



L. Roy Papp & Associates, LLP
Investment Counsel

2201 East Camelback Road, Suite 227B
Phoenix, Arizona 85016
(602) 956-0980
FAX: (602) 956-7053

VIEWS FROM CAMELBACK MOUNTAIN

“Investing for Safety”

Investors are scared to death of stocks. Who can blame them after all the challenges the markets have faced over the past five years. They have been moving out of risk assets like stocks in search of safety.

Investors have moved into cash and bonds and to a lesser degree, gold and some other commodities or hard assets. Over the past five years, \$425 billion has fled equity mutual funds and \$1.178 trillion has flowed into bond funds. In order to make their investments “safe” they are earning almost 0% in money market funds and 0.5%-1.0% in CD’s. In bonds they can earn 1.7% in a ten year U.S. Treasury. All of these assets are returning the level of inflation or less, before income taxes. In riskier bonds, like 30-year treasuries or junk bonds, they can earn 2.8%-5% per year. With interest rates at generational lows, it is most unlikely that rates can fall enough from current levels for bond investors to earn meaningful capital appreciation. In our view, these items are now far more risky than the average stock. The cash moving from stocks to bonds has left stocks relatively cheap in our opinion and made bonds extremely expensive.

Even with the problems of the past five years, the Dow Jones Industrial Average, which closed at 13,104 on December 31, 2012, has recovered to within 7.7% of the all-time high. Stocks have also paid dividends over the past five years and are currently paying dividends on average at higher levels than interest rates on most bonds. The reason that stocks have recovered is that corporate earnings have recovered.

The whole world is focused on the impending fiscal cliff. Republicans and Democrats continue jockeying for political advantage and at this point both appear to be willing to continue the battle into 2013. Beyond the fiscal cliff issues, we have the coming fight over the debt ceiling. We think the likely outcomes are as follows:

- Higher taxes for wealthy Americans
- At best, limited control of government expenditures
- An even more complex tax structure with Alternative Minimum Taxes, depreciation limitations, and excise taxes, all of which will impact wealthier taxpayers to various degrees

Once the near term uncertainty is resolved, people and businesses will be able to plan and adjust. If dividends really do end up getting taxed as high as 43.4%, many companies will reduce or eliminate dividends and use the cash to buy back stock. Investors will make greater use of insurance products and complex tax and estate planning techniques.

For all the bravado exhibited by both parties leading up to the fiscal cliff, it is hard to believe that either party really wants the country to go over the cliff or fall into a recession. On the odd chance that this really does happen, we believe that a recession would be mild and short lived. In such an event,

companies are very well positioned, as they have been very cautious over the past few quarters leading up to the cliff.

Like everyone else, we are frustrated with a dysfunctional government where both Republicans and Democrats have not been willing to control spending and deficits. Nevertheless, we remain bullish on America. Our country is the worldwide leader in technology, higher education, and innovation. While the U.S. has serious problems with mainstream education, our research universities and graduate programs are still the envy of the world. We are tired of pessimistic comments that most of the economically important innovations have occurred over the past 200 years and that future advancements are likely to be less significant. We look forward to major advances in healthcare, electronics, communications, renewable energy and other scientific breakthroughs.

Many of our corporations enjoy global reach and operate much more efficiently than foreign competitors. Our markets are the largest, most efficient, and for all their challenges, the most transparent. We wish government regulators were more effective at preventing trading abuses but our markets are still more fair and equitable than anywhere else in the world. U.S. financial institutions are strong when compared to European banks and financial service companies. When crises occur anywhere in the world, including here in the U.S., investors run to the safety of the U.S. dollar, U.S. Treasuries and U.S. markets.

Over the past several years corporations have adapted well to a more challenging operating environment. They have right-sized staffing and eliminated unprofitable business lines. They have paid off debts and built huge cash reserves. They have invested in productive technology and focused on manufacturing closer to the consumer. The results have been impressive with strong earnings and cash flow which we believe is sustainable. As future challenges arrive with regulation, tax policy, healthcare costs, and others, we are confident that businesses will adapt.

Stocks are currently trading at about 13 times our estimate for operating earnings in 2013. This looks quite attractive to us, particularly compared to most other asset classes as well as investments in most other parts of the world.

We look forward to a fairly quick resolution to the fiscal cliff, a gradually improving U.S. economy, and a good stock market here in the U.S. for 2013. In short, a very happy new year.

Warmest regards,



Harry Papp
Managing Partner
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