CLIFFORD SWAN
The Investment Counselor
Serving Clients Since 1915 | First Quarter 2014

Sticking to Our Knitting

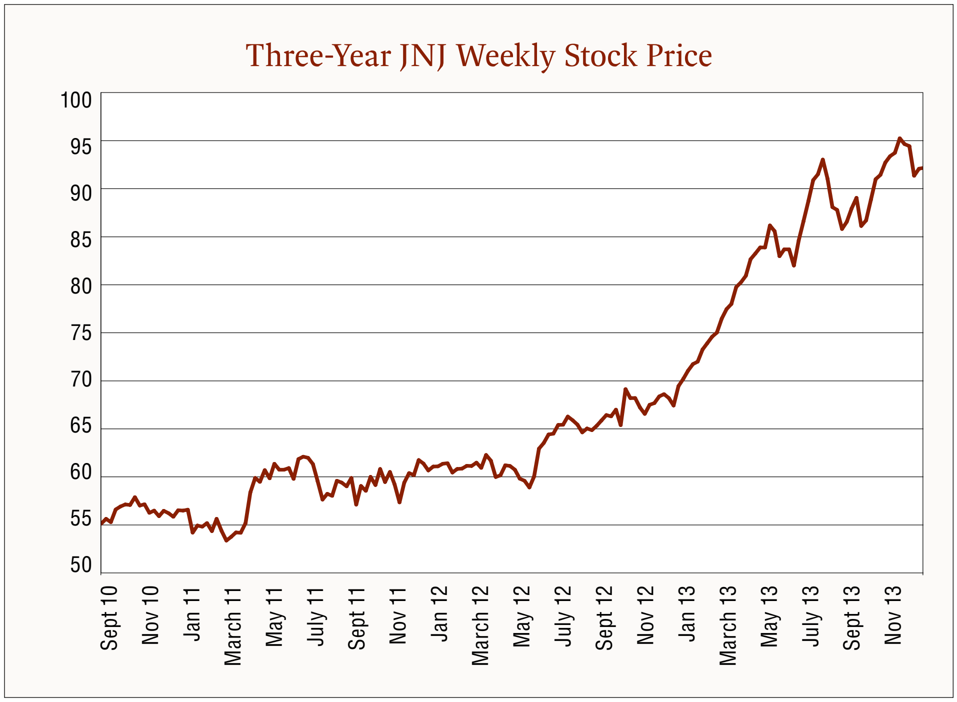
By Anil Kapoor, CFA

Throughout the history of our firm, we have sought to make our investment philosophy and the logic behind portfolio structures transparent and understandable. One question we have been asked is why our investments may lack hyper-growth characteristics. As our clients know, we tend to gravitate towards more established, high-quality companies. Our portfolios have growth, but the focus is on investments that display steady recurring revenues and high profit margins/returns, purchased at attractive valuations. This can test an investor's patience when they see smaller, enticing, richly-valued corporations doing well. However, as has been the case through much of our past, 2013 proved to be a good environment for our style, and we anticipate that will be the case again in 2014.

Among the many things we consider when entrusted with your wealth, two factors are:

1. **Capital Preservation:** While our primary focus is on downside protection, we still expect to capture most, if not all, of the upside.

2. **Minimizing taxes (for taxable accounts):** We are generally averse to realizing short-term gains and subsequently creating a large tax expense. Our priority is long-term capital appreciation with a keen focus on after-tax returns.



SOURCE (BLOOMBERG)

With our minds on capital preservation and tax efficiency, Clifford Swan may lag relative to the Standard & Poor's 500 Index (S&P 500) in years like 2013, where equity markets were up over 30%. Often, during really strong years, there is an industry or sector that grabs the attention of the masses. We tend to shy away from these hyped investments as they are usually fad-oriented and overvalued. When things go badly in the companies, capital can vanish quickly and permanently.

In 2013, our portfolios did well as a result of several factors:

1. **Rotation into dividend-paying stocks:** With interest rates on bonds remaining extremely low, there was a continued attention paid to dividend-paying stocks on the part of many investors, particularly those relying on income to survive. As a result, prices of these stocks continued to be bid up. Great examples of this rotation out of bonds and into the stock market are the Johnson & Johnson (JNJ) securities. In the December 2010 issue of this newsletter, I wrote about an interesting phenomenon. At the time, JNJ's stock was yielding 3.5% at an attractive valuation, while its bonds were only yielding 2.6%. Since then, JNJ stock has appreciated

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almost 50% and we have collected 3.5% in dividend income each year. Combined, that is a return of almost 60%, while JNJ bonds returned only 9% in total (see Three-Year JNJ Weekly Stock Price chart on Page 1). This example is a microcosm of what has been happening across the marketplace: stocks are being viewed as an important source of income. Over 80% of S&P 500 companies now pay dividends, and with the investor appetite for income, management teams are continuing to grow these payouts at a healthy clip.

