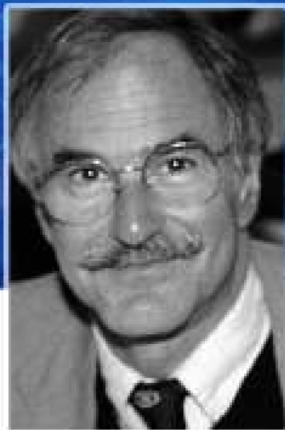
The PAD System Report



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EASY MONEY

It's been easy to make money in stocks this year. Just buy 'em. The market rises every month! The dips have been few and shallow, since volatility is normally low in bull markets. To paraphrase Gershwin, "Summertime, and the money is easy. Stocks are jumpin', and the bond market's high..." Indeed, the current bull market has propelled stock indexes to historic highs, more than doubling their levels set a mere four years ago. Not surprisingly, the public, like the moth attracted to the proverbial flame, has been easing back into stocks after shunning them in 2009, 2010, 2011, and 2012. How will this end? While we cannot know the future, we can at least know the past. And public love affairs with stocks have always ended badly. Why should this time be any different?

The current bull market is showing signs of excess. Our beacon of long-term value, the VL MAP, has been at 40% for two weeks, the first time it has stayed at that low level since 2007. While this indicator does not tell us when the market will peak, it does tell us that current prices are high relative to their likely levels 3-5 years in the future. The VL MAP has been very low at every one of the major market peaks since the 1960s. The level of margin debt has also become worrisome. It has now reached a new high ($384 billion), exceeding the peaks of 1999 and 2007. (While the ratio of margin debt to GDP is not yet at an all-time high, it is getting close.) But the VL MAP first signals trouble far in advance of any decline, and the public's growing appetite for stocks could push the market up for many more months. What makes us truly worried right now is that the prime mover driving this bull run is about to be curtailed. The Fed's exceptionally easy monetary policy is going to end. Interest rates are already rising at the long end of the maturity spectrum, even though the Fed will no doubt keep short rates near zero until next year at least. But at some point even short rates will rise. The Fed's policy of Quantitative Easing (QE), which is currently set at $85 billion a month in purchases of long-term US government and mortgage securities, will be dialed back and eventually ended. If there were any doubt as to the delicacy and danger of this wind-down, consider the tremors in the stock market when hints of the end of QE surface. Friday's sharp decline gives an inkling of just how far and how fast the market could fall as the Fed implements its "exit strategy." And we are in uncharted territory. While there was always a page in the playbook for QE (written in part by Bernanke himself), there is no page which explains how a central bank can end QE without repercussions in the financial markets.

The best the Fed can do is to repeatedly warn the markets that QE is going to end at some point. Having members of the FOMC publically hint at this possibility is a key part of the strategy. It reminds us of humorist Dave

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Barry's suggestion of when to tell the kids that you are moving: at birth! But the hints are not the same as the real thing. Our guess is that one month this year the Fed will announce that QE monthly purchases are being reduced to, say, $80 billion. No one, not even the Fed's brightest economists, knows how the markets will react. Ideally, the ensuing selloff in bonds and stocks will be mild, but the markets will have to face the fact that interest rates are going to be rising for years into the future. We didn't fight the Fed when money was easy and stocks were jumping, and we won't fight the Fed when money gets tighter and stocks and bonds wilt. Bonds are already falling, and QE has not even been reduced yet. And who has been pouring vast sums of cash into bond mutual funds in the last few years? The American public investor. Could these be the same individuals who bought Priceline in 1999 and five Miami condos in 2006?

The reason the Fed will wind down QE is that the economy is indeed healing from the economic and financial collapse of 2007-09. The Fed deserves much credit for acting more boldly than either the ECB in Europe or the BOJ in Japan. (The BOJ has recently reversed course and gone all-in on easy money.) But as the US economy continues to recover, and perhaps even picks up speed, the Fed will want to gradually withdraw the enormous amount of monetary stimulus. While the continuing recovery should be good for stocks, the real problem is that corporate profits as a percent of GDP are unusually high, so that future growth will probably be no higher, and could be lower, than the growth in nominal GDP. Since that rate will most likely be less than 5% a year for some time, the stock market is not cheap at 15 times earnings. And it is even less cheap if interest rates rise, as they are sure to do.

Housing is now propelling the economy forward. Rising prices across the country, and pickups in construction activity, are now reaching a self-sustaining rate of growth. Buyers who qualify can still borrow at less than 4% for 30 years, and they know they are competing to buy a relatively smaller supply of homes, as we have passed the midpoint of the foreclosure crisis. Americans not buying or selling are still feeling richer as the value of their homes increases at a 10% annual rate in many cities in the US. Every month more homeowners are climbing back above water, with positive equity in their homes. Reflating stocks and homes can gradually undo the balance-sheet damage of the 2007-09 collapse.

