

## Portfolio Commentary Fourth Quarter 2012

“I fear the day that technology will surpass our human interaction.  
The world will have a generation of idiots.”  
-Albert Einstein

“Whatever method you use to pick stocks...your ultimate success or failure will depend on your ability to ignore the worries of the world long enough to allow your investment to succeed. It isn't the head but the stomach that determines the fate of the stock picker.”  
-Peter Lynch, former manager of the Fidelity Magellan Fund

“The unmentioned truth is that in 2006, the forces of privatization got Congress to shackle our post office to an absurd requirement that it must, by 2015, set aside funds to cover the health benefits of all workers who'll retire in the next 75 years. ...this includes workers who're not yet born... it's a deliberate effort to bankrupt an invaluable public asset so it can be cannibalized by privateers.”  
-Jim Hightower, former Commissioner of the Texas Department of Agriculture

“Something has gone terribly wrong when the biggest threat to our American economy is the American Congress.”  
-Joe Manchin III, Senator from West Virginia

“Democrats should have said to Republicans, ‘You're the guys who created the debt. We'll deal with the debt when we return to growth. Get lost!’”  
-Mark Blyth, in Austerity: The History of a Dangerous Idea

“Mere abstinence is not enough by itself to build cities or drain fens. If Enterprise is afoot, wealth accumulates whatever may be happening to Thrift; and if Enterprise is asleep, wealth decays whatever Thrift may be doing. Thus, Thrift may be the handmaiden of Enterprise. But equally she may not. And, perhaps, even usually she is not.”  
-John Maynard Keynes, British Economist, 1930

“The government is the last major entity left in America that doesn't use accrual accounting...if you can't measure it, you can't manage it...Congress has very poor eyesight and won't necessarily cut in the right places.... Accrual accounting would acknowledge how much the country owes future retirees. It would also differentiate investments in roads, bridges and Head Start (for example) from day-to-day spending...”  
-Jim Cooper, Representative from Tennessee

### Overview

2012 turned out to be positive one for us, as we anticipated last January. We averaged 12.4% return on all accounts, with our best gaining 40.4%. Remember that this average represents all accounts: conservative, aggressive, trading, etc. This average gives us a benchmark on which to improve. The return on your personal portfolio is what's important to us. We will devote some space in this letter to describe the steps we take to bring up the returns on those portfolio's that preform under our average. But first, what we anticipate for 2013.

We believe that the New Year will deliver positive surprises to those invested in equities. I have a sense that we are on the verge of a break-out in the value of equities. Too many have been gloomy for too long and this attitude will change. Then, the billions of dollars that sought refuge in treasuries, bonds and cash over the past four years will shift into equities. Each week delivers more positive economic news. This

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will continue. The worst is behind us. Two of the three major uncertainties that hovered over our economy during the past two years have been clarified. The first, our presidential election and the second, the Fiscal Cliff nonsense, are behind us. The lifting of the uncertainty connected to each offers us a clearer path to move forward. The final hurdle of this trinity of uncertainty, the Debt Ceiling Crisis, awaits resolution within the next two months. I think that most of us have come to realize that some in our Congress are not rational and therefore will be dealt with accordingly. Steps will be taken so that our nation will live up to our commitments and laws. We will pay our debts. We will not default on them. Our economy will continue to expand, despite the naysayers. We most likely will continue to grow at slower than historical rates, but in the long run, this is good. Ignore the "Breaking News" that we're not growing fast enough. Any stock market weakness will be an opportunity to buy values at a discount.

We took advantage of several such downturns in 2012 to add to our positions and to buy new ones. We grabbed Eaton (ETN), Intersil (ISIL) and ION Geophysical (IO) and added to our positions in Corning, Ares Capital, Manitowoc, Intel, Quicklogic, EZChip, Harmonic, Finisar, CIA Siderurgica, Nabors and Pengrowth Energy, during the year when the selling pressure was high. We missed buying several companies, including Timken, Green Mountain Coffee Roasters, Goodyear, Varian, Cliffs Natural, Johnson Controls, Jacob Engineering and Cree, when our buy limits didn't hit. However, since we have no desire to be overly aggressive on the buy side and are close to being fully invested already, we live with the misses. Several of our dogs from 2011 provided stellar returns in 2012. Anadigics (ANAD) rose 15% and MIPS Technology (MIPS) rose 75%. These were two of the five companies we featured on our 2011 Fourth Quarter commentary sent out to you last January. The other three of this group, Pace Oil, Companhia Siderurgica Nacional and Dragonwave, haven't turned the corner yet and weakened further during 2012. They will turn, in time.

Some of our most notable winners in 2012 were Alliance Bernstein (+33%), Gilead Sciences (+79.5), ITT Corp. (+21%), Exelis (+25%), DRA Property (+548%), Cedar Fair LP (+56%), Mueller Water (+130%), STMicroelectronics (+22%), Proshares Ultra Financials (+53%), Manitowoc (+71%), Huaweng Power (+77%) and Wyndham Worldwide (+42%). These returns do not include dividends. The Goodrich (GR) take over by United Technologies was completed in July and gave our long term holders a 747% gain over our cost. We originally bought GR in November 2002.

### **Your Portfolio**

The enclosed Progress Report reflects the growth of your portfolio during 2012. We are pleased with those that have exceeded our average return of 12.4% and the DJIA, which grew by 8% during 2012. We are not happy with those accounts which, for one reason or another, fell under our averages. To these, we focus special attention. We need to understand why and establish steps to improve performance.

