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October = Market Volatility?

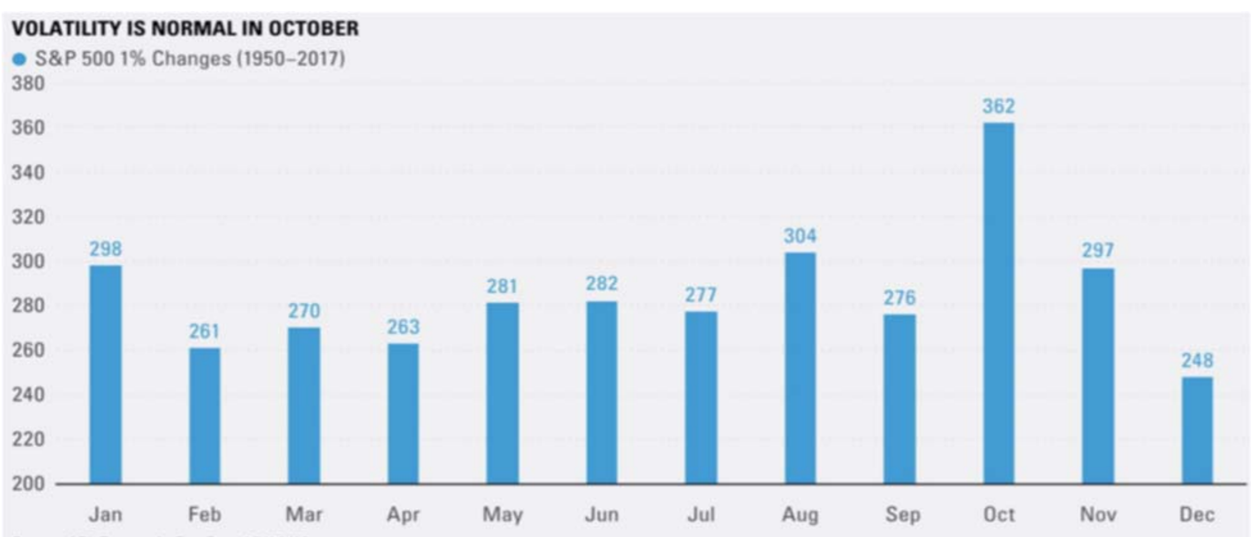
In case you haven't noticed, we have experienced increased market volatility in October. What is going on? Why is this happening? Will it continue?

Let's review what has happened recently in the markets and our economy:

- The S&P 500 just registered its largest quarterly gain since the end of 2013 with an eerily calm, steady climb higher
- The Federal Reserve continued to raise rates and the 10-year Treasury yield hit a 7-year high
- U.S Employment data continued to show strength with the unemployment rate nearing a 50-year low
- Trade tensions between US and China continue to mount

The month of October has historically been more volatile than other months of the year. And, some of the most notorious market moves have occurred in October (1929, 1987 and 2008).

Below is a chart showing the number of 1% changes in the S&P 500 during different months of the year. As you can see, October tends to be the month that we see the greatest market volatility.



Source: LPL Research

The important thing to remember is market volatility is normal. The stock market will fluctuate UP and DOWN, we cannot control or predict it. For our investment strategy, we try to focus on what we can reasonably control and predict…the income. We focus on owning high quality companies that pay dividends and have the potential to increase their dividends, no matter what the daily market averages are doing. And, if you are reinvesting the dividends, then a down market can actually be beneficial because you can accumulate additional shares at lower prices, which can potentially increase your income in the future .

One Trillion Dollars

On August 2nd of this year, the market value of Apple (AAPL) exceeded the one trillion-dollar mark. For those of you who are numerically challenged, that figure is $1,000,000,000,000.00. The market value is the number of outstanding shares multiplied by the market price per share.

The race to be the first company to reach the one trillion-dollar mark was relatively close with Amazon (AMZN), Alphabet (GOOG) and Microsoft (MSFT) all appearing to have a chance to be the first.

Of course, there is nothing magical about a company's market value hitting a certain level, but we do tend to "win" if we are the first company to hit some large round number.

Microsoft was the first company to have a market value of $500 billion and that occurred in 1999. Its share price dropped shortly after that milestone and it did not reach that market value again until 2014 which was fifteen years later.

IBM was the first company to see its market value exceed $100 billion in 1987. Interestingly enough, the three companies closest to IBM at that time in market value were Exxon (XOM), General Electric (GE), and General Motors (GM).