"As the calendar has shifted into 2014, valuations for stocks are not as attractive as they once were."

2. **Stability rewarded:** Up 39%, one of the top performing sectors in 2013 was Healthcare. Many of our portfolios are heavily weighted within Healthcare as it generally provides safety even during economic downturns. The sector includes historically stable industries such as pharmaceuticals, medical devices, and generic drugs. The Consumer Staples sector (toothpaste, food, etc.) has been another winner for us over the last couple years, although it lagged behind other sectors a bit in 2013.

3. **Earnings matter:** Over the long run, companies that execute on business fundamentals will outperform. In 2013, we saw correlations between stocks decline, meaning that those firms that executed and achieved earnings targets outperformed, while those that missed targets underperformed. Since our companies often have less earnings risk, we tend to do well in this environment. This is in contrast to markets in which a "rising tide lifts all boats," both good and bad.

As the calendar has shifted into 2014, valuations for stocks are not as attractive as they once were. On a stand-alone basis, the S&P 500 is trading at a 17x P/E (price/earnings) multiple. This is at the higher end of the range for the past ten years. Also, relative to bonds, stocks have lost some of their appeal. The biggest indicator of this attractiveness is the difference in yield on the 10-year Treasury note versus the earnings yield on the S&P 500 (inverse of the Price/Earnings ratio).[1] The current yield spread is 2.9%, while it was 6.4% at this time two years ago. It has averaged 0-2% over the last 50 years, so 2.9% is still above the norm and points towards equities potentially outperforming bonds.

The biggest wildcard for 2014 is how the Federal Reserve (Fed) will begin to scale back its assistance to the economy. Since the downturn in 2008-09, the Fed has pumped unprecedented amounts of liquidity into the financial system. The final phase of the liquidity pump was dubbed Quantitative Easing, or "QE." The last part of QE consisted of approximately $85 billion in U.S. Treasury and mortgage bond purchases per month—a little over $1 trillion per year. These purchases effectively take the bonds out of peoples' hands and replace those bonds with cash. This cash is then hopefully used to purchase goods, invest in riskier assets like stocks, or invest in growing a business. All three of these alternatives should help foster economic growth versus just holding onto bonds. There is no doubt that on the margin, QE has helped the economy, but it is difficult to quantify how much. Can we say with certainty that most of the additional cash created was used for investments and purchases? Probably not.

QE is now getting closer to its end with bond purchases slowing down, a process referred to as "tapering." Just as we do not know how much QE helped, it is hard to quantify how much the taper might hurt. The first soft indication of tapering was provided by the Fed in May 2013; in response, equity indices plummeted for two days. Subsequent to that, on December 18th, a concrete figure of $10 billion per month in reduction was announced (from $85 billion to $75 billion) and the equity markets staged a broad rally. All indications are that the taper will be deliberate. However, the varied reactions thus far lead us to believe there is some uncertainty. Due to this uncertainty, when the taper does take hold, we could get a correction to the market. Whether as a direct result of the diminished purchases or just the psychology behind it, equities may suffer a bit.

We continue to believe that our investments in higher-quality companies can provide protection against market uncertainty, like we are facing with the Fed's taper. If we do get a substantial sell off, we hope to preserve more capital than riskier managers. Additionally, individually-tailored portfolios with appropriate allocations to liquidity and income producing securities should provide further cushions in the event of an economic downturn. ◆

"... our investments in higher-quality companies can provide protection against market uncertainty ..."

1 The lower the P/E ratio, the cheaper a stock is relative to its earnings. Earnings yield is the inverse of the P/E ratio expressed as a percentage. The higher the earnings yield, the cheaper a stock is relative to its earnings.

