Investment Series Presentations

The need for steady cash flows was the theme of the 2011-12 Investment Series presentations. While the economy showed slow growth, the general feeling of market participants rarely deviated from neutral.

On August 5, 2011, S&P downgraded the United States’ credit rating from AAA to AA+. The DJIA fell over 600 points on the news. Congress raised the debt ceiling. GDP growth was positive but never greater than 2.0% for the year. The unemployment rate fell from 9.1% during the summer 2011 to 8.1% by April 2012 only to bounce back up to 8.2% for May and June 2012. The Federal Reserve maintained its policy of low interest rates through Operation Twist. The Fed sold short-term securities and bought long-term securities in an effort to spur the economy.

Politically, the Republican primary/caucus presidential selection process dominated the news for much of the year. The Republicans talked down the economy while President Obama discussed the bright spots in the economy.

Tony Thompson, CEO of Thompson National Properties, presented his outlook on the future of real estate investing on October 26, 2011. He has invested over $3 billion in 250 properties nationwide. Of particular interest was his focus on commercial real estate near manufacturing facilities. Mr. Thompson’s discussion on Amarillo’s Western Plaza was equally enlightening. Daryl Curtis graciously sponsored this presentation.

Fritz Meyer, well-known economist and market commentator, presented his views on the economy on April 26, 2012. A strategist, Mr. Meyer presented an in-depth analysis of the current economic environment. Mr. Meyer’s discussion of the relationship between P/E and interest rates was informative as was his discussion on household debt versus government debt. Dale Buckner graciously sponsored this presentation.

Dick Railsback generously donated stock to the Student-Managed Investment Fund. He gave 269 shares of Transocean and 100 shares of Merck. The students thank Mr. Railsback for his support of the portfolio and of scholarships.

George Raffkind continued his generous support of the Investment Series by providing gift certificates at each event.

On August 31, 2011, the portfolio managers attended the Hodges Capital Management’s Investment Forum. During the daylong event, the students listened to presentations from fourteen companies and interacted with the corporate leaders of these firms. The students also visited with WTAMU alumni Don Hodges, Eric Marshall, and Derek Maupin.

On September 10, 2011, the portfolio managers were guests on Dale Buckner’s Financial Clinic radio show on KGNC. It is an exciting two hours for the students, especially addressing caller questions. The students learn the importance of conveying useful information with the fewest possible words.
Inflation

Inflation has been a worry for many investors since the Federal Reserve’s policy of quantitative easing (QE) started in 2008. Luckily, inflation has not been a concern. Since 2008, the consumer and producer price indexes have remained steady at around 2%, and the Federal Reserve is predicting inflation rates will stay under 2% for the next decade.

Quantitative easing and the resulting increase in the money supply have not led to an increase in inflation due to the lack of demand in the economy. If the US economy does see a major uptick in demand in the next decade, there may be a brief increase in inflation until the Fed raises interest rates. Most of the QE has been in the form of increased excess reserves, on which the Fed pays 0.25% to the banks. The excess reserves represent a huge potential increase in the money supply and long-term inflation. When loan demand increases, the banks will switch from holding reserves to lending. While stimulating the economy, this could also lead to inflation.

When analyzing inflation’s impact on firms, it is important to understand how well a firm can pass on an increase in costs to its consumers. If the producer price index increases, this means firms will experience an increase in costs and profit margins will shrink. Firms that are able to increase the prices of consumer goods without decreasing demand will be the winners during these times.

In 2008, the PPI increased with oil prices as overall demand dropped, causing many firms to face huge losses. Since then, demand has recovered enough to keep consumer prices in line with increased costs. Additionally, oil prices have backed off their highs. In the past few months, the economy has seen a substantial decrease in producer prices with consumer prices staying the same. This may create a boost to the bottom line of many companies this year.

Within the CPI and PPI, it is also important to identify how these indices relate to the prices of food and energy. These two items can lead to volatility in the prices of goods. Firms that are more food and oil intensive will face different challenges. The PPI of all items for May 2012 is around -0.5% while the PPI less food and energy is closer to 2.5%. The CPI of all items in May 2012 is slightly above 2.5% while the CPI less food and energy is just under 2.5%.

