January 2012 – Account Management Efficiency

In a year like this it is easy to appreciate how important it is for your account to be managed efficiently. Applicable costs could determine whether you have an up year or a down year. Callahan Advisors' philosophy is to minimize turnover and strive for tax efficiency. Such costs that affect you are: (1) transaction costs which include commissions (2) market efficiency (the difference between what someone is willing to buy or sell a stock for – even though there is usually just a one to three cent difference per share, it all adds up) and (3) income taxes. (Long-term capital gains may be taxed at 15.0% while short-term capital gains can be taxed at up to the maximum individual tax rate.) Income taxes are also affected by the holding period of the asset, the nature of the account (IRA or other tax deferred account), or the type of security (taxable or non-taxable), and in the case of mutual funds all of these same costs plus their management fees. (The average stock mutual fund was down 2.9% in 2011. This 5% underperformance was before income taxes). Callahan Advisors also charges you a fee.

To state this all another way is to say that everything counts. And when you have a year like 2011, or like the twelve years ending in December 2011 (See Exhibit.), these costs can really impact whether or not you are creating, preserving, or depleting your wealth. Then, on top of all of that are the insidious aspects of inflation and that 0.67% CD rate the average bank is paying.

Are Stocks a Good Investment? – Part II

We would like to continue the discussion we began last quarter regarding whether or not stocks are good investments. As we stated in that letter, we continue to believe they are, particularly in light of the very low interest rates even for "risky" securities.

We recommend you refer to the Exhibit while reading the following.

The ten stocks selected are the ten largest companies in the S&P 500. Together their market value is equal to 20% of the total market value of the S&P 500; thus, the other 490 stocks combined are only four times larger than these ten.

Consider these points for the twelve years ending December 31, 2011:

- The S&P 500 index is down 9.8% during this time.
- 3 of the 10 stocks (Microsoft, General Electric, & Pfizer) are down for this period.
- Only Apple and Chevron do better than 5.0% annually, although Exxon just misses it.

- All ten have more cash flow return per share today than they did twelve years ago. AT&T has about the same cash flow return per share, but Microsoft is 5.5 times greater. Apple's Cash Flow Ratio (see below) is the lowest of the ten.

- Apple doesn't pay a dividend. Exxon and Chevron, while paying a higher dividend than they did twelve years ago, have a lower yield. Microsoft did not pay a dividend twelve years ago, but today its dividend yield is 3.1%

Our conclusion is that since the Cash Flow Ratio (cash flow per share as a percent of market value per share) is so much higher than it was, and the dividend yield is also generally higher than it was, and much higher than the current CD rates or the two-year U.S. Treasury Bond, owning such securities makes a lot of sense today. Probably GE, AT&T, and Pfizer would give people the most concern, but in analyzing the changes those companies have made in the last three years we believe they have shown that they have capable managements which are taking them in a positive direction. The nine that pay dividends have also increased their dividend in the last year and are likely to continue to do so for the foreseeable future.

Thus, while we have many concerns about the domestic and international economies, the political process in the U.S., the levels of government debt, and the adequacy of capital of multi-national financial institutions, these companies have demonstrated over many years that they will take appropriate strategic actions and reward the owners of their securities through growing and preserving their wealth while providing them with income that continues to grow.

There are many other things that can be written on this topic, but we believe that it affirms strongly our conviction that stocks deserve a significant allocation of your investment dollars.

As we start 2012, we are optimistic, but we are also very grateful for your trust. Your comments and questions are always welcome.

EXHIBIT

Selected Stock Data
12/31/1999 to 12/31/2011

	S&P 500	XOM	AAPL	IBM	CVX	MSFT	GE	PG	T	JNJ	PFE
MARKET VALUE/SHARE 12-31-1999	1394.46	31.70	25.94	97.42	28.15	38.17	31.37	38.20	24.81	32.59	24.65
MARKET VALUE/SHARE 12-31-2011	1257.60	84.76	405.00	183.88	106.40	25.96	17.91	66.71	30.24	65.58	21.64
% INCREASE (DECREASE)	**(9.8%)**	**167.4%**	**1461.3%**	**88.7%**	**278.0%**	**(32.0%)**	**(42.9%)**	**74.6%**	**21.9%**	**101.2%**	**(12.2%)**
CASH FLOW/SHARE 1999		2.40	0.79	7.50	3.76	0.99	1.77	2.34	4.59	2.03	1.02
CASH FLOW/SHARE 2011		12.00	29.55	17.45	21.65	3.09	2.20	5.21	5.70	6.20	2.30
% INCREASE IN CASH FLOW		**400.0%**	**3640.5%**	**132.7%**	**475.8%**	**212.1%**	**24.3%**	**122.6%**	**24.2%**	**205.4%**	**125.5%**
CASH FLOW RATIO 1999		**7.6%**	**3.0%**	**7.7%**	**13.4%**	**2.6%**	**5.6%**	**6.1%**	**18.5%**	**6.2%**	**4.1%**
CASH FLOW RATIO 2011		**14.2%**	**7.3%**	**9.5%**	**20.3%**	**11.9%**	**12.3%**	**7.8%**	**18.8%**	**9.5%**	**10.6%**
% INCREASE IN CASH FLOW RATIO		**87.0%**	**139.6%**	**23.3%**	**52.3%**	**358.9%**	**117.7%**	**27.5%**	**1.9%**	**51.8%**	**156.9%**
DIVIDEND PAID - 1999		0.88	—	0.48	1.30	—	0.55	0.64	0.98	0.56	0.32
DIVIDEND PAID - 2011		1.88	—	3.00	3.24	0.80	0.68	2.10	1.72	2.28	0.80
INCREASE IN DIVIDENDS		1.00	N/A	2.52	1.94	0.80	0.13	1.46	0.74	1.72	0.48
DIVIDEND YIELD - 1999 (%)		**2.8%**	**N/A**	**0.5%**	**4.6%**	**N/A**	**1.7%**	**1.7%**	**3.9%**	**1.7%**	**1.3%**
DIVIDEND YIELD - 2011 (%)		**2.2%**	**N/A**	**1.6%**	**3.0%**	**3.1%**	**3.8%**	**3.1%**	**5.7%**	**3.5%**	**3.7%**
% INC(DEC) IN DIV YIELD		**(20.1%)**	**N/A**	**231.1%**	**(34.1%)**	**N/A**	**117.9%**	**87.9%**	**44.6%**	**102.3%**	**184.8%**

CASH FLOW RATIO IS CASH FLOW PER SHARE AS A PERCENT OF MARKET PRICE PER SHARE AT YEAR END

XOM = Exxon Mobil Corporation
AAPL = Apple Inc.
IBM = International Business Machines Corp.
CVX = Chevron Corporation
MSFT = Microsoft Corporation
GE = General Electric Company
PG = Proctor & Gamble Co.
T = AT&T, Inc.
JNJ = Johnson & Johnson
PFE = Pfizer Inc.

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