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PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

Market Update

By Che H. Lee
President

I think it is fair to say that never has such a strong market rally produce so many sour faces among the investment public. Judging from our extensive daily readings and research, it seems 90 to 95% of market participants, amateur and professional alike, are skeptical of this rally. Undoubtedly, part of the reason is that they have been conditioned during the past three years, comprising the second worst bear market of all time, to distrust every rally. The more important reason is that most investors were grossly under-invested in stocks when this rally began in April. Understandably, their massive losses during the bear market (especially for those who got caught up in the market bubble) convinced them to stay away from equities as far as possible. This rally has added insult to injury, by making them feel they had bought too high and sold too low.

Given the investment masses' overwhelmingly skeptical reception to this rally, it is likely sustainable at least for now; such a lopsided consensus is rarely correct. There is no question that there have been some troubling and isolated pockets of rampant speculation returning to certain market segments; however, selective equities continue to be attractively valued. As always, generalizations are difficult to make and not particularly useful.

It is interesting to point out that the amount of cash residing in banks and money market funds as a percentage of the total stock market capitalization recently reached a multi-year high, indicating there is ample liquidity should the masses decide to "correct" their drastic under-allocation to equities going forward, unfortunately for them at much higher prices than were available last October.

Investor sentiment and the market, in hindsight, may have hit bottom (at least for this market cycle) on October 9, 2002. At the time, there was panic and rampant pessimism regarding the future of equities. People were fleeing equities for the greener pasture of bonds, to the tune of over $130 billion pulled out of equity mutual funds. Purely by luck, we predicted in the Fall issue of *Observations* (published in October 2002) that a market reversal would likely materialize within 6 months. It was out of character for us to be predicting market movements, but we felt the need to communicate our more optimistic variant view in light of the prevailing hopelessness seemingly infecting all market participants at that time. Since then, the market has twice rallied over +20% from the October lows, and the current rally that began in April has rallied over +28%.

We stated then and stress again now that we are not one of those all-seeing gurus with purported expertise to accurately predict the direction of the markets. Therefore, the purpose of recounting the foregoing is not to suggest that we are good at divining "where the market is going;" frankly nobody is any good at doing that. ***However, we do want to emphasize that the market events since last October highlight, once again, the importance of concentrating on valuation levels, and not being swayed by popular opinion, whether in the midst of a roaring bull market three years ago or at the depth of a brutal bear market last October.***

As we said, neither we nor anyone else is any good at predicting mar-

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ket movements. ***We believe our strength at PDV is to bring integrity, an unemotional temperament, patience, discipline, analytical rigor, and a thoughtful and deliberate valuation approach to the investment process in assisting you to reach your financial goals over time.***

As always, we would be happy to hear from you if you are interested in discussing how we might assist you in achieving your financial goals.

Custodial Account or 529 College Savings Plan?

By Deborah W. Lee
Senior Financial Advisor

Before so-called College 529 plans became available in 1996, many parents set up custodial accounts under the Uniform Transfers to Minors Act (UTMA) or the Uniform Gifts to Minors Act (UGMA) to put away money for their children's college tuition. Under UTMA or UGMA, money deposited into these accounts as gifts is considered the child's money. Parents typically serve as custodians to take care of the account until the child reaches legal age, which ranges from 18 to 21, depending on the state. However, one disadvantage with these accounts is that once the child reaches legal age, he can spend the money for any purpose since he technically owns the funds in the account.

If you have not yet set up accounts for your children to fund college tuition expenses, and are worried about your child blowing the money on something other than education, you are in luck. To maintain control of the money to ensure that it will only go towards college tuition, parents now have the option of setting up a 529 account. The person funding a 529 account (most often one of the parents) remains the owner of the money, while the child becomes the beneficiary.

The considerations are different and more complicated if you have an existing custodial account already set up. You may desire to change from a custodial account to a 529 account for one of two reasons: 1) you had set up the custodial account for educational purposes and desire more control to ensure the money is indeed spent on education, not to mention getting increased tax benefits associated with 529 plan accounts; or 2) you had set up the custodial account for non-educational purposes, but need to tap the balance in the account as the sole source of funding for a 529 account.

Applicable law doesn't allow the direct transfer (akin to a "direct rollover") of money from the custodial account to a 529 college savings plan account. This is because the money in the custodial account technically belongs to the child, while the money in the 529 account belongs to someone other than the child (who is only the beneficiary). Using money from a custodial account to open a non-custodial 529 account is arguably tantamount to the parent taking back money that had been legally gifted to the child. While the law governing this situation is still very much influx, commentators have observed that this could possibly be interpreted as a potential (technical) violation of applicable laws.

It is possible to terminate the custodial account, and then use the proceeds that technically belong to the children to open a ***custodial*** 529 account. This would have the benefit of addressing the issue of legal ownership of the money, since ownership will stay with the child before and after the transfer. ***However, you will not be entitled to the full benefits of a typical 529 plan account in this case, as the 529 plan administrator will be legally required to treat the child as the legal owner of the account.*** Because of this, the beneficiary cannot be changed from the child to some other person, as would be possible under a typical 529 account situation. It is also likely the child can demand the money from the plan administrator when he reaches legal age, when he would normally not have such a right under a typical 529 account. Opening a ***custodial*** 529 account is therefore very different from opening a typical 529 account.

In addition, there are other considerations you should take into account before terminating a custodial account to fund a 529 plan account. Because 529 accounts only take cash deposits, you have to liquidate all the investments in the custodial account prior to withdrawal. The cost basis of the investments in the custodial account will determine how much tax has to be paid upon liquidation. If the tax is huge, this will at least partly negate the tax benefits of a 529 account.