Federal Deficit and Debt

The U.S. faces a “fiscal cliff” with a mix of spending cuts and tax increases set to take effect at the end of 2012. With real GDP growth at 1.9%, the market is worried that there is not enough economic growth to offset spending cuts and tax increases.

The U.S. is already at record debt levels. Total public federal government debt is at $15.6 trillion while GDP is at $15.5 trillion. Federal debt held by foreign and international investors has increased to $5.1 trillion. Because of what it deemed a lack of concern regarding the debt level, Standard & Poor’s downgraded U.S. debt from AAA to AA+ in August 2011. While the increase in taxes and reduction in spending would reduce the deficit by about $500 to $600 billion, GDP growth could fall by as much as 4%, sending the economy back into recession.

The current figures underestimate the total because the U.S. faces growing obligations in the forms of Social Security and Medicare. Some estimates have the level of unfunded liabilities at $62 trillion or over $500,000 per household.
Commodities

Commodity prices have rebounded since the recession but are down from the highs experienced in 2011. A stagnant domestic demand and worries about the future of the European economy have been the driving factor for these declines. For the foreseeable future, short-term price movements of most commodities will be erratic and depend heavily on the daily news from Europe.

Oil is down about 20% since the beginning of the year, mainly due to the weak European economy. On June 29, oil jumped 9.2% following the announcement that the European Union would implement a single financial advisor for the region. Investors must also pay attention to tensions with Iran, as U.S. oil sanctions began June 28, and European sanctions on July 1.

Precious metal prices have remained relatively flat for 2012 but analysts expect them to increase in the following months. If Europe trades austerity plans for inflationary policies, precious metals should rally as investors seek a hedge against inflation. In addition, any rumors of a QE3 will increase metal prices.

The prices of U.S. agricultural commodities such as grains and cattle, like last year, will depend on drought conditions. Grain prices have recently begun to surge as expected crop yields in the Midwest have dropped due to dry weather conditions. If oil prices begin to recover and drought conditions remain, we may see new highs in U.S. agricultural commodities this year.

International Considerations: China, India, and the Middle East

Although a seeming unstoppable force, China’s economy has hit a snag recently. Like any progressing country, China is experiencing growing pains. China’s problem is the absence of a middle class. Production has slowed in China as workers are starting to earn higher wages and firms are moving production elsewhere where labor is less costly. Service industries have also taken a big hit, as Chinese citizens remain skeptical of the growth of Chinese jobs and the economy, straining service jobs that require confident consumers. China is depending on a S$315 billion government package to stimulate the Chinese economy.

Along with the slowdown of growth, political issues have increased uncertainty. The main political scandal centers on former Chinese Minister Bo Xilai, known for creating jobs through improving the infrastructure but at the expense of huge deficits that need to be paid. Erroneous business deals and the death of a British businessman have generated additional questions concerning Xilai.

India’s growth, like China’s growth, is beginning to slow. GDP growth is at 5.3%, the lowest level in nine years. A weak infrastructure has hurt the country. With either no transportation or systems incapable of supporting the large cities, exports are slowing to a standstill. India is trying to improve its infrastructure to accommodate the import growth of vehicles and other products that Indians are now able to afford. India faces a growing trade deficit, which can further divide a country known for a stark class system.

The Middle East remains an intriguing area. With wars in some areas, other areas are finally seeing a steady political system that encourages business. The youthfulness of the region combined with oil money and a growing middle class make the Middle East a region of growth for many U.S. firms. However, the risks from violence and the ongoing tension with Iran hamper enthusiasm.
Federal Reserve Policy

In the Federal Reserve’s June open market committee meeting, the Fed decided to continue the policy known as “Operation Twist.” Though it was due to expire mid-2012, this policy will continue at least through the end of this year. The Fed sells short-term securities to generate funds to purchase long-term securities, flattening the yield curve. The purpose of this policy is to reduce long-term interest rates and stimulate the economy without increasing the money supply.

Since December 16, 2008, the Federal Reserve has held the target Federal Funds rate at 0% - 0.25%. Since the inception of “Operation Twist” in September 2011, long-term interest rates have gradually declined. It is unclear what interest rate will jumpstart economic activity. At the beginning of June 2012, the 10-year Treasury note had an interest rate of only 1.442% - the lowest yield ever.
Unemployment and Jobless Recovery

After a disappointing May jobs report in which only 69,000 jobs were added and the unemployment rate increased to 8.2%, the June report confirmed fears as only 80,000 were added and the rate stayed at 8.2%. The economy needs to add 150,000 jobs per month just to keep up with population growth.

