

Balancing Personal Budgets

The Road to Peace of Mind



By Maye Albanez,
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"I'm living so far beyond my income that we may almost be said to be living apart."

—e. e. cummings

Budgeting is a subject we discuss often with non-institutional clients, regardless of net worth. Most of our clients come to us with significant assets following an important event in their lives—marriage, divorce, widowhood, retirement, inheritance—searching for someone to help them manage their assets responsibly, or to help get them through a difficult transition period. Some have just enough assets to last their lifetime; others have more than enough to take care of themselves, in addition to leaving a legacy for the next generation or their favorite charity. Both of these client types fit what we term *Wealth Consumers*: people who have already gathered their wealth and are now using it for specific purposes.

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“Staging” Success

Profiling Industries for Investment



By Roger L. Gewecke,
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At Clifford Swan, we believe it is a competitive advantage to be a long-term investor, especially in an age where the holding period of the average investor seems to be measured in days, not years. To maximize our long-term advantage and your investment returns, we spend a lot of research time trying to understand companies and their industries. Investors who attempt to perform well over the long term often look for companies and industries that have a durable advantage. In this article, we will consider two different frameworks commonly used by investors and analysts when trying to understand an industry and determine durable advantage: (1) the industry life cycle and (2) the five competitive forces originated by Harvard Business School Professor, Michael Porter.

Most industries evolve along a similar path known as the industry life cycle, which is broken down into four stages: introduction, growth, maturity, and decline. Though not all industries and products evolve in the same way or at the same rate, we find these four stages can be useful in understanding where an industry or company falls within its projected timeline.

In the *introduction stage* of the industry life cycle, new products are brought to market that consumers do not yet know they need. Buyers have to be convinced to try the product, which often sells at high prices as companies attempt to recoup

their development costs. It is during this initial stage that most products fail, unable to establish a market for themselves.

If a product has proven itself successful after its introduction, it enters the *growth stage*. As the group of interested buyers grows, the product attracts a larger group of producers. These producers then attempt to differentiate themselves along the quality and price scale, while consumers evaluate which of the products along that scale best fit their needs.

In the *maturity stage*, a product's market is well-saturated and some of the weaker producers have exited. Repeat buyers are now critical, and the costs of manufacturing and marketing have stabilized. Leading companies have generally established market shares, and few new companies will make the capital investment necessary to take on industry leaders.

In the *decline stage*, a company's growth has slowed as consumers have become accustomed to the product, and increased market exposure has given buyers the tools and knowledge to make educated purchase decisions. With little differentiation among products, a company seeking to maximize its profits needs to relentlessly focus on controlling its costs.

Implications for potential investors differ at each stage of the life cycle. Investment at the introduction stage is not unlike entering a crowded maternity ward and attempting to wager on which newborn has the greatest lifetime-earnings potential. It is a risky proposition, and one that does not fit the preferred risk/reward profile of our clients. Likewise, long-term investors would

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By contrast, *Wealth Accumulators* come to us while they are still working. Their goal is to accrue enough assets during their working life to fund their retirement and other life goals. Both Consumers and Accumulators have the potential to benefit from maintaining a budget.

The purpose of a budget is to help us understand how much money we have, where it goes, and how best to allocate those funds in order to achieve a healthy balance. The process should be rational and not emotional. It is not meant to teach us how to become richer or how to stretch the dollars we currently have. Instead, it is meant to help us learn how to live within our means. At the end of the day, there is no clearer, sustainable path to financial peace of mind than practicing this discipline.

Understanding Money Coming In

In our world, *money coming in* refers to one of two things:

- Money from external sources such as salary, business income, rental income, Social Security, etc.
- Money originating in investment portfolios, usually represented by a periodic distribution (monthly, quarterly, or annually). At Clifford Swan, we calculate reasonable distribution amounts to help our clients attain their portfolio objectives. For many, that means minimizing the risk of outliving money or spending money intended for an inheritance. We also monitor distributions periodically, in addition to all other outflows, to determine whether adjustments should be recommended to protect the long-term sustainability of the portfolio plan.

