

1999 in 2012

The world feels a lot like 1999 again today from an investment perspective in regards to high technology stocks. It feels this way in the technology sector with mind boggling valuations of tech companies, but only the “new tech” companies. Old and established tech giants like Microsoft, Intel, Oracle, Cisco are all reasonably and fairly valued. When a company value is determined, an important metric is the price/earnings ratio or how much an investor is willing to pay for a dollar of company earnings. Historically the P/E of the market is around 15. It’s currently trading at that range and the old tech companies are in line with normal figures. There are a plethora of metrics we use to determine values, but this is one of the most popular and easy to understand.

The crazy valuation numbers come in when it comes to the newest generation of technology companies, those who have most recently come to market with IPO’s (initial public offerings) such as Pandora, LinkedIn, Zynga, Zillow, etc. Many of these companies have no earnings and never have, so they’re hard to value. Valuing such a company requires a lot of guesswork and speculation. Some of these companies do have earnings, but the multiples they are trading at P/E ratios in the 100’s, not in the teens. Here is a great example. Google is currently trading around \$610.00 per share. Its earnings are \$42.00 per share so its P/E ratio is right in line with historical numbers at 15. If Google were to be trading with a P/E of 100 it would have a current share price of \$4,200.00 per share. Yes, its’ insane and likely won’t happen.

In 1999 we had a very similar situation with anything internet or any company whose name ended in dot com (.com) having a valuation of greater than hundred year old global conglomerates even though these companies had none or negligible earnings. In 1999 it was common for companies to have P/E’s in the hundreds, not just 100 but 2, 3, 400; it just didn’t matter for a while. At that

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Economics

Many of the basic financial fundamental concepts one learns in an economics education is not applicable to our world in many ways. We have a political system that has run out of hand and basic personal responsibility is no more. Banks are now paying delinquent homeowners between \$20,000 - \$35,000 to get out of their home so the bank can move on and short sale the property. Rather than getting forced out and losing everything, these people who are behind on their payments are now getting a pile of cash to move on. This is less expensive for the bank than taking the typical foreclosure route as that has become a political hot potato. This is just another example of rewarding poor behavior in our nation.

Our government, in an attempt to create an illusion of fairness, is rewriting many of the basic financial rules of the world as we know it. This changing of the game is not good for improving outcomes; it simply creates a bigger problem.

The world is highly complicated today and on a government level, highly leveraged. This means governments have borrowed too much money and now some of them cannot pay it back. This will lead to defaults and bankruptcies in countries. Greece is at this point now and politicians are trying to stretch it out for as long as possible. It’s imminent; it’s just a matter of time when this sovereign bankruptcy unfolds. Many developed countries are in a similar situation so the leverage in the world is scary indeed today.

Governments across the world are responding with “austerity” measures. The measures taken include raising taxes, cutting back programs and attempting to balance their books. This isn’t going to work; they need structural changes to allow their economies to grow. There is little to no growth in many European countries because of the welfare state they’ve become. People expect the government to take care of everything and it’s just not possible. People must be responsible for themselves on most levels, and the government is a backstop for those who are incapable, which is the vast minority, not the bulk of a population. The work rules and labor laws in these places are archaic. These countries have no chance of growing until they restore honor to government, end corruption and give the private sector the incentive to work and invest. The tax plans that simply redistribute wealth by taking

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point it didn't matter because everyone said "this time is different" and it's a new way for businesses to operate and these businesses will be more profitable than any other before them. Fast forward to 2012 and most of those firms are gone, those that are still in business have normal valuations.

It's no different this time. Today we've got a mania going on with the new tech companies and it will not last. Facebook will go public this year if all goes according to plan. They'll be big and you'll need to be politically connected or filthy rich to get in on this deal. They're talking about going public with an initial value of around 100 billion. I've read their offering memorandum and they're currently making 668 million. That would make their IPO P/E ratio 150. They are a popular site with 845 million users, they cannot continue to grow as they have but if they can turn the existing traffic into advertisement dollars they'll make money. Bottom line is in order to have a "normal" valuation they'd have to increase their earnings to 6.66 billion each year to justify the price they're going public at. A 1000% increase in earnings to justify the current valuation, how likely is that? I'm not saying it won't happen because the site is mind boggling popular, I'm just not a buyer of these types of deals where the only way to make a real long term sustainable profit is to grow at 30, 40, 50% annually for a long time. If things unfold as they appear they will right now, Facebook (their symbol will be FB) will be one of the 70 largest corporations on the planet by market capitalization.

