidly sell the debt in a time of crisis. Foreign investors and international entities own $5.7 trillion of the debt or about one-third of the total debt.

The federal deficit, the yearly difference between tax receipts and government outlays, has only exceeded 5% twice since WWII (1983 and 1985). The Great Recession resulted in deficit spending more than twice any level in over 60 years. Four years post recession, the deficit has fallen to under 7%; a number only exceeded between 1942-46. Standard economic theory indicates that a deficit should not exceed 3% for a developed country unless it is a time of crisis.

Even though analysts expect the federal debt to continue to increase for the next five years, which is not surprising since the Baby Boomers are retiring and the economy is growing, the deficit and the debt as a percent of GDP are what are important to examine. Analysts expect debt as a percent of GDP to remain above 100% through 2018, with the peak at either 2013 or 2014. The deficit as a percent of GDP is falling and may go below the threshold of 3% in 2016. These estimates assume no new increases in spending and steady growth in the economy.
Commodities

While commodity prices have seen a substantial increase since the recession, prices have trended downward the past year. The lack of strength of European economies is a major driving factor in the decline and volatility of the prices of commodities.

An example of this is oil. It is down 3% from the beginning of the year because of an increase in U.S. supplies. Since the recession, prices of oil have been steadily rising, causing an increase in exploration activity. The number of drilling rigs has nearly doubled since 1986, resulting in increase in production. However, recent demand has weakened primarily due to Europe’s weak economy, causing the price per barrel to decline.

Gold prices have decreased due to falling global inflation, reducing gold’s value as a hedge against rising prices. In June 2013, gold futures closed below $1,250 per ounce, a decrease of over 25% since the beginning of the year. If inflation fails to accelerate, gold could drop below $1,000 an ounce within a few years.

If interest rates increase in the United States because of a growing economy, the U.S. dollar will strengthen, weakening the benefits of holding gold. An additional potential negative for gold is an increase in supply if Cyprus sells its gold reserves to finance a bailout, which might induce other indebted Eurozone countries such as Portugal, Italy, and Spain to sell their reserves.

International Considerations

Over the last decade, China has been steadily growing. However, analysts recently lowered their GDP growth forecast for China to 7.4% from a previous 7.9%, signifying a slowing economy. Production has slowed, and inflation has remained below the central bank’s target of 3.5%. Producer prices have fallen continuously for over a year, indicating a lack of demand and overcapacity, which is another reason production has fallen. Wages have risen in many industries, leading to firms relocating plants to keep labor costs at a minimum.

Due to the slowdown in economic growth, Xi Jinping has plans to revamp the current growth model by decreasing the amount of government control and replacing it with market forces to drive innovation and development. Changes could include liberalizing interest rates, streamlining government regulation, and fostering greater competition and private investment. Xi Jinping faces the reality that many middle-class Chinese citizens want to focus more on quality of life issues and not just raw growth.

India is experiencing a tremendous slowdown in growth. In the 2012-2013 fiscal year, India’s economic growth fell to 5%, a record low for the past decade. A substantial decrease in manufacturing and services has taken a toll on India’s economy. The service industry accounts for nearly 60% of the Indian economy. In April, the service sector activity index fell to 50.7 from a 51.4 recorded the previous month, which continued the trend from the last three consecutive months. While not in a recession, the service industry is nearing one. Infrastructure has also been a major issue for the Indian economy. A lack of proper transportation systems to support manufacturing can result in a decrease in exports because products cannot get from the plant to the port in a timely manner. India is working on building roads, highways, railway lines, and power plants that are necessary to propel growth.

The Middle East remains an intriguing area due to their fundamental importance in shaping future economic, social and governance systems. The youthful populations combined with energy endowments and some of the fastest-growing economies give the region a highly positive outlook. However, skepticism due to the violence and tension in Iran is curbing enthusiasm for many U.S. firms. A major issue for the Middle East is unemployment, especially youth unemployment. In the Muslim world, over 25% of young people are without work. This represents a challenge to the economies to create jobs for them, but also an opportunity because of the potential for growth if employment increases.
The Dodd-Frank Act is the most sweeping financial reform since the Great Depression. While enacted in 2010, less than half of the regulations have been written. One area of interest for investors is role of the shareholder activism. The Act encourages shareholder involvement in executive compensation and in proxy access. At the heart of the debate is the relationship between the CEO and the board of directors. The CEO is involved in nominating members for appointment to the lucrative board of directors while the board of directors decide on CEO compensation. Neither transaction is arms-length, which causes the potential for a conflict of interest.