To eliminate some of the natural noise of budgets, *money coming in* has to first be adjusted for income taxes in order to be meaningful. Once adjusted, *money coming in* becomes the starting point of any budget.

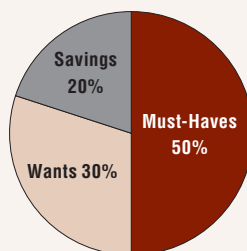
Understanding Money Going Out

For this section, I have borrowed a great concept made popular in the book *All Your Worth*.¹ The authors classify expenses or *money going out*, into three basic types:

Must-Haves, Wants and Savings.

- *Must-Haves* are what we must pay every month, in good times and in bad. They include payments for a place to live, utilities, medical care, insurance, transportation, and minimum payments on debt. As one might expect, some items in this category are less obvious, such as must-have clothes and must-have food. Common sense helps us decide whether or not that purple-and-gold pair of shoes is a “must have” or that \$500 dinner out with friends fits this category.
- *Wants* represent everything that is fun in our lives. Only we get to decide what our Wants are. Anything from eating out, to theater tickets, to massages, to vacations, to fishing trips, to gifts, to safaris...to just about anything we desire, fits this category. If you have ever been forced to count calories, you know that, over the short term, it makes no difference if you consume all your daily calories in one decadent dessert or in the form of three sensible meals and two snacks. There are no judgments passed on what we select as our Wants. What is critically important, however, is knowing that once money allocated to Wants is gone, it is truly gone (at least until the next *money coming in* cycle arrives).
- *Savings* is the final category of *money going out*, but it is by no means the least important. We can categorize Savings into two types of money, both familiar to most of us: (1) traditional savings, and (2) the repayment of the principal portion of debt.

Remembering that we define total *money coming in* as after-tax inflows, the authors of *All Your Worth* recommend the following *money going out* budget allocation, which, for obvious reasons, is commonly referred to as the 50/30/20 Rule:



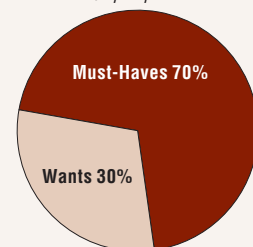
Wealth Accumulators

If you are still working and/or accumulating wealth, you might benefit from adopting the 50/30/20 Rule in its original form. As always, remember that budgets are meant to be rational and not emotional. For example, if your house payment alone makes up more than 50% of your *money coming in*, you probably are living in too much house. If you are living in too much house, you probably are not enjoying too many Wants (all the fun in our lives), and it's almost certain you are not setting anything aside for Savings. Reducing this obligation by sharing the payment with someone else, or perhaps downsizing, may be options for you to consider.

Determine how your own *money going out* is structured today. Following the Must-Haves/Wants/Savings order established above, are you a 90/5/5 or are you a 30/20/50? Is this a temporary situation or is it permanent? Is there a good reason for this? If not, would you like to start moving in a different direction? If so, set realistic goals and don't beat yourself up because change will not happen overnight. But it can happen.

Wealth Consumers with Just Enough

If you fit this group, you have probably finished accumulating all the assets you expect to have in your lifetime. You have enough to cover your Must-Haves and some Wants, but there doesn't seem to be much left for Savings. You probably own your house outright, you have no other debt, but at this stage of your life, medical care seems to cost more and more each day. If this description fits you, you probably are unable to apply the 50/30/20 Rule. Don't worry. This is why you accumulated assets throughout your life. That 20% Savings of the past is probably being consumed as a Must-Have today, so you should follow the 70/30/0 Rule instead.



It goes without saying that anytime you can add to that 20% Savings, you should. But if you are simply not able to, don't beat yourself up. This is the stage you prepared yourself for.