In 1999 things were eerily similar and valuations for tech companies regularly were insane in those days. Following that was 2000 & 2001, two very bad years for technology companies in general. Back then we had technology as any company in the tech space, internet companies especially with sky high valuations because of what people thought they could do moving forward. I don't see that same thing happening again because the "old tech" companies are now blue chips and very reasonably valued. I do see the clock resetting for these new tech companies and valuations coming back to reality for them.

Social networking is the new thing today. I'm not a big fan of these things but they're popular, nobody can deny that. They are great for keeping track of friends and kids, and people use them all day long. Too much information is posted online today for the entire world to see. Nobody cares if you're making dinner, going to the ball game or otherwise living your daily life. How well these firms can turn the big traffic they have on their sites into real dollars will be seen. New technology is great, but the game changers are often not the ones we think they'll be. My experience with insane valuations typically leads to pain, not profits.

Economic Genius

This is a true lesson from an economics professor. This man prided himself on never failing a student, but had to fail an entire class. This class of "progressive" youth had insisted the social model of society worked best, nobody would be poor, nobody rich, it would be the great equalizer.

The professor's theory was to substitute grades for dollars and he would grade the entire class on the average. After the first test all grades averaged out to a B. The students who studied were upset and those who didn't were quite happy. As the second test rolled around, those who studied a little studied even less and those who studied hard decided they wanted a free ride too so they only studied a little. The average of grades on the second test was a D. No one was happy. By the time the third test rolled around, the average was an F. As the tests preceded the scores never increased as bickering, blame and name calling all resulted in hard feelings and no one would study for the benefit of anyone else.

To their great surprise, all failed and the professor told them that socialism would ultimately fail too. When the reward is great, the effort to succeed is great. When the government takes all the reward away, no one will try or want to succeed. It couldn't be any simpler than that. How much does this sound like the insanity currently unfolding in Europe?

I'm all for helping people, but it needs to be helping those in need, not giving everyone a free ride or vote buying. Here are a few takeaways from the story:

- You cannot legislate the poor into prosperity by legislating the wealthy out of prosperity.
- What one person receives without working for, another person must work for without receiving.
- The government cannot give to anybody anything that the government does not first take from somebody else.
- You cannot multiply wealth by dividing it.
- When 50% of the people get the idea that they do not have to work because the other half is going to take care of them, and when the other half gets the idea that it does no good to work because somebody else is going to get what they work for, that is the beginning of the end of any nation.

This is no joke; we're dangerously close to this type of mentality here in America. Let's all work together to make sure this attitude of sloth doesn't overtake our society. I'm an eternal optimist and believe good things will happen. This is the warning flash! ☺

Noteworthy News!!!

- Our condolences to the Flugrad family on the passing of Ken, a wonderful man, husband, father, brother, uncle and friend.
- Congratulations to Randy Graham on his recent retirement! ☺
- Congratulations to Jim & Betsy Brophy on their recent marriage!

Question & Answer

Ask any financial question you have and we'll address it here.

Q: Why are great old companies like Kodak & Hostess failing today?

This is a twofold problem. We have one issue in Kodak in that the management was not able to look ahead and change as the business climate changed. They owned and dominated the photo business for decades, but as the digital world emerged, they grossly underestimated the threat this new technology posed to their business. When they didn't move to adapt, they fell way behind the eight ball and then tried to become a printer company. Too little too late is what it all boils down to for Kodak. Bottom line is the reason for Kodak's demise is twofold – lack of vision by management and a retiree obligation that is suffocating. Kodak has 17,000 employee and 65,000 retirees. The ratio of working people to those collecting benefits is just not affordable for a company on the ropes.

Hostess has a workforce problem. The hostess products are loved by all and they're not a dying company. They're selling their goodies all around the world. Who doesn't love a Twinkies snack? I grew up on Ho Ho's, Cupcakes, Suzy Q's, Ding Dongs, etc. I see this generation now enjoying the sugar filled delights all around the world. I do love these foods a lot unfortunately even though the bugs won't eat them and they don't expire. They have a longer half-life than plutonium! ☺ Hostess is a teamsters shop and what the workers are contracted to get is simply unaffordable for the company. Here we have a rigid structure that isn't moving with the tough economics of the times. This company is doing okay and isn't on the ropes like Kodak, but the costs of wage escalations and benefits that were contracted decades ago are now unaffordable. The problem here is a lack of flexibility. Nobody could have possibly predicted health care costs would be as insane as they are today. Since the parties cannot come to a mutually acceptable conclusion, we file for bankruptcy.

