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Crummer/Suntrust Portfolio: Analysis and Recommendations [2008]

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Unfavorable economic conditions have prompted the investment team to meet a short-term goal: preserve the value of the portfolio by reducing overall risk. A top-down analysis of the current portfolio resulted in recommendations to change the portfolio by eliminating funds, investing in long-term government bonds, TIPS, and large cap value type securities. Allocations of securities were performed by either overweighting or underweighting a particular sector, depending on its historical and expected return during a recession. Individual securities were analyzed by our sector analysts and recommendations of hold, buy, or sell were made. The outcome: a robust portfolio, that will preserve its value during the recession by reducing its overall risk by 25%.

The goal is to hold or increase the value of the Crummer Suntrust Portfolio. The organization needs to raise enough equity for administrative and trading expenses, allowance for inflation and distributions of approximately $25,000 for scholarships. Exceeding the goal next year would entail having positive real portfolio growth.

A revision of our Investment Policy Statement (IPS) was required to bridge the gap between asset class allocation and sector allocation method. It became clear that the two methods were best used for different time periods. Sector allocation helped manage our short term goals, while asset class allocation helped manage our long term goals. Meeting our tactical goal of 0 – 2 ½% real growth we would be heading in the right direction to meet our 5 year strategic goal of 2-2 ¼%.

IPS is attached in the insert of this report.

Sectors that have historically performed well in a recession, or have a catalyst that may spur growth next year were overweighted. These sectors include:
- Consumer Staples
- Materials
- Energy

Sectors that have historically performed in a recession, or are expected to contract next year were underweighted. These sectors include:
- Financials
- Consumer Discretionary
- Technology

Proposed addition of investment vehicles with less risk, such as long-term treasury notes and inflation-protected securities, will provide a stream of income and protection against inflation, respectively.

Value @ Risk was the method used to determine our overall current and proposed portfolio risk. Value @ Risk defines the worst expected loss with a 99% selected confidence level over a one month timeframe.

Results

Relative to the current portfolio, we are 99% confident that the Value @ Risk of the new portfolio is reduced by 25%.

Graph above confirms that the new portfolio is expected to produce virtually the same level of return at a considerably reduced level of risk.
The proposed portfolio eliminates mutual funds, but adds treasury inflation protected securities.

Relative to the current portfolio, the following summarizes the proposed changes:
- Cash, Bonds: Increase 11%, This includes addition of TIPS.
- Staples proposed increase of 3%
- Materials proposed increase of 1%
- Energy proposed increase of 3%
- Industrials proposed increase of 1%
- Telecom proposed decrease of 3%
- Healthcare proposed increase of 3%
- Utilities proposed decrease of 3%
- Consumer Discretionary proposed increased of 3%
- Technology proposed decrease of 5%
- Financials proposed decrease of 3%

The Crummer/Suntrust current portfolio holdings (to the left) lean more towards value and are reflective more of mid cap companies.

The proposed portfolio maintains its tilt to value but is more reflective of a large cap company.

This change is reflective of our goal to reduce the risk of the portfolio in efforts to maintain its value.
**Industry Threats:**
- Patents are expiring in many drugs
- Elections will have impact on healthcare

**Industry Opportunities:**
- Demographic growth in the elderly

**Characteristics of companies chosen:**
- #1 firms in their specialty
- Large firms with healthy revenues
- Large domestic corporations