Wealth Consumers with More Than Enough

If you find yourself in this group, you are probably done accumulating the bulk of your assets, but you differ from other Consumers in that you are able to pay for your Must-Haves (even the cost of high medical and long-term care) and your Wants, and still have more than enough for Savings. You probably also own your house outright and have no other debt. If you fit this description, you should follow the original 50/30/20 Rule, with one twist. You have a choice in what to do with the 20% normally allocated to Savings.

If you believe one can never have enough, keep on saving. Set aside that 20% and continue to build your overall wealth. If, on the other hand, you believe you have more than enough assets to meet all your needs, and are looking for ways to reduce your estate, you should consider gifting that 20%. The obvious choices available to you include the option to give away \$13,000 annually in tax-free gifts, contributions to 529 plans for children and grandchildren, and the payment of medical and tuition costs on behalf of someone else. Another option is to give some portion of this 20% to your favorite charity.

If you choose to give your 20% away, first make absolutely sure you can afford to do so. Ask your advisor when in doubt. There are few things worse than working hard all your life to secure your financial independence, only to have to seek help from your children and the money you originally gifted to them.

Budgeting is a subject complex enough to fill seminars and books. We hope this article has provided some basic tools that may help you understand where your money is going, and more importantly, whether that flow of money is sustainable over the long term. Even if you have no need or desire to maintain a budget, we encourage you to put yourself through the 50/30/20 or the 70/30/0 exercise. Perhaps you know someone who could benefit from following this exercise. Either way, we all know one of the greatest feelings in life is financial independence. But what not everyone remembers, or chooses to remember, is that the first step to financial independence is learning to live within one's means. ♦

1. *All Your Worth* by Elizabeth Warren and Amelia Warren Tyagi

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not wish to invest in companies in the decline stage when the risk of seeing their capital steadily erode over time is high.

Fortunately, the growth and maturity stages can offer good risk/reward profiles for potential investors. If spotted during its growth stage, a company can provide a long period of strong returns as sales and earnings grow. Investors in companies such as Microsoft, General Electric, Johnson & Johnson, and other titans of American industry have enjoyed above-average returns for a long time, even if initial investments were made after the companies' major products had been introduced and proven successful. Companies at the maturity stage can also be fine, low-risk investments. The leading companies at this stage generally exhibit predictable market shares and cash flows, thus lowering investment risk. Many of the larger healthcare companies fit the bill here, as the industry is not growing as quickly as before and dividends comprise a larger part of investment returns.

Both academic theory and real-world experience acknowledge that, in a perfectly competitive market, shareholders earn only a “normal” rate of return given the level of risk taken; any excess returns attract other competitors who drive down the return to an appropriate level. Thankfully, not all markets are perfectly competitive, providing the opportunity to find companies and industries that earn excess returns for a longer period of time. How then, do we determine which growth and mature industries fit this profile? In an attempt to answer that question, we turn to Michael Porter and the five competitive forces.

In his book, *Competitive Strategy*, Harvard Professor Michael Porter introduces five forces that help define how attractive an industry might be, given its competitive environment. These five forces are: 1) the threat of new entrants; 2) the competitive rivalry within an industry; 3) the threat of substitutes; 4) the bargaining power of buyers; and 5) the bargaining power of suppliers. Let's look at each of these forces in turn, beginning with the

first and, by far, the most important.

The threat of new entrants. In general, when an industry or company earns attractive returns, it does not escape the attention of potential competitors. When new competitors enter a market, the amount of product supplied increases, and market participants must either lower prices or increase their own spending in order to maintain market share. Either way, returns on investment for those companies in the industry decrease.

As a result, investors with an eye to earning higher, long-term returns should look to industries or companies that have high barriers to entry—characteristics that might cause potential competitors to stay away. For example, General Electric has had a long-stated policy that it will not compete in markets where it does not think it can capture a leading market share, arguably a built-in deterrent to competition. Barriers to entry and lack of competition may not be such good things for a company's customers, but they are very good for a company's investors.

