

Parsec Financial

FIRST QUARTER 2009 NEWSLETTER

Our Investment Process—A Behind the Scenes Look

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SPECIAL POINTS OF INTEREST

- The big issue today is what consumers will do.
- Find out what tax credits may be available to you.
- Don't forget to sign up for the e-newsletter at: news@parsecfinancial.com



Sarah DerGarabedian

RESEARCH AND TRADING
ASSOCIATE

As a Parsec client, you receive quarterly statements from us which list your individual holdings – stocks, bonds, mutual funds, exchange traded funds, and other securities, combined in a way that is appropriate for your individual situation. But how did we select those particular securities, and what is our ongoing review process? You may be surprised to find out that Parsec has a dedicated team of people who are involved in the day-to-day process of identifying, reviewing, and selecting the securities that you see on your statements. In this article, we will focus on individual stocks, as they constitute the majority of our clients' assets.

Our process is heavily rooted in fundamental analysis, which means that we look at an individual company's earnings, cash flow, debt, and profitability measures, compared to similar companies operating in the same industry. These data come directly from the company's financial statements, and are combined to form various ratios such as price to earnings (P/E), price to free cash flow (P/FCF), debt to equity (D/E), and return on equity (net income/equity). We also use consensus estimates (for measures such as 5-year earnings growth rate forecasts), third party research (Value Line, Standard and Poor's, Argus, Credit Suisse), recent news, and regulatory filings to flesh out the quantitative data.

In general, we look for financially strong

companies that are market leaders, with high-quality balance sheets, stable earnings growth, above-average profitability, and sound management. We compare each company to others in the same industry, as well as to an industry average, so that the fundamentals can be evaluated in the context of that particular type of business.

Based on our research and analysis, we have compiled a list of securities from which an advisor builds your portfolio. We monitor the prices of the securities on this list throughout the day, as well as any news regarding these holdings. In addition, every security in our coverage universe is formally reviewed at least 3 to 4 times a year, and more often if circumstances dictate. Each week, Mark Lewis and I (collectively known as the Research and Trading department) gather information for a group of companies in a particular sector. We analyze the data and submit it to the other members of the Investment Policy Committee (IPC) for review.

Parsec's IPC consists of eleven members, nine advisors and two research and trading associates (the latter are non-voting). Committee terms are for one year at a time, but advisors may remain on the committee for longer if they wish (the two research and trading associates are permanent members, as are the CEO and one of the managing partners). Every Tuesday morning, the committee meets to discuss each company and vote on a recommendation: buy, sell, or neutral. If the committee votes to sell a stock, the Research and Trading department initiates a block trade across all discretionary client accounts so that the committee's convictions are effected on a firm-

wide basis in an orderly and timely fashion. When the trade is executed, all accounts participating in the trade receive the same price.

Over the past year, as the credit crisis has unfolded, the economy has worsened, and markets have exhibited abnormal volatility, you may have noticed more trading activity in your portfolio as we seek to implement our convictions in response to rapidly-changing conditions. However, of the approximately 80 buy-rated securities that we cover, there are many companies that have been rated a 'buy' for a long time

and are considered core holdings. You are undoubtedly quite familiar with their names, as you see them on your statements quarter after quarter, and you may have wondered what we do in the way of ongoing research and due diligence. Hopefully, this glimpse into our investment process assures you that we are reviewing those companies as well as the ones garnering more media attention, and we will continue to do so, day in and day out.

Dr. Jim Smith's Economic Commentary



Dr. James F. Smith

CHIEF ECONOMIST

There's a Huge Debate Among Economists These Days

President Harry S. Truman was famous for many things, among them his plain-spoken way of making points. One example was that when he acquired the nickname of "Give 'em Hell, Harry," he told the media as an explanation that, "That's not correct. I just tell the truth and they think it's hell."

At one point, he became quite exasperated at a briefing by members of his Council of Economic Advisers, which was created early in his term. They were attempting to explain the two major competing scenarios of the day. One camp of economists thought the economy might either have a really long and deep recession after the end of World War II or even return to the sort of stagnation of the Great Depression years. The minority viewpoint, which turned out to be basically correct, was based on two assumptions; 1) that the Marshall Plan would work to kick start the global economy and boost exports and 2) that consumers would spend the wealth they had accumulated during the war because we had more than full employment and there were no new cars or appliances to buy as all the production of these items had been converted to the successful effort to defeat the Axis powers. A few really farsighted proponents of this view expected that the flood of new college graduates supported by the GI bill would lead to levels of income and consumption never before seen. No one predicted the baby boom.