**Areas Explored:**
- Pharmaceuticals, Medical Supplies, Services and Biotechnology.
- Electric & Water Utilities.

**Proposed Holdings**
- CVD
- JNJ
- PRGO
- SYK
- STJ
- MRK
- AWR
- EXC

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**Preservation of Value**

**Underweight, -1%**

**Industry Threats:**
- Reduced dividends & profits due to regulated pricing and high energy costs

**Industry Opportunities:**
- Inelastic demand for goods
- Steady Earnings Growth
- Above average dividend yields

**Characteristics of companies chosen:**
- Foreign demand (China & India) rising
- Large firms with healthy revenues

**Areas Explored:**
- Software and Services, Technology
- Hardware and Equipment, Semi-Conductors.

**Proposed Holdings**
- IBM
- HPQ
- MSFT
- CAN
- EMC
- ADP
- FLEX
- others

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**Discretionary Spending**

**Underweight, -5%**

**Industry Threats:**
- Postponable expense
- Companies are looking abroad for sales

**Industry Opportunities:**
- Foreign demand (China & India) rising

**Characteristics of companies chosen:**
- Large firms with healthy revenues

**Areas Explored:**
- Software and Services, Technology
- Hardware and Equipment, Semi-Conductors.

**Proposed Holdings**
- IBM
- HPQ
- MSFT
- CAN
- EMC
- ADP
- FLEX
- others
**Industry Threats:**
- Consumer cut-backs on luxuries
- Insolvency of insurers
- Tightening labor market
- Subprime mortgage meltdown
- Increased energy costs
- Consumer credit crunch

**Characteristics of companies chosen:**
- Firms with high credit quality
- Firms with strong balance sheets
- Firms with dividends

**Areas Explored:**
- KO SPLS BAC HIG
- MCD ANF GS LYGURBN DIS NLY BR

**Discretionary Spending**
Underweight, -3%

**Areas Explored:**
- Autos, Auto Parts, Apparel, Household Durables, Lodging, Gaming, Restaurants,
  - Commercial Banking, Insurance, Asset Management, Investment Banking, REITs.

**Proposed Holdings**

**Financials**

**Proposed Holdings**

- KO 24%
- SPLS 11%
- MCD 19%
- ANF 14%
- URBN 11%
- BAC 48%
- GS 6%
- HIG 13%
- NLY 10%
- LYG 11%
- DIS 5%
- BR 5%
- USB 43%

**ECONOMIC CONDITIONS**

**RECESSION**
We are currently faced with what people were afraid to hear, see or taste... RECESSION. The economic outlook for the next year is bleak. In January 2008, John Silvia, leading economic advisor for Wachovia Securities, stated there was a 57% chance of a recession; in March 2008 he raised the figure to 100%. We are in a recession. Many economic events have triggered negativity in the marketplace. The #1 bandit was the financial sector; leading the decline on concerns regarding issuance of poor quality debt. The consumer discretionary sector followed the financial sector in the downhill race, as the tightening credit market left buyers without a source of capital for purchases.

Inflation has been on the rise and is expected to continue to increase as Federal Reserve decreases its federal funds rate...
Current Holdings

CVD MRK EXC HPQ ACS
PRGO PFE FLEX MXIM
.ACN ADP NVD A
other

Strategy
- Invest in large international companies
- Remove securities that compete / are in the same segment

HOLD
CVD, Covance Inc:
Leading global contract research company
Sales are steady due to strength in testing
MRK, Merck:
Steady sales due to strong product demand
PRGO, Perrigo:
Over the counter prescription manufacturer will retain steady stream of revenue

ADD
JNJ, Johnson & Johnson:
Diversified business with steady stream of revenue from over the counter prescriptions
STJ, St. Jude Medical:
Positive outlook for medical supplies. St. Jude poised to benefit due to realized R&D
SYK, Stryker Corp:

Strategy
- Invest in domestic companies with strong balance sheets
- Preference given to companies with full scope services

HOLD
EXC, Exelon:
Large customer base with a focus on clean electricity production utilizing nuclear and natural gas.

ADD
AWR, American States Water Company:
Provider of water services
Provider of electricity distribution services.

Strategy
- Invest in services companies
- Invest in large global companies
- Focus on IT companies providing services to businesses and hardware companies

HOLD
HPQ, Hewlett Packard:
2/3 of revenue from international sales
FLEX, Flextronics International Ltd.:
Inorganic growth
ADP, Automatic Data Processing:
Client outsourcing yields more revenues
ACN, Accenture:
Increased client outsourcing yields more revenues from services

ADD
EMC, EMC Corp:
Global company with steady sales
IBM, International Business Machines:
Services for leaner business processes
MSFT, Microsoft:
Large global company with steady sales, PE
The recession will have a large negative impact on our current portfolio if we continue to hold as is. We are in a defensive mode that requires re-allocation of current assets based on next year's economic outlook.