Employers are reluctant to hire new employees until they are certain that the economy will continue to grow. The job market has also changed considerably since the recession; therefore, many employees’ skills are not up to par for the available jobs. The long-term unemployment figures confirm the jobless recovery.

The U-6 unemployment rate is 14.9%. This unemployment rate includes not only the unemployed but also the employees who are only able to find work part-time when they would like to work full-time and people who would like a job but gave up looking because they were unable to find a job. The long-term unemployment, people who have been unemployed for 27 weeks or over, is at 5.2 million. These individuals account for 41.9% of the unemployed.

As the economy continues to improve, jobs will not be available for all workers. With the advancing technology, computers now do the simple work. The jobs that technology cannot do include the top-of-the-line jobs of professionals such as lawyers or computer software designers. Retail jobs require fewer skills but also have considerably lower pay than the old-line manufacturing jobs of the past. Additionally, firms have reduced the number of support staff as a cost-cutting measure. Furthermore, many Baby Boomers have delayed retirement. This has clogged the top-half of the job market ladder.

Demographic Considerations

As developing countries continue to grow, companies are increasingly moving into international markets. While this can result in major growth and benefits to shareholders, there are numerous considerations and risks for a company moving into a new international market. There are vast differences in culture, laws, religion, and values in developing regions that, if over-looked, can prove fatal to a company. However, companies are evaluating taking these big risks because the future of growth lies in these regions.

The median age of developed countries is growing older while developing countries are getting younger. The current average age for the United States is 36 and expected to increase to 40 by 2050. Other developed countries such as Germany and Japan are seeing similar trends. Meanwhile, developing countries such as Yemen have a population whose average age will be in their mid-20’s by 2050.

It is not just the young age that is alarming but also the rate of growth for these developing countries that is astonishing. For example, demographers expect Yemen’s population to increase by 156%, Saudi Arabia by 64%, and Egypt by 52%. Germany, Japan, and Russia, however, will see decreases in population by 9%, 14%, and 12%, respectively.

Based on the future growth for these countries, it is obvious that there should be opportunity for future sales. As companies move into these new markets, they will have to adopt the business practices of the countries’ cultures. Because much of the growth exists in countries where Islam is the primary religion, business practices must recognize the differences. One example is that Islam forbids interest payments, thus, negating the use of debt. Entrepreneurship is different because the market is viewed as a zero-sum game where competition does not create more business but rather takes someone else’s market share. This will make it very difficult for companies to move into markets where related local
businesses already exist.

As the world demographics change, wealth distribution also changes. As the developing world grows older, the dependency on younger generations increases. The dependency ratio is the ratio of children and seniors to working adults. As the number of working adults decreases, it becomes too low to fully support dependents. This means that the next generation will have difficulty breaking even and accumulating wealth because of the taxes paid to support seniors.

The high unemployment is a double negative for the Eurozone. High unemployment corresponds to lower tax revenues, just when the countries need higher revenues to pay down debt. Additionally, the high unemployment requires more government subsidies to stabilize families.

This downward spiral has a root cause in excessive government debt. Government debt has a role in the economy to stabilize households and firms during downturns in the economy. However, many of the Eurozone countries created not just short-term cyclical deficits but a long-term structural debt. A country can survive a structural debt as long as a country can pay the interest and can rollover the debt. Greece and maybe Spain and Italy face this situation. The lenders are no longer willing to lend at the same rates. The higher interest rates are not affordable based on current tax revenues.

The next question is, will Greece leave the Eurozone? It would not be beneficial for nations or investors holding Greek debt. If Greece were to leave, the currency would return to the drachma, which the market may devalue to the point of a Greek bankruptcy unless the European Central Bank would provide funding. It is more likely that the European Central Bank becomes a financial mediator over Greece in order to try to stabilize the euro. This could work as long as Spain and Italy do not need stabilization and only if Greece needed the funds for a short time period. As Alan Greenspan stated, “Expanding the balance sheet of a central bank is working for the short-term, but it’s like a boat with small holes with water still seeping in, you will end up sinking.”

