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Written by: Philip C Benedict, CFP®

OUR OFFICE:
Philip C Benedict, CFP®
Travis M James, CFP®
Mark A Beaver, CFP®
Ashley A Thompson, CFP®
Jackie McAdoo
Fredda B. Schwartz

the BENEDICT REPORT

6000 Lake Forrest Drive NW, Suite 550, Atlanta, GA 30328-5901 • 770 671 8228 • 770 671 0232 *fax* • 800 678 8227

The Perfect Investing Environment

Think about what you would consider the perfect environment for successful longer-term investing.

Let's make a list:

1. High interest rates that are getting ready to decline for multiple decades.
2. Stock market prices that are very depressed and have been for many years
3. A government that no longer has to have a currency tied to gold, thus able to "print" money and take on debt…all it wants.
4. The general public is scared of investing.

We could add more to the list: declining energy prices, increasing work-force participation and lower income tax rates.
What we have pretty much described is the last thirty-five years of the U.S. economy and financial markets. Not perfectly, of course, but in a big-picture way the last three and one-half decades have been about as perfect of an investment environment as we could expect.

"Does this mean the future will be bad?"

We currently have very, very low interest rates that don't seem to have much further to fall. We currently have relatively high stock market valuations that don't feel as though they can go much higher. We currently have more government debt than we can ever repay with "real" money. We also have low energy prices and a declining work-force participation rate.

"So everything is going against us now?"

As passive investors it is very difficult to say that the big economic and financial winds are at our back. About the only *good* news is that the general public is very uncertain, almost afraid, of the future.

"So what do we do now?"

The last thirty-five years were great for individuals who:

- Invested following a general stock market index.
- Invested in longer-term government bonds.
- Invested in companies that were borrowing to expand and able to continually re-finance their debt at lower interest rates.

But, that was then and this is now.

Probably the biggest stock market risk now for most investors is not a cyclical down market that lasts for a couple of years and then returns to previous levels. It is a major down market that stays down for a long period of time. We have experienced this before:
The Dow Jones Stock Market Index;
"The Dow Jones Industrial Average is an unmanaged index that cannot be invested into directly."

February 1966 = 1001
August 1982 =1051

NASDAQ Composite:
March 2000 = 5132
July 2015 = 5232
(Note: market figures from The Chart Store)

These are two long *bear* markets in which a follow-the-index was not a valid investment strategy, especially if one was counting on their investments for retirement income.

During the 1970's we had an economy that was called by some media sources as "stagflation." Meaning, we had significant inflation and stagnant economic growth. We have written before about how the government, our government and most major governments around the world, needs inflation to make repayment of the massive amount of debt they have taken on easier to pay.

Inflation can probably occur naturally when the economic times are booming, but inflation caused by "bad" government policies probably has a high likelihood of causing poor economic growth.

Let's focus on the performance of the Dow Jones Industrial Average of the 1970's. IF a similar pattern develops, what would be an appropriate investment strategy during this cycle?

But first, let's identify three types of investors:

- Those that **need to withdraw income** from their investments to supplement their retirement income. In a market cycle that is down and then sideways, their best strategy is to create an income from their investments that is not dependent on the stock market level. (This is basically what we generally try to do.)

- Those that will need their investments to provide an income at some time in the **future.** These investors will benefit most from a down and then sideways market. Each quarter their dividend income will buy shares at lower prices. This would be a great 'compounding' market even though it would probably not 'feel' good.

- Those that are **withdrawing more than the income** from their account. These are the investors that will get hurt the most if they don't prepare properly.

Let's say this again in a different way. If you are only withdrawing the true income from your investment account, the account value doesn't matter…at least not financially. HOWEVER, you need to understand that just because your account goes up $10,000 in market value, that is not INCOME. It is market appreciation and markets appreciate and they depreciate on a regular basis. Income is the dividends and interest that your investments earn.

Let's go back to the questions we posed earlier, IF a similar pattern develops, what would be an appropriate investment strategy during this cycle?

- Financially, not necessarily emotionally, if you are withdrawing only the *income* from your investment account or if you are re-investing the *income*, then what matters is the **stability, and growth, of the *income***. The market value is really not important. Thus, your strategy should probably lean heavily towards creating a sustainable, growing income.
- However, if you are withdrawing significantly more than the current *income* of your account, you need a much different strategy. At minimum you need to have at least three years of principal withdrawals somewhere on the sidelines not subject to normal market volatility. This way you are not withdrawing principal that has declined or is declining in value, but you *are still* withdrawing principal. Of course, putting this money on-the-sidelines means it earns almost nothing, so your overall investment *income* is less. Thus, you can see **this is a rather dangerous time** to be withdrawing significantly more than the *income* of an investment account. Also, if we enter an extended down market like the two illustrations above, three years of withdrawals on the sidelines will not solve the problem. In this scenario, one really needs to examine their overall financial situation, because it can be dangerous to not make significant changes.

