

CLIFFORD SWAN THE INVESTMENT COUNSELOR

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MARKET OUTLOOK



By Ralph Weil, CFA

Over the last six months, the equity market has traded inversely with the price of oil. While the trend in oil prices has been rising since the first of the year, the equity markets have had a downward turn. We believe the correlation between the two can be largely explained by: 1) the cost of energy on consumer spending, 2) the impact of energy costs on the economic system, and 3) the resulting inflationary pressures.

Firstly, the most recent Consumer Confidence number came in at another new low for

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DOES THE STOCK MARKET CARE Who is President?



By Mike Davis, CFA, CIC

Presidential election years are always interesting, but this year's election has already captured the public's imagination like no other in recent memory, and we are only through the primaries. As we approach the November election date, the stock market may look for clues as to what the outcome of the vote will mean for stock prices. Will the stock market react more favorably to McCain or Obama, or does it really matter? This is an intriguing question, so we decided to look for answers.

Hypothesis: The stock market does better under Republican presidents.

The basis for this statement can be found in a remark attributed to the American humorist, Will Rogers. When asked if he knew when the Republican party was formed, he reportedly responded, "Yes, it was formed when the first business was started." Indeed, media stereotypes hold that business owners and the wealthy tend to be Republicans, while Democrats are viewed as the party of the working class and social change. Therefore, the stock market, which acts as a barometer of business health, should perform better when government policy is made by the party that favors business interests.

The Evidence:

Many academic studies have examined the possibility of a correlation between

President	Party	Date in Office	Months Stock Return	Annualized
Truman	D	11/48-10/52	48	18.3%
Eisenhower	R	11/52-10/60	96	15.0%
Kennedy	D	11/60-10/63	36	15.2%
Johnson	D	11/63-10/68	60	10.4%
Nixon	R	11/68-7/74	69	-1.3%
Ford	R	8/74-10/76	27	17.2%
Carter	D	11/76-10/80	48	11.0%
Reagan	R	11/80-10/88	96	15.2%
Bush	R	11/88-10/92	48	14.4%
Clinton	D	11/92-10/00	96	19.0%
Bush, G.W.	R	11/00-2/06	63	-0.9%
Average from 1948 to February 2006			Democrat	42.8%
			Republican	57.2%
			Overall	100%
				15.3%
				9.5%
				12.0%

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MESSAGE FROM THE PRESIDENT



By Peter Boyle, CFA, CIC

Just as April showers bring May flowers, April demolition brought May construction and, by the time you read this, June completion of our new office space. Evidenced by the return of pictures to the walls, we must be close. Photos of Phil Swan and three generations of Cliffords now hang across the hall from one another—a comfort to all.

For those who had the opportunity to visit us before construction commenced, a word of caution. Don't turn out of the elevator and wander down the hall as you have done in the past, for you will find our former front door missing. To the pleasure of all, our office doors are now right off the third floor elevator. Drop by when you have a chance and we'll show you around.

As much as we look back and honor the past created by our former firms, we have been busy moving forward in building our new firm together. The first tangible evidence of this evolution has been the hiring of Anil Kapoor who joined us as an analyst in April. Anil, who is both a CPA and CFA, began his career at Ernst & Young before deciding to concentrate on the investment management industry. In his ten years in the industry, he has covered various sized companies in a variety of industries. Given the challenging market environment, he has hit the ground running and already produced some valuable research. Now, if only the market would cooperate.

A couple of closing comments on some of the newsletter articles you may

find timely. Given the turmoil surrounding banks and other financial institutions, we increasingly find ourselves fielding questions regarding the safety of our custodians. Jim Gamb's Q&A covers the ins-and-outs of FDIC and SIPC insurance. And with the primary season behind us, news will turn to the November general elections. We are likely to see market reaction to the varying post-election proposals presented by both candidates, but does the market really care who wins? Mike Davis's article delves into this question.

As I mentioned previously, we hope you enjoy our efforts. As you are reading, if there are any topics you would particularly like us to cover, please let us know.