World markets have experienced a great deal of volatility over the last year in response to the Eurozone situation. It is unclear how much of a default the market already has priced into asset values. Potentially, regulatory authorities would allow banks to realize losses over time instead of at once. During the recent European Summit, the Eurozone countries reached an agreement to allow struggling banks to recapitalize directly through the European Rescue Funds, without adding new debt to the
balance sheet of the country. Another agreement allows countries in the Euro to begin buying sovereign debt, which elevates stress on Spain, Italy, and Greece. While these measures should help in the short-term, the underlying problem of a lack of economic growth has not been solved.

Over eighty percent of the stocks pay a dividend. Some of our large income producers include Medallion Financial (yield of 8.13%), Merck (4.47%), Paychex (4.27%), and Johnson & Johnson (3.9%). In terms of annual income, our leaders include Johnson & Johnson ($488 per year), Pepsi ($431), and Chevron ($360).

Our top performing stocks in terms of price appreciation for the last year are Gilead (65%), O’Reilly’s (60%), Abbott (25%), CVS Caremark (25%), Kimberly Clark (25%), and Walmart (25%).

In the last few years, the SMIF has accumulated cash because of an inability to find good value at the annual summer rebalancing time. Because of the heavy cash holding, the fund has not had the volatility or the growth potential of the market. Since the start of 2007, the S&P 500 index is still down 3.9%. However, the SMIF has increased by over 17%. Since the start of 2009, the S&P index is up 46% but the SMIF is only up 24%.

The SMIF gained 1.7% during the prior year. The SMIF has a conservative asset allocation with 42% cash, 6% fixed income, and 52% equity. The stock portion of the fund increased 4.3%. In comparison, the S&P 500 index gained 3.1% over the same period. Using the portfolio beta of 0.876, the SMIF beat its benchmark index by 1.6%.

The SMIF’s largest weight after cash is large-cap value stocks at 25% followed by large-cap growth at 15%. The fund held about 5% in international holdings, primarily international ETFs.

The SMIF’s largest weights are in the health care sector (20%) followed by consumer staples (18%) and information technology (16.5%). Industrials and energy are each about 11% to 12% of the portfolio.

The SMIF has an income orientation.
Sell Decisions

Based on fundamental and technical analyses, the SMIF portfolio managers decided to sell the following holdings. Some of the holdings had reached their fair value while other holdings have lower growth expectations.

- Illinois Tool Works (ITW)
- IBM (IBM)
- Lowe’s (LOW)
- Novartis (NVS)
- National Presto Industries (NPK)
- O’Reilly Automotive (ORLY)
- Paychex (PAYX)
- Peabody Energy (BTU)
- Proctor & Gamble (PG)
- Taiwan Semiconductor (TSM)
- Teva Pharmaceuticals (TEVA)
- United Health Group (UNH)
- Wal-Mart (WMT)
- Western Digital (WDC)

Buy Decisions

Activision Blizzard (ATVI)

Strengths
- Highly anticipated Starcraft and Diablo launch in 2012
- World of Warcraft generates considerable cash flows from subscription fees and extension packs
- No debt and high cash levels

Weaknesses
- Has not released a game requiring motion-based controllers
- Video game sales are cyclical

Future Expected Price: $30

AES Corp. (AES)

Strengths
- Diversified utility operating in 27 countries
- Major player in high growth areas of Brazil and Chile
- Increasing cash flows per share

Weaknesses
- Significant exposure to foreign currency fluctuations
- Low dividend yield of 1.3%

Future Expected Price: $20

Agrium (AGU)

Strengths
- Increased worldwide demand for grains and meat increase demand for fertilizers to increase crop yield
- Fragmented retail agriculture market allows for increases in market share and bargaining power with suppliers
- Working capital exceeds long-term debt

Weaknesses
- Cyclical cash flows due to volatile pricing and demand
- Underfunded pension obligations

Future Expected Price: $950

Apple (AAPL)

Strengths
- Product innovations – iPhone 5, iPad3 and Apple TV
- No debt with strong cash flows
- Start paying dividend September 2012

Weaknesses
- Weakening economy in Europe could hurt sales
- Competition from Android operating systems

Future Expected Price: $75
Buy Decisions

Goldcorp (GG)
Strengths
- Low debt – only 3% of capital structure
- Increasing cash flow
- Increasing production

