



# CLIFFORD ASSOCIATES

*Investment Counselors since 1915*

FIRST QUARTER 2005

## THE INTRINSIC ESSENCE OF A COMPANY

*by Ralph Weil*

Over the years there have been a number of approaches to evaluate a potential equity holding for addition to a portfolio. The two most common are Technical Analysis and Fundamental Analysis. Each of these is further divided into sub-groups. Technical branches off into momentum, chart patterns and other approaches that care very little what the company actually does. Fundamental Analysis, on the other hand, cares very much how the company actually earns its way in the corporate world. We at Clifford follow the Fundamental approach in looking at companies to add or delete from our clients' portfolios.

The basic difference in the two techniques is how each determines the attractiveness of the current price of a company's stock. Technicians believe that a stock's price movement in relation to the market is the key determinant of value. For example, if the market is rising and a stock's price is moving up at a faster rate than the market itself, the stock represents good value. People who follow this approach tend to have high turnover in their portfolios, which not only increases portfolio expenses but can also have a negative impact from a tax

perspective. For Technicians, then, the market itself determines relative value, which can lead to periods of extreme over valuation (1999/2000) or extreme under valuation.

Fundamentalists, on the other hand, focus on financial statements and company operations to find relative value. They look at historical industry and company data to help in forecasting future operating performance. The more company history they have to evaluate, the better the forecast. This work results in an intrinsic or investment value of a company's stock, which can be compared to its current price to determine if it should be bought, sold or held.

The Fundamentalist School can be broken down into two sub-sectors, Top Down and Bottom Up. The two are not mutually exclusive; their differences lie in the initial approach to setting the overall parameters and the importance of individual company characteristics. Top Down starts out with an economic forecast while Bottom Up starts with an individual company forecast.

The Top Down approach assumes that historically, on average, certain industries out-perform during certain parts of an economic cycle and that history will repeat itself. To us, this approach is close to the market timing methodologies used by Technical

Analysis. The technical system, which relies on historic price movement to predict future price changes, is the same as saying "because this industry out-performed historically at a point in time, it will out-perform at the same point in the current economic cycle." One of the great advantages we have at Clifford Associates is an investment team which represents over 200 years of market experience in aggregate. While we recognize there are cycles in the market, and have arguably experienced most of them, we do not subscribe to the belief that these cycles can be used as accurate predictors of a particular industry's performance at a given point in time.

Another difficulty we have with the Top Down approach is the fact that the whole investment process is based on economic forecasts. In our careers, we have read many economic predictions that relate to local, regional,

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**"FUNDAMENTAL ANALYSIS ...CARES VERY MUCH HOW THE  
COMPANY ACTUALLY EARNS ITS WAY IN THE CORPORATE WORLD."**

# LONG-TERM CARE: PROTECTING YOUR NEST EGG

by David Andrew

**M**ost of us would like to be able to look into a crystal ball to see what our lives will be like ten, twenty or thirty years from now. Will we be healthy, or will we need care and assistance from others? Will we spend time in a nursing home? Will we need long-term care?

Sooner or later, each of us will need to focus on how we plan to provide for the long-term care of ourselves or a spouse, parent or loved one. While everyone's situation is unique, this is a subject that is often ignored until a crisis arises.

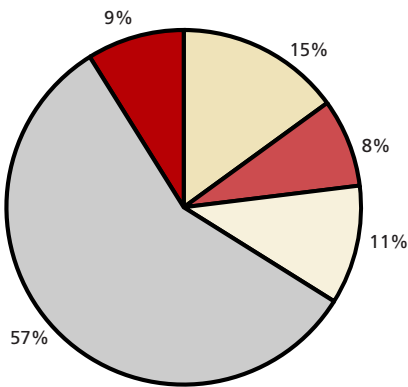
The need for assistance usually results from a disabling or long-term medical or physical condition which may be the result of an accident or sudden illness, or the slow progression

of chronic diseases such as rheumatoid arthritis, Alzheimer's disease or Parkinson's disease. In addition to age and disability, there are other factors that determine the likelihood of needing long-term care services. These factors include gender, marital status, functional limitations, family genetic disposition and the family support system. For example, women are more likely to need long-term care services than men. One reason may be their longer life expectancy; women outlive men by about 8 years. Another reason is that women tend to marry older men. When a woman needs long-term care services they are more often provided by someone other than a spouse. Also, women have more chronic diseases that impair mobility, such as arthritis and osteoporosis, than men.