Yet economic growth is still painfully slow. Unemployment is still too high at 7.5%, and median wages have been stagnant. The sequester has reduced government spending, and the end of the payroll-tax holiday has crimped consumers' paychecks. This argues for a very gradual reduction in QE stimulus, which is almost certainly the Fed's plan.

We can expect a chorus of boos from the Congress when the Fed commences its exit strategy. Yet this same Congress gave us gridlock, the Fiscal Cliff, and the Sequester. Although the short-term budget outlook is now much brighter than it was when we almost went over the self-imposed Cliff last year, our long-term fiscal position is still precarious. Ironically, the improvement in our short-term fiscal position is likely to mean that the hard decisions on Medicare, Medicaid, Social Security, and taxes are likely to be put off again.

The bottom line: the economy is likely to do better than the stock market for the rest of 2013, after four years of soaring stocks and a limping economy. This is not a bad thing, but stock investors must be prepared for lackluster returns. Bond investors should prepare for negative returns. PAD investors must be disciplined enough to hold big cash reserves and patient enough to wait for better prices.

RECOMMENDATION: VL MAP is deep in the SELL range at 40%. Raise cash reserves to 50%. We will sell 100 shares of FISV and 100

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shares of FEIC to get there. Only one Model Portfolio stock is currently cheap relative to its 3-5 year appreciation potential. (6/1/2013 3:00 PM PST)

MODEL PORTFOLIO-C

PORTFOLIO STATISTICS AND STRATEGY: Weighted year-ahead performance rank: 3.08; Weighted safety rank: 2.22; Portfolio MAP: 58%. (These statistics and more can be found on the subscriber's corner of our website.) The weighted performance rank for the portfolio is not good, with Fairchild Semiconductor, Varian, and Cognizant ranked below average for year-ahead performance. At the current level of the market, it is very hard to find stocks which are well-ranked for year-ahead performance and also cheap compared to their 3-5 year appreciation potential. Value Line, which has its own portfolio of stocks with high appreciation potential (we think they copied us), has the same problem, only worse: they have several stocks in that portfolio which are "5" for year-ahead performance. We are generally unwilling to do that. Our safety is very good, though, and that should protect us in a downturn. A number of our stocks also have low betas. The low level of our portfolio MAP, even though it exceeds the VL MAP of 40%, is another sign of how picked over this market is.

We are getting close to selling **LinkedIn** (LNKD) short. The stock zoomed to 200 before settling back. Even though Value Line has boosted 3-5 year appreciation potential to 145-205, the stock at 167 is still selling for more than the low end of that range, one of our key hurdles for a short sale. (See *Outsmarting Wall Street*, Chapter 11.) What is even more exciting is that the stock's chart finally shows clear signs of forming a major top. While we don't have a lot of faith in technical analysis, this stock is clearly not trading on fundamentals. If the stock market continue to advance, we will sell LNKD short.

UPDATES ON PORTFOLIO STOCKS:

Celgene remains strong, although Value Line refuses to raise its 3-5 year appreciation potential, and has even cut this range a bit. The new drug pipeline is strong, and the company continues to invest a staggering 31% of revenues in R+D. We are particularly hopeful about Abraxane, a breast cancer drug, which, in Phase III trials, significantly extends the life of patients with pancreatic cancer, a relatively uncommon but truly deadly affliction. Normally we would not hold shares of a stock selling at the high end of its 3-5 year appreciation potential, but we have just sold half of our holding, and we do expect Value Line to cave in and raise 3-5 year appreciation potential soon.

DIRECTV, our newest addition to the portfolio, missed its latest earnings target, but the stock has rallied anyway. The miss was caused by a one-time loss in Venezuela because of its currency devaluation. Excluding that, earnings were up nicely. The company continues to expand in Latin America, and their stock buyback program continues unabated.

Automatic Data is now a "3" for year-ahead performance, but that is not a concern for long-term investors like us. The company has a top safety rating of "1", financial strength of A++ (highest), a low beta of 0.8, and a yield of 2.6%, which is better than the 10-year Treasury. Earnings should grow steadily, if not spectacularly, for the foreseeable future. A good stock to hold when the market looks overextended.

We still disagree with Value Line over **FISERV**'s 3-5 year appreciation potential. We believe the company deserves an above-average p/e, considering its record of steady growth with low risk. Nonetheless, the stock is now almost 10% of our portfolio, and the price is a near triple from our first purchase back in 2004, which should trigger some selling, based on the PAD rules. We will sell 100 shares. We still consider this one of our core PAD holdings for

the long-term. (The Editor owns it in his personal portfolio.)

Fairchild Semiconductor reported another weak quarter. The earnings turnaround should begin in the next quarter, and then should accelerate sharply. The history of this company suggests that management cannot consistently grow earnings, with a few years of growth inevitably followed by years of decline. The time to sell the stock, though, is when earnings are in a strong uptrend, not when earnings are at a minimum, as they are now. Hold.