Weaknesses
- Price highly correlated to gold price
- Significant exposure to foreign currency fluctuations

Future Expected Price: $75

Kansas City Southern (KSU)
Strengths
- Increased profits from growing Mexican business
- 50% ownership of Panama Canal railway
- New U.S. oil & gas production should increase margins

Weaknesses
- Significant political risk to Mexico and Panama
- Required maintenance expenditures consume 17% of revenue

Future Expected Price: $105

Kennametal (KMT)
Strengths
- Backlog of aircraft orders ensures sales for up to seven years
- Working capital exceeds long-term debt
- Recent strategic acquisitions target expanding markets

Weaknesses
- Cyclic stock with beta of 1.40
- Low dividend growth rate

Future Expected Price: $80

Microsoft (MSFT)
Strengths
- Four major product launches for 2012
- Working capital four times long-term debt
- Steadily increasing the dividend

Weaknesses
- Strong competition for entertainment and devices divisions
- Investor sentiment lies with Apple

Future Expected Price: $50

Nike (NKE)
Strengths
- Global exposure from NFL and the London Olympics
- Increasing demand from emerging markets
- Working capital 33 times long-term debt

Weaknesses
- Product innovation costs increasing
- Risk from controversial endorsement

Future Expected Price: $120

Rio Tinto (RIO)
Strengths
- Growing demand from emerging economies
- Strong balance sheet with cash about 50% of long-term debt
- Diversified global operations in over 40 countries

Weaknesses
- Cyclic stock with beta of 1.60
- Price highly correlated to commodities prices

Future Expected Price: $100

Siemens (SI)
Strengths
- Recent strategic acquisitions target expanding markets
- Increasing net profit margin
- High dividend yield of 4.1%

Weaknesses
- Exposure to Eurozone economy
- Facing pricing pressure in renewable energy segment

Future Expected Price: $190

Visa (V)
Strengths
- No debt and $2 billion in cash
- Strong growth from Central Europe, the Middle East, and Africa
- Leader in expanding debit card business

Weaknesses
- Low dividend yield
- Regulatory pressure on swipe fees

Future Expected Price: $190

Wellpoint (WLP)
Strengths
- Recent strategic acquisition of 1-800-Contacts targets expanding market
- Growth in segment of managing Medicaid for states
- Moving from volume-based payments to value-based programs

Weaknesses
- Costs could increase if not able to manage patients dually eligible for Medicaid and Medicare
- Recent acquisition reduced cash

Future Expected Price: $100
Investment Series Scholarship Winners

A fundamental part of the Investment Series and the Student-Managed Investment Fund is scholarships. The scholarship is also an award for academic achievement and campus involvement. For the upcoming 2012-13 academic year, the SMIF awarded $8,500 in scholarships. Three thousand of the total are Doores Athletic Scholarships, given to outstanding student-athletes.

Dylan Doss – Dylan is a freshman accounting major from Carlsbad, TX. An athlete in high school, Dylan currently works for the Activities Center as a lifeguard.

Cydney Friemel – Cydney is an MSFE student from Hereford, TX. Cydney graduated with her BBA in finance in 2011 as the Outstanding Finance Student. She is currently a commodity merchant with Cargill, Inc. in Minneapolis, MN.

Laura Beth Hallman – Laura Beth is an MSFE student from Cleburne, TX. She graduated in December with a BBA in Finance and is currently a Graduate Assistant for the College of Business.

Trent Trahern – Trent is an MSFE student from Sunray, TX. He recently finished his BBA in economics. Trent is an active member of SIFE and the COB Student Advisory Board. He works as a graduate assistant for the AEF department.

Kyle Williams – Kyle is an MSFE student from Chicago, IL. His goals include pursuing a PhD in economics with the hopes of becoming a professor.

Scott Doores Investment Series Athletics and Activities Scholarships

Kyler Gregory – Kyler is a junior general business major from Canyon, TX. Kyler is member of the WTAMU football team. The son of missionaries, Kyler is active with his church.

Sophie McBride – Sophie is a senior finance major from Minneapolis, MN. She is a member of the WTAMU Volleyball team and a member of the Student-Athlete Leadership Team. Sophie has been on the President’s Honor Roll for three straight years. She also volunteers with Make-a-Wish, CASA, and Big Brother/Big Sisters.