Enjoy your summer. ♦

MARKET OUTLOOK *continued from page 1*

this cycle implying further slowing in consumer spending. It is logical to tie the lower sentiment to rising energy prices to some degree. Higher energy prices at the consumer level mean that individuals will have less to spend on other goods and services. While in the past an individual could have gone out and borrowed money to make up the difference, in today's lending environment that option can be more problematic.

Secondly, energy costs impact many parts of our daily lives, one of the largest being the transportation of goods from one place to another. As a major chain linking our economy together, the transportation of agricultural products from the farm to the processor, raw materials to the manu-

facturer, and finished goods from the manufacturer to the consumer are all affected by rising costs. For example, transportation costs are now being discussed in conjunction with the growth of manufacturing in China. Even with China's low labor costs, the shipping expense may be pricing their goods out of the market.

Finally, without getting into a long discussion on the true causes of inflation, the price increases for oil will add to inflationary pressure. One of the main components in both the Producer Price Index and the Consumer Price Index is energy. When the PPI and CPI are reported by the Labor Department, there are two sets of numbers for each: one including energy and food and the other without those two

components. We believe that the truer picture of inflation includes the two sectors. Energy is part of almost everything we produce in both goods and services. The added cost of energy will get passed on to some degree in end product prices, thus adding to inflation.

We have seen a similar situation before in the 1970's. Back then, just like now, the price of energy was having a negative impact on the economy. In fact, the importance of oil in the equation was much more significant, because we were not using energy as efficiently then as we are now. Since then, we have grown our economy on less fuel and oil. This is a

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CHARITABLE TRUSTS AND THE IRS Discount Rate



By Ken Dike, Esq., CPA

The monthly IRS discount rate, which is at historically low levels, is used in the present

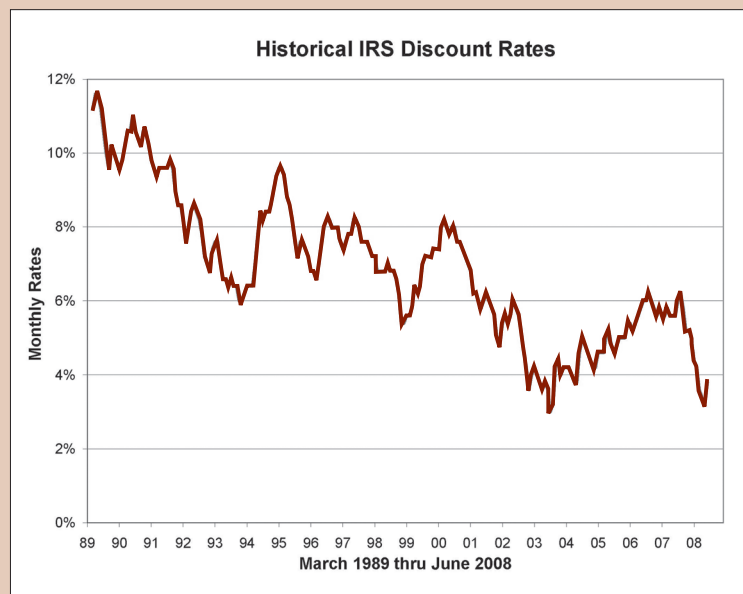
value calculations required for split interest charitable trusts such as charitable remainder trusts and charitable lead trusts. This article will explore the effect of low IRS discount rates on these calculations and how they impact charitable remainder, and lead, unitrusts and annuity trusts.

What is the IRS discount rate?

The IRS discount rate, also known as the *Applicable Federal Rate* or *AFR*, is the discount rate that is used for the calculation of the charitable deduction for gifts to split interest charitable trusts. Published monthly by the IRS, the rate for the month of the gift can be used as well as the rate for each of the two months prior to the gift. This rate is the earnings assumption used to determine the present value of the future cash flows from split interest charitable trusts. The rate is set at 120% of the monthly federal midterm rate rounded to the nearest 0.2%. The federal midterm rate is the average annual yield of U.S. Treasuries with maturities of three to five years as determined by the monthly auctions.