One of the major barriers to entry often enjoyed by market-leading companies is economies of scale. Large companies often have a high level of fixed costs associated with production facilities, distribution systems, research, and consumer analytics. With economies of scale, industry leaders are able to spread their high fixed costs over the large amount of products sold. A smaller competitor simply cannot be as profitable if it attempts to spread a large amount of fixed costs over a smaller number of products. Even if a newer competitor is relatively successful, the larger company can often lower prices to the point where its competitor is unable to earn sufficient returns. Faced with these choices, entrepreneurs generally choose not to compete in industries where market-leading companies have achieved economies of scale, and will look elsewhere for a greater chance at success.

Another barrier to entry occurs where there are high switching costs to the consumer, making the risk of switching to another product too great. For ex-

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ample, large businesses that are deeply dependent on customer and proprietary data have a lot to lose if something goes wrong during a switch to a new software systems provider; therefore, a company like Oracle, which provides these systems, can be said to have created high switching costs for its customers. Microsoft, whose operating system is now familiar to a generation of personal computer users, is another example where high switching costs have helped to maintain market leadership and earnings growth for over 25 years. Companies like this can significantly extend their time along the life cycle and be very good long-term investments.

The competitive rivalry within an industry. If there are more than a few significant competitors, and the products within an industry are not that different from one another, the industry is not attractive. As companies fight for market share, lower prices often result, which is great for consumers but bad for investors. In many ways, this is the antithesis of an industry with significant barriers to entry. One might think of big screen TV producers in this way.

The threat of substitutes. If an industry’s

products have substitutes, it lessens the industry’s profits. The U.S. Postal Service is a good example here, as e-mail now substitutes for a large part of regular mail delivery.

The bargaining power of buyers. If an industry serves relatively few buyers, the bargaining power of those buyers is high. Other factors that might increase a buyer’s bargaining power include a lack of differentiation among suitable products, low switching costs to the buyer, or the buyer’s own ability to make the product. Defense companies, for example, often sell the majority of their products to one major buyer—the U.S. government. As a result, they usually sell at lower valuations than they would with a more diverse customer base—an unfavorable characteristic for a long-term investment.

The bargaining power of suppliers. Supplier power is essentially the flip side of buyer power. If a product is unique, has no substitutes, and supplies a large number of customers, the supplier’s bargaining power is increased—an attractive characteristic for a low-risk, long-term investment. For example, although there are only a few major supermarket chains today in the United States, Pepsi, Coca Cola, Colgate Palmolive, and Procter & Gamble are all critical suppliers whose products those

supermarkets must carry. If they didn’t, a large number of consumers who regularly buy those products would shop elsewhere, lowering the supermarket’s profits.

We hope this brief introduction to evaluating industries will help you understand some of the things that research analysts and industry consultants look for when analyzing prospective investments. Companies within industries with long-term, durable competitive advantages are hard to find, but occasionally they can be identified and, when combined with a proper valuation discipline, investments in these companies can lead to handsome returns. ♦

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We Invite You To: The Young Stewards Program

Sunday, September 11, 2011 1:00-5:30pm
The Huntington Library, Art Collections and Botanical Gardens

Clifford Swan’s Young Stewards Program challenges teens (ages 15 to 19) to learn the responsibilities associated with spending, saving, investing, entrepreneurship, and philanthropy, and to explore how their own goals, values, and history influence those choices. The program incorporates a series of activities that introduce teens to the fundamentals of basic money skills, as well as the concept of human capital—personal experiences, networks, values, and traditions—as a resource for creating opportunities for themselves.

A separate program is offered for the parents, grandparents, and other adult mentors of attending teens, during which our speakers provide mentors with tools for preparing the next generation for independence as well as advice on how to approach the college admissions process.

We end the programs with a joint session, during which teens and mentors engage in activities together.

Want more information? Interested in attending? Call Sonja Weich at 626.792.2228 ♦