In frustration at this continuing argument, President Truman finally said, "Won't somebody find me a one-handed economist?" Ever since, we economists have been subject to ridicule whenever we say "on the one hand....and on the other hand" when attempting to explain differences in our forecasts.

Of course, anyone who has ever been involved in a strategic planning exercise, whether for a business or for the Pentagon, where the practice was first developed in its modern form, knows that the smartest thing to do is to develop scenarios that are logically sound views of how the future economic environment might develop. After all, as country singer Clint Black has taught us "If you don't know where you're going, any road will get you there."

While it's possible to develop an unlimited number of scenarios or at least limited only by the budget and time available, it makes the most sense to try to limit them to three. One is the most likely outcome, which can usually be approximated by the consensus of economic forecasters, although that may require considerable tweaking to make it industry specific.

Another is the best scenario. In my days as part of the strategic planning department at Union Carbide Corporation, that was usually taken to mean a situation in which our sales and market share and profits in a particular business shot up quickly and unexpectedly. The most common cases of that situation were when a competitor's major plant was shut down by a strike or other problem.

The third is the worst-case scenario. That hit Union Carbide on December 3, 1984 in Bhopal, India when a disgruntled employee (mad because he had not received an

anticipated promotion) decided to get even by “ruining” a batch of chemicals used in pesticide production by connecting a water line to a storage tank. The resulting chemical reaction released toxic methyl isocyanate into the air and killed over 5,000 people and injured more than 20,000.

My forecast, which was completed the week after the disaster, of the eventual settlement costs from the litigation resulting from that disaster was one of my best ones ever. It was within 2.0 percent of the eventual outcome many years later. Had top management been able to convince investors that would be the case, the company would still be around today.

However, the Bhopal disaster led directly to the breakup and eventual disappearance of Union Carbide. In the 1940s, it had been the largest company in the world by stock market capitalization. The remnants of the chemical operations today are part of Dow Chemical.

That’s a great cautionary tale as to why it’s important to correctly specify the worst case scenario. It also shows the value of a “two handed” economist.

The Big Issue Today Is What Consumers Will Do

The years 2003 through 2007 were the best five consecutive years for economic growth in the history of the world. That fact does not seem to be mentioned often by the purveyors of gloom and doom who dominate the media these days.

Consumers in the U.S. drove much of that global growth. In 2002, total personal consumption expenditures (PCE) in real (adjusted for inflation) terms were \$7.1 trillion or 70.6 percent of real GDP. By 2007, real PCE had grown by 16.2 percent to \$8.3 trillion. That was 71.6 percent of real GDP and was a record for the years since 1941. It had been higher in the 1920s and 1930s.

Homeowners who refinanced their houses and took cash out to spend on other things fueled much of this boom in consumption. While the most common use of such funds was investment in improving the house, some went to other purposes. Those purchases helped to drive up imports and thus improve the economies of all the countries that were exporting to the U.S.

That all came to an end in December 2007 when the U.S. entered a recession that is on a path to be the longest since the Great Depression that began in August 1929 and ended in March 1933. That was 43 months.

The National Bureau of Economic Research (www.nber.org) has dated business cycles in the U.S. back to December 1854. Since then the longest one was the original “Great Depression” that lasted 65 months from October 1873 to March 1879. Professor Nouriel Roubini of New York University expects the current recession to seriously challenge that record, but no one else has an outlook remotely that dire. Thus, you could use that as your “worst case” scenario to perform a “stress test” on your business to see how it will hold up if the recession does not end until 2012.

The 1929-1933 episode was the second-longest downturn ever recorded in the U.S. Third was the 38-month one from March 1882 to May 1885. Note that that episode followed hard on the heels of the horrible record-holder with only a 36 month upturn separating them.

The pessimists believe that consumers will not be able to increase spending until they have drastically paid down their debts. Many of them think that could easily take 3 to 4 years, which would put recovery off until some time in 2010 or even 2011. Steve Roach, the former chief economist for Morgan Stanley who is now chairman of Morgan Stanley Asia, is a leading proponent of this view. He has written many articles about it.

Others in this group point to the idea that consumers have a target for their savings and with the tremendous destruction of wealth over the past few years, they will feel compelled to increase savings dramatically to get back to where they were in 2003.