Cognizant Technology has been cut by Value Line to a "4" for year-ahead performance. This is an unkind cut, since there is no sign of a slowdown in their steady growth. Every quarter and year sets a record, and even Value Line is forecasting 17% annual growth in earnings over the next five years. And the stock is the only one in our portfolio that can be bought at current levels. So what gives? The Value Line year-ahead performance ranking is influenced by relative strength, and the stock has indeed been weak in recent months. But as long-term investors, we say to Value Line, with Annie Hall, "Well, lah-di-dah." If the market declines enough to bring the VL MAP back to the neutral range, this will be the first stock which we will purchase.

Varian Medical is also now a "4" for year-ahead performance, and the problem is the same. Varian beat Value Line's earnings estimate for the latest quarter, and growth should continue at 10% a year out to 2016-18. The demand for oncology services will only grow as the Baby Boomers age, and populations also age in other countries like Asia in particular. R+D is a healthy 6.6% of revenues, and the stock has A+ financial strength, a safety ranking of "1", and a below-market beta of 0.85. Lah-di-dah!

FEIC has been another one of our strong performers, and the stock, like FISV, is now almost 10% of our portfolio. Since we have nearly tripled our money since first purchase, we will sell 100 shares to raise our portfolio cash percentage to 50%. This stock is also a core holding for PAD, and the Editor also owns it in his personal portfolio.

Sigma Aldrich is a old PAD favorite. (Sigma was first purchased by the Editor the day after the crash of 1987. The buy confirmation appears in *Outsmarting Wall Street*.) The stock has been an excellent long-term holding. Sigma has increased earnings and dividends every year for the last 10 years, and is likely to continue to do so for the next ten. The company is broadly diversified, with almost 200,000 products in its catalogues, and well-diversified geographically and by sector. Earnings growth is not rapid, but steady, and the company is conservative managed. Our worry is that the bull market has pushed the stock to the low end of its 3-5 year appreciation potential. Hold.

Thermo Fisher is another old PAD favorite which has gotten a second wind. Its purchase of Fisher Scientific has paid off, and now the company has purchased Life Technologies, which itself was a company often considered for purchase for the PAD Portfolio. Earnings are trending up, and the pace should accelerate after Life Tech is fully absorbed. The stock has risen to the low end of its 3-5 year appreciation potential, but in this case, Value Line is aiming low, assuming that TMO's projected growth will be capitalized at a below-market multiple. We disagree, and expect the 3-5 year appreciation potential to be raised this year. Hold.

Taiwan Semiconductor has also been an outstanding long-term performer for PAD. The stock is close to a triple from purchase price in 2004, and it has paid a nice dividend for years. Value Line projects significant future growth for this semiconductor foundry, as the circuits etched on semiconductor wafers get ever smaller. If the stock market does rally significantly, though, we will have to sell some

shares in accordance with the PAD Rules.

ADVICE: Raise cash reserves to 50%. Sell 100 shares FISV and 100 shares FEIC at market. Hold all remaining stocks. The maximum buy prices of our current favorites are listed below.

Shares	*Company (Ticker)*	*Recent Price*	*Value*	*Advice*
250	Automatic Data (ADP)	69	17,180	Buy @ 53
100.13	Celgene (CELG)	124	12,381	Hold*
160	Cognizant (CTSH)	65	10,344	Buy @ 72.5
300	DIRECTV (DTV)	61	18,357	Buy @52.5
600	FEI Corp (FEIC)	72	43,206	Hold*
1000	Fairchild Semi (FCS)	14.5	14,510	Buy @ 12.5
501	Fiserv (FISV)	87	43,667	Hold*
160	Sigma Aldrich (SIAL)	84	13,392	Hold
1450	Taiwan Semiconductor (TSM)	18.7	27,057	Buy @ 13.5
160	Thermo Fisher (TMO)	88	14,128	Hold
309	Varian Medical (VAR)	67	22,706	Buy @ 45
CASH	Money Mkt Fund		202,000	
TOTAL			$436,928	*Advice change

WWW.PADSYSTEMREPORT.COM: subscribers can renew online, and check the status of their subscription. Subscribers also have access to back issues, the current issue in PDF format, and the PAD Portfolio Excel spreadsheet, which summarizes short-term rankings, 3-5 year appreciation potentials for all PAD portfolio stocks, and measures of the Portfolio-weighted overall ranking for year-ahead performance, safety, and MAP.

Note: New subscribers baffled by the details of the PAD System should purchase a copy of Daniel Seiver's *Outsmarting Wall Street* (3rd edition, Probus/McGraw Hill, 1994). This book contains a full discussion of the PAD System and all of its rules. Although out of print, it is regularly available on Amazon.com. Unfortunately, recent publicity about the PAD System has meant that cheap copies can no longer be found. **We are planning a Google ebook version for $9.95, with eventual electronic updates of chapters**. A number of public libraries still have copies of the physical book.

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