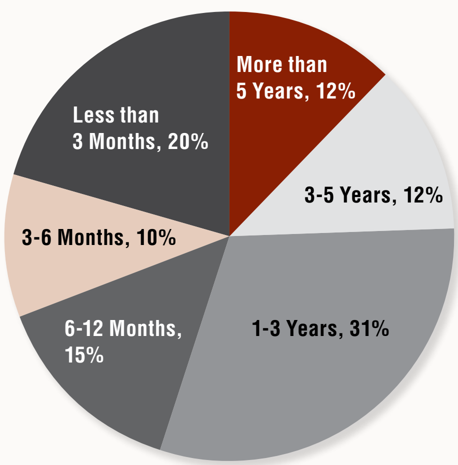
Long-Term Care Insurance: What You Need to Know

By Maxwell R. Pray, CFA

Considering whether you will need long-term care, and determining how that need will influence your financial picture, requires careful thought and planning. You must first determine the likelihood of being a candidate for long-term care. Then, if the need for long-term care is likely, what are the ways to fund it? Various factors can help to determine which mode of funding is most appropriate.

The need for care usually results from a long-term medical or physical condition, which could result from an accident or sudden illness, or the progression of a chronic disease. Other factors that contribute to the likelihood for care include age, gender (women are more likely to need long-term care because they tend to live longer than men and have higher rates of disability and chronic health problems), genetic disposition, functional limitations, and family support system. A significant disease that often requires long-term care is Alzheimer's, which affects about one in nine people 65 and older. The odds increase with age, with approximately a third of those over 85 having Alzheimer's. A unique aspect to Alzheimer's is that it usually lasts longer (4-8 years) than other serious illnesses, and long-term care support is important. If there is a family history of Alzheimer's, it is especially important that long-term care insurance be considered.

Average Length of Stays (Nursing Homes)



SOURCE (U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES)

There are four basic ways to pay for long-term care: Medicare, Medicaid, self-financing, and long-term care insurance (LTCI). There is no easy answer concerning whether you should get LTCI, but as a general rule of thumb, if you have between $500,000 and $5 million in assets, LTCI may be necessary. For those with less than $500,000 in assets, the cost of LTCI may be prohibitive. If someone has over $5 million in assets, self-financing is often the best option for long term care.

The first thing to consider is what Medicare and Medicaid cover. Medicare will help pay for a short stay at a skilled nursing facility, hospice care, or home health care, if you meet the following conditions: 1) A recent hospital stay of at least three days; 2) Admittance to a Medicare-certified nursing facility within 30 days of a prior hospital stay; 3) Need for skilled nursing services or therapy. If all these conditions are met, then Medicare will pay for the first 20 days, followed by any amount over $140/day for the next 80 days. After day 100, you pay for any additional care. Once your personal savings have been depleted, Medicaid kicks in.[1]

For additional coverage beyond Medicare, one option for those who fall in the range between $500,000 and $5 million in family assets is to purchase long-term care insurance. To break-down the decision process for these individuals, personal needs and the offerings from the industry must be jointly considered.

Over the last few years, we have seen some companies stop providing LTCI, including well-known names like MetLife, Prudential, and the Unum group. The two major reasons for this are record-low interest rates and uncertainty regarding future claims. Low interest rates inhibit the ability of insurance companies to earn a decent return on the assets they manage to pay future claims. A number of factors influence the uncertainty about future claims. These include underestimating how long policy holders will live, the rapid rise in health care costs and a dropout rate that has been much lower than estimated. Insurance companies had predicted a 5-7% dropout rate for policies written in prior decades, and that rate has been running at less than 3%. If a 2-3% dropout rate had been used in actuarial assumptions, policies would have been priced with about 20% higher premiums. Due to these factors, we have seen companies increase premiums

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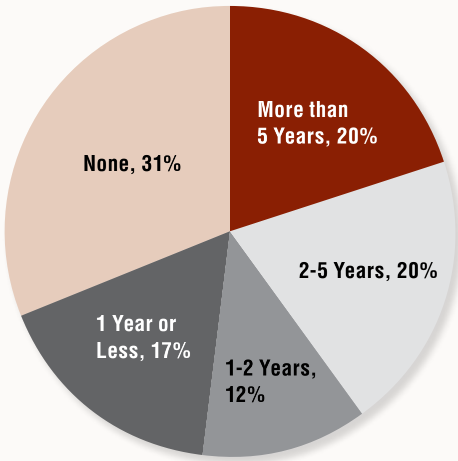
recently as much as 20% to 40%. For a relative comparison of health care costs, just five years ago the median yearly cost of a nursing facility was $67,000; today it is $85,000.[2]

With this backdrop, when considering the purchase of a long-term care policy, have clarity around the following:

1. What services are covered? Nursing care, home health care, and assisted living are typical. Also, make sure mental/nervous disorders like Alzheimer's are covered.