What both companies are seeking in court is the ability to change the obligations from decades ago that are no longer affordable. It comes down to do we have a company that is viable with a reduced benefit package or do we just close it down entirely. What we're seeing here is the same problem Europe is going through and many states and municipalities are going through as well. Moving forward, the problems will be dealt with by changing pensions to 401k type plans and health care will likely look something like a health savings account type scenario assuming the Obama care racket shell game never plays out. ☺

Economics

(Cont'd. from page 1)

from the productive people and giving to the unproductive ones simply do not work. Many things will need to be privatized to have a healthy European economy and the public workforce needs to shrink exponentially. The private sector is more efficient in every way. This has been their model for the past 30 years and look where it has placed them. The truly productive leave the country for greener pastures, those on the government dole keep taking and the federal employees keep growing. This is a recipe for disaster. Sadly, it's the route the USA is taking. One would think the administration would see the failure of the European welfare model and steer us in the opposite direction, instead they try to replicate it. A definition of insanity is doing the same things and expecting a different result.

This same process is happening here in our states. States are broke so they raise taxes, cut services, increase pressure on everyone but the broken structure never changes. This type of backwards government policy forces people to leave the imbalanced states such as CT, CA, NY, IL, etc. This doesn't fix the underlying problems, it simply treats the symptoms.

The Postal Service is another example of something government that is just not sustainable. The post office is great, but it's not forward looking. When technology changes the way the world operates, someone needs to look ahead and make the appropriate changes to keep up with the times. This isn't happening and doesn't happen in government in general. What is the one thing we see in many if not all of the places that have extreme fiscal instability and difficulty? Contracts, lack of flexibility to deal with reality and union dominance.

We currently have a feeling of happiness in the air as the markets are not currently factoring in any of the world's problems. This is a very temporary situation and reality will be back shortly. I don't know exactly when, but it's either here now or its months away. I equate this to the calm before the storm. The insanity of last fall isn't done, not by a long shot. We've got a slowing global economy, massive public debt to deleverage and a consumer who is getting squeezed on every level. Our economy is 70% consumer spending, and with virtually no wage growth in the past 5 years and the cost of food, energy and taxes - local state and federal all going up, where does that leave the consumer? Not in a position to increase discretionary spending!

Job growth has been pretty good here in America lately, but the numbers are suspect as they do not count people leaving the workforce. Most indicators point towards a slowing world. This isn't bad, the correction coming is needed and should cause healthy change, and it just requires patience as it'll be coming hard and fast when it does show up.



Money Quiz

This month's challenge is to tell me what percentage of Americans received a monthly benefit from social security? Last month's winner was Paul Simpson, when a country goes bankrupt; investors typically get 36% of their investment back in return. Not too good for a so called "safe have" investment. The winner will enjoy a meal on us at Ruby Tuesday. ☺
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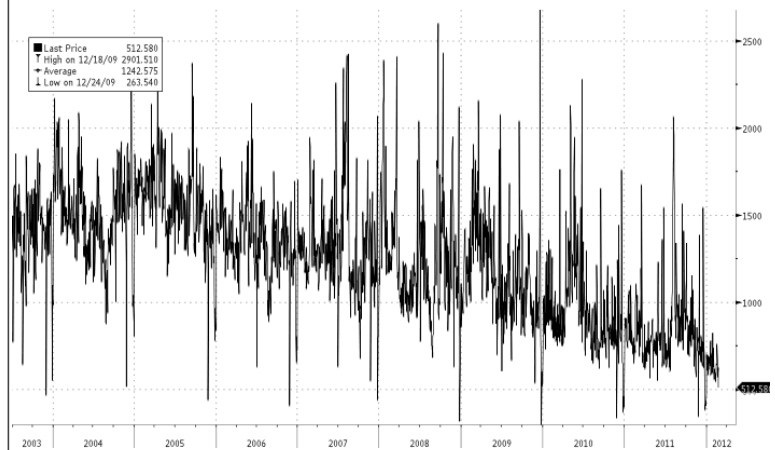
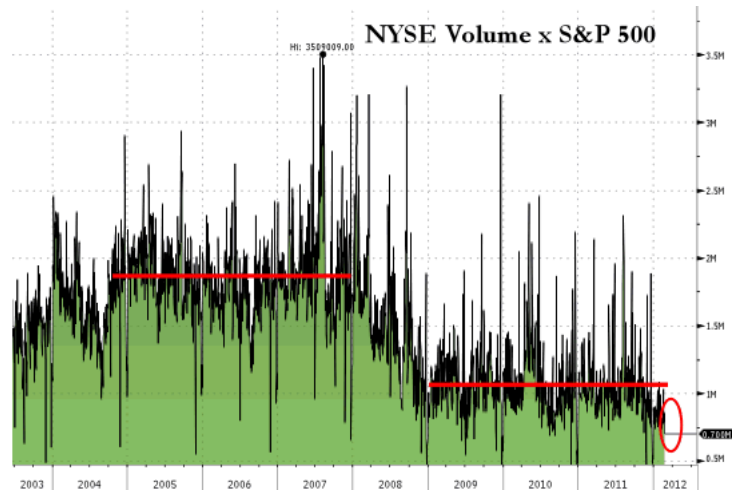
Monster Diversion