If we go back fifty years, to the end of 1967, we see the ten companies with the highest market values:

IBM
AT&T
Eastman Kodak
General Motors
Exxon
Texaco
Sears, Roebuck
General Electric
Polaroid
Gulf Oil

Obviously, fifty years is a relatively long period of time. Several of these companies did not survive the five decades and if they did survive it was in a much different form.

If we go back further, the first company to have a market value of $10 billion was GM and they hit that level in 1955.

Going back even further, U.S. Steel (X) is generally considered the first publicly traded company to achieve a market valuation of $1 billion and that was in 1901. (The inflation calculator at westegg.com/inflation indicates that $1 billion in 1901 is the equivalent of about $30 billion in 2018.)

Looking over the names of these large companies, it is easy to see the changing corporate landscape. I often wonder what industries will contain the largest market value companies in ten, twenty or fifty years??

(NOTE: This is not an article encouraging you to purchase or sell shares of any company we mention, we are just having a little fun. Information for this article came from MarketWatch, Visual Capitalist and WINTON Global Investment Management.)

The Rich Guys

If you have traveled around the country a little, you may have toured the “estates” of some rich corporate barons from the past. The Carnegie Mansion, the Biltmore Estate, The Getty Villa, etc. These gentlemen made their money from the manufacture of steel or the pumping of oil. Other historically wealthy men made their wealth from real estate, mining or many other areas.

The “New Rich Guys” are a little different. Most of the recent corporate wealth has been created by some form of technology company.

You may have read recently where the share price of Facebook (FB) dropped about 20% in one day; thus destroying $120 billion of market value for the company. The company’s founder, Mark Zuckerberg, age 30, saw the value of his shares drop by about $15 billion.

But, don’t feel too bad for the young entrepreneur as he is giving about $45 million in stock every single trading day to his philanthropic foundation. *(MarketWatch, July 30, 2018.)*

Or, what about the parents of Amazon’s Jeff Bezos? Apparently, they invested all they had, about $245,000, in Amazon when it was founded in 1995. They could have lost it all, but instead Bloomberg estimates they are now worth about $30 billion…making them two of the richest people in the world. *(Business Insider, July 31, 2018)*

The Big Just Keep Getting Bigger

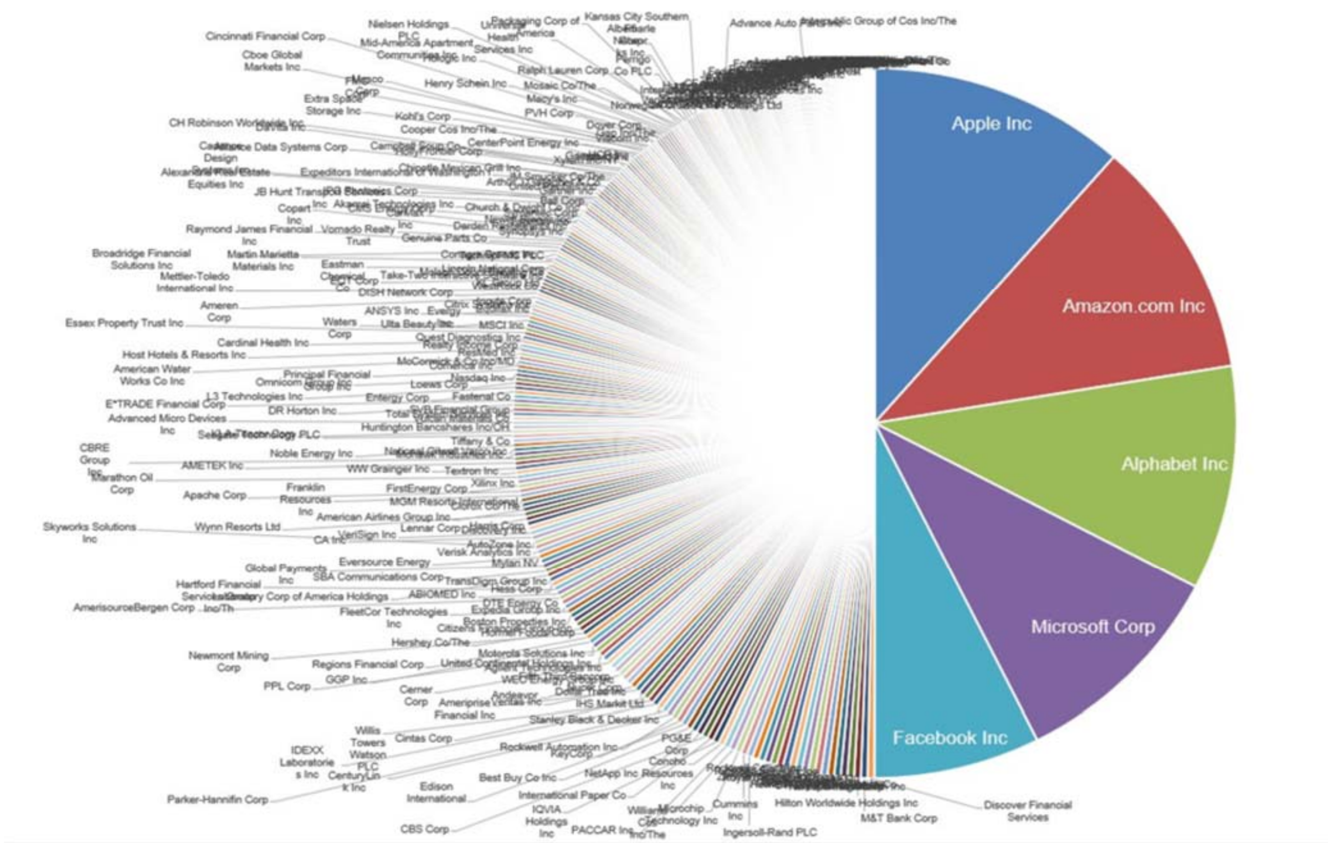
Below is a diagram from Ritholtz Wealth Management that shows the top five companies by market value of the Standard and Poor's 500 Index and compares them to the smallest 282 companies of the same Index.

