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When Will the Big-Cap Stock Cycle Turn?

By Che H. Lee
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Cycles are endemic to financial markets, businesses and the economy. If you take a long enough snapshot, you see recurring events and patterns. These cycles swing like pendulums, sometimes to extremes before regressing towards a mean.

From 1994-1999, the big-cap stock bubble was in full force, only to be replaced by an even bigger tech bubble at the turn of the century. Our long-time clients will remember this. During this period, the valuation of companies like Microsoft, General Electric, Walmart and Cisco Systems rose to absurd levels (p/e ratios for many of these big-cap stocks ranged from 30 to over 50); investors just could not get enough of these stocks at *any* price. These companies were unquestionably great, but you can overpay for a good thing. The fact that almost everybody favored these stocks created a positive feedback loop, triggering further waves of demand.

We too admired these companies, but as value-conscious investors we refrained from overpaying for this quality. The big-cap stock cycle, like all extreme cycles, then turned with a vengeance; the formerly overloved became the unloved and stayed that way for years. They have yet to turn convincingly in the past decade. Punch up the 10-year stock price charts for these 4 companies and many other similar high-quality companies and you see stock prices that have either gone nowhere or actually ***dropped*** in the past decade, while per share profits have ***tripled or more*** in some cases. Consequently, valuation for these high quality stocks has swung from ridiculously high to unduly low currently, with profits first catching up to and then overtaking stagnant stock prices.

It is ironic and surprising that these high-quality stocks have not caught investors' fancy after the horror of the 2008-09 financial meltdown. You would think that after such a horrific experience, investors would embrace the desirable qualities possessed by these companies: strong finances; exposure to faster-growing emerging markets; ample cash flow; market-leading positions; decent growth; and beneficiaries of competitors weakened by the financial meltdown.

While these companies will not grow like weeds because of their size, prospectively they have bright futures. They are overcapitalized, brimming with cash, ready and

Thanks for your referrals!

As we conclude our sixteenth year of publishing *Observations*, we would like to take this opportunity to express our gratitude and appreciation to all our clients and friends for their client referrals over the past year. We always welcome the opportunity to be of service to relatives, friends, and acquaintances of our clients. As many of you know, we do not market our services to people with whom we are not acquainted. Our business has grown over the past sixteen years primarily due to satisfied clients adding business and through their referrals. We hope you'll think of us if you come across anyone who would benefit from our services. Thanks again!

Inside This Issue:

able to buy up other companies that might enhance their future, and likely to either initiate or increase dividends. They have meaningful exposure to fast-growing foreign markets and the critical mass in infrastructure and connections to sustain their leads in those markets. The positives go on and on. All these companies have projected earnings per share growth of 10% or more over the next few years, in some cases with relatively high dividend yields that are destined to go higher still. And yet they have attracted a collective yawn from investors. Even assuming their multi-year low price-to-earnings ratios (p/e ratios) do not expand, they are likely to generate double-digit annual total return for the foreseeable future.

Stock market history clearly shows recurring cycles of big-cap stocks and small-cap stocks doing better relative to each other. After big-cap stocks left small-cap stocks in the dust in the late 1990's, the cycle turned. I have no doubt that big-cap stocks will again have their turn in the sun. In the meantime, some of the largest cap, highest quality companies can be bought at attractive valuations not seen in a generation.

Consider just a couple of examples. Cisco has over $4.50 a share in net cash. Using analysts' average consensus estimate of 2011 earnings per share and deducting the net cash, Cisco is selling at a p/e ratio of 10. Backing out Microsoft's net cash of over $4.25 per share, the company sells at less than 10 times 2011 average consensus earnings per share. Particularly in Microsoft's case, reported earnings significantly understate its free cash flow (because of how it is required by accounting principles to book deferred revenues on its income statement). On a free cash flow basis (a better measure), Microsoft is even cheaper! Yes, the company has wasted a lot of money in the past 10 years on failed attempts to diversify away from its main businesses, but it is still hugely profitable, produces a ton of cash, and is in the front end of a huge multi-product refresh cycle. The p/e ratios of Cisco and Microsoft are much lower than the general market and at the very low end of these two companies' historical p/e ratio ranges, evidencing likely undervaluation.

The above valuation process is a gross simplification, and there are a number of problems with it. For example, it is true that if we are to deduct the net cash, then we need to exclude the income earned from the cash from reported earnings (this is not a big problem right now because cash earns no return). Also, most of the cash is kept overseas. To use it for US domestic purposes, Cisco and Microsoft would have to pay a lot of taxes on repatriating that cash. Further, using p/e ratio alone as a valuation tool is problematic. Still the valuation of Cisco and Microsoft is currently so compelling that the adjustments needed to address these problems would not meaningfully change the conclusion that they are drastically undervalued. Cisco has already announced that they will begin paying dividends later this year at around a 2% annual rate. Microsoft is likely to raise its already sizable dividends again this year.

I have little doubt that big-cap stocks will come back into investor favor at some point, as the fundamentals certainly support more enthusiasm. In my view, high-quality, big-cap stocks are one of the most undervalued and attractive market segments right now, and investors with enough patience to wait for the cycle to turn should profit handsomely in hindsight.