Below is a graph of the monthly IRS discount rates from March 1989 through the most current rate of 3.8% for June 2008 (the discount rate was fixed at 10% prior to March 1989). During this 19+ year period, the rate fell below 4% only twice; April and May of 2004, and March through June of 2008. Also noticeable is an overall decline in rates since their inception with one of the

more significant declines occurring in the past year.



How is the IRS discount rate used in the charitable deduction calculations?

Split interest trusts have two interests; an *income interest* and a *remainder interest*. The income interest is the right to receive periodic payments during the life of the trust and the remainder interest is the right to receive whatever remains in the trust upon its termination. The amount of the periodic payments will fluctuate each year if the payments are based on a percentage of the trust's periodic market value, as in a unitrust, or the payments could be fixed in amount throughout the life of the trust, as in an annuity trust. In a split-interest charitable trust, a charity can hold either the income interest (*charitable lead trust*) or the remainder interest (*charitable remainder trust*), but not both. At any point in time, the present value of the income interest plus the present value of the

remainder interest equals the market value of the trust assets.

The charitable deduction for a contribution to a split interest charitable trust is the present value of the income interest (*charitable lead trust*) or the present value of the remainder interest (*charitable remainder trust*). The variables used in the present value calculation are (1) the actuarial

tables published by the IRS as an estimate of the trust's duration, (2) the IRS discount rate as an estimate of the trust's investment return, and (3) the amount of the periodic payments to be paid from the trust. The resulting present value of the income interest is an estimate of the amount, as of the date of the addition, that would be sufficient to make all the required payments from the trust assuming the trust earned an investment return equal to the IRS discount rate. The present value of the remainder interest is an estimate of the amount that, if invested to earn a return equal to the IRS discount rate, would equal the funds remaining in the trust when the trust terminates.

Holding all else constant, a decrease in the estimated investment return (IRS

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“How to Love Financial Team Sports”



By *Randy Zaharia, CFA*

In a recent interview, Randy Zaharia, research analyst and Principal, discussed the Clifford

Swan research process with his partner, Kathleen Gilmore:

KG: Now that Clifford Associates and Swan Associates have merged, what has been the impact to our investment research effort?

RZ: Stock research is one of those areas where more minds increase the value of the work done. A key benefit of the Clifford Swan merger is the expanded strength of the Research Team and the Investment Committee. In addition to our Chief Investment Officer (with 40+ years experience), there are several full-time and part-time analysts, as well as several investment counselors with substantial analytical background. In fact, we recently added an experienced, full-time analyst to our group, in part, due to the merger. All in all, eleven of us hold the Chartered Financial Analyst (CFA) designation, underscoring our strong analytical and professional standards.

KG: How does the Research Team find new stock ideas from among the thousands of companies out there?

RZ: The resources we utilize are multifaceted, drawing on all the talent and experience of the combined investment team. Many of our ideas originate from the quantitative and qualitative research resources we subscribe to and review. Beyond these research materials, ideas come from the daily exchange of opinions and expertise among the people with whom we interact, whether they are within our own firm or at the confer-

ences we attend or our clients. With the increase to the size of our firm, the number of these interactions multiplies, adding to the depth and breadth of the potential for intriguing ideas.

KG: So, once you find a good idea, how do you evaluate the company?

RZ: When a new stock idea is identified, we assign an analyst to initiate a basic review of the underlying company. We begin with a general overview of the company, the business, and the industry, as well as the financial characteristics... that is, revenue growth, margins, debt, leverage, etc. If the analyst's general sense of the company is favorable, an initial intrinsic value model is run to determine a "rough" fair value for the stock based on the company's discounted cash flow. This gives us a ballpark idea whether the stock has sufficient return potential to justify further work. Ultimately, the analyst prepares a short report which is presented to the Research Team and discussed, eventually resulting in a yes/no vote to continue the research process for that stock.

KG: So, once the Research Team has approved a stock for further investigation, how do you expand the depth and scope of the initial work?

