



CLIFFORD ASSOCIATES

Investment Counselors since 1915

FOURTH QUARTER 2006

ESTIMATES, ASSUMPTIONS, AND SHOTS IN THE DARK

By Randy Zaharia

Okay. The “shots in the dark” line is a little over the top, and really meant to grab your attention. However, the other two, “estimates” and “assumptions,” are indeed instrumental in much of the research process at Clifford Associates, especially as they relate to a specific company and stock analysis. Let’s take a closer look at this process in our continuing efforts to remove the “mystery” of investing for our clients.

GENERAL OVERVIEW

The individual stock research we do is typically described as “bottom up” analysis. This approach primarily emphasizes the unique strengths, weaknesses, and valuation of a specific company with secondary consideration to other issues such as economic cycles and industry dynamics. For example,

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**THE INDIVIDUAL STOCK
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TYPICALLY DESCRIBED AS
“BOTTOM UP” ANALYSIS.**

IS THE CAMEL BACK?: MEDICARE PART B MEANS TESTING

by Peter Boyle

January 2007’s mail will bring more than the traditional post-holiday credit card bills. For thousands of Medicare beneficiaries, it will also usher in a higher Medicare Part B bill from Uncle Sam.

While most seniors have focused on the benefits of the prescription drug benefit (Plan D) portion of the Medicare Modernization Plan of 2003, an additional provision will likely garner significant attention in 2007. Under this provision, the size of the premium that a senior pays for Medicare Part B will, for the first time, be calculated on a sliding scale based on income - in other words, means testing.

Until this year, the premium that nearly everyone paid was set at 25% of the cost of the program or \$88.50 per month in 2006. The federal government picked up the tab for the balance. Beginning this year, to offset rising healthcare costs and the high cost of the prescription drug program, Congress and the administration chose to reduce the subsidy for higher-income seniors. Interestingly, this provision was not contained in either of the initial House or Senate bills, but added later in conference committee.

For those individuals [couples] with Modified Adjusted Gross Income (MAGI) less than \$80,000 [\$160,000], the only increase will be the cost of the plan itself, which is currently priced at \$93.50 per month for 2007. But for

those seniors with modified AGIs greater than \$80,000 [\$160,000] there will be an additional surcharge based on a sliding scale ranging from 13% up to 73% (\$12 - \$70 per month for 2007). By now, most seniors should have already have been notified of their own 2007 Part B calculation.

If there is any silver lining to be found, it is the fact that these surcharges will be phased-in over 3 years, but that also means 3 consecutive significant increases for affected seniors. Also, unlike AMT, the income brackets will be adjusted for inflation beginning in 2008.

While important, why does this discussion find its way into our newsletter?

Though the calculation for 2007 has been made, the investment decisions seniors make now may impact Part B premiums in 2009, 24 months from now.

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FUNDED WITH REAL ESTATE**

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FOE OF THE CHARITY’S PLANNED
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our first step is to sort through a universe of individual stocks using a set of quantitative criteria, ultimately creating an initial “attractive valuation” group of companies. From this group, we begin to look at a wider universe of data and issues (e.g., control of destiny) to begin to isolate strong candidates. In contrast, a “top down” approach would systematically start with global and national economic cycles, then flow to sectors and industries, and finally end with an individual company. The key is where the primary emphasis is placed, since aspects of all this data are incorporated in a company’s analysis.

The global and US economic cycles, as well as patterns within the economy and within industries, can have a strong influence on key inputs into our analyses of companies, particularly after the initial screens provide attractive candidates. Two key quantitative variables would be revenue growth patterns and margins. To illustrate the interplay between specific company variables and more macro-economic issues, let’s consider two specific sectors: energy and healthcare.