In the investment arena we typically have certain indicators pointing in certain directions which lead us to make decisions on where to be and where not to be. Our indicators generally tell us which way to go and which way to stay away from. Recently it's been all fog, nothing is clear and the indicators are giving us indications of going in both directions simultaneously.

Below you'll find the chart of the Treasury Yield against the S&P 500 index. Notice how the two move in generally the same direction but at varying degrees. Notice in the two circled areas where we have a great diversion between magnitude and direction of travel. To get back in line, we either have to have a monster rally in treasuries, a massive fall in stock prices, or some combination thereof. I think it'll be in the middle, with a bias towards credit. Credit markets are typically correct in predicting price movements as they are more conservative in nature. It's hard to fathom all of the global credit suddenly getting better in the immediate future. Notice the last time this happened the result was the implosion of 2008. We continue to tread lightly in this environment despite the current euphoria in the world today. Sometimes it's tough not to follow the crowd, but successful investing requires a maverick. We'll see how this plays out.

Volume, or a complete lack thereof!

What is this volume business anyway? People have been talking a lot about volume lately and it is an important consideration. Volume is how many buyers and sellers there are in the markets at any one time. Volume typically peaks when there is a selloff, slows down as the markets cool off, and then ramps up substantially as the markets pick up steam and head upward again. This time around we have a no volume rally. In the past six months volume has fallen off a cliff, there is no volume to speak of and it's currently at levels not seen since records on volume started to be kept. This is a cause for concern and it is new territory for the markets. Obviously there are a lot more market participants today than there were a decade ago. Why the lack in volume? We cannot tell for sure but it appears that institutions are not in the game and it's mostly individuals. Individual traders are typically small dollar players and institutions large dollar players, so the logical conclusion is the big guys are out for now.



Inspirational Quotes

- His ignorance is encyclopedic, Abba Eban
- Political correctness is tyranny with manners, Charlton Heston
- You can avoid reality, but you cannot avoid the consequences of avoiding reality, Ayn Rand
- Sex and religion are closer to each other than either might prefer, Saint Thomas More
- In theory, there is no difference between theory and practice, but in practice, there is, Yogi Berra
- Whether you think that you can, or that you can't, you are usually right, Henry Ford
- Try to learn something about everything and everything about something, Thomas Henry Huxley
- Against stupidity, the gods themselves contend in vain, Friedrich Nietzsche



**We can piece the puzzle together
and make your money work for you!**



Deferred Gratification

This is a secret of self-control and success and one all of our children should have mastered at an early age. Those who exhibit the ability to defer reward are happier and more successful in life; this applies to people as well as organizations and countries. Studies have shown a strong correlation between being able to defer gratification and successful outcomes. Those children who were able to defer pleasure showed stronger results in test scores including SAT's, better interpersonal relationships, less behavioral problems, better coping skills, better focusing ability, higher educational levels and fewer health problems.

This is huge! We should all focus on making sure the kids can wait for things and are not instantly rewarded for everything. This is a challenge today, the world works so quickly people are used to instant results, and this in turn leads to a society where we come to expect instant gratification. This is another example of slow and steady wins the race. I'd much prefer to see slow, steady and consistent progress in life over monster ups and downs as often experienced by those in entertainment.

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