Preferred Stocks

By Louisa Ho, *Senior Portfolio Analyst*
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After a "lost decade" of no stock market returns, the pain from the 2008-09 financial meltdown still fresh on investors' minds, and cash earning nothing, investors are increasingly interested in investing for steady income. There are a number of alternatives available, ranging from investment grade to junk bonds, dividend-paying common stocks and preferred stocks. In this article, we explain the pros and cons of preferred stock (a.k.a. preferreds). Known as hybrid securities, preferreds have characteristics of both stocks and bonds. Preferreds occupy a relatively obscure segment of the fixed-income market, and their hybrid nature makes them quite difficult to understand.

Straight Preferreds

Like bonds, preferreds are typically issued with a fixed par value, usually $25, and pay quarterly income based on a fixed percentage of par value, like bonds' coupon rate. Preferred stocks are generally perpetual securities with no maturity. But they may be callable at the issuer's option at some future date, usually at par value or slightly above that. In the event of bankruptcy, preferred stockholders have a priority claim on the issuer's assets which is junior to debt holders but senior to common stockholders.

There are many varieties of preferred stocks, and the terms specific to an individual issue can differ significantly. The basic types of preferred stock include the following:

- **Cumulative preferred stock**, which requires dividends to accrue in the event the issuer does not make timely payments. The unpaid dividends are called dividends in arrears and must be paid by the issuer before making any dividend payments on the issuer's common stock.
- **Non-cumulative preferred stock**, which does not offer the benefit of dividend accruals. If the issuer decides not to make dividend payments, it is not obligated to pay the delinquent dividends at a later time; however, no dividends can resume on the issuer's common stock without initiating them again on the preferred stock first.
- **Callable preferred stock**, which gives the issuing company the right to redeem the preferred stock at a specified date and price (much like callable bonds).
- **Participating preferred stock**, which confers the right to receive, in addition to regular dividends, additional payments based on certain specified circumstances.
- **Convertible preferred stock**, which can be converted into common stock at a predetermined time and price.

As with any fixed-income investment, credit analysis is important prior to investing in preferred stocks. This is particular so since preferreds rank below debt in bankruptcy. Ratings on many preferred stocks are available from major credit rating agencies like Standard & Poor's and Moody's.

Trust Preferred Securities

Preferreds come in the form of **trust preferred securities (TruPS),** issued by a special trust set up by the company raising funds. The special trust buys bonds of the issuer company, and in turn issues TruPS to third-party investors. The TruPS sale proceeds are passed through the trust and transferred back to the company in payment for its bonds. The maturity of the TruPS typically matches that of the bonds in the trust, with the bond interest payments used to pay the dividends on the TruPS. Like traditional preferred stocks, TruPS generally are issued with a par value of $25, pay quarterly dividends, and are callable at the issuer's option a few years following issuance. In the event of bankruptcy, TruPS are senior to the issuer's straight preferred and common stocks but junior to its debt.

The structure of TruPS offers certain advantages to the company raising funds over traditional preferred stocks. Because (unlike preferred dividends) the interest paid on the bonds is deductible, the issuer enjoys a lower cost of funding via TruPS. However, taxable corporations generally find TruPS less desirable than traditional preferred stocks, because such corporations enjoy tax benefits on straight preferred dividend income that are not available on TruPS dividends.

Positive Attributes

The main positive attribute of preferreds is that they pay higher yields than similarly rated bonds and the common stock of the preferred stock issuer. Also, preferreds typically pay income quarterly rather than semi-annually like bonds, allowing for more frequent compounding. Further, preferred dividends must be paid before common stock dividends. Finally, preferreds tend to go down less than common stocks during poor market conditions, because their relatively high yields act as partial price support and because of their superior position in bankruptcy.

Negative Attributes

As with any investment, preferreds possess some negative attributes. Preferreds (other than possibly participating and convertible preferreds) don't have the upside potential of common stock, since straight preferreds do not share in growing profits. It is true that growing profits increase the likelihood of continued payment of preferred dividends, potentially raising the credit rating of the preferred and resulting in some price appreciation. Nevertheless, the fixed par value of preferred and any call feature limit any upside. You should note that preferred shareholders have no voting rights, and cannot influence corporate matters like common shareholders can. Also, unlike bond interest, preferred dividends can be deferred at the issuer's discretion. Unless the preferred is ***cumulative***, the issuer does not have to pay accrued dividends. While suspending preferred stock dividends is permissible, doing so could potentially jeopardize the issuer's future sources of capital funding, as it tarnishes the issuer's credibility and makes future debt and equity offerings possibly cost-prohibitive. It is therefore not in the issuer's interest to suspend dividends for capricious reasons, but only as a last resort.

The call feature embedded in many preferreds can also hurt you. If you buy a preferred at a premium to par value (i.e. for more than $25 a share), you could be faced with having part of your high yield negated by being paid back $25 for each preferred share that cost you more than $25. Especially for preferreds that are selling at a premium to par, you should calculate the yield-to-call, which takes into account the premium price you are paying and the likelihood you would incur a capital loss at the call date.

Like bond prices, prices of preferred stocks also move inversely to interest rates. The degree of movement is proportional to something called duration, which is affected by, among other things, the term to maturity. Since most preferreds have no maturity, they are long-duration assets that are highly sensitive to interest rate movements. Nevertheless, such risk is partly mitigated by the relatively high dividend income payments that tend to shorten duration.

As you can see from the foregoing, preferred stocks and TruPS offer both pros and cons relative to common stocks and bonds. The issue is whether the higher yields that typically come with preferreds are sufficiently high to more than compensate for their undesirable characteristics. The hybrid nature of preferreds makes them quite difficult to comprehend, producing occasional pricing inefficiencies that can be exploited, especially during volatile markets.