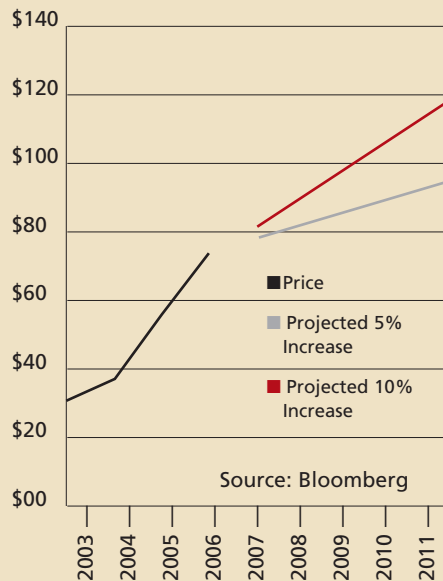
ENERGY SECTOR

A key assumption among investors, including ourselves, is that energy costs will continue to climb over the next five years. Given the increasing demand for energy from not only the developed world (US, Europe, Japan), but also the escalating needs of India, China, and the Asian-Tigers for oil and other energy sources, we anticipate the price of oil could increase significantly. Over the last three years, oil has more than doubled from roughly \$30 per barrel to over \$60 (at one point, over \$70 during 2006).

...A COMPANY WITH SPECIALIZED EXPERTISE...MAY BE ABLE TO WIDEN MARGINS...AS WELL AS INCREASE REVENUES...

Oil Prices

West Texas Intermediate Crude for the period 2003 to 2011



Assuming annual rates of increase between 5% and 10%, the price of oil could reach \$80 to \$100 per barrel by yearend 2011. Overall, this would imply a positive economic tone for energy stocks.

Within our analysis, we would incorporate this stronger revenue growth trend into our models and assumptions. In addition, a closer analysis of company operations might suggest what the possible trend in margins would be, given the company’s strengths (e.g., exploration and drilling vs. marketing). Does a company’s dominate position make a difference? Is the management a notch above the competition? Does a specific energy service provider have a seeming monopoly on a new technology? Does a company’s huge natural gas reserves make a significant difference over the next five years? These types of questions go into determining what level of margins we assume for many of the companies we analyze. Obviously, other factors are incorporated, but these two (revenue growth and margins) are critical ones to our analysis.

Many of these answers translate into actual and specific inputs. For example, an energy company’s superior management may lead it to acquire more profitable assets and eliminate minimally profitable ones,

ultimately increasing margins and overall profitability. Also, a company’s dominate position might allow it to take on large development projects as other companies and countries turn to it for expertise and capital. This may translate into both higher revenue streams and improved operating margins. A small 0.5% increase in operating margins can easily result in a fair valuation of the company’s stock that is several dollars higher. Finally, a company with specialized expertise, especially when increasing oil prices are initiating more development projects, may be able to widen margins (say, up 5% to 10% in absolute terms), as well as increase revenues (up 15% to 25%, vs. 5% to 15%). Given this expertise “barrier to entry” and its positive benefits to the company’s stock, the fair value of that company may have increased significantly. Overall, it is possible to draw out benefits and extrapolate the estimated impacts on the stock’s target price.

The above approach assists in determining the “estimates” that go into our analyses. Informed “assumptions” also influence our decision making, often leading us to approach a given sector from less obvious or more unconventional directions. We question, what companies might be significantly involved in providing equipment to the energy and utility industries? What companies might be needed to construct new facilities and plants? What technology companies might benefit from increasing energy costs? In the recent past, this has lead us to consider several industrial companies, as well as some technology companies, that we felt were indirect beneficiaries of the apparent trend in the energy sector. For example, General Electric (GE) has significant operations in power turbines, in more fuel efficient locomotives, and in nuclear energy, making GE an attractive consideration from an energy perspective.

HEALTHCARE SECTOR

In the healthcare sector, there is yet another long-term secular trend, although this is a much more

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pronounced and growing one: the increasing demand for health services by the “baby boomer generation” (defined as those born between 1946 to 1964 and roughly 42 to 60 years of age). As this generation, which is now in its 40s and 50s, moves into its 60s and 70s over the next several decades, the demand for healthcare will skyrocket. Applying microeconomics, when a limited or modestly growing supply meets a substantial increase in demand, there will inevitably be a spike in healthcare costs.