This may seem like a big concentration among a small number of companies, but *MarketWatch* reported that in 1965 two companies, AT&T and GM accounted for almost 15% of the Index.

Why is this happening? Well, these five companies are very successful at what they do, their revenues and earnings are growing rapidly, and they are in industries that, at least now, seem to have an unlimited future.

There may be another reason as to why these companies are seeing their share prices rise so rapidly. Since 2009, we have seen an extremely big increase in the amount of money flowing into funds that follow a market index. The industry calls this *passive investing,* meaning there is no active management to make decisions as to what stocks to buy or sell. Naturally, since there is no active management of the funds, it is cheaper than the typical *actively managed* fund. It is also, in a way, a momentum strategy in that the more money that flows into this strategy, the more the large holdings go up in value. The more the index goes up in value, the more money is attracted to it.

We actually used a lot of this strategy in the mid-1990's. It works very well…until it doesn't.



Twelve Years with No Gain

Do you have an investment strategy that can survive twelve years with no stock market gains?

Is your basic investment strategy to invest in some sort of *index fund* that follows a market index?

The 2000's:

In early-2000, the S&P 500 Index was at about 1,500.

In early-2013, the S&P was at about 1,500.

The 1970's:

In late-1968, the S&P 500 Index was at about 110.

In mid-1982, the S&P was at about 110.

Today:

The S&P 500 Index is currently in the 2,800 range. Will your investment strategy be successful if, in 2030, the Index is still in the 2,800 range?

"*The S&P 500 Index is an unmanaged index that cannot be invested into directly."*

What is the potential solution?

Obviously, if we had that magic, crystal-ball view of the future and we saw a very volatile, essentially flat stock market for the next twelve years, we would follow some strategy other than merely riding a market index.

It would be easy to see a relatively flat stock market for several years in the future. That is basically the future we feel may happen.

There are several strategies that would probably be more successful than merely following a large index if the above scenario plays out. Some of the more common strategies may be:

- Focus on the generation of income
- Focus on high-growth segments of the market
- Focus on out-of-favor industries and companies

Most people have no strategy at all.

Our focus has been on the generation of income, especially income from dividends that have a history of growing. We think this is a very solid, common-sense approach that is understandable by our clients.

Remember, the dividend is a function of the operations of the company, thus if the company stays profitable and generates plenty of *free cash flow* the dividends are secure. Dividends are not dependent on a rising share price. The share price is determined by the emotion of the marketplace on a daily basis.

We are very comfortable with this strategy, but we are always considering adding other strategies. Life is not static.

I've Been Following This Strategy…

"I moved my retirement account to the money market sub-account when my account dropped more than ten percent in 2015. I read that is what you are supposed to do."

When did you re-invest your retirement account?

"I haven't, it is still in the money market, and actually, I feel pretty good about that."

