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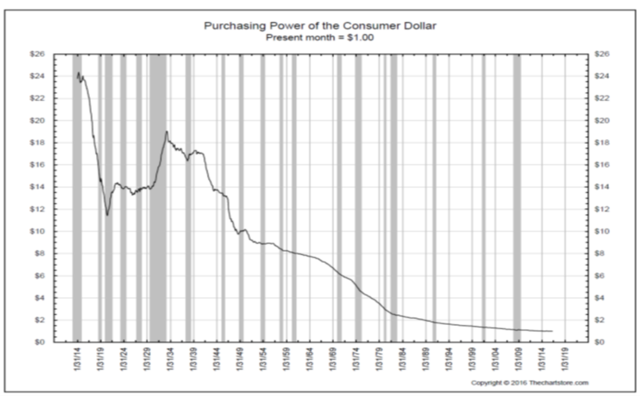
MORE Purchasing Power in the Future?
Here is a chart of the purchasing power of a dollar since the creation of the Federal Reserve in late 1913. Obviously you see a pattern…the dollar that was worth about $24 at the beginning of the chart is now worth $1. To say that a different way…the U.S. Dollar has "lost" about 96% of its purchasing power over the last hundred years or so.

I don't know if this is a good thing or a bad thing, but it is what has happened. Will this trend continue?



One would certainly think that as a government that has made trillions of dollars of commitments into the future and has no way of honoring those commitments with "real" money that we have no choice but to see significant inflation…loss of purchasing power…in the future.

However, look at the period from about 1920 through 1934. The dollar actually gained purchasing power during that cycle. That was a fourteen year cycle.

Think about what it would be like if that happened. Your money would be more valuable every year. What last year cost one dollar, now costs ninety cents. Sounds like good times, doesn't it?

But, it also means that your employer gets less for the merchandise that is sold or manufactured. Which would probably mean lower profits. Which would probably mean no expansion, maybe even contraction. Which would probably mean lower wages. Lower wages mean less ability to pay for things, especially the things that do not go down in price…your mortgage, your car loan, etc.

This economic scenario is called DEFLATION. The costs of things go down, except the cost of debt is generally fixed. Most loans do not have a clause that says, "if overall costs in the economy go down, then the principal and interest owned on this loan will also go down."

So if we do go through a period of deflation, who gets hurt the most? Those who have a lot of debt. And, the biggest debtor in the world is the U.S. Government, thus we would expect the government to do everything in its power to avoid deflation and create inflation. But, sometimes even the government doesn't get what it wants…at least not immediately. As we are all well aware, the government has issued a tremendous amount of new debt over the last cycle. And by its nature, debt is deflationary.

Think about this: if your household borrows (goes into debt) one hundred thousand dollars, it must at some time in the future pay that money back. It doesn't matter how low the interest rate is, the money must be paid back at some time in the future. So borrowing, debt, is spending tomorrow's purchasing power today.

During the inflationary times most of us have experienced, we have not really felt the pain, but what IF we experience deflation…

So, as an investor, what do you do to protect yourself from deflation should it happen?

Normally, you would answer this by saying to own a lot of government bonds, because deflation generally means even lower interests rates, and you would want to "lock in" today's higher rates. However, in today's low-interest rate world, the income from government bonds is rather meager. Actually, if we do experience deflation, keeping your money in cold, hard cash makes sense. In a way it is getting a little more valuable every year.

If you invest in stocks, you would want to have your holdings in companies that do not have a lot of debt.
"So you are telling me to put all my money in cash and stocks of companies with no debt?"

I'm just writing an article, not telling you specifically what to do with your money. I think there is a good chance we may see a few years of deflation or near-deflation, however, I believe the "powers" that control the government, know they must have inflation. We have way more debt than we can ever repay with "real" dollars. We need to almost desperately lower the purchasing power of our dollars…that means inflation. Don't ever take your eye off the "inflation" risk to your investment portfolio and your life in general. But, be prepared for a period of deflation. And, neither period will be without a lot of financial and economic stress.

The Federal Reserve
"Why is it such a big deal? The world seems to almost stop waiting to hear whether the Federal Reserve is going to raise or lower interest rates by a little bit. Why is it so important?"

The question was posed to me and I should have had a quick, pithy response. After all, long ago I studied banking and finance in college, even taught a few classes and have worked in the world of finance my entire adult life.

Apparently I have a real interest in this because sitting proudly on my credenza… waiting to be read… sits, "The Creature of Jekyll Island". You can't tell it by its name, but the basis of the Federal Reserve was a secret meeting attended by the most influential financial people in the country at the resort on Jekyll Island, thus the book is a history of the creation of the Federal Reserve. Near the end of 1913 President Wilson signed the law that created the Federal Reserve, to put an end to the financial panics that devastated the economy of the country during the nineteenth century.

The mandate of the Federal Reserve was:
- maximizing employment,
- stabilizing prices, and
- moderating long-term interest rates

For many decades the doings of the Federal Reserve were pretty much known only by those in the financial industry.