RZ: Following the initial approval of the Research Team, the analyst returns to the earlier materials and supplements them with any additional reports and information he/she can obtain on the company. We have access to financial information from the company itself, third party research, and extensive databases to assist in this effort. Some of the key factors more closely reviewed include the company's control of destiny (especially barriers to entry for their competition), the company's position in the industry and

the marketplace, growth and profitability, financial strength, the market valuation factors (such as P/E ratios and cash flows), and management commitment and quality. With all of this information, we get a sense of the appropriate value for the stock based on estimated earnings and cash flows over a future timeframe.

Eventually, all of the information is summarized by the analyst in a report presented to the Research Team. It is not unusual to have the Research Team identify one or more additional issues that may need to be vetted by the analyst before the stock will be considered further. Once this is done, the group puts the stock to a vote. Usually approved stocks do not have more than one dissenter in the voting group.

KG: That is quite an intensive process. What happens when the recommendation goes from the Research Team to the Investment Committee and how does the Committee add value at this point?

RZ: Well, the Investment Committee has expanded to 15 members now: half is the Research Team and the other half is the Investment Counselors from the combined Clifford Swan professionals. The new stock idea is presented to the group as a whole, with a thorough review of the key factors and a run-through of the valuation models that support the fair value/target price. The counselors have varied backgrounds, and bring different perspectives. As a result, there may be questions that arise that were not previously considered. Once all issues have been addressed, the Investment Committee votes up or down to approve the stock to the Buy List.

Again, the diversity of opinions and insights expressed through this process gains value from the expansion of the

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discount rate) results in an increase to the present value of the income interest (less income means more required up front) and a decrease to the present value of the remainder interest (less income means less funds remaining at termination). The converse is also true; an increase in the IRS discount rate results in a decrease to the present value of the income interest and an increase to the present value of the remainder interest.

For a charitable lead trust that allows the donor a charitable deduction, the amount of the charitable deduction is the present value of the income interest since a charity receives the periodic payments from the trust. For a charitable remainder trust, the amount of the charitable deduction is the present value of the remainder interest since a charity receives the funds remaining in the trust upon its termination.

How much do the present value calculations vary due to changes in the IRS discount rate?

Changes in the IRS discount rate have little effect on the present value calculation for charitable remainder unitrusts and charitable lead unitrusts. This is because, as mentioned before, the periodic payments from a unitrust fluctuate based on the periodic market value of the trust assets. For example, an increase in the IRS discount rate (assumed investment income) increases the value of the unitrust resulting in an increase to the amount of the periodic payments. In this way, the income interest and remainder interest “share” in the unitrust investment income since both the periodic payments and the remainder value will increase due to an increase in the investment income.

Although the unitrust’s periodic payments will increase due to an increase

in the IRS discount rate, the present value of these payments (income interest) will actually decrease. This is because of the “reinvestment of income” component of the present value calculation. The reinvestment of additional investment income from the increase in the assumed rate of return (IRS discount rate) more than offsets the increase to the amount of the periodic payments which, in turn, lowers the present value of the periodic payments.

The following reflects the present value of the remainder and income interest for a split interest unitrust. These calculations, which are stated as a percent of the unitrust’s market value, are based on a 5% payout for the life of a person age 70.

Present Values (percent of the unitrust’s market value)	1% discount rate	10% discount rate
Remainder Interest	53.0%	54.6%
Income Interest	<u>47.0</u>	<u>45.4</u>
	100.0%	100.0%

The payments made from an annuity trust are fixed; they do not change due to changes in the trust’s investment return. The remainder interest bears the full burden of declines in the investment return (IRS discount rate) and enjoys the full benefit of any increases in the return. Therefore, changes in the IRS discount rate have a significant effect on the present value calculations for charitable remainder annuity and charitable lead annuity trusts.