That is a good strategy to keep your account from declining in value, however, you retired recently. Aren't you going to need income from your retirement account?

"Oh, yes. I figure I will need about four to five percent per year."

But, your *strategy* has no earnings, thus you will be withdrawing your principal.

Well, IF that is all you ever have to withdraw, it would mean that your account will last about twenty to twenty-five years before it is fully depleted.

"I will be dead in twenty-five years."

Maybe. However, I believe you are looking at your account with a very singular focus…one that seems quite emotional. You have a strategy to protect the account value from losing market value, but you have no strategy to protect against inflation.

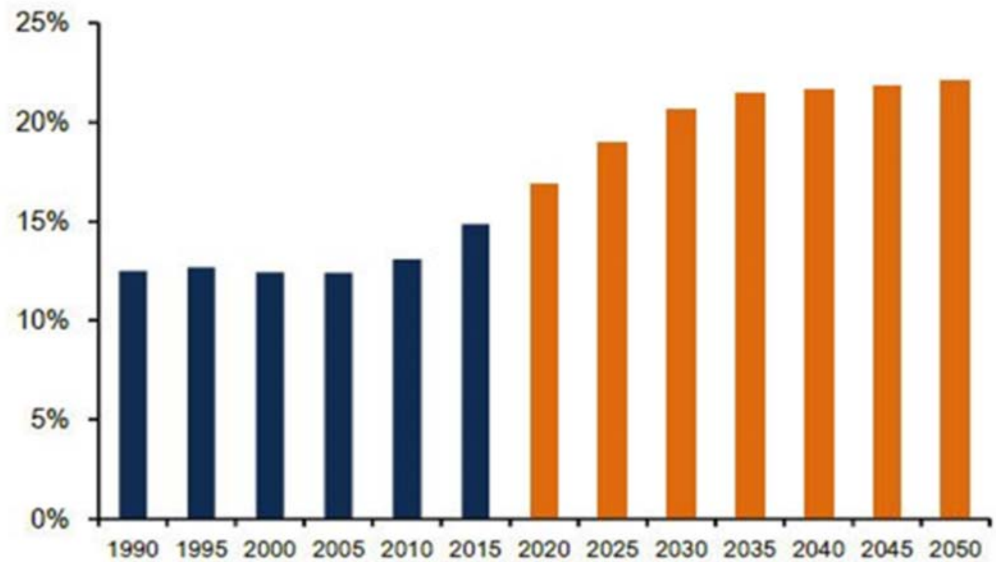
At just three percent inflation, in ten years you will lose about thirty percent of your purchasing power. In twenty years, the loss will be almost one-half.

You have a strategy based on an emotional response, but you don't have a meaningful, realistic retirement income strategy.

Demographics and Your Investing Success

We have all been hearing this for years… how the aging baby boomers will impact our economy. Here is a chart that illustrates the potential impact. The "baby boomers" are getting old! They will draw on our resources like no generation has done before them. They are collecting social security benefits and are likely to draw them for a long period as their life expectancies are likely to extend past previous generations. They are using Medicare benefits and are likely to use the benefits for a long period of time. Also, most of the medical costs are a lot more expensive than when previous generations collected benefits. The baby boomers are also paying a lot less income taxes than during their working years as well as FICA taxes (Social Security).

Chart 8: Percentage of US population older than 65 (1990-2050)



Source: Census Bureau (Population Division), BofA Merrill Lynch US Equity & Quant Strategy
Note: orange bars denote Census forecasts

Are we ready for all of this to happen? I don't think so. Social Security is not adequately funded, Medicare is underfunded and we can't afford to see a decrease in our income tax revenues.

What will be the result? I don't know, but I'm guessing a lot of political turmoil. The recipients… the older generation…won't want to give up any of their "benefits." And the payees…the working generation…will tire of paying so much in taxes. Plus, money that goes into promised benefits is not available for current spending.

It is difficult to see how we can avoid a lot of stress and conflict. Hang on!

WHAT WE DO...

We prepare retirement income plans, which are essentially blueprints to help our clients pursue their long-term retirement goals.
We manage our clients' investment accounts on a fee basis with discretionary authority focusing on meeting their objectives rather than focusing on what the financial markets may be doing.

The primary author of The Benedict Report is Philip C. Benedict, CFP®. Travis M James, CFP®, Mark A Beaver, CFP® and Ashley A Thompson, CFP® provide technical assistance. Fredda B Schwartz and Jackie Thompson handle the layout and editing of the newsletter.

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