Making Sense of Finance

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Second Quarter Review

STOCK MARKET

After a robust first quarter, the U.S. stock market realized a correction in the second quarter of 2012, affected by ongoing economic worries originating from the Eurozone. Following a double digit performance in the first three months, the NASDAQ Composite had the worst performance in the past quarter among all the major U.S. equity indices with a decline of 5%. Even after a strong June performance by the S & P 500 index (+ 4%), it still posted a loss of over 3% for the quarter (Dow Jones Industrial Average decline was slightly less than 3% for the second quarter).

Although stock prices in general decreased in the second quarter, on a more sanguine note, dividend net increases (increases less decreases) were $12 billion, possibly a new record dividend payout in aggregate dollars for U.S. domestic listed common stock issues. Of approximately 10,000 U.S. traded issues, 505 reported dividend increases versus only 37 decreases. Significantly, the payout ratio (dividends per share divided by earnings per share), which historically averages 52%, remained near a low of 31%. This is an encouraging fact which implies room for potential future increases and also highlights the magnitude of the decision to extend dividend tax cuts which are set to expire at the end of this year. Under current legislation, taxes on dividends to individuals could possibly almost triple for the top income earners to a rate of 43.4% (currently 15% on qualified dividends). If Congress does nothing by year end, the Bush tax cuts expire and investment tax rates rise for everyone, regardless of income. Dividends would then be taxed at your ordinary income rate.

Some of the worst performing sectors in the market last quarter were energy and technology. Energy stocks, in particular oil equipment (-13%) and exploration & production companies (-11%), reflected the decrease in oil prices in the past three months (approximately 20%) which was a boon to the consumer at the gas pump. Technology stocks had been some of the biggest gainers in the earlier part of the year and were subject to some profit taking (example

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Everybody and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is more about making sensible and prudent choices based on logic and experience, and not on emotion.

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semiconductor stocks, -11%) but were also affected by concerns of a slowdown in the world economies. Due to the fear of a decrease in economic growth rates worldwide, more “defensive” sectors performed better in the second quarter such as healthcare (pharmaceuticals + 4%) and telecommunication services (+11%).

Foreign stock markets also fizzled after a strong start in 2012. The non-U.S. developed market equity index, MSCI (Morgan Stanley Capital International) EAFE lost 8% in the second quarter. This is after an outstanding June gain of almost 7%. The index managed to hold onto a positive year-to-date return of 1% at the end of June. It is no surprise to most that the European markets weighed down the performance of this index, particularly those countries in the European Monetary Union (for example the MSCI Greece Index and the MSCI Spain Index declined 31% and 15% respectively). Although most Asian markets did decline last quarter, they held up better than their European counterparts. High volatility also prevailed in emerging markets. The MSCI Brazil and Russian Indices posted second quarter returns of – 20% and -17% respectively.

BOND MARKET

U.S. Treasuries gained ground last quarter as yields again dropped. The ten year Treasury yield actually hit a record low of 1.47% on June 1st (German Bund and United Kingdom Gilts also had record low yields on the same day for their ten year securities) before closing out the quarter at 1.67%. Investors were still willing to accept interest rates which have no real inflation adjusted return (May CPI year over year rate was 1.7%) in the name of safety. Very short duration three month Treasury bills barely pay anything, .09% at the end of the quarter. Money market investors know this all too well as money market fund rates are usually tied to short term Treasury rates. An interesting note, recently in Denmark in order to fight a capital influx, their central bank issued two year notes at a negative yield and cut the central bank’s deposit rate to a minus 0.2%!

Besides government bonds, investment grade corporate bonds performed well in the second quarter of 2012. The greater certainty of fixed income securities versus the fluctuating stock values (even given attractive dividend rates) caused most bonds to appreciate last quarter. Municipal bonds were the only bond sector not to show a positive total return in the last few months.

OVERVIEW

Last year, we suggested that there was a possible bubble in internet social network companies. These are more legitimate businesses than many from the late 1990’s, however, their valuations seemed out of step from their true potential earnings. The most prominent of these IPOs are Facebook (FB), LinkedIn (LNKD) Groupon (GRPN) and Zynga (ZNGA). GAAP (generally accepted accounting principles) price-to-earnings ratios for FB and LNKD, are currently 78x, and 287x, respectively, compared to about 14x for the S&P 500. Both Groupon and Zynga are unprofitable based on GAAP accounting. During strong markets, these stocks can do extraordinarily well with valuations built on confidence and optimism; however, when the tide turns, these stocks often deflate to more realistic levels. With our value strategy, we aspire to do better than the average investor by avoiding these deflations in value. For Example, Facebook IPO’d on May 18th at $38 per share and has declined about 16% (it was down over 30%) at one time; Groupon Is down 26% over the same period, and down 63% since its IPO; Zynga, is down 27%, respectively, and down 50% from its IPO price; and LinkedIn was up 4% over the same period but has done well since its IPO. Still, all these tech darlings underperformed the meager S&P 500 index which was up 4.4%.

Since the beginning of the year, the 10-year treasury yield declined from about 1.9% to 1.5%, which we attribute almost entirely to fear. The great fallacy is that bonds are safe and stocks are risky. With long-term average interest rates of between 5%-6% for the 10-year treasury bonds, we argue that fixed income securities are the least safe for investors who do not hold them to maturity. When interest rates rise eventually, bond prices would decline. However, this may occur over years, not months. The better bet in our opinion is to buy good dividend paying “blue chip” stocks that have a strong chance of standing the test of

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time. Currently, the dividend yield for the S&P 500 is 2.2%, vs. 1.50% for the 10-

year treasury. Even more compelling is that over time dividends usually increase in addition to appreciation from the stock itself. This is compared to the 10-year which almost guarantees a loss over time with an unimpressive 1.5% yield, and great potential downside in price if rates rise. The question people often ask is “But isn’t a 1.50% per-year return better than potentially losing money if I hold to maturity?” Yes, but it also guarantees that you will lose money due to inflation which has averaged between 3% and 4% per year over the long haul, or a loss of 1.5% to 2.5% in real value per year. The market has proven that it is fixated on the short term which explains why these incongruous values occur. It is investments in these uncertain times, though, that often yield the greatest returns.

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