

SUMMER 2011 e-NEWSLETTER

COMING EVENTS

- > **StockTalk:** September 10 at [Indian Tree](#) and November 12 at [Southglenn Library](#).
- > **Fall Investors' Forum:** September 24th, [Colorado Christian University, Beckman Center](#).
- > **Intro to Investing & Value Line:** [Bear Valley Library](#)
- > **Intro to the Stock Selection Guide (SSG):** October 8, [Indian Tree](#)
- > **Beginning Toolkit:** October 29 in the morning and
- > **Supercharge Your SSG with Sound Judgment:** October 29 in the afternoon, both classes at the [Colorado Christian University, Beckman Center](#)
- > **Portfolio Centered Decision Making & Lab:** November 19 in the morning and
- > **Club Mechanics** in the afternoon, both at [Colorado Christian University, Beckman Center](#)

INFLATION AND YOU!

Inflation is currently running a supposedly benign 2 or 3%. Not a very big number and not much to worry about. Or is it?

Suppose inflation is running an average of 2.5% per year. What affect might that have on real income?

Suppose you're a 65 year old retiree with one million dollars in savings seeking "safe and dependable" income in retirement. Your first thought will run to bonds and what can be safer than Treasury bonds which are backed by the "full faith and credit" of the US government? So you buy a million dollars of worry-free ten year Treasury bonds so you can sleep at night and enjoy that safe and dependable income.

Current ten year Treasury interest rates are running 3.22% yielding you an annual income of \$32,200 and combined with Social Security of maybe \$14,000 gives a nice total of \$46,000. But you must compensate the effect of inflation in order to maintain your **purchasing power** and inflation is running 2.5%. So you must set aside \$25,000 of that \$32,200 to add to the initial million dollar investment just to keep purchasing power constant next year. And you must do this year after year just to maintain your purchasing power. Hummm. That only leaves \$7,200 this year. Wow that hurts. But wait, you must also pay taxes on the Treasury bond income and the tax is figured on the \$32,200, not the more realistic \$7,200 which is what's left in purchasing power after accounting for inflation. So assuming you are in the 20% tax bracket, the government must be paid \$6,440 in taxes. After inflation and taxes, you only have a paltry \$760 left.

Now do you see why we must be savvy investors even in retirement? We have to maintain a portfolio that grows faster than inflation while paying us a decent income. That means taking on more risk. You can find more on this important topic by reading a great article by Christine Benz titled [The Error-Proof Portfolio: Inflation Could Destroy Your Retirement if You Don't Plan Ahead](#)

How does one find out what the current inflation outlook is according to the investor community? All you have to do is go to the US Department of the Treasury Resource Center ["Daily Treasury Yield Curve Rates"](#) and look under the 10 year column and the row

for today's date and read the 10 yr. bond yield. As of 7/20/2011 it is 2.99%. Now do the same for "[Daily Treasury Real Yield Curve Rates](#)" and look for the real yield for today. As of 7/20/2011 it was 0.61%. Now the currently anticipated inflation rate is just the difference in these two numbers: 2.99% minus 0.61% equals 2.38% the anticipated inflation rate.

TALES FROM THE BRIGHT SIDE

One of the best things that can happen to us as investors is to have a company buy the company we own and pay a good price for it. The stock of the company being acquired frequently jumps 20% or more in value overnight on the news even before the deal is closed. Very nice! But what if the deal falls through? Then the stock will probably come back down to earth and we'll feel we missed our opportunity. Should we have sold for a nice profit when our stock jumped on the news? Or is it wiser to wait until the deal closes and take even more profit? Much depends upon what you feel is the chance of the deal closing and the value of the deal if and when closed.

Let's work through an example that may strike home to many of you reading this newsletter. Just recently, [Express Scripts \(ESRX\)](#) offered to buy out [Medco Health Solutions \(MHS\)](#) stockholders and merge the two companies. Both are PBMs or [pharmacy benefits managers](#) growing at 16% and 17% respectively so they should fit well as a merged company. And it's a very good deal for MHS stockholders. The deal is that ESRX will pay \$28 cash and 0.8 ESRX stock for each MHS share. MHS stock jumped 24% on the news. ESRX also jumped 9% on the news because investors feel this would be a great acquisition. So, as

an MHS stockholder you could take a hefty profit right now before the close of the actual deal, or hold on and see if the deal closes and realize even more profit.

The first thing is to calculate the value of the deal if it closes. MHS stock today (7/25/2011) fetches \$65.96 and ESRX sits at \$57.30. The value of the deal to MHS stockholders should be the sum of the \$28 cash payment plus 0.8 times the value of ESRX stock, \$57.30. That works out to be \$73.84. That's what the deal is worth if closed. Should you sell at \$65.96 or wait to see if the deal closes for a net worth of \$73.84 in cash and ESRX stock which is a 12% premium to current value.

Now it turns out that analysts believe this deal faces a huge approval hurdle at the FTC because of anti-trust concerns. Most analysts believe ESRX has only a 50% chance of gaining FTC approval. Without that approval, the deal falls through and MHS stock falls back to \$54.48 per share and you could end up missing out. Hold or sell?

Remember, you have only an additional 12% to gain by holding and the chances of that happening are only 50 – 50 so multiplying 12% by 50% gives 6%. By holding and hoping for a deal closure, you have only a 6% risk adjusted gain beyond the 24%, i.e. 30%.

These are the options:

- Sell now for a quick gain of 24%
- Hold and hope
 - Deal approved: 36% gain
 - Deal disapproved: 0% gain
 - Risked gain of 30%

Only you can make that final decision. We should be so lucky as to have these kinds of decisions more often! 😊

"The deepest sin against the human mind is to believe things without evidence". - T.H. Huxley