Estimated Years of LTC Needed After Age 65



SOURCE (U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES)

2. How much does it pay for each level? Typically $150-200/day is covered for 3-5 years. Skilled nursing can be up to $200/day, while in-home health assistance (which provides for basic needs like shopping, cleaning, and cooking, but not skilled health care) for a four hour block may be $80/day.[2]

3. What is the waiting day period before care coverage starts? Sometimes referred to as the "elimination period," this is the amount of time that needs to pass after the individual begins receiving a long-term care service and before the policy begins to pay. A typical elimination period is 90 days.

4. Is there an inflation adjustment feature, and is it simple or compounded? The range is usually between 3-5%. For example, a policy that has a 5% compound feature would have benefits that are automatically increased each year by 5%, compounded annually. So a policy that provides $100/day would provide $105 the next year and $110.25 (5% more) the second year. A simple plan would only go up $5 every year (not 5%).

5. Will I have friends/family that will contribute to my care? If not, LTCI may be a more vital option.

6. Be aware of state Long-Term Care Insurance Partnership policies, a concept that started in the 1990s to provide individuals access to Medicaid under special eligibility rules if they require additional LTC beyond what their policies provide.

Of course, we can't ignore the question of the likelihood of need, and cost of that need, in determining what coverage is appropriate. Estimates are that the average 65 year-old person has a twenty percent chance of not having long-term care expenses. Most people will have medical costs of less than $100,000, but insurance is normally bought for the "what if" or worst-case scenarios. Of those that enter a nursing home (not a retirement home), the average stay is 2.4 years, though many stay one year or less; they either get better or pass away.[3] However, one issue our society is facing is that with all the advances in medicine and healthcare we are living longer and, as a result, sometimes living sicker longer—not a pleasant thought, but a true fact. The consequence of this is that the average length of stay may increase over time.

The national median daily rate for a nursing home is $222 (semi-private) or $248 (private), and in-home health aid (personal care assistance) is $18-$19/hour. The national median monthly rate for an assisted living facility is $3,550. Some cities are higher (e.g. New York City) or lower (e.g. Little Rock).[2]

So what does this all cost? Keep in mind that most individuals apply for LTCI between the ages of 52 and 64, when premiums are more manageable. Today, a typical 60 year-old may pay $3,000-$4,000 per year for a long-term policy with a 90 day waiting period, 5% inflation protection, and which provides $6,000/month in benefits for three years.[4] If an individual knew they would require a nursing facility at age 85 for 2 ½ years, they would definitely sign up for the policy.

It is also worth noting that LTCI may be a deductible expense for income tax purposes (depending on adjusted gross income limitations). If you have a permanent life insurance policy or annuity that you may not need, you may be able to move the money tax-free to pay for LTCI. Hybrid policies may be another route to take, where a combination of LTCI and a life insurance or annuity product are combined.

Every individual's situation is different, so discussion is important and there may be more than one way to meet your needs. With a better understanding of what is happening in the long-term care industry and assistance from financial resources that include your investment advisor, your accountant and your insurance agent, everyone ought to be in a position to evaluate whether LTCI makes sense for their situation. But ultimately, the first discussion to have is with your friends and family, as they are the number one source for assistance to the elderly in the United States today.[5] ◆

1 Centers for Medicare & Medicaid Services (accessed January 1, 2014); available from http://www.cms.gov/.
2 MetLife (accessed January 1, 2014); available from https://www.metlife.com/.
3 The Federal Long Term Care Insurance Program (accessed January 1, 2014); available from http://www.ltcfeds.com/.
4 American Association for Long-Term Care Insurance (accessed January 1, 2014); available from http://www.aaltci.org/.
5 Congressional Budget Office (accessed January 1, 2014); available from http://www.cbo.gov/.

Philanthropy from the Donor's Perspective

By Bruce. C. White

Many of our clients are either active philanthropists or seeking opportunities to positively impact their communities. If you are considering contributing to a not-for-profit, there are several factors to keep in mind to make your gift as effective as possible. Before focusing on financial donations, however, we want to acknowledge that the gift of your "sweat equity," given by serving as a board or committee member, or offering your expertise in management, investing, fundraising or life experience, can sometimes be the most effective gift of all.

Donors often ask us to help them determine an appropriate dollar amount for their charitable gift in the context of their individual tax and financial situation. From a broad perspective, the amount given should be driven by a desire to make a real impact on the charity without endangering your personal financial goals. The method of the gift can help focus on a range of appropriate amounts. Although tax considerations should never be the only reason to give, they are a benefit that should be considered.

