



CLIFFORD ASSOCIATES

Investment Counselors since 1915

FOURTH QUARTER 2004

ON TURNING 90

by Kathleen Gilmore

Clifford Associates is an old firm. We like to think we have aged well, grown strong on the talent of our team and the trust of our clients and professional friends. We celebrate our 90th anniversary this year and, as is the case with most significant milestones, we are provided an opportunity to reflect on our legacy and the foundations laid by a visionary individual in the creation of an entire industry and its cornerstone, Clifford Associates.

Ours is a story about providing stability and structure to the financial health of our clients. It begins with the determination of one man, A.M. Clifford, to serve investors on a purely professional and advisory basis, without exposure to conflicts of interest. As appealing as this concept is today, it was revolutionary in 1915 when Clifford first called himself an Investment Counselor. It was not an easy decision for Mr. Clifford. As his grandson, A.M. Clifford II writes, "...after much soul searching with other family members, on August 22, 1921, Clifford announced that henceforth he would serve exclusively as an investment counselor and no longer act as a broker-dealer." Even visionaries need a transition period.

The years that followed have seen many market cycles, the Great

Depression, and two World Wars. We have seen bubbles build and bubbles burst. The question we ask ourselves is: would A.M. Clifford recognize the firm that still bears his name? We think he would. What was true in A.M. Clifford's day is still true about the firm today: objective, fundamental analysis is paramount – both when discussing a client's needs and in determining the merits of a potential investment. The firm's strong proprietary research is the driving force behind our investment work. Though the firm continues to grow, our culture remains true to A.M. Clifford's commitment that we "...consider only [our] client's best interests to the exclusion of every other consideration." These things will never change about Clifford Associates. Indeed, they define who we are.

The function of this anniversary celebration, however, is not just a self-indulgent trip down memory lane. It is also an opportunity to take our best practices and build on them to meet the needs of the next 90 years. To mark this moment in time, both historical and future-sighted, we determined to establish a new "mark" or logo, as representative of our firm. The bridge icon you see for the first time in publication with this newsletter helps graphically tell our story of providing financial stability, spanning generations of clients, based on the

rock-solid foundation of our heritage. Like the bridge, Clifford Associates represents dependability, a less risky and more consistent path forward across the ups and downs of the financial terrain. The bridge is incomplete, for there are generations yet to come, but the pillar is well-grounded and secure, and the arch strong in its support. When A.M. Clifford found a gap between a product / commission-driven financial world and the needs of the client, he built a bridge called the Investment Counseling Industry and made Clifford Associates its cornerstone. Today that cornerstone serves to bridge the gap between our clients' financial success and their continued financial well-being for generations to come. We look forward to celebrating this anniversary year with each of you. **S**