With say-on-pay, public firms must ask shareholders to approve executive compensation. However, the vote is non-binding and only advisory. While there has been much debate about the impact of the vote, less than 5% of the firms received “no” votes. The negative votes tended to be from firms with other problems, in particular, rising pay and falling stock price. For the first six months of 2013, only 41 out of almost 1800 firms had negative votes. Over 72% of the firms have over 90% positive votes for the compensation packages. Additionally, the percent of positive votes are higher for larger firms, with higher compensation, than with smaller firms. This is the opposite result of what lawmakers intended. Boards and CEOs were emboldened by the votes and raised executive pay by 6.5%.

With proxy access, it is easier for shareholders to nominate candidates for the board of directors. While there have been shareholder moves to nominate board members, just like with say-on-pay, the largest shareholders have the greatest impact. The largest shareholders focus on stock price performance and less on executive compensation.

The market has yet to see the impact of shareholder activism. Actions by large investors such as CalPERS may make the non-binding votes have meaning.

Quantitative easing is still the main policy of the Federal Reserve. In September 2012, Chairman Bernanke announced QE3, another round of bond buying to lower long-term interest rates, especially mortgage rates. QE3 is in addition to Operation Twist, in which the Federal Reserve sells short-term securities and buys long-term securities flattening the yield curve. Since September 2012, the Federal Reserve has bought approximately $85 billion in long-term bonds each month.

As the chart indicates, Federal Reserve involvement in the economy has increased since the crisis in September 2008. Current assets are more than four times the balance sheet quantity before the recession.

After the June 2013 Open Market Committee meeting, Chairman Bernanke indicated that the Federal Reserve might begin to reduce the pace of bond buying during the fourth quarter of 2013. Analysts expect that rates will remain low through 2014 with some analysts predicting rates will remain low into 2015.

The Fed Funds rate has stayed below 0.25% since the end of 2008. During the last half of 2012, the 10-year Treasury note rate stayed below 2%. Starting in 2013, the rate fluctuated between 1.70% and 2.05% until June 2013 when the rate moved above 2% and now vacillates around 2.5%. The 30-year conventional mortgage rate has stayed below 4% over the last year but has increased of late from the December 2012 low of 3.35% to 3.54% at the end of June 2013. Many analysts expect mortgage rates to increase in conjunction with the increase in the 10-year Treasury note rate. The move in the 10-year Treasury note rate along with the expected move in mortgage rates has stimulated the housing market in that homebuyers are purchasing now to beat any further increase. This is a sign that perhaps the economy has passed the bottom of rates. However, the market has thought this before, most notably at the end of 2011, only to see rates fall again in 2012.
The Student-Managed Investment Fund (SMIF) gained 13.3% during the past year. The SMIF has a conservative asset allocation of just 60% equity, 35% cash, and 5% fixed income. The stock portion of the SMIF gained 20%, in line with the S&P 500 index. With a beta less than 1, the SMIF performed slightly better than the market.

The SMIF is a large-cap fund with weights in large-cap value (29%) and large-cap growth (23.4%) that constitute over 50% of the portfolio. Cash holdings are another 28%. Equity holdings are divided equally between value and growth. International holdings are about 8% and mostly in the form of international ETFs.

Healthcare stocks have the highest weight at 16% followed by information technology (15.65%) and industrials (14.05%). Another 11% each is invested in consumer staples and financials. The major income-producing stocks are Annaly Capital Management (yield of 12.72%), Transocean (4.67%), and Xcel (3.95%). Gilead (88.7%), Kansas City Southern (45.6%), Nike (36.4%), Southwest Airlines (40.3%), Visa (41.6%), and Wellpoint (53.5%) were the top performing stocks for the last year.

**Student Portfolio Managers**

**Ethan Douglass** – Ethan graduates in August with his Bachelor’s in Finance. He is from Amarillo. Ethan is a Mineral Interest Administrator in the Asset Management Department at Amarillo National Bank. He teaches private baseball lessons. Ethan loves to read historical novels.