Before terminating the custodial account, you should also consider the age of the child. Generally, the older the child, the less time you have to take advantage of the tax benefits of the 529 plan before the child enters college. Custodial accounts do have their own, albeit reduced, tax benefits. If the child is under 14, the first $750 of interest and dividends each year is tax exempt. The next $750 is taxed at the child's rate. The parents' tax rate is only applied to anything over $1,500. If the child is between 14 to 18, all investment earnings are taxed at the child's (usually much lower) tax rate.

The custodial account also allows the money in the account to be invested in whatever way the parents feel appropriate. On the other hand, 529 plans have more limited investment choices. As it presently stands, you are only allowed to change investment options periodically, which is typically once a year in most plans.

Some commentators have suggested that there is a way to use custodial account funds to fund 529 accounts without actually terminating the custodial accounts. It would work along these lines: assuming the custodian is the parent, she would pay certain expenses that arise from activities beneficial to the child, such as summer camp tuition, using money inside the custodial account. The amount that the parent avoids paying out of her own pocket for these expenses would then be put into a 529 account for the child's benefit. We have to stress that this method has not been tested to our knowledge. You should therefore consult your attorneys and tax advisors regarding whether this method will withstand legal scrutiny.

Following Insider Trading: the Legal Kind

By Chad Escarcega
Assistant Portfolio Specialist

When deciding whether to buy, hold or sell the stock of a company, it is necessary to analyze a myriad of factors relating to its investment merits. One significant factor to consider is what the company's "insiders" are doing with respect to the stock. "Insiders" include beneficial owners of greater than 10% of the outstanding shares, directors and officers. Since insiders are presumably most familiar with the company's underlying business prospects, it would be useful if we could monitor their actions with respect to the company's stock. Do the insiders share your optimism or pessimism regarding the company's outlook?

Fortunately, there is a simple way to obtain the necessary information to monitor the insiders' actions. The Securities and Exchange Commission (SEC) requires that insiders promptly report any transactions affecting their ownership of the company's shares via public filings on SEC-prescribed forms, commonly known as "Forms 3, 4, and 5." Insiders are required to file Form 3's upon initially acquiring ownership of their company's shares. Form 4's are filed by insiders to report changes to their ownership position that was initially established through the Form 3 filings. Form 5's must be filed annually to summarize all transactions for the year. Since Form 4's cover interim ownership changes, they are the most useful and timely insider actions to analyze, and will therefore be the primary focus of this article.

Form 4's are basically broken down into derivative and non-derivative sections. The first section describes non-derivative transactions affecting actual stock. Derivative transactions, reported in the second section of Form 4's, are basically those affecting certain rights that derive their value from the company's stock. The most typical derivatives appearing on Form 4's are stock options that grant insiders the right to buy a certain number of the company's shares at a pre-determined price and under certain prescribed circumstances. The stock option is not the same as actual stock, but the value of the option/right will correlate with the underlying stock price.

Transactions reported on Form 4's have varying significance. For example, an insider may file a Form 4 reporting acquisition of a stock option to buy 100 shares at a future date at the price prevailing on the date the option was granted. This by itself does not give particularly useful information regarding the possible merits of the investment. Lots of companies compensate their insiders through stock option grants; such grants, unless excessively large, do not shed much light on the company's investment merits. Excessive large grants, however, might indicate inappropriate transfer of value from shareholders to management.

The two categories of transactions that potentially provide the most valuable information about the company's investment merits are buys and sells, or derivative-related transactions that are functionally similar to outright buys and sells. First, let's discuss the buy transactions. There are usually only two reasons why insiders buy their own company's stock: 1) to make money because they expect the price to go up over time based on promising business prospects, or 2) it is a condition to their continued employment. Buy transactions can be effected either through direct purchases or by exercising vested stock options, paying the exercise price and related taxes out-of-pocket, and retaining all shares acquired through the option exercise. The latter series of transactions would be functionally similar (though not equivalent) to an outright stock purchase—it is like an outright stock purchase at a discounted price.

Useful definitive conclusions are more difficult to draw from sales transactions, as there are legitimate reasons for insiders selling company stock that do not necessarily reflect negatively on the company's investment merits. For example, a large component of overall compensation in the tech industry consists of stock options, rather than cash compensation. Insiders working at tech companies may need to sell shares from time to time to produce the needed cash to paying living expenses etc. Other insiders may have so much of their net worth tied up in one single company that it would be prudent for them to sell for diversification or estate planning purposes. Therefore, in contrast to buy transactions which are generally bullish indicators, sales may (but do not necessarily) reflect bearish sentiment.

There is yet another category of transactions that are particularly difficult to evaluate. For example, you might come across an insider who exercised her stock options, and then immediately sold off some, but not all, of the shares that she acquired. While that would technically be a sale of shares, such a transaction might turn out to be more bullish than first appears, if the partial sale was simply to generate sufficient proceeds to cover the out-of-pocket costs of the exercise price plus the related taxes that are due, while retaining the remaining shares because she is bullish on her company's prospects. If the option exercise occurred shortly prior to the expiration date for the option, the partial sale may not have been truly "voluntary," since it was needed to pay for out-of-pocket expenses that were triggered by a premature option exercise to avoid the option expiring worthless. Anything short of a total sale might in fact be deemed bullish under this scenario.

In summary, you can draw many useful conclusions about a company's investment merits by examining the action of its insiders—those who are most familiar with the company—with respect to its stock.. Their actions can be monitored by analyzing Form 3,4 and 5's that are required to be filed by law. Buy transactions, if conducted by multiple insiders and for large amounts, are almost invariably bullish. In contrast, sale transactions will, by their nature, be more ambiguous and difficult to interpret, especially partial sales that are made to pay taxes and the exercise price.