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NO LEGACY IS SO RICH AS HONESTY. —WILLIAM SHAKESPEARE

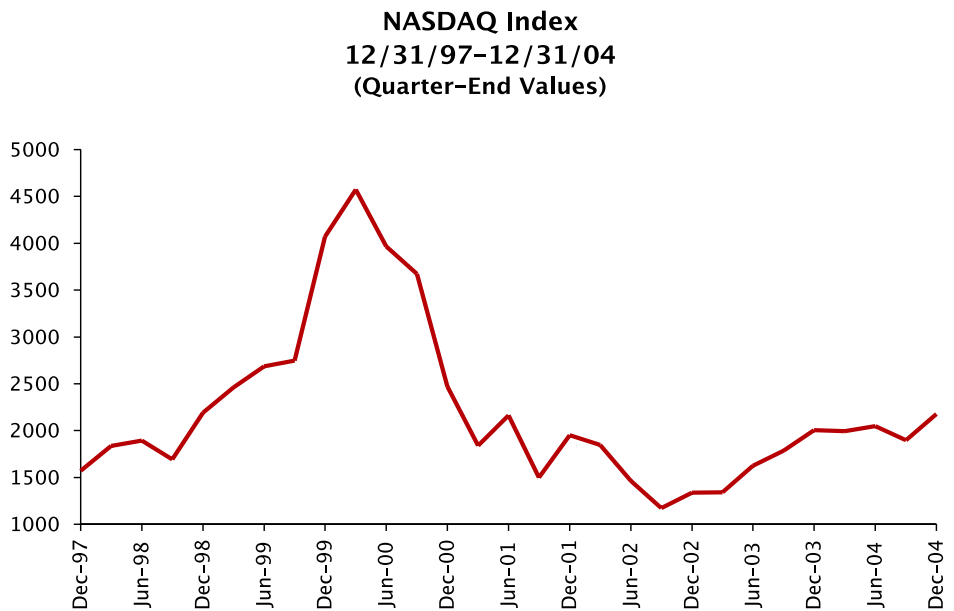
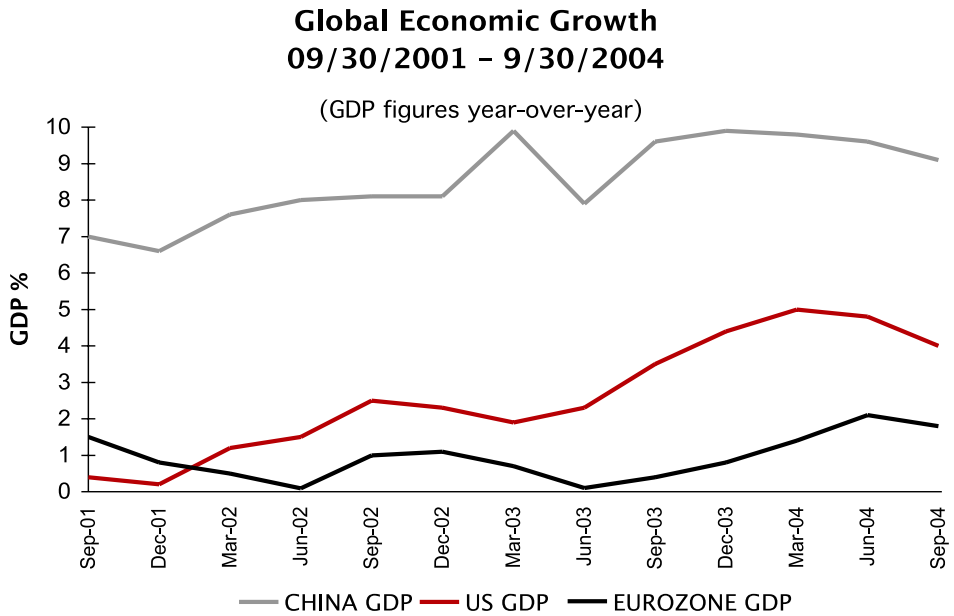
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steady at 2% since mid-2003, and the European Central Bank does not appear to be changing rates in the near term. As a result, Eurozone economic growth has been below 2% with high unemployment. Alternatively, Japan continues to keep its short term rates near 0%, and has maintained those low levels for several years as Japan continues to recover from the significant 1990s downturn. Overall, this points out some countries that appear to be adapting to global economic changes (U.S., Britain, Asia) and those that are lagging in making changes (Eurozone).

These factors have several effects. One, with a stronger U.S. economy relative to Europe and Canada, and with increasing interest rates, the long-term trend could potentially be for a stronger dollar, despite the persistent deficits. This would make the domestic equity and bond markets more attractive over the next several years to foreign investors. Also, this may help keep interest rates from rising too fast and support the idea of gradually increasing interest rates, both short and long term. In this case, a more neutral position on bonds (neither too long nor too short) might be appropriate.

However, at the end of the day, real returns, which are determined by the difference between interest rates and inflation, make the difference. Inflation is much closer worldwide than one would expect. Over the last year, most core U.S. inflation measures were about 2%. In Britain, the main inflation index has been around 1.5% to 2.0%. In Europe, inflation appears to be about 2.0% to 2.5%. In contrast, Japan's inflation rate is basically zero over the last year. Much of the goods from Asia and especially China have been instrumental in keeping inflationary pressures in check, and probably will continue to do so in the future. As a result, inflation levels should be somewhat contained and interest rates may not climb as high.

The point here is that in a global economy with variable interest rates and flexible currencies, real return in the short term is a moving target. We



prefer a long-term perspective to manage these risks. In this respect, the U.S. appears well positioned, as do many of the companies we invest in, for anticipated lower inflation and interest rates. While our bond maturities have been shorter over the last year, we have begun moving to a more neutral stance as a number of factors, including those noted above, draw an uncertain picture of interest rates.