**Ashley Peterson** – Ashley is an MBA student from Wray, CO. Ashley graduates in August with a Bachelor’s in Finance. She was very involved with Students in Free Enterprise/Enactus throughout her undergraduate program, most recently serving as Marketing Officer. She will begin as the Assistant Director of Undergraduate Programs for the College of Business in the Fall.

**Pictured Left to Right:**

Ethan Douglass, Dr. Anne Macy, and Ashley Peterson
The revised asset allocation updates the portfolio to a current model of diversification. The fund will use a broad group of Exchange Traded Funds (ETF) for exposure to the various asset classes along with a limited number of individual stocks that the portfolio managers chose. The SMIF allocation will mirror the broader market but with greater exposure to mid-capitalization firms. The variety of ETFs provides exposure to the various firms without over-weighting any one asset. No one stock has an initial weight in excess of 2%, with the vast majority of weights below 1%.

<table>
<thead>
<tr>
<th>ETF Name</th>
<th>Category</th>
<th>Focus</th>
<th>Yield (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vanguard High Yield Dividend ETF (VYM)</td>
<td>Large Value</td>
<td>Focuses yields higher than S&amp;P 500 index</td>
<td>2.97%</td>
</tr>
<tr>
<td>WisdomTree Large Cap Dividend ETF (DLN)</td>
<td>Large Value</td>
<td>Focuses on highest payout and yield stocks</td>
<td>2.74%</td>
</tr>
<tr>
<td>WisdomTree Equity Income ETF (DHS)</td>
<td>Large Value</td>
<td>Focuses on highest dollar dividend stocks</td>
<td>3.62%</td>
</tr>
<tr>
<td>Vanguard Dividend Appreciation ETF (VIG)</td>
<td>Large Blend</td>
<td>Focuses on firms that have raised dividends for at least 10 straight years</td>
<td>2.20%</td>
</tr>
<tr>
<td>Vanguard Mid-Cap Value ETF (VOE)</td>
<td>Mid-cap Value</td>
<td>Focuses on mid-sized firms that pay dividends</td>
<td>1.67%</td>
</tr>
<tr>
<td>Fidelity Nasdaq Composite Index Tracking ETF (ONEQ)</td>
<td>Large Growth</td>
<td>Focuses on large technology stocks</td>
<td>1.23%</td>
</tr>
<tr>
<td>WisdomTree Small-Cap Earnings ETF (EES)</td>
<td>Small-cap Blend</td>
<td>Focuses on firms with increasing earnings</td>
<td>1.55%</td>
</tr>
<tr>
<td>iShares Russell Mid-Cap Value Index ETF (IWS)</td>
<td>Mid-cap Value</td>
<td>Focuses on dividend paying stocks of Russell 1000 index</td>
<td>1.40%</td>
</tr>
<tr>
<td>WisdomTree Emerging Markets Small-Cap Dividend ETF (DGS)</td>
<td>Diversified Emerging Market</td>
<td>Focuses on dividend paying and lower volatility emerging market stocks</td>
<td>3.88%</td>
</tr>
<tr>
<td>WisdomTree Mid-Cap Earnings ETF (EZM)</td>
<td>Mid-cap Blend</td>
<td>Focuses on mid-sized growth firms with steadily increasing earnings and dividends</td>
<td>1.59%</td>
</tr>
<tr>
<td>WisdomTree International Mid-Cap Dividend ETF (DIM)</td>
<td>International Mid-Cap Value</td>
<td>Focuses on foreign stocks with increasing earnings and dividends</td>
<td>3.75%</td>
</tr>
<tr>
<td>WisdomTree Emerging Markets Equity Income ETF (DEM)</td>
<td>Diversified Emerging Market</td>
<td>Focuses on emerging markets stocks with high dollar amount of dividends</td>
<td>4.19%</td>
</tr>
<tr>
<td>WisdomTree Middle East Dividend ETF (GULF)</td>
<td>Middle East Value</td>
<td>Focuses on dividend payers in Middle East region</td>
<td>3.29%</td>
</tr>
</tbody>
</table>

Vanguard Mid-Cap Growth ETF (VOT) | Mid-cap Growth | Focuses on mid-sized growth firms with established markets | 0.61%
Buy Decisions

Stock Buys:

**Altera (ALTR)**
- Global leader in logic devices
- Cash is six times debt
- Raising dividend; yield is now 1.8%
- Technology is cyclical
- Expected future price = $50

**CA (CA)**
- Develops and licenses enterprise software to help firms manage their IT systems
- Restructuring business to focus on services and less on mainframe customers
- Margin growth slowed but expected to restart after restructuring
- Technology is cyclical
- Yield of 3.6%
- Expected future price = $45

**EMC (EMC)**
- Leader in virtual infrastructure and storage
- Majority owner of VMware
- Times interest earned greater than 45 times
- Internationally diversified
- Technology is cyclical
- Many players in cloud computing
- Expected future price = $40

**Expeditors International of Washington (EXPD)**
- Global logistic services
- Strengthening operating margin
- No debt
- Transportation and technology are cyclical
- Expected future price = $60

**Ford (F)**
- Heavy investment in China
- Margins are improving
- Debt ratio at over 80%
- Revenues dependent on consumer tastes
- Yield = 2.8%
- Expected future price = $30

**Visa (V)**
- Processing payment generates majority of sales
- Growing internationally
- No debt
- Expected future price = $300

**Wendy’s (WEN)**
- Revamping image by remodeling stores and refocusing advertising
- Rebalancing higher-end and value products
- Expanding overseas, especially Latin America
- Margins are improving
- Faces strong competition from other fast food restaurants and take-home food from grocery stores
- Expected future price = $9

**Maintain holdings:**

**Dollar General (DG)**
- Adding tobacco and alcohol along with increasing health and beauty lines
- Just completed major refinancing to lengthen maturities and lower interest cost
- Sales per square foot growing
- Expected future price = $90

**Wells Fargo (WFC)**
- Steady grower of national banks
- Passed “stress test”
- Raised dividend
- Expected future price = $65
Scholarship Winners

A fundamental part of the Investment Series and the Student-Managed Investment Fund is scholarships. The scholarships are awards for academic achievement and campus involvement. For the upcoming 2013-14 academic year, the SMIF awarded $8,000 in scholarships. Three thousand of the total are the Doones Athletic Scholarships, given to outstanding student-athletes. Since 2001, the Investment Series and SMIF have awarded $107,500 in scholarships.

**Emilee McKnight** – Emilee is a new Master’s in Professional Accounting student, having completed her Bachelor’s degree in May. Throughout her undergraduate years, Emilee was involved with the Students in Free Enterprise/Enactus team, including serving as vice-president during the most recent academic year. She married this summer, and they reside in Amarillo.

**Rhemecka Graham** – Rhemecka is a sophomore pre-business major from Fort Worth, TX. Rhemecka is a member of the cross country/track team. She works part-time as a lifeguard at the WTAMU Activity Center. Rhemecka is also active with her church.

**Kyler Gregory** – Kyler is a senior finance major from Canyon, Texas. Kyler is a member of the WTAMU football team. He tutors for Canyon ISD and umpires baseball games for the West Texas Youth Baseball League. The son of missionaries, Kyler is active with his church.

**Christopher Olson** – Chris is a senior double major in management and finance from Highland Village, TX. Chris is a member of the WTAMU football team. He was named All Conference Linebacker for the Lone Star Conference. Chris is a recruitment host for the football team.

**Ashli Parkhurst** – Ashli is a senior accounting major from Amarillo. Ashli works at Hillside Christian Church and nannies for various families. Horses are one of Ashli’s loves. She showed horses and was active with 4H.

**Mary Trimble** - Mary is a senior management major from Spring, TX. Mary is a member of the WTAMU equestrian team. Her equine skills have afforded her unique opportunities such as spending one summer in Switzerland at the Gstaad Equestrian Stable. She is currently a summer exercise rider and stable hand for Bruce Springsteen’s Stone Hill Farm in New Jersey.

**Kolten Wilder** – Kolten is an MBA student from Plainview, TX. Kolten just graduated with a double major in accounting and finance. He was a member of the CFA Research Challenge team that placed fifth in the region. In his spare time, Kolten plays golf.

Pictured Left to Right:
Christopher Olsen, Kyler Gregory, Dr. Anne Macy, Emilee McKnight, Ashli Parkhurst, Kolten Wilder, and Mary Trimble