The following graph depicts the present value of the income and remainder inter-

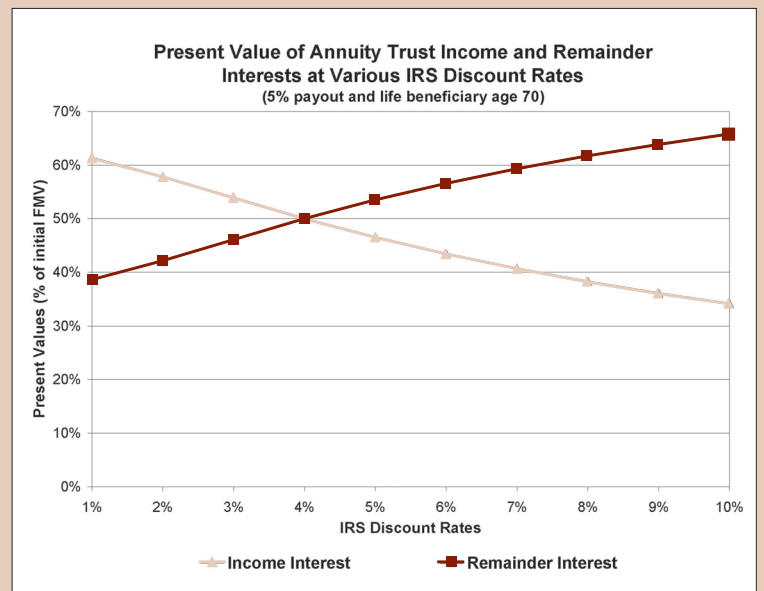
ests for split interest annuity trusts. These calculations, which are stated as a percent of the annuity trust’s initial market value, are based on a 5% payout for the life of a person age 70.

What other calculations are affected by changes in the IRS discount rate?

In addition to present value calculations for charitable deduction purposes, the IRS discount rate is used to determine whether charitable remainder trusts meet certain required tests related to the amount ultimately going to charity.

Both charitable remainder unitrusts and charitable remainder annuity trusts must meet a “10% minimum remainder value” test that requires a remainder interest present value of at least 10% of the trust’s market value. Charitable remainder annuity trusts must also meet a “5% probability of corpus exhaustion” that requires there be no more than a 5% chance that the annuity trust will use all its assets for the periodic payments leaving nothing for the charity upon its termination. These tests are not required for charitable lead trusts since the charity receives the periodic payments from the trust and the remainder, if any, goes elsewhere.

In our next newsletter we will discuss these tests and how they are affected by changes in the IRS discount rate. We will also take a close look at charitable lead trusts, including the types of lead trust arrangements that are available and their tax implications. ♦



DOES THE STOCK MARKET CARE continued from page 1

stock market returns and presidential politics. The results will be surprising to many: the stock market does just as well, and often better, under Democratic presidents as it does when Republicans are in the White House. Data derived from a study done in 2006 by Jeremy Siegel, Ph.D., showing the average annual returns for the Dow Jones Industrial Average under each president for the past 60 years is presented on page one.

Data over longer time periods and using broader indices than the 30 stocks in the Dow Jones industrials, seem to indicate less of an advantage or no advantage for the Democrats. There is no evidence that indicates the stock market favors Republican presidents. Therefore, we must declare our hypothesis null and void.

You may be thinking that it is unfair to focus solely on the influence of the president because Congress also has a role to play. A recent study by Ned Davis Research examines this point. The study looked at the performance of the Dow Jones industrials since 1901, broken down into all President/Congress combinations by political party. A summary of the find-

Party Alignment	Average Annualized Market Gain
Democratic President, Democratic Congress	6.5%
Democratic President, Republican Congress	9.6%
Republican President, Republican Congress	1.5%
Republican President, Democratic Congress	6.4%

ings is presented in the table above.

Clearly, the stock market appears to prefer a divided government with a Democratic president and a Republican Congress. The next best combination is Democrats in control of the White House and Congress. Again, the evidence invalidates our hypothesis.

Possible Explanations:

There appears to be no simple answer to explain the counter-intuitive evidence. Several factors are explored below.

Firstly, the simplistic view of Democrats as the tax and spend, high deficit party and the Republicans as the tax-cutting, fiscally prudent, deficit-reducing party may no longer be valid. For example, President Bush has reduced taxes, but has increased government spending and the budget deficit.