But now… well let's see what the public sees about the Federal Reserve:

Asian markets were mixed Wednesday as investors watched for news from a U.S. Federal Reserve policy meeting and from China's annual legislative session. (U.S. News & World Report, March 2016)

European shares were mostly higher but Asian markets were lower as investors watched for news from a U.S. Federal Reserve policy meeting (Associated press March 2016)

Everything you need to know ahead of the Federal Reserve's latest announcement today. (BUSINESS INSIDER, March 2016)

It's the biggest Federal Reserve meeting of the year — so far. (Thomson Reuters, March 2016)

Five Things to Watch at the Fed Meeting (The Wall street Journal, March 2016)

What is it? Is the Federal Reserve way more important to our daily lives than a few decades ago or has the media catapulted of the most mundane, generally behind-the-scenes, banking organization into superstar status.

As I was asked at the beginning, "Why is it so important?"

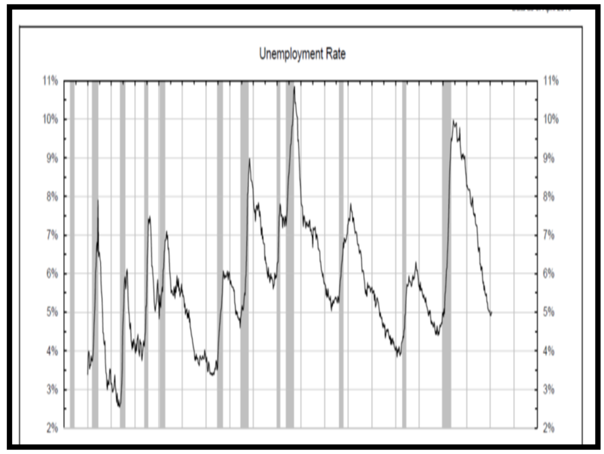
I recognize that the Fed has some control over short-term interest rates in this country. And, I recognize that our economy is critical to the entire world. And, I recognize that the level, and maybe direction, of interest rates is an important factor in the health of an economy.

But, those things alone, while economically important, do not make the Fed the Godfather of finance. I think it was when the Fed took on the responsibility to provide *economic stimulus* to the system, that it became almost bigger-than-life. Think actions like: Quantitative Easing, negative interest rates, bank bailouts and other forms of *money printing*. The Fed is taking responsibility for trying to eliminate, or greatly moderate, the normal financial and economic cycles that are present in the economy.

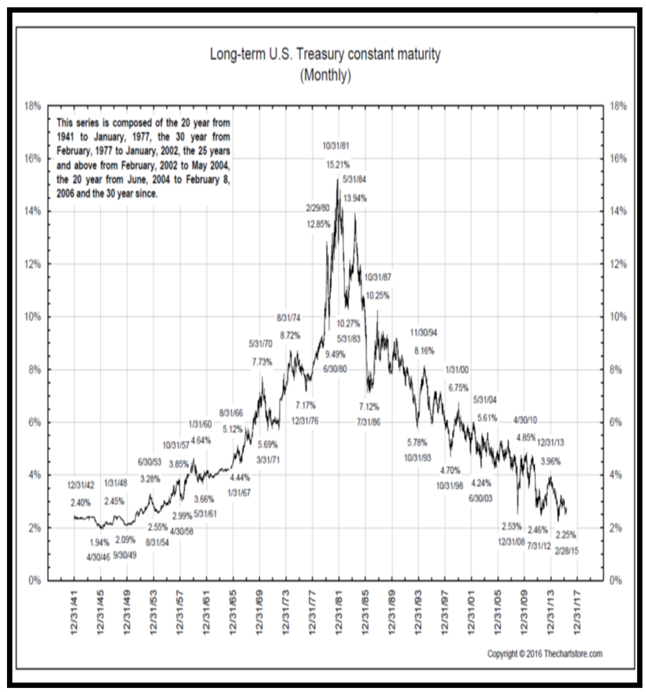
I don't doubt the importance of the Federal Reserve, but I do think it's power is far over overestimated.

Earlier in this article we listed the three mandates of the Federal Reserve. One was "**stabilizing prices**." The chart in the previous article showing the purchasing power of the dollar might be an indicator on how well The Fed has done in this area. Another mandate was "**maximizing employment**."

Here is the chart of the unemployment rate.



Another mandate was "**moderating long-term interest rates**." Here is the chart of long-term interest rates.



Will The Fed's new actions succeed? I don't know. I am naturally very skeptical of actions that try to change the laws of nature. Time will tell how this all plays out.

How Can I Lose?
It was around the first of the year, 2014, when we spoke with him. He had a retirement account of one million dollars all invested in a diversified pool of what the industry calls "high yield" bonds.

A **bond** is a loan. If a big company wants to borrow money, it may sell bonds to the public that come due at some time in the future. For example, they may sell one million dollars of bonds that come due in ten years and they agree to pay six percent each year in interest. If an investor buys one of the bonds, he has a very predictable investment…gets six percent per year for ten years and then he gets his money back. The major risk with this type of investment is if the issuing company runs into financial trouble and can't honor its commitment. Not a risk to be taken lightly. The term "**high yield**" is industry talk for lower-quality bonds, or bonds issued by companies that do not have stellar financials. The investor, or buyer of the bonds, is willing to accept the risk that some of the issuing companies may not be able to honor their commitment in exchange for a yield that is above, sometimes way above, what a high-quality company would have to pay.