The “Flow of Funds” report (www.federalreserve.gov) released by the Board of Governors of the Federal Reserve System on March 12 showed that as of December 31, 2008 the net worth of consumers in the U.S. was \$51.5 trillion. That was the lowest since the \$51.9 trillion at the end of 2004. The total net worth of consumers fell \$11.2 trillion or 17.9 percent during 2008.

Still, that \$51.5 trillion is more than four times personal income. It was 3.6 times nominal GDP in 2008.

Chinese consumers save over 35.0 percent of their incomes. In both Germany and Japan, the ratio is about 25.0 percent.

It’s always been much lower than that in the U.S. It was below 1.0 percent in 2005 through 2007. According to the Bureau of Economic Advisors release of March 2, the personal savings rate was 5.0 percent in January 2009. That was the highest since March 1995.

Total personal income was running at a seasonally adjusted annual rate \$12.2 trillion in January. Disposable personal income was \$10.8 trillion at a seasonally adjusted annual rate, second only to the \$10.9 trillion of June 2008, which was boosted by the original bunch of stimulus payments.

Personal consumption expenditures were running at a seasonally adjusted annual rate of \$9.89 trillion in January, the highest since the \$9.93 trillion of November 2007. Spending on services was \$6.2 trillion, a new record.

The good news is that the overwhelming majority of consumers in the U.S. find it much more enjoyable to spend than to save. Of course, the primary purpose of savings is to fund future consumption.

Purchases of vehicles fell to an annual rate of 9.1 million units in February 2009. That's the lowest since December 1981. It's also well below the scrappage rate of about 13.0 million units a year. Sooner or later, the demand for vehicles will pick up and that will be an early sign that the recovery is under way.

The Authorities Just Won't Allow the Recession to Drag on Interminably

If you still have any doubts that the FOMC will do whatever it takes to get the economy back into growth mode, two things should dissuade you. The first is to read their statement of March 18. In it they state: "Although the near-term economic outlook is weak, the Committee anticipates that policy actions to stabilize financial markets and institutions, together with fiscal and monetary stimulus, will contribute to a gradual resumption of sustainable economic growth.... In these circumstances [referring to the continuing recession and deflationary pressures], the Federal Reserve *will employ all available tools to promote economic recovery* [emphasis added] and to preserve price stability."

They went on to announce actions to buy up to \$750 billion more of mortgage-backed securities issued by Fannie Mae and Freddie Mac, bringing the total to \$1.25 trillion in 2009. They also said they'd buy another \$100 billion of the debt of these agencies.

Furthermore, they announced plans to buy up to \$300 billion of longer-term Treasuries over the next month. That caused the stock market to swing from a loss to a gain by the end of the March 18 trading session.

If you missed the extraordinary over 26-minute interview

with Chairman Bernanke on "60 Minutes" on March 15, then you should go to cbsnews.com and watch it. He should be able to convince you that he and his colleagues fully expect to succeed in returning the U.S. economy to growth this year.

It is always a shock to find myself in agreement with Princeton professor and *New York Times* columnist and 2008 Nobel laureate in economic science Paul Krugman, but on the issue of the inadequacy of the \$787 billion fiscal stimulus package that President Obama signed into law on February 17, we are. That is that the bill, "The American Recovery and Reinvestment Act" had far too little stimulus. We probably don't agree that it had too many elements of the Democrat's "wish list," which is why no Republicans in the House of Representatives and only three in the Senate voted for the bill.

On January 28 the American Society of Civil Engineers (www.asce.org) issued a report saying that the U.S. needed to spend \$2.2 trillion over the next five years to bring the nation's airports, bridges, dams, highways, ports, railroads, schools, transit and public water and sewer systems up to modern standards. There is no better way to put people to work and to improve the overall productivity of the U.S. economy than to fix our infrastructure.

For some unknown reason, the U.S. and all other Anglo-Saxon countries have failed to invest adequately in infrastructure for at least the last forty years. President Obama had a golden opportunity here and inexplicably failed to seize it.

Virtually no one cares what happens to the deficit in the short run. The official Office of Management and Budget projection has grown from \$400 billion for this fiscal year to a mind-boggling and record-shattering (three times last year's record) \$1.75 trillion.

Also, nearly all members of Congress agree on the need to get our "crumbling" infrastructure up to 21st century standard. The I-35 bridge collapse in St. Paul, Minnesota on August 1, 2007 provided dramatic reinforcement for this sentiment.

The stimulus package should have contained at least \$880 billion to fund the first two years of the ASCE recommendations. Instead it contained a paltry \$20.7 billion for highways (governments spent \$80.3 billion for this in 2008) and lesser amounts for other types of infrastructure improve-

ments.