To maintain the value of our portfolio, the Target Total Return will need to satisfy the following items:

> Administrative and trading expenses will be reduced to a minimum
> Expected inflation greater than 3%, will be recovered by using TIPS
> The disbursement of 20,000 USD will be replenished through interest earned on bonds and dividends received from several securities.
> Real Growth Rate will be greater than or equal to 0%

A top down analysis of the market was performed to recommend changes to the portfolio. Sectors were reviewed individually against the S&P sectors, and were either overweighted or underweighted depending on the economic outlook for the coming year. Each sectors were grouped into the following themes:

**The Underweights: Credit & Discretionary Spending.**
These sectors underperformed in the last two recessions:
- Financials
- Technology
- Consumer Discretionary
- Energy

**The Neutrals: Preservation Of Value**
These sectors have relatively inelastic demand:
- Telecommunications
- Industrials
- Healthcare
- Utilities

**The Overweights: Counter-Cyclical**
These sectors overperformed in the last two recessions:
- Materials
- Consumer Staples

For the current year, energy was also classified as an over performer due to the rapid expansion both globally & domestically.
**Industry Opportunities:**
- Best performing sector in last 2 recessions
- China & India expansion
- Non-residential construction

**Industry Threats:**
- Domestic Auto Industry Struggles

**Characteristics of companies chosen:**
- International firms specializing in metals

**Areas Explored:**

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**Counter Cyclical, Over 4% Overweight, 5%**

**Industry Opportunities:**
- Inelastic demand for goods.
- Outperforming sector in last 2 recessions

**Industry Threats:**
- Lower profits due to higher energy costs

**Characteristics of companies chosen:**
- Firms that increase revenue in recessions

**Areas Explored:**
- Agricultural Products, Brewers, Distillers, Vintners, Drug Retail, Food Distributors, Food Retail, Household Products, Tobacco.

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**Counter Cyclical Overweight, 3%**

**Industry Opportunities:**
- Increasing demand globally through emerging markets
- Increasing domestic demand for alternative energy
- Disruptions of supply
- Rising Energy Prices

**Characteristics of companies chosen:**
- Diversified firms with global market demand

**Areas Explored:**
- Energy Equipment and Services Industry & Oil, Gas and Consumable Fuels Industry.

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**Proposed Holdings**

- **Counter Cyclical, Over 4% Overweight, 5%**
  - FCX: 49%
  - RIO: 23%
  - DOW: 28%

- **Counter Cyclical Overweight, 5%**
  - PG: 18%
  - CVS: 13%
  - AVP: 8%
  - CL: 16%
  - BUD: 13%

- **Counter Cyclical Overweight, 3%**
  - SU: 21%
  - CVX: 17%
  - VLO: 17%
  - CLNE: 21%
**Preservation of Value**

**Overweight, 2%**

**Industry Threats:**
- Financing sector may impact spending

**Industry Opportunities:**
- Energy infrastructure expansion
- Expansion in emerging markets

**Characteristics of companies chosen:**
- Firms involved in China & India expansion

**Areas Explored:**

**Preservation of Value**

**Overweight, 1%**

**Industry Threats:**
- Revenue reductions due to consumer cutbacks on luxuries (credit crunch US)

**Industry Opportunities:**
- International expansion of wireless services

**Characteristics of companies chosen:**
- Large firm with wireless product

**Areas Explored:**
Integrated Telecommunications Services & Wireless Telecommunications Services.

**Proposed Holdings**

- JEC (16%)  
- MMM (21%)  
- GE (21%)  
- DHR (11%)  
- UTX (11%)  
- IXP (11%)  
- HEI (20%)  

**Cash, Bonds and TIPS**

Cash, Bonds and Tips comprise approximately 20% of the entire Crummer/Suntrust Portfolio. The team utilized bonds to provide interest income for the purpose of funding scholarships and TIPS in an effort to reduce the negative effects of inflation. The picture below illustrates the allocation of these three categories:

- **Cash**
  Cash will be used to pay administrative and trading expenses. Excess cash will be invested in the money market.