Secondly, when investors envision the impact of one presidential candidate on the stock market, they tend to focus on tax policy as it relates to capital gains and dividends. Thus, Obama's policy platform to raise these taxes has caused concern that stock returns will be eroded if he is elected. This concern may be overblown because other factors could be at work. For example, the stock market investments of many individuals and institutions are held in tax-deferred entities such as IRA's, 401(k)'s, and other retirement plans. An increase in tax rates could actually increase the incentive to save using pre-tax dollars. The resulting

flow of contributions into these retirement vehicles could increase the demand and, all else being equal, the prices of common stocks.

Thirdly, ultimately the health of the stock market is more dependent upon interest rates and growth in jobs, the economy, and corporate profits than it is on taxes alone. From this perspective, the typical Democratic public spending on a broad range of initiatives such as transportation infrastructure, education, and healthcare may provide a stronger boost

to the economy than a more narrowly focused Republican spending on defense.

Finally, a highly regarded article in the October 2003 issue of *The Journal of Finance* by professors Pedro Santa-Clara and Rossen Valkanov of UCLA, among

... it may not be the president who influences stock market returns, but rather stock market returns which influence who becomes president.

other observations, argues it may not be the president who influences stock market returns, but rather stock market returns which influence who becomes president. They argue that when stock prices are high, investors want to maintain the stability identified with the Republican party and vote accordingly. Conversely, when stock prices are low, investors want change as exemplified by the Democrats. With reversion to the mean at work, this dynamic leads to Republicans being elected at the peak of market cycles when the only direction is likely down, while Democrats tend to be elected at the bottom of market cycles when the future direction is likely up.

Conclusion:

The evidence indicates the stock market has performed much better under Democratic presidents than we would have expected. However, the most important takeaway from this analysis may be that market returns, on average, are strongly positive regardless of who is in the White House. Therefore, we hope you will enjoy the excitement this election season is certain to provide, but will take the long view and not become unduly concerned about the effect the outcome will have on your investments. ♦

continuing trend and, given the current rise in the price of oil, we expect a more rapid shift to less oil-based energy consumption. We also believe that the current “sticker shock” at the gas pumps will cause a further shift to alternative fuels.

Ultimately, we believe the equity market anticipates the future by looking at expected inflation, economic activity and profitability, not just in the short term but over a longer horizon. The

recent actions by the Federal Reserve and other Central Banks around the world have given us cause to believe that the problems faced by our economies are being addressed. After seven consecutive cuts in the Federal Funds rate, the Fed is now standing pat. Comments from the Fed make it clear that it is very concerned about inflation, implying that its next move is likely to be a rate increase.

Other Central Banks have already raised their interest rates. These measures should put the brakes on inflation, while still allowing for moderate economic growth towards the end of this calendar year and into next year. Therefore, we believe that sometime before year-end we will see a positive tone return to the equity markets. The road from here to there may get a little bumpy but not enough to cause a serious crash. ♦

QUESTION & ANSWER



By Jim Gamb, CFA

We frequently receive questions from clients who have become concerned about the security of their investments during periods of significant stress in our financial markets or the banking system. The major broker-dealers and bank custodians provide multiple layers of protection through the Federal Deposit Insurance Corporation (FDIC), the Securities Protection Corporation (SIPC), and supplemental private insurance.

What is the FDIC and what level of protection does it provide?

The FDIC is an independent agency established by the U.S. Congress in 1933 to help provide stability to our nation's financial system. In the unlikely event that a financial depository institution fails, the FDIC, if there is any shortfall, makes payments of insured deposits to all of the institution's depositors as soon as possible in accounts up to \$100,000 *per customer*.

How are retirement accounts protected by FDIC insurance?

Certain “self-directed” retirement accounts such as an IRA, a 401K or a state government 457 plan may be eligible for coverage up to \$250,000. “Self-directed” means that the individual chooses where the money is deposited, e.g., a money market fund or a bank CD.

Does the FDIC insure living trust accounts?

They do, and, if certain conditions are met, these accounts may be insured up to \$100,000 per owner for each qualifying beneficiary. The requirements for qualification can be complex and require careful investigation.

What is the SIPC and what level of protection does it provide?