With increased likelihood of needed care, of course, comes increased likelihood of expense. The Brookings Institute estimates that the average 65 year old person has a 20 percent chance of having no long-term care expenses in a nursing home or at home during their lifetime. The remaining 80 percent will have some expenses. People have a 58 percent chance of incurring long-term care expenses between \$1 and \$50,000, a 9 percent chance of realizing expenses between \$50,000 and \$110,000, and a 13 percent chance of having expenses of \$110,000 or more. However, most nursing home stays are relatively short. Seventy five percent of people who enter a nursing home stay one year or less, and 52 percent stay less

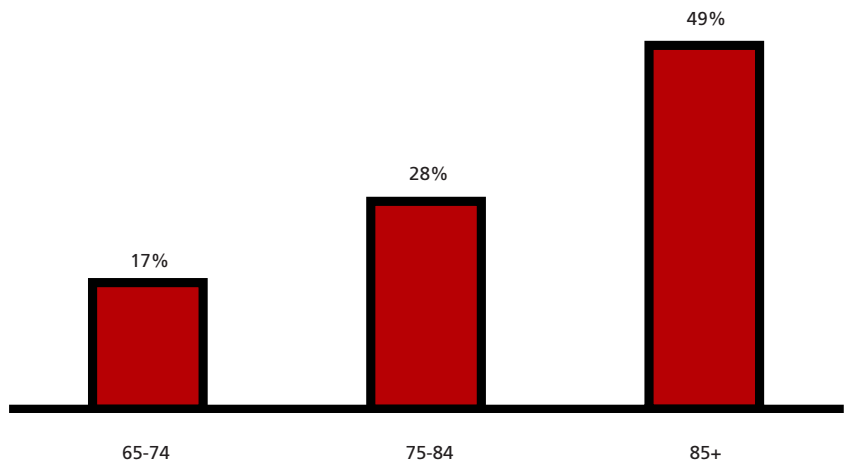
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**Projected Lifetime Use Of Nursing Homes For Persons Who Reached Age 65 In 1990**



Source: Kamper and Murtaugh. Lifetime Use of Nursing Home Care

**The Need For Long-Term Care Assistance In Percentage by Age**



Source: Data from National Center for Health Statistics, Health Interview Survey

**“AT THE END OF THE DAY, THE LIKELIHOOD THAT LONG-TERM CARE EXPENSES WILL IMPACT OUR FINANCIAL LIVES AT SOME POINT IS VERY HIGH, REQUIRING PROACTIVE PLANNING.”**

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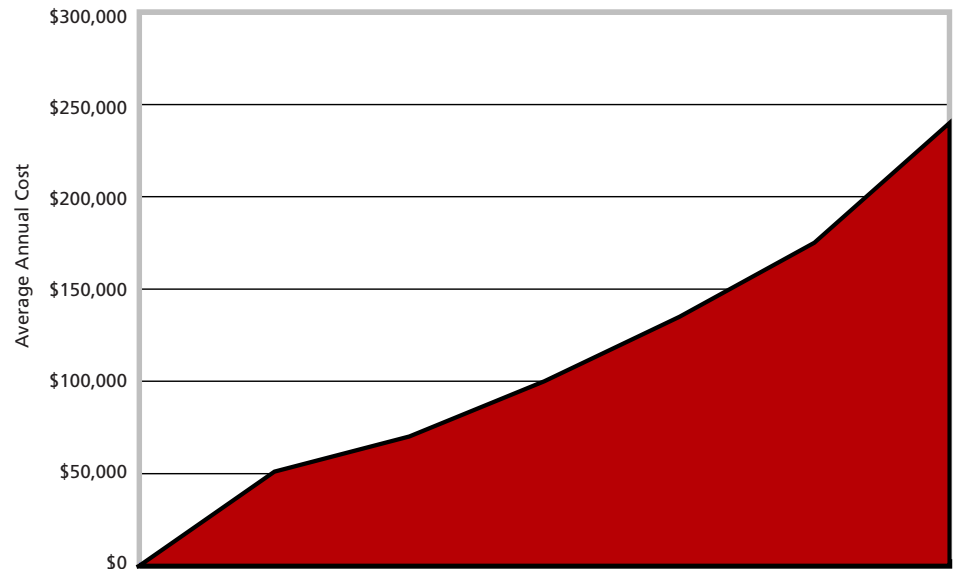
than three months. Typically, nursing homes cost \$3,000 to \$9,000 per month depending on the area and the quality of the facility.

Most long-term care is furnished in nursing homes to people with chronic long-term illnesses or disabilities. The care they receive is personal care, often called custodial care. Medicare does not pay for custodial care. Also, disability insurance does not pay for medical care, personal care or long-term care as its purpose is to replace earned income. Medi-Cal is California's version of Medicaid, a joint federal and state program for people with low income and few assets. Medi-Cal only provides health care services to people on public assistance and to others who cannot afford to pay for these services themselves.

In light of these limited options, many family members provide personal care for their older family members. However, it is difficult to predict if potential caregivers will be available to provide care when you need it. Family members frequently live far away from their older relatives, and providing daily care is often impossible. Families that do live nearby often provide informal care in the beginning, but few families can provide full time care. Most do not have the financial resources to pay for care in an older person's home or in a nursing home.