The Whole World Is Waiting on the USA

The rest of the world is in worse shape than the U.S. Europe is in a deep recession with no good ideas on how to get out of it while Japan is in a morass never seen in a major economy before. Its government debt to GDP ratio is in danger of growing exponentially.

The IMF, OECD and the World Bank all expect 2009 to be the first year since the end of World War II in which the global economy shrinks. They all have a decline in global GDP of around 0.5 percent. Should the pessimists on the U.S. prove correct, then that could continue into 2010.

The pessimists are likely to be proved wrong, as is nearly always the case. The U.S. economy posted positive real GDP growth in 96 out of 104 quarters through 2008. That's the highest ratio every seen for such an extended period. That's one big reason why the 1984-2008 period has been dubbed "The Great Moderation." The others are that growth was more stable and inflation and unemployment lower for longer than in comparable previous 25 year spans.

We've seen more growth with less variation and sustained lower inflation than at any other time in U.S. history. The odds strongly favor a return to growth very soon.

Keep watching the data looking for signs of the upturn. All this stimulus has to start showing up soon.

A Summary of the American Recovery and Reinvestment Act of 2009



Rick Manske, CFP®

MANAGING PARTNER

First Time Homebuyers Tax Credit

Beginning in 2007, the First Time Homebuyers Tax credit has been improved by the American Recovery and Reinvestment Act of 2009 (ARRA). Under the provisions of ARRA, the maximum amount of the credit is increased from \$7,500 to \$8,000, and the requirement to repay the credit is completely removed if held for 36 months as a primary residence. It is \$8,000 for both individual and married couples.

The tax credit is refundable. This is critical, meaning that an individual that does not pay more than \$8,000 in tax liability will not pay any tax and would receive a refund back.

Anyone who has not had a present ownership interest in a principal residence for the three years preceding the purchase date will be eligible for the credit. The credit is not available if purchased by someone who is related to the buyer or between a business and most types of trusts.

The credit is subject to a phase-out based on adjusted gross income (AGI). Individuals \$75,000-\$95,000; Married \$150,000 to \$170,000.

If property is sold by the end of 2009 the taxpayer cannot take the credit. If sold within 36 months of the purchase date the credit must be repaid, thus should not be looked at for a quick buy and then sale strategy. There are other important tax details about calculating capital gains taxes, please seek advice from a qualified tax expert.

The credit is calculated as 10% of the purchase price, up to \$8,000.

American Opportunity Education Tax Credit

ARRA provides financial assistance for individuals seeking a college education. For 2009 and 2010, the credit is \$2,500 of the cost of tuition and related expenses paid during the taxable year. The credit is based on the first \$2,000 of tuition and related expenses (including books), plus 25% of the next \$2,000. This expands upon the size of the credit from the predecessor Hope Scholarship Credit.

The credit will be subject to phase out for individual taxpayers with adjusted gross income (AGI) in excess of \$80,000 and married taxpayers with AGI in excess of \$160,000.

If the credit results in a negative tax liability, up to 40% of the credit will be refundable. A refund of the credit will not occur if is for a child that will be subject to the "kiddie tax" (child under 18, or student under 24 who does not have earned income). The credit is available for the first four years of qualified education expenses.

The credit will only apply to 2009 and 2010, and the education expenses must be paid in those tax years to be eligible. Families with multiple kids in college may benefit. A family can declare the credit for each student instead of being restricted to just one.

Using the credit is complicated because you must consider other education expense tax strategies, to maximize the American Opportunity Tax Credit. The Lifetime Learning Credit, Hope Scholarship Credit and 529 plans are other strategies that could be considered but new credit is likely to be better than most other incentives.

For families with 529 plans and Coverdell Savings Accounts they should plan to cover a portion of annual child expenses from their taxable accounts to be eligible to declare the credit.

There are intriguing planning strategies for parents willing to gift to children and who are not eligible for any of the credits due to high income, while the child might be eligible to claim the credit on their own tax return. Please feel free to contact your advisor for a more detailed explanation if this situation pertains to you.

Computers as a Qualified Education Expenses in 529 Education Plans

Section 529 Education plans are tax-advantaged savings plans that cover all qualified higher education expenses, including: tuition, room & board, mandatory fees, books. This law provides that computers now qualify as qualified education expenses.

ADV Offer

Parsec's Form ADV, a disclosure document, describes services provided to our clients and is available upon request. If you would like a copy, please contact us.

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