In most cases the underperformance has to do with the time the account came to us and the size. If, for example, you turned your account over to us during the first or second quarter of 2011, we made purchases that may still be underwater. The fiscal cliff and debt ceiling debacles in the third quarter of 2011 knocked the wind out of our economic sails and stock prices. Unless we received new funds which we could have deployed during the subsequent market weakness in September and October of 2011, for example, we are compelled to hold our original positions and await their move up in value. We wish to underscore the importance of you making systematic and periodic additions to your portfolio. New cash gives us the opportunity to buy additional stocks during times of market weakness. Additionally, and this is especially relevant to smaller accounts, new money allows us to broaden out your portfolio into other sectors beyond those made with any initial investment.

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This segues into the size of your account. As you may know, we do not require a minimum account size here at Porro & Co. We wish to encourage all to begin investing and therefore work with anyone who sincerely wishes to start. However, we do not have the ability to diversify sufficiently with small accounts, unless we use mutual funds. Generally, for accounts under \$50,000, we use mutual funds as a foundation of the portfolio. This works if our funds perform. We have had good and poor results with funds over the years. In many instances, we have had better performance success with individual stocks selections in small accounts. When we bought Wyndham (WYN) in 2008 for \$5.44 in small accounts, we blew away the performance of mutual funds, as Wyndham is valued at \$56 today. Those smaller accounts that owned a preponderance of MIPS experienced substantial returns in 2012, as MIPS rose 78%. Thus, we find it difficult to ignore the possibility of delivering similar returns for smaller accounts by purchasing individual stocks instead of mutual funds. We only need one investment to move substantially to greatly enhance the performance of a small account. On the other hand, if the individual investments we make in small accounts don't work, the performance of the small account is unduly punished. We are able to diversify adequately in larger accounts and thereby do not have this problem. This is a long winded way of under-scoring again the value of your making periodic additions to your account especially if it is small. Having made my point, I hope, I'll move onto how we go about examining those accounts that are under-performing. We have developed a series of tools used to undertake this process.

The first is the Performance Report. You have a copy of this accompanying this letter. This illustrates the actual performance of your account. We run these for both short term and long term periods in order to gain better perspective. A short term blip up or down, for example, may not raise as much concern as will a longer period of underperformance.

Then we produce an Appraisal Report of what you own. We look for overall balance, diversification and income. If there is a position that is over-weighting the portfolio, we look to find an exit point in order to bring the portfolio into better balance. This is rare, since we generally do not commit more than 5% of any portfolio to any one investment. Should a holding appreciate from original purchase price to overweight the portfolio, we determine whether to lighten up or hold.

Then we look to our third tool: our Progress Report of each individual position. Here we view the period performance of each security in your portfolio and thereby come to know that which hurt us the most. With this information we move to further study the culprit and make a determination as to whether we should add, sell or hold the position. Many times we find that the lower stock price presents a great buying opportunity, and if cash is available in your account, we will buy more of the beaten down stock. I must emphasize that your periodically adding new cash to your portfolio gives us the wherewithal to do this. We then produce what we call our Stock Report. We created this in order to view your specific portfolio and sort data by fifteen different criteria that we've found helpful in selecting one stock over another. The report sorts each position so that the "better" of any one criterion prints to the top of the report, while the "worst" prints to the bottom. We use this report to select potential sellers, holders and buyers.

Finally we prepare our Portfolio Projection Report. In this we project the value of and income from all of your individual holdings three to five years into the future. With this final report we look to uncover changes we may make to your portfolio that may enhance the overall returns. Or we decide to make none and let the portfolio ride. Last year, our decision to let Anadigics and MIPS Technology ride, despite their poor 2011 performance, proved fruitful. We look at the projected annual return of your portfolio and measure this against alternatives.

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When you come to see us to discuss your portfolio, we use these reports as a baseline for our discussions with you. Of course, these are just tools and provide no guarantee that all projections will hit their targets in the time frame posted. But these do give us a basis for comparison and judgment.

In closing, I wish to emphasize that we are not market timers and therefore are never sure where the market and stock prices will go from one hour to the next or from one day to the next. However, we do know that when we are able to buy at moments when others are selling because we have fresh cash to deploy, we are able to grab bargains. This action enhances your overall long-term returns. So, please do add to your portfolio periodically and systematically, especially if you are young and in the accumulating phase of your investment life. We can make this simple by establishing monthly drafts from your checking account into your investment account. Pay yourself first, and then worry about your utility bill.

### **Retirement Cash Flow Analysis**

I have written about this analysis previously. I mention it again because it is very helpful in our financial planning work with our clients. This report projects the growth of all of your assets, income, expenses and debt over a 25 year period. With these numbers before us, we are able to determine whether you may retire comfortably, make gifts without jeopardizing your income or run into cash flow problems. We encourage you to have us prepare this analysis for you if you haven't yet or if your last one is over five years old.

In closing, we look forward to 2013. Despite all of the turmoil in the world, we will continue to forge ahead. Please give us a call should you wish to discuss further the contents of this letter. We look forward to hearing from you.

Sincerely,

Michael J. Porro, CFP, EA  
January 18, 2013

### **The day that Albert Einstein feared has finally arrived.**

(If this photo mystifies you, please refer to the first quote by Einstein on page one)