BEHAVIORAL/ PSYCHOLOGICAL RISKS: Not all risks are quantitative in nature. "Perceived" risk can be a

powerful catalyst, albeit not always a rational one. Boom-and-bust cycles are one example of irrational motivations. In 17th century Holland, thousands bought tulip bulbs, believing that the value of tulips would continue to climb. Ultimately, tulip prices peaked and plunged. Several centuries later, in 1980s California, real estate prices took off, and owners began realizing double-digit returns. Individuals began buying second and third homes and selling them months later for a profit.

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RISK/RETURN: “A RUN FOR YOUR MONEY”

“THE RETURN SHOULD BE IN PROPORTION TO THE RISK... [I]F THE RISK IS LARGE, THE INVESTMENT YIELD SHOULD BE LARGE... [AND] IF THE RISK IS LARGE AND THE RETURN INSUFFICIENT, THE INVESTOR HAS NOT HAD A ‘RUN FOR HIS MONEY’—HE WAS NOT ADEQUATELY COMPENSATED FOR THE HAZARDS HE ASSUMED. IT REQUIRES SPECIALIZED SKILL TO MEASURE ‘RISK’ IN ORDER TO KNOW WHAT THE RETURN SHOULD BE” —A.M. CLIFFORD, 1921

by Randy Zaharia

Our founder made these comments during the early years of this firm. The risk/return relationship was important then, and continues to be important today. Yet, what do we mean by “risk/return” and “a run for your money”? In recent decades, the words risk and return have been used so much that they have become mundane. In our Second Quarter 2004 newsletter, we discussed returns in the article “Cash is King” by peeling back the layers of analysis which ultimately define the path by which returns are generated. The task before us is to do the same for risk.

A.M. Clifford was concerned about the probability of loss relative to the return on investment. In other words, if the investor “risked” only recovering \$0.50 from \$1.00 invested, was he compensated appropriately for that “hazard”? Several decades later, the academic giants of the 1950s (Markowitz; Sharpe) modified the risk concept to include measurement of the movement (deviation) of a security or portfolio relative to the return. Yet, defining risk as a simple measurement is too limiting when considering the broader universe of risks—global, economic/financial, and behavioral/psychological—which impact our investment decisions about asset classes, industries, and companies.

GLOBAL RISKS:

Worldwide economic ebbs and flows seem unending, underscoring the risks in a global society. Let’s examine recent developments in Asia as a case in point.

Asian economic power is rising. Economic growth in China over the last 10 years has been about 9% with China becoming one of the largest U.S. trading partners. Specifically, the link between the shift in trade flows in Asian countries and the shift in capital flows is undeniable. In 2003, \$531 billion in capital flowed into the U.S. Of that, 58% came from Asia (China, Japan, others) while 18% came from Western Europe and Canada, a ratio of 3 to 1, underscoring the increasing capital and trade flows from Asia. According to a recent International Monetary Fund study, after adjusting for differences in the prices of similar goods and services between countries, the U.S. economy currently produces over \$11 trillion, followed by China at nearly \$7 trillion, Japan at about \$3.5 trillion, and India at just over \$3 billion. *BusinessWeek*, in its 12/6/04 article, “The China Price,” may have summed it up best: “A massive shift in economic power [towards China] is underway.” Please refer to the graph Global Economic Growth, page 3.

The shifting economic power between Asia and much of the rest of the world are factors we must consider with respect to industries and companies Clifford buys. For example, IBM, the company which introduced personal computers (PC) in 1981, recently sold its PC division to the Lenovo Group of China for about \$1.75 billion. This decision helps IBM increase its software and services emphasis and establish a 19% ownership stake in Lenovo, now the world’s third largest PC manufacturer.

Bringing the Asian economic boom even closer to home, from 12/99 to

12/03, U.S. dollar foreign bank assets increased by about \$1.23 trillion, of which 78% of the increase was accounted for by Japan, China, and the other Asian developing countries. In fact, the amount of central bank reserves that Japan and China each held more than doubled over that time period. The huge reserve balances (predominantly U.S. Treasury securities) raise concerns for the U.S. economy and the potential for increasing interest rates should some balances be liquidated. With these concerns in mind, among others, we have kept bond maturities somewhat shorter over the last year as we anticipated potential increases in interest rates.