Another method of paying for long-term care is through long-term care insurance. This type of insurance can cover a wide range of services for individuals when they need long-term care, from home and community

### Average Projected Cost of Nursing Facilities



Source: 2002 California Partnership for Long-Term Care projections based on data from the California Office of Statewide Health Planning and Development and a 5% annual increase.

based care to institutional care. As with most forms of insurance, you cannot purchase coverage after you need the company to pay benefits. Preplanning is required and companies selling this insurance will screen most people for existing medical conditions when they apply for a policy.

Some people may conclude that a long-term care policy is not necessary due to other assets (i.e. securities, home or savings) which could be sold and used for this purpose. The trade-off in this investment decision is a consideration of the returns that could be realized on the money set aside for long-term care insurance premiums if these funds were retained in an investment portfolio whose growth would support future care

needs. Some may decide that they don't want to risk having to liquidate and spend most of their assets to pay for long-term care no matter what the return trade-off might be. Long-term care insurance provides a form of asset protection.

At the end of the day, the likelihood that long-term care expenses will impact our financial lives at some point is very high, requiring proactive planning. The potential solutions to offsetting or insuring against these expenses are varied and can be quite complex. Clifford Associates can help by discussing aspects of the long-term care decision in the context of your individual financial circumstances. We also network with insurance experts who can provide specific advice. §

**“IN ADDITION TO AGE AND DISABILITY, THERE ARE OTHER FACTORS THAT DETERMINE THE LIKELIHOOD OF NEEDING LONG-TERM CARE SERVICES.”**



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national and international segments of the world economy. The amazing thing about these reports is that even when the writers are talking about the same recently released economic data, they can have completely different interpretations of the key elements. Each of these economists, then, translates his or her interpretation of the data into an individual forecast of future economic activity. This results in a large number of predictions with the majority of them being wrong, leading to the question of which prediction to use in constructing our portfolios. Over the years we have found a few economists that are more often correct in their projections than they are incorrect. The key still is that they are wrong more than an acceptable number of times.

The Bottom Up approach starts at the other end of the research process. This approach places an intrinsic value on a company and then compares that value with the current market price. Intrinsic value is determined by evaluating the company's fundamentals and using different techniques to estimate a current intrinsic value.

The process utilizes both qualitative and quantitative variables. The qualitative items include such things as determining if the company is a market leader/market consolidator, does it have a proprietary position, can it control prices/margins, and has it demonstrated an ability to shift strategy as the competitive world changes. Competitors need to be identified so that their strengths can also be evaluated. When looking at qualitative factors, management ownership and insider transactions need to be evaluated.

Quantitative factors weigh more heavily in the establishment of intrinsic value. Quantitative inputs relate to sales, income, cash flow, balance sheet and other items that can be measured in numerical terms. Analysts need to concern themselves with real sales growth, gross margins, administra-

tive margins, EBITDA (earnings before interest, taxes, depreciation and amortization), and dividend growth. In addition, the analyst considers pretax margins, after-tax margins, return on equity, return on assets and other significant financial ratios.

After all of the factors related to establishing intrinsic value are in place and evaluated, the next step in a Bottom Up approach looks at valuation relative to standard ratios such as price/earnings, price/cash flow, price/book value, pe/eps growth rate and, most importantly, price to the estimated intrinsic value.

As mentioned above, the intrinsic value is compared to the current market price and the resulting relationship is used to determine if the stock should be bought sold or held. The two things that must be guarded against in a Bottom Up approach are investment in companies that represent good value but have lost their place in today's economy, and an over-concentration in one or two industry/economic sectors because the companies in those areas represent the best relative value. Clifford's examination incorporates both Top Down and Bottom Up analysis. Our years of investment experience allow us to place the results of our company specific research within the overall context today's investment climate.

In summation, the differences between a Top Down and a Bottom Up approach rest on the idea that in a Top Down environment the individual company's fundamentals are the least important factor in stock selection (economic factors are most important by virtue of being first in the pecking order), while in the Bottom Up arena company fundamentals control the overall investment selection process. With this said, it is clear why we at Clifford Associates, with our long and successful history of fundamental Balance Sheet/Income Statement analysis, follow the Bottom Up approach in the management of client portfolios. §

**“THE TWO THINGS THAT MUST BE GUARDED AGAINST IN A BOTTOM UP APPROACH ARE INVESTMENT IN COMPANIES THAT REPRESENT GOOD VALUE BUT HAVE LOST THEIR PLACE IN TODAY’S ECONOMY, AND AN OVER-CONCENTRATION IN ONE OR TWO INDUSTRY/ECONOMIC SECTORS BECAUSE THE COMPANIES IN THOSE AREAS REPRESENT THE BEST RELATIVE VALUE.”**