There are many ways to gift, several of which are explored here:

Giving cash or an appreciated security is the simplest way to give. The avoidance of realizing a gain on real estate or appreciated stocks, along with the deduction for the market value of the gift for assets that have been owned for more than one year, can allow for a larger gift with less impact on the donor's financial well-being. IRS rules change often, so it is critical to secure the advice of a tax professional before a gift is given. For example, appreciated securities must be in the control of the charity before sale or the capital gain is still the donor's taxable obligation.

Should a donor make a **restricted or unrestricted gift?** An unrestricted gift is used at the discretion of the charity's board of directors. It may be added to an endowment pool for later use, or spent immediately on a current project. A higher level of confidence in the leadership of the organization

"The donor advised fund has many of the advantages of the private foundation and few disadvantages."

is required, but the flexibility of the unrestricted gift is better for the organization. The restricted gift is designated by the donor for a specific purpose, such as a building fund, a scholarship, endowing a professor chair, supporting a specific research project, or adding to the endowment fund with the caveat that principal cannot be spent. These may be more attractive gifts as the donor can see the donation's results more clearly, but restricted donations can cause problems for the institutions as missions and programs evolve over long periods of time. To allow for appropriate levels of flexibility within a restricted gift, a discussion with the charity is important.

For many years, Clifford Swan has been very involved in working with not-for-profits' **planned giving** programs. These programs use several types of fund pools and trusts, creating both a tax advantage and income for the donor. A more detail description is beyond the scope of this article, but other Clifford Swan newsletters have detailed some of those options and their benefits. Your investment counselor would be happy to discuss planned giving vehicles and help you decide if they are appropriate for your financial and gifting goals.

Testamentary gifts are very attractive when evaluating the effect of a gift on personal long-term financial goals, as they are distributed from the estate after the money is needed. Testamentary gifts do reduce the estate for heirs, so that must be evaluated. Considering a testamentary gift presents an opportunity for a conversation with the next generations about the importance of supporting the not-for-profit community.

Private foundations provide a vehicle to make charitable contributions with significant control and flexibility over giving. As these foundations can live in perpetuity, they provide both an opportunity to involve future generations and to make an impact well into the future. Because private foundations are subject to complex IRS regulation and some taxes, they are most commonly used for larger philanthropic gifts.

The **donor advised fund** has many of the advantages of the private foundation and few disadvantages.

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Community foundations organize and offer these funds with some varying characteristics. Brokerage firms have also offered their version of a donor advised fund for several years. Donations to the fund are tax advantaged immediately and will allow a larger donation as a portion of adjusted gross income than a private foundation (please see your tax advisor before committing to a gift). The ability to recommend the charitable beneficiaries while relinquishing the administrative burden is attractive. Donor advised funds can also be a solution when a private foundation becomes too small, expensive, or cumbersome to successive generations. The private foundation can be donated to a donor advised fund and effectively closed while retaining the original intent. For these and other reasons, the donor advised fund approach has grown twice as fast as family foundations over the last twenty years. We have helped facilitate the establishment and management of these funds for many of our clients.

"It takes careful consideration to determine which methods will be of the greatest benefit to both you and the charity whose mission you want to support."

In conclusion, the reasons for individual gifting and the vehicles for doing so are varied. It takes careful consideration to determine which methods will be of the greatest benefit to both you and the charity whose mission you want to support. If you are interested in giving, or want to reevaluate your gifting strategy, please don't hesitate to speak with your investment counselor. We always enjoy a conversation with our clients about giving to charities as part of their investment objectives and community support. ◆

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Message from the Chairman

By Linda Davis Taylor

As we start off the New Year, I am happy to announce the newest addition to our team, Thomas Moritz. Tom joined the firm January 1st as an Investment Counselor. In addition to managing portfolios and working with clients, Tom brings over 20 years of experience in equity research to our firm.

Tom graduated from the University of Southern California with a B.S. in Business Administration and received an MBA from Claremont Graduate School. Additionally, he has earned his Chartered Financial Analyst (CFA) designation. Prior to joining the firm, he was a Partner at Crowell, Weedon & Co., where he was responsible for research and portfolio management.

Tom shared with us his thoughts on why he is dedicated to our profession: "Helping clients reach tangible financial goals with carefully constructed portfolios and a sound investment strategy is exceptionally rewarding."

Born and raised in Southern California, Tom lives in Arcadia with his wife and two daughters. Before entering the financial world, he played for the Chicago White Sox for four years.

Thomas Moritz

Please join us in welcoming Tom to the Clifford Swan family. He can be reached at tmoritz@cliffordswan.com. ◆