ECONOMIC/ FINANCIAL RISKS:

Currency flows could be construed not only as a global issue, but also as a financial issue. From that standpoint, two critical financial risks to consider are interest rates and inflation rates.

In the U.S., interest rates have been rising since mid-2004 with short-term rates currently at 2.25% (up from 1.0%). Britain has increased short-term rates from 3.5% in mid-2003 to 4.75% now. In addition, China’s economy has been growing strongly and it recently increased its short-term rates in order to cool off double-digit increases in lending and asset growth. The bottom line is the faster-growing economies are generally increasing rates.

Some countries are not changing rates at all. In the Eurozone (without Britain), short term rates have been

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However, by the early 1990s, the real estate market had collapsed due to a downsizing defense industry and to a full-blown recession. As a result, housing prices dropped as much as 40% in some areas of California. Foreclosure rates skyrocketed as many people walked away from their homes. A decade later, the stock market peaked in 1999 (Dow Jones) and 2000 (Nasdaq) as the rise of the Internet and the dot.com companies reached a crescendo. At that point, the NASDAQ reached over 5,100 in March 2000 before plunging to less than 1,200 by mid-2002....a decline of over 75% in just over two years, signaling the bust of another boom (see Graph NASDAQ Index, page 3).

What is evident from these three time periods is the repetition of the boom-and-bust cycle throughout history. Other examples include the 1850s California gold rush and the 1870s railroad boom. The phenomenon goes by various names: momentum, herd mentality, unrealistic expectations or Alan Greenspan's "irrational exuberance." Ultimately, the cycle was a volatile combination of greed and fear. At Clifford Associates, we utilize an independent approach and comprehensive analytical tools, combined with the extensive experience of the staff (over 200 years), to evaluate individual stocks and general industries. This process allows us to determine what we think the "fair value" of a security is, regardless of the market. Clifford Associates looks for good companies at solid values, a process that tends to avoid boom-bust cycles.

The boom-bust phenomenon garnered recognition in international economic circles. Dr. Vernon Smith, Professor of Economics at George Mason University, received the 2002 Nobel Prize for Economics for his work on experimental economics. Dr. Smith's research in the economics laboratory found that first time participants, given information common across all participants, managed to create a boom-and-bust bubble in a laboratory stock market. Subsequent repetitions reduced the severity, as it appeared people eventually did learn consequences (experience). Another significant finding was that markets operated more effectively with inefficient dispersion of information rather than common dispersion of information (i.e., markets work better

with everyone thinking independently using his own available information). From an investment standpoint, we at Clifford Associates have long eschewed the herd mentality of Wall Street analysts, believing in the power and discipline of fundamental research over the lure of momentum investing. As a result, in-house, independent research is a hallmark of Clifford Associates investment counseling.

IN SUMMARY: WHAT IS RISK?

In the phrase, "risk-and-return", determining the return from the investment sometimes can be easier than determining what the risks are. As A.M. Clifford noted, "it requires specialized skill to measure" the risk and return relationship, and at Clifford Associates, that begins by assessing the full context of the stock and the portfolio. For that, we draw on the extensive expertise and background of our principals and staff.

There are basic risk metrics and broader conceptualizations of risks (of which we have just explored a few), all of which attempt to get to the essence of what risk is. Recently, Glyn Holton (*Financial Analysts Journal*, Nov/Dec 2004) wrote that risk "is exposure to a proposition of which one is uncertain". He notes the incompleteness of measuring risk when he states that "it is not so easy to operationally define perceived risk because perceived risk takes many forms. To simplify the task, we may operationally define some *aspects of perceived risk*... [W]e adopt risk metrics—such as variance of return or maximum likely credit exposure—to define specific aspects of perceived risk." In other words, one cannot easily capture risk in a single measure like standard deviation. Risk exists in a broader and more extensive sense, and serious consideration must be given to many of its aspects.

So, how does one know that the investor has had a "run for his money"? In a Clifford portfolio, we feel that many risk components have to be considered, including quantitative measurements such as standard deviation. In the final analysis, what Clifford Associates brings to the investment counseling relationship is judgment: our ability to take in all the relevant factors and make the optimum determinations, given our best analysis and expertise. Our track record is solid for investors who remain focused on the long-term. We call that a good "run for their money." §