Christie Russell – Christie is an MBA student from Grapevine, TX. She recently completed her BBA in marketing. As a four-year member of the WTAMU softball team, Christie also served as team captain in 2011. She participates with the Buff Minds Research Team and its projects with the Terry Fator Show in Las Vegas, NV.

Overview of the Student-Managed Investment Fund

The Student-Managed Investment Fund (SMIF) is a central part of the finance program for WTAMU’s College of Business. Each year, the finance majors, through the Investments and Portfolio Theory courses, learn about investing and portfolio management while analyzing the stocks in the SMIF and evaluating potential stocks. All of this takes place over 32 weeks. At the end of the year, student leaders become portfolio managers who scrutinize the stocks in the portfolio and decide the buy-sell decisions. The overall goal for the SMIF is to provide students with practical experience in security analysis and to increase the confidence of students in managing portfolios.

Knowing that the SMIF generates scholarships provides pressure on the students to perform at the best of their abilities.

The two-course rotation is available to any student, regardless of major or age. For each course, the student creates an analyst’s report on two stocks and the corresponding industry using Microsoft Publisher.

The SMIF follows a top-down approach to investing. First, each student synthesizes how the current macroeconomic environment will affect the industry and stocks. In particular, the students evaluate the impact of inflation, employment, and interest rates. The next step is to examine the industry-specific characteristics such as fixed costs, sales stability, and profit margins to forecast the success of the industry for the next few years. Finally, the students examine stock-specific characteristics such as debt level, cash flow, dividends, and growth rates as they estimate future prices for each asset.
Student Portfolio Managers

Emilee Cavaness – Emilee is a senior accounting and finance major from Amarillo, TX. After graduation, Emilee plans to pursue her MPA and eventually become a CPA. Emilee is currently an Accounting Clerk at American Star Corporation, a local oil and gas company. In her spare time, Emilee enjoys reading, spending time with family, and playing with her cat.

Laura Beth Hallman – Laura Beth is an MSFE student from Cleburne, TX. She earned her BBA in Finance December 2011. While finishing her MSFE, she is serving as Students in Free Enterprise (SIFE) Co-President, is a member on the Student Advisory board, and is working for the College of Business as a Graduate Assistant. She will graduate in May 2012 and is looking forward to starting her career in Finance.

Kami Rundell – Kami is senior double major in accounting and finance from Nazareth, TX. After her August 2012 graduation, she will be moving to Lubbock, TX to begin working for CED, an electrical distribution company, where she will be training to do either sales or management. Currently, Kami is a campus tour guide and enjoys meeting prospective students and telling them what it will be like to be a Buff.

Jake Samarron - Jake is a senior double major in accounting and finance. He is an OIF/OEF veteran and served six years in the U.S. Air Force. He is a member of the National Society of Leadership and Success. Jake will continue his education this fall pursuing an MBA and his CPA license. In his spare time, Jake loves participating in various outdoor sports and playing guitar and singing for his band.

Adrian Walker – Adrian is an MSFE student from Frisco, TX. He earned his BBA in Finance in May 2012. As an undergraduate student, he served on the WTAMU Student Body Government, Student Business Advisory Board, the Accounting & Finance Association, and SIFE. Some of his honors include President’s List, Dean’s List, Omicron Delta Epsilon, Alpha Chi Honor Society, Gamma Beta Phi Honor Society, and Phi Eta Sigma Honor Society. Adrian is also a McNair Scholar. Adrian enjoys shopping, watching movies, cooking, working out, politics, and CNBC.

Kolten Wilder - Kolten is a senior finance major, accounting minor from Plainview, TX. Kolten plans to pursue the MSFE degree at WTAMU with a goal of career in investment banking. He works for the Accounting, Economics, & Finance department while also working for P&E Leasing Inc. Kolten enjoys playing golf in his spare time.

Kyle Williams - Kyle is a graduate student studying finance and economics from Chicago, IL. Since obtaining a BS in management from the University of Illinois at Chicago, he has worked in real estate, retail/hospitality management, and banking. He currently works in accounting at the People’s Federal Credit Union in Amarillo. After obtaining an MSFE degree from WT, he plans to pursue a PhD in economics. In his spare time, he enjoys mountain biking and practicing mixed martial arts.

Since 2001, the Investment Series has awarded $99,500 in scholarships.