A major player in this entire sector is, of course, the federal government (Medicare) and to a lesser extent, the states and cities. In the last 12 months alone, we have seen a significant expansion of Medicare prescription drug benefits, most likely signaling additional federal involvement in the years to come. As a result, our choice of healthcare companies must take into account not only the demographic trend noted above, but also the current and possible governmental regulation within the healthcare area. Even with increased regulations, some companies may benefit (e.g., generic pharmaceuticals - at least, some of them).

The challenge, then, is to sort out the conflicting forces in this area, and to ask a number of probing questions. If the government is already involved in prescription healthcare, will big pharmaceutical companies suffer? Will generic companies benefit? What about international companies? What about biotech research and the resulting pharmaceuticals? What is the impact of governmental regulation in the managed healthcare area? If services are squeezed, are hospitals to be avoided? What is the least likely industry to be squeezed by these pressures? Labs? Orthopedic companies? Medical device companies? Specialty companies? Overall, which industries within healthcare will be the least restrained by federal regulation? Which industries will benefit best from the increasing demand for medical goods and services?

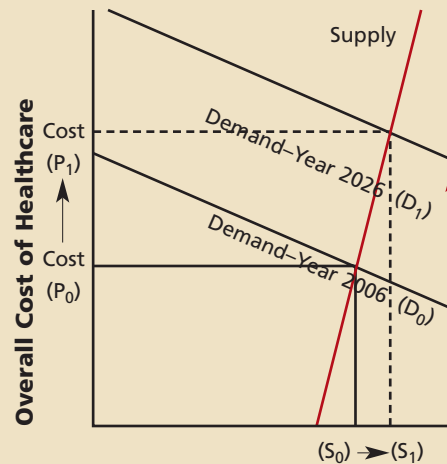
Again, it is possible to project out the possible benefits and costs to a

INFORMED ASSUMPTIONS

**ALSO INFLUENCE OUR
DECISION MAKING, OFTEN
LEADING US TO APPROACH
A GIVEN SECTOR FROM
LESS OBVIOUS OR MORE
UNCONVENTIONAL
DIRECTIONS.**

specific company. For example, given the recent Medicare prescription changes and the growing involvement of government in the prescription drug area, we have scaled back future expectations on new drugs, given that many of the more marginal drug developments will be curtailed. Following this logic, most large pharmaceuticals are expected to have lower revenue growth and narrower margins. Much of the market has anticipated this and the stock prices for big pharmaceuticals have come down in response. Our projections, based on reduced revenue flows and tighter margins, has substantiated much of these declines in pharmaceuticals. On the other hand, some of the more “technology” driven areas of healthcare have significant opportunities for upside as revenue and margin growth are significantly more attractive. These areas include biotech, medical devices, and other related industries. Even among the managed care areas, there have been some companies which have demonstrated superior management skills in keeping costs under control. As a result, the revenue stream and operating margins have been much higher than their peers, and the resulting fair valuation of the company’s stock may reflect those facts. Drawing on a previous example, GE also has a significant presence in healthcare, especially in the fast growing high-tech areas including magnetic resonance imaging, as well as others.

As seen from these two different



Overall Supply of Healthcare Goods and Services

Due to aging baby boomers, healthcare demands will increase substantially (D_0 to D_1) over next 20 years (2006 to 2026). It’s expected that the supply of healthcare will probably only increase modestly (S_0 to S_1) while the cost of healthcare, assuming no change to the current healthcare system, should jump dramatically (P_0 to P_1). The supply of doctors, nurses, etc., typically increases very gradually.

