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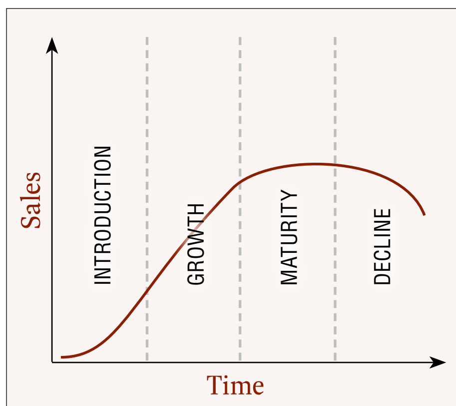
Is the PC Dead?

by Lloyd Wong, CFA

Headlines abound touting the death of the personal computer (PC). Just this past July, it was widely reported that personal computer shipments in the second quarter declined 11% globally, the fifth straight quarter of declines and the worst downturn since the advent of the PC. Is the PC dead? No. Should I be selling all my PC-related stocks? Probably not. In order to analyze why one might want to hold onto PC-related stocks (in spite of the PC's journalistic obituary), let's examine the life cycle of a company and how this concept informs our investment decisions.

There are different stages in the life cycle of a company, originating from **introduction,** to **growth**, advancing to **maturity**, and eventually, to **decline**. Companies in different stages exhibit different characteristics in terms of leverage (debt), profitability, cash flow, and yield. How a company utilizes its resources and how its products or services are adopted or consumed in the market place are also critical indicators of a company's life cycle stage. Progression through these stages typically takes many years, and each stage can interest investors for different reasons.

In the **introduction** stage, when a company's products are initially brought into the marketplace, the company is often strapped for cash. Introduction-stage companies rapidly burn through financial resources by ramping up manufacturing and spending on marketing and promotions. There are large upfront costs as companies accumulate capital, hire workers, and build infrastructure to develop products and services. While there may be few competitors, there are also few sales and often negative profits. Company leadership may need to borrow money through the debt markets and plow whatever precious cash they make back into the company to increase manufacturing and build inventories to meet increasing demand for their products.



It is difficult to anticipate which firms will succeed past this stage. Studies have shown failure rates of startup companies to be as high as 75%, with companies running out of money, ideas, or both. As a result of the high risks involved, companies in this stage tend to be more speculative in nature and, therefore, do not fit the appropriate risk/reward profile for many of our clients' portfolios. We need only reference the dot-com bubble for examples of these types of investments.

Companies in the **decline** stage are also of little interest to investors. In this stage, companies experience declining sales growth, declining prices, and declining profits, with demand shifting from products the market perceives to be obsolete to newer alternatives. The company lays off personnel and cuts costs, eventually looking for a buyer or shutting down. Through the years, the PC industry has seen many companies come and go. We are reminded of the likes of Commodore International and AST Research which have been supplanted by the likes of Google and Amazon.

From an investment standpoint, we are most interested in companies that are in their growth or mature stages. When companies emerge from the introduction stage and enter the **growth** stage, there may be little competition early on for their products and services. As sales growth starts to accelerate, these companies become more profitable. They may need additional funds to exploit all available growth opportunities, and they may go public. Potential competitors notice the handsome returns and begin entering the growth-company's market.

From an investor's perspective, companies that are in the **growth** stage tend to be cash poor, may have debt on the balance sheet, and experience faster than average growth. Since both sales and earnings grow at both higher and accelerating growth rates, investors are willing to pay more for them as, reflected by their above-market Price-to-Earnings

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(P/E) and Price-to-Sales ratios. These companies don't usually have the resources to pay a dividend and generally increase value through price appreciation. Other characteristics include higher sensitivity to stock market movements, with a tendency to do better than the overall market when stock prices are rising. Investors in growth-style stocks require a slightly higher risk tolerance, as well as a longer time horizon. Examples today are Facebook and LinkedIn.

By contrast, as a **mature**-stage company faces increasingly significant competition for its products or services, its profit margins may begin to narrow and it may no longer experience accelerating growth, but its growth rate is still positive. For these companies there is less need for debt, returns on equity start to stabilize, and financial statements are healthy. Cash flow is strong.

This stage can persist for some period of time and is typically the longest stage of a company's life cycle. As long as sales and profits are stable, there is not a great incentive to change the status quo. These companies focus on cost control and efficiency rather than novelty. The tendency is to follow competition and imitate rather than lead. It is also at this point that a company may need to make decisions regarding resources—either by innovating new features in their products in order to increase market penetration or by deciding to forego margins in order to become the low cost provider of that product. In the latter case, the product becomes increasingly undifferentiated as the market becomes saturated with competitors. Hence, the commoditization of the PC and concern over its ultimate demise.

If a company successfully focuses on innovation rather than imitation, and is able to renew growth by becoming more inventive, expanding product lines, and/or acquiring other companies, it can enter a stage of diversification or revival and stave off decline. At this stage, a company will redirect its focus from controls and efficiency to customers and markets as a means of differentiating existing products or services, introducing new products and services, or expanding to new markets.