- **Bonds**
  Bonds were used to provide a source of steady income to fund the scholarship disbursements from the portfolio. We chose the 30 year bond because it provides a good return while interest rates are low. Given the current economic conditions we foresee a fed fund rate reduction and although we do not anticipate any fed fund rate increases, we are poised to benefit off any reductions with this long term bond.

**Integrated Telecommunications Services & Wireless Telecommunications Services.**
Current Holdings

DOW PG BUD HP CVX
CASH SYY CVS MRO
STZ AVP XOM

Strategy
> Invest in large global companies
> Favor firms with commodities that are required for global expansion in energy

HOLD
DOW, DOW Chemical Company:
International sales account for 50%+ revenue

ADD
FCX, Freeport-McMoRan Copper & Gold Inc.
China growth supports copper prices - 80%
FCX revenue generated from copper.
RIO, Companhia Vale do Rio Doce
International growth supports iron demand - 63%
RIO revenue generated from iron.
Large amount of product is exported to China
Large player in iron ore trade.

PG
SYY
STZ

BUD
CVS
AVP

Strategy
> Invest in large global companies
> Favor firms that are inelastic in demand

HOLD
PG, Proctor & Gamble:
Steady sales and cost reductions
Increasing presence in developing countries
SYY, Sysco Corp:
Steady sales in wholesale food.
BUD, Anheuser-Busch Companies Inc:
Sales increase expected.
Globally expanding
CVS, CVS Caremark Corp.:
Accelerated growth due to acquisition
Increased sales of high margin generic drugs
AVP, Avon Products
China & Eastern Europe growth in revenues
Cost reduction efforts being realized
ADD
CL, Colgate-Palmolive Co.:
In pursuit of business in high growth areas of the world

HP
MRO
CVX

Strategy
> Invest in firms specializing in renewables
> Invest in firms specializing in oil exploration, production, and sale.
> Invest in firms with focus on natural gas

HOLD
CVX, Chevron Corp.:
International firm specializing in exploration, production & sale of crude oil & natural gas.
XOM, Exxon Mobil Corporation:
Interests in renewable energy
International firm specializing in exploration, production & sale of crude oil and natural gas.
ADD
CLNE, Clean Energy Fuels Corp.:
CLNE’s product is considered a solution to greenhouse gas effects.
VLO, Valero Energy Corp.
Main business is refining oil. Expected profits to increase with high oil prices.
SU, Suncor Energy:
International sale of fuels.
Invested in oil sands project.
Current Holdings

TIPS: Treasury Inflation Protected Securities

Inflation is a problem. 2008 has started off with an inflation rate of about 4%, which is expected to rise with decreases in the federal funds rate. We will need to produce enough capital to overcome the negative effects of inflation; thus increasing our target for real growth rate. In a recessionary period it is already difficult to have real growth so we plan to reduce the effects of inflation by choosing a treasury inflation-protected security (TIPS). The purpose of a TIPS fund is to take advantage of economic conditions with moderate to high inflation. It helps our portfolio by reducing the risk associated with the inflation.

Strategy
> Invest in large diversified companies
> Invest in firms providing product to non-US customers
> Invest in firms with backlogs

HOLD
JEC, Jacobs Engineering Group:
International technical & engineering services focusing on environmental and defense fields
MMM, 3M Corporation:
Diversified products & international customers
HEI, Heiko:
3rd party provider to parts for airline industry
DHR, Danaher Corporation:
Recession proof company
50% international sales
GE, General Electric:
Growth through organic and inorganic means
Supplies diverse products internationally

ADD
IXC, ishares:
Diversification strategy is implemented with the purchase of global ishares
Any mergers or acquisitions of firms in the industry will increase the value of ishares

CONSUMER PRICE INDEX

VIPSX - Vanguard Inflation Protected Securities
This fund was chosen because of its above average return from year to year compared to similar funds in the category. VIPSX has a low expense ratio, it invests only in AAA rated bonds and it is comprised of 99.75% TIPS only. Additionally, both managers had exposure to the last recession which positions us for above average returns.