Back to the story of our friend in early 2014. His million dollars was invested in a diversified packaged pool of "high yield" corporate bonds. The interest the bonds paid gave him a monthly income of $5,000, which was his main reason of choosing this investment…the monthly income. "And, I didn't want to take the risk of the stock market going down a lot." Now it is springtime 2016 and our friend reappears. "How can this be. My one million dollars is now worth less than nine hundred thousand dollars. AND, my monthly income that was five thousand dollars has dropped to four thousand, one hundred dollars. I thought bonds were 'guaranteed.'" The bonds are a contractual obligation of the issuing company, thus that company HAS to honor its obligation UNLESS it can't. Maybe some of the companies in the pool of bonds you invested in went bankrupt. Or, maybe the 'market' just sensed that there was more risk with these bonds than previously thought and the market value has declined. "But, why would my monthly income go down so much. I thought the income of a bond was guaranteed."

The bond income, or coupon, is also a contractual obligation of the issuing company and they have to honor it UNLESS they can't. Also, you don't own an individual bond, you are invested in a large pool of bonds. Most likely some of the bonds matured, or were called, and they were replaced by new bonds that had a lower coupon yield, this would lower the income you receive. This has been a common occurrence in this declining interest rate environment. "So nothing is really guaranteed?" That's pretty much true in the investment world…and in life.

Asset Values

It is difficult, very difficult for most people, when thinking about or discussing an asset to ignore the asset's market value. Think about it, the market value thing is part of our DNA.

"I live in a four hundred-thousand-dollar house…"

"I drive a thirty-two-thousand-dollar car…"

"My 401(k) is worth sixty-three thousand dollars…"

We tend to treat *market value* as something permanent or even important. What does a four hundred-thousand-dollar house mean? Is it a big fancy house that is the envy of the community? Or is it an old house on a valuable lot? It could be either. And *market values* can and do change. Sometimes quickly and sometimes rather dramatically. Your thirty-two-thousand-dollar car was probably worth closer to twenty something thousand-dollars the minute you drove away from the dealership.

Your 401(k) could "lose" ten-thousand-dollars in a week.

What does all this mean? Where am I going with this?

You should NOT plan on retiring on "asset values." For retirement you need a rather predictable and sustainable INCOME. You want a check that will arrive in your bank account at the beginning of every month. You need INCOME.

You can invest in a pretty piece of property that overlooks the ocean. That's fine, but it doesn't give you a retirement INCOME. In fact, even worse, it costs you money every year in property taxes, insurance and possible some maintenance. It is NOT Retirement Income Investing.

You can invest in something that tries to mimic a stock market index. That is fine, but it doesn't necessarily give you a retirement INCOME. If you choose the 'wrong' index, you could actually get all the stock market price volatility with almost none of the predictable income. But, you may say I don't think I will need any income from my investments, I'm just planning to leave them to my children. I would say, "Your children are likely to need one important thing in their retirement… INCOME. And, if they don't, that's good. But, who has TOO much income?"

Investing can be a lot of fun, if you do not focus on the generation of income, especially if you don't need any additional income. You can buy stocks of young, technology companies and feel a spike in your adrenalin if they double in value. You can invest in shares of a company that is using some new biotechnology discovery to cure an old health problem and feel as though you helped the world. During some stock market cycles you can make a lot of money and during other cycles you can lose a lot of money. It is like sports…the thrill of winning and the agony of defeat. Investing for a rather predictable, sustainable retirement income is rather un-interesting. In fact, it can be rather boring. Some would say very boring... It is like planting trees versus annual flowering plants. It is like eating vegetables versus dessert.

Many people can speak the next day about the fabulous dessert they had the evening before at a nice restaurant. Few have fond memories of the green beans. We rarely invest in anything that does not produce income. In fact, a rather predictable, sustainable income is probably the most important thing we look for in choosing a new investment. We are not unaware of the asset values and we are always looking for ways to moderate the volatility of our accounts, but, most importantly, we focus on the income of our accounts. That income may be for now or it may be for many years from now, but we want it to be there.

Yield-to-Cost

When we are analyzing an account's performance, one of the metrics we look closely at is what is called the "yield-to-cost." This is the current dividend divided by the original purchase price. Here's an example:

January 2013: share price $44, dividend $1.04, dividend yield 2.3%

May 2016: share price $81, dividend $1.52, dividend yield 1.9%

Most people look at this and say, "Wow nice increase in share price." While we are always happy to see share prices rise, we like this for a different reason. The current annual dividend, $1.52, is 3.5% of our original cost of $44…thus, our yield-to-cost. In about three and one-half years, this company has increased its dividend by over forty percent. Over the years, we are quite certain that we will go through cycles in which the share price of the company will decline. But, as long as the revenues and profits of this company remain solid, we feel we can count on receiving a dividend and we like to see that dividend grow.

BENEDICT
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More Purchasing Power in the Future...

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 McAdoo handle the layout and editing of the newsletter.