From an investment standpoint, companies that are in the **mature** stage tend to have debt free balance sheets, lower P/E ratios, be slower growing yet have steadier growth, and tend to be cash rich and have steady cash flows that can be used to pay dividends and buy back shares. Today Microsoft and Intel are examples of mature companies. Mature, established companies generally exhibit lower business risk and higher predictability of earnings.

From an investment standpoint, then, we are most interested in companies that are in either their growth or mature stages.

From this perspective, we can see that something has happened to many of the "growth" companies of the PC industry. With slower growth rates over larger bases and good dividends, several of these companies appear to have entered the mature stage of their life cycle. Their stocks are attracting a different type of investor: the value-style investor. Value-style investors focus on perceived safety rather than growth, often investing in undervalued, mature companies that are primarily using their earnings to pay dividends. Value-style companies tend to produce more current income than growth-style companies and offer the potential for long-term appreciation if the market recognizes the intrinsic value of the companies. While both styles of investing have their specific risks, growth-style investing generally represents a greater risk than value-style investing.

This style shift in the PC industry investors parallels the life cycle changes within the companies themselves. Ideally, companies will try to prolong desired stages of the life cycle (**growth** and **maturity**) and forestall the negative stage of **decline** through innovation or acquisition. Many companies in the PC industry have long growth stages due to upgrades in hardware, services, add-on features, and new products. Apple is a perfect example of a PC company which has successfully revived itself through innovation. While its legacy has been in its computers (Apple I, Apple II, Lisa, Macintosh), in recent years it has experienced a renaissance through its iPod, iPad, and iPhone products.

What about the PC industry itself? It too continues to evolve. Even the definition of "personal" in "personal computer" has changed to become synonymous with "mobile," reflecting the mobile lifestyles of those who go to work and school. The boundary separating PCs and tablets is blurring with tablets now able to functionally do 80% of what previous generations of PCs could do. There are more innovations in the works, such as "hands free" features for PC wristwatches, longer battery usage with improved chips, and improvements in security (e.g., retina, thumbprint, or cardiac rhythm recognition). Despite the apparent death knell for the PC, more than 300 million units are expected to be shipped globally this year. While the consumer PC market may be shrinking as family members increasingly use tablets and smartphones to complement their existing PCs, the business PC market remains significant and is forecast to grow at a rate of about 10% per year for the next few years.

In summary, the PC industry and PC-related companies have grown nicely through the years, and we continue to look to them for solid investment opportunities. Regardless of the industry in which you invest, it is important to buy the right stocks at the right price with an understanding of where they are in their life cycle. Each company develops at its own pace. Thus, determining where a company lies on the life cycle continuum can sometimes be difficult. Yet, as we hope to have clarified in this article, where a company is situated in its life cycle can have different risk implications for shareholders. ◆

President's Perspective: Are Investors any Safer?

by Peter J. Boyle, CFA, CIC

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") was signed July 21, 2010. It brought the most significant changes to U.S. financial regulation since the Great Depression. At 850 pages, it touches every federal financial regulatory agency and almost every corner of the nation's financial services industry, including Clifford Swan.

For our clients and readers, I want to explore whether, for all this effort, individual investors are better protected.

We have seen positive steps: overall stability of the financial infrastructure, increased regulation of advisors to hedge funds, limitations to financial institutions' ability to invest their capital in private equity and hedge funds (the "Volker Rule"), improved regulation of the rating agencies, enhanced whistlerblower programs, and increased shareholder voice in executive compensation. However, the actual implementation of many programs has yet to be accomplished. For example, the re-privatization of the mortgage market languishes as Fannie and Freddie continue to operate under government receivership.

For individual investors, a key issue is outlined in Section 912 of Dodd-Frank. This section requires the Securities and Exchange Commission (SEC) to conduct a study to determine whether the current standards of care—fiduciary duty for investment advisors and suitability for broker-dealers—are sufficient and/or whether they ought to be "harmonized."

What are the origins of these two standards of care? Broker-dealers must comply with NASD Rule 2310, under which they are required to conduct due diligence in two areas: 1) to know their customer, and 2) to know the security, so that any recommended security is suitable based on their knowledge of the client—hence the "suitability" standard.

Investment advisors are governed by the Investment Advisors Act and its judicial interpretations, which recognize investment advisors owe clients a fiduciary duty. The Act doesn't mention "fiduciary" or "fiduciary duty;" instead this standard has been shaped via the statute's judicial history and the SEC's public documents, speeches, and enforcement actions.

> **"An Investment Counselor... should place himself in a position to consider only his client's best interests to the exclusion of every other consideration."**

Two specific quotes help clarify what is meant by the fiduciary standard of care. In the SEC vs. Capital Gains Research Bureau, the Supreme Court commented that investment advisers are fiduciaries with "an affirmative duty of 'utmost good faith and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' ... clients."

In a 2006 speech before the Investment Adviser Compliance Summit, Lori Richards, then Director of the SEC's Office of Compliance Inspections and Examinations, commented: "I would suggest that an adviser, as that trustworthy fiduciary, has five major responsibilities when it comes to clients. They are: 1) to put clients' interests first, 2) to act with utmost good faith, 3) to provide full and fair disclosure of all material facts, 4) not to mislead clients, and 5) to expose all conflicts of interest to clients. These responsibilities overlap in many ways. If an adviser is putting clients' interests first, then the adviser will not mislead clients. And, if the adviser is not misleading clients, then it is providing full and fair disclosure, including disclosure of any conflicts of interest."