Limited Supply + Huge Increase in Demand = Substantial Cost Increases

sector views, themes and trends can assist in identifying potential beneficiaries, as well as help make estimates of revenues, margins, and other key data points. With better estimates, we can produce valuation targets with higher degrees of confidence. In addition, new ideas or “out-of-the-box” connections may lead us to other investment possibilities. Ultimately, all managers and analysts have to work with the same vast body of information, so all must operate with uncertainty and make estimates and informed assumptions—both good and bad. Clifford Associates, drawing on over 200 combined years of expertise and skills among its professionals, provides reasoned analysis and a disciplined approach with a focus on the solid cash returns valuation of each individual company. It is on this solid footing that we build attractive and thoughtful portfolios that should do well over the long term. §



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Is the Camel Back? continued from page 1

Let's go back and explain this thought more thoroughly. The legislation defines a new tax term, Modified Adjusted Gross Income which you will not find on your tax return. Instead you will find a more familiar figure, Adjusted Gross Income (AGI). AGI is gross income (including wages, dividends, interest, capital gains, income from retirement accounts, alimony paid to you) less any business expenses and deductions like retirement account contributions or alimony paid by you.

To determine Modified Adjusted Gross Income (MAGI), one begins with AGI, but adds on tax-free income. It is this MAGI which is used to determine the appropriate income bracket and related surcharge. Below is one estimate from The Senior Citizen League of 2007-2009 premiums using average annual growth rates in base premiums:

no provisions for smoothing one-time realized gain events over a period of years, and, as a result of the timing of the filing of tax returns, the premium impact of such events are felt in the future and not when they occur. For instance, 2005 tax returns are the basis for this year's calculations, so gains taken in January 2005 affect current 2007 premiums. While cloaked as a premium surcharge, in essence seniors are at risk of being "taxed" twice in these circumstances: first on their income tax returns and a second time through an increase in a future year's Medicare Part B premiums.

But does this have investment implications? In the area of capital gains, it is clearly worth monitoring whether an anticipated transaction pushes MAGI into a higher bracket. As outlined in the chart below, the estimated 2009 premium difference between the first and second bracket is over \$500 annually and over \$800 annually between the next two brackets. In most

Estimated Part B Premiums Under Means Testing

MAGI: Individuals	MAGI: Filing jointly	Monthly premium in 2006	Monthly premium in 2007	Monthly premium in 2008	Monthly premium in 2009
Under \$80,000	Under \$160,000	\$88.50	\$93.50	\$104.30	\$116.50
\$80,000 - \$100,000	\$160,000 - \$200,000	\$88.50	\$105.80	\$132.20	\$163.00
\$100,000 - \$150,000	\$200,000 - \$300,000	\$88.50	\$124.40	\$173.90	\$232.90
\$150,000 - \$200,000	\$300,000 - \$400,000	\$88.50	\$142.90	\$215.60	\$302.80
Above \$200,000	Above \$400,000	\$88.50	\$161.40	\$271.82	\$372.60

There are two areas of concern with regard to this new premium calculation: the inclusion of tax-free income and the impact of realized capital gains. Adding tax-free income to the calculation for MAGI could result in a higher Part B premium. This is particularly relevant for high income tax states such as California, as seniors are more apt to own tax-advantaged municipal bonds. This is not the first time, however, that the camel has stuck his nose under the tax-free income tent. The taxability of Social Security income is also impacted by the level of tax-free income a recipient receives.

With the shift to a sliding scale based on income, realized capital gains from the sale of a business, residence or stocks could also result in a higher Part B premium. There are

cases, the premium difference will not drive investment decisions, but should always be considered for its financial consequences.

For tax-free income, there does not appear to be the same implications and it is unlikely to change the appropriateness of municipal bonds for our clients. Interestingly, because MAGI is calculated without regard for the taxability of income, seniors presumably should be better off from a premium surcharge standpoint with 80 cents of tax-free income generated from lower yielding municipal bonds than \$1.00 worth of taxable income.

As a final comment, this indirect "taxation" trend is important to watch because without taxpayer, or in this case senior citizen, pushback we may see it pop-up elsewhere. **\$**