The SIPC is a nonprofit member corporation established by the U.S. Congress in 1970, to which broker-dealers belong. If a U.S. broker-dealer fails, SIPC funds are available to clients to make up for any shortfall in client accounts that the broker-dealer was required to maintain – up to a maximum of \$500,000 per client for securities and inclusive of up to \$100,000 per client for cash.

Is protection provided by broker-dealers in excess of SIPC limits?

Most, if not all, broker-dealers provide

additional coverage which is supplemental to SIPC coverage. For example, Charles Schwab & Co. obtains additional brokerage insurance through Lloyd's of London, which provides protection of securities and cash up to an aggregate of \$600 million for all of Schwab. Merrill Lynch and UBS Paine Webber also insure through Lloyd's of London with similar terms. Fidelity Brokerage Services and other broker-dealers provide supplemental coverage through different insurance organizations; one example is the Customer Asset Protection Company (CAPCO), a licensed Vermont insurance company.

As a general matter, customers are not considered general creditors of a failed broker-dealer; customers receive distributions *ahead of* general creditors. General creditors of a failed broker-dealer do not receive any distribution unless all customers have been satisfied in full. Neither the FDIC, nor SIPC, nor any private insurer provides protection against a decline in the market value of securities. ♦

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Investment Committee. In the end, the counselors not only get to know the stock well but have been provided a forum to debate the application of this stock in their client portfolios.

KG: Once the stock has been approved, how do you monitor and stay up-to-date on it?

RZ: Once a stock is on our Buy List, it is monitored in several ways. First, as its earnings are periodically released, we will recheck the stock and evaluate how the quarter and year are progressing. This “earnings review” includes write-ups and commentaries from various analysts as well as financial results from the company. In addition, we will, at regular intervals, evaluate the entire sector in which a stock resides, causing all the stocks in the sector to come under review. Of course, we are automatically alerted whenever there is significant news on the stock which may drive additional research and analysis of the company. Finally, if the stock price moves up to and/or over the fair value price that we have determined, we will re-evaluate the stock and reconfirm our estimates and assumptions about the company.

KG: OK. So, that is how a stock gets on the Buy List. How do you take a stock off that list? What makes a stock “fall from grace”?

RZ: There are probably two key factors that determine when a stock must be eliminated (or reduced). One, the valuation becomes so extreme that you either have to sell some or all of the stock. For example, let’s say that ABCD Company’s stock has a fair value of \$25 per share according to our research. However, six months later, the stock price soars to \$37 due to a number of factors, some of which might be temporary. The long-term fundamentals of the company still look good. In this case, we might recommend selling some of the position, in order to lock in some of the gains, especially if we felt the price was out of alignment.

The other factor is a fundamental change in the nature of the company. For example, XYZ Corporation, which focuses strictly on industrial products, decides to acquire a consumer products company and a financial services company in order to reduce cyclicalities, but the mergers go poorly with increased expenses. This may be a company that is severely off-track and one we might choose to exit. A real world example is First Data Corporation. In the early 2000s, we owned the stock for various reasons, especially for the Western Union business. However, FDC began spinning off businesses, including its Western Union franchise, resulting in a clear change in the nature and business of FDC. We sold FDC as a result of its change in business operations.

Again, our expanded Research Team has the analytical strength and forcefulness to point to stocks that need either trimming or outright selling. This was and is an area of difficulty for many firms, and a stronger research team helps push both the buy side and the sell side.

KG: Why can selling a stock be difficult?

RZ: There are usually a number of headwinds against selling or reducing stock positions. Two key ones are: 1) the issues an investment counselor faces in managing significant capital gains and 2) the history of success a stock possesses; it can be hard to sell the “winners.” In the case of Clifford Swan, the larger Research Team brings with it additional discipline and analysis; generally the more peers an analyst has to answer to, the more rigor to the discipline. One of the great strengths of our team is that our diversity of opinion and experience ultimately drives a strong consensus around the stocks we choose. If we can all agree to move forward or pull back on a company, our clients know that the choice has our collective brain power behind it.

KG: Randy, we covered a lot of research ground today. Thank you. ♦