The distinction between the two standards of care will continue to be debated as investment advisors and broker-dealers compete for retail investors. Investor protection will remain a challenge to regulate, examine, and enforce, since issues of suitability and fiduciary duty are often measured in shades of grey, as opposed to black and white issues like insider trading. In black and white areas, the SEC and state regulators will continue to make progress. But regarding the standards of care issue, the SEC is hamstrung by lobbying pressures.

We continue to believe that investors need better protection. Too many seeking our services walk through Clifford Swan's doors with "suitable" portfolios which were not built with the investors' interests first—a critical, if "grey," area of distinction that after 20+ years as a fiduciary, can look more "black and white" to this advisor. Perhaps it's the legacy of our founder, A.M. Clifford, who wrote almost 100 years ago, "An Investment Counselor... should place himself in a position to consider only his client's best interests to the exclusion of every other consideration." These words predated the Investment Advisor Act and have always defined our firm's fiduciary standard of care.

Somewhat timely, I recently received an updated brochure published by the Investment Advisor Association (IAA) entitled, "Cutting through the Confusion: Where to Turn for Help with Your Investment." As a member of the board of the IAA, it is our hope that this brochure will lessen the confusion which exists regarding various service providers in the financial services industry. A copy is available on the IAA website, or call our office and we can send it to you. ◆

Market Outlook

by Randall L. Zaharia, CFA

Asset returns over the 12 months ending September 30, 2013, have been a contrast in results. U.S. equities returned roughly 20% (as measured by the S&P 500 index) while bond returns, depending on the sector, declined 1% - 3%, due mainly to increasing yields. Much of the decline in bond returns occurred from May to August in reaction to comments in June 2013 by the Federal Reserve (Fed) and its chairman, Ben Bernanke, suggesting that the U.S. central bank was ready to reduce the massive degree of monetary stimulus.

This stimulus was provided through the outright purchase of government securities—also known as "quantitative easing" (QE). Short-term rates were expected to remain near zero into 2015. These actions were dependent on economic data, such as unemployment and inflation. The Fed expected real economic growth (GDP) of 2.5% to 3.5% growth through 2015. Unemployment was expected to decline below 7% during 2014. These economic expectations underpinned the Fed's plan to "taper" monetary stimulus, and ultimately, increase interest rates.

The markets generally accepted the Fed's economic expectations and immediately factored in increases in interest rates, taking the 10-year treasury note yield from 1.8% in early May to 3.0% in early September, roughly a 1% absolute increase. The key question for the balance of 2013 and into 2014 is whether these economic expectations are realistic. There are arguments for both sides.

From a positive growth perspective, auto sales are currently over 15 million vehicles on an annualized basis, versus a low of 9 million in 2009, and the housing market has rebounded significantly. Debt levels and debt servicing levels are down, relative to 2009, the heart of the Great Recession. Oil and gas production from key new areas (e.g., Permian Basin in West Texas, Bakken Shale Fields in the Dakotas, and Marcellus Shale Fields in Pennsylvania) have increased domestic energy sources and produced high paying jobs.

But there are also headwinds working against economic growth. The payroll tax increase at the beginning of the year may still be working itself through the economy. Federal government sequestration cuts are impacting this fiscal year and will likely impact next year, reducing government spending and creating economic drag. Increased interest rates have lifted mortgage rates up towards 5% from under 4%. Combined with the significant appreciation in homes, affordability has declined, which could hinder the housing recovery. Europe continues to languish with little economic growth, and China's economic growth is uncertain given the financial excesses in their economy (e.g., substantial shadow banking activity and real estate overbuilding). Finally, ObamaCare implementation and the government shutdown may create additional economic drag.

Given the severe back-up in interest rates, financial markets appear to have factored in the Fed's expectations and partial tapering of monetary stimulus. However, over the last four years, real GDP growth has averaged 2.2% and has been below 2% so far in 2013. If the U.S. economy continues to move in this 1.75% to 2.25% range, there could be corrections in the equity markets. Impacts in the fixed income markets are less clear, but rates could decline significantly and bond prices increase. The Fed's decision on September 18, 2013, to not reduce quantitative easing underscored this more sluggish economic scenario. The wild card is whether the Fed has lost confidence in the efficacy of QE3 (the current third round of monetary stimulus) and whether they will maintain the program regardless of economic data.

The adage "the only thing that never changes is that everything changes" applies today in the financial markets. The U.S. economy faces massive monetary stimulus, gridlock in Washington, and numerous regulatory changes. Given the increasing levels of uncertainty and the substantial increase in equity values, a less attractive risk/return relationship may have been created. If so, the upside for the short term may be limited with a possibility of some equity market consolidation and correction. In this environment, we recognize the increased importance of stock valuations and the quality of the companies in which we invest. Selective additions, as well as rotations to other companies and sectors, within portfolios may be appropriate. ◆

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