Get Out and Avoid the Pain

You hear a news story, one of several, telling you how the stock market is going to "crash" to new all-time lows. It is because of the: Chinese economy, U.S. corporations not making as much money, the Federal Reserve is going to raise interest rates/or lower interest rates or you can fill in many blanks with the reasons the stock market is going to suffer a big decline.

Your emotion is strong and it tells you to sell everything and be safe. That is a very valid emotion, but it may not be a good alternative. Let's look at this a little further.

Let's say you saved some money during your working years and that money is now providing you a monthly income during your retirement years. It is not a big amount, but the 3% you are earning on a diversified portfolio of dividend-paying stocks and bonds adds to your income and makes your financial, and emotional, life much more stress free.

But, suddenly, you can't take it any longer. Every time you hear, "the Dow dropped over one hundred points today," you cringe with financial fear. I don't want to lose all my money, you say to yourself, thus I will do what is prudent and sell my risky investments and move my savings to a bank account.

We will come back to that story, but let's explore this a little further.

I imagine if the stock market does suffer a big decline, your home will also decline in value a great deal. Maybe it makes sense to sell your home and move into an apartment, then when your home value drops a lot, let's say in half, you can re-buy your home.

You think about it and offer, "I'm not sure that makes sense. Wouldn't I have to pay rent on the apartment?" Well, yes. "And, what if my home doesn't drop a lot in value?" I guess you could buy it back, maybe for what you sold it for. "But, what if I have to pay more to buy it back? I can't do that without using up my savings and then I wouldn't have the savings providing me with that monthly income for the things we enjoy."

Now, we go back to our story and remind our friend that his savings are no longer earning much of anything since he sold his retirement income investments. "But, as soon as the market drops, I'll buy them back and maybe I will be able to earn even more."

We then reminded him that the 3% he is now withdrawing is principal, since the account has almost no earnings, thus his *guaranteed* account is going down almost 3% per year. "But, as soon as the market drops, I'll buy back in and the market will probably go up and I'll easily recover my losses."

Many decades in this business tells me that it is a very, very rare soul who will have the nerve to invest when the market is down a lot and the news is terrible.

This is NOT a good investment strategy, but our emotions are very powerful.

Isn't the stock market too high?

As I write this, many stock market indices are at or near all-time highs. Does this make it a bad time to invest in the stock market? I guess the best answer is maybe. Since we don't know what the future will bring, there is no right answer, at least there is not a right answer without going forward and looking back…then it will be very clear.

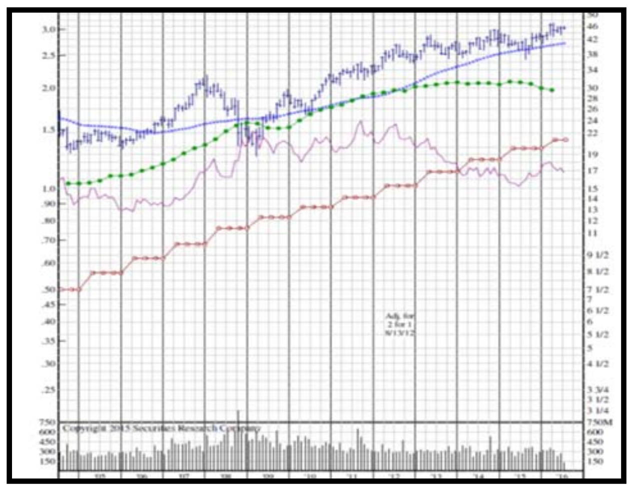
What may be more important is whether or not a company's share price is at a reasonable level. Obviously this is not a perfect science.

We don't know what a reasonable share-price level is other than to compare it with the past, compare it with similar companies and to compare it with the operations of the company…this may be profits, revenues or some other measure.

Here is a twelve-year chart of a large U.S. company. For our purpose it doesn't matter what the name of the company is or even what industry it is in. Let's take a look and see what we see:

Vertical blue line = monthly share price
Dotted green line = quarterly earnings per share
Dotted red line = dividend paid quarterly per share

(Note: the dotted blue line (moving average) and the purple line (relative performance) are irrelevant for this discussion)



The investors in this company are probably feeling pretty smug right now. Look at the vertical blue lines, the monthly share price, and see how it has performed.

Then drop down and look at the red line, the quarterly dividend. The dividend has increased every year for many, many years.

BUT, look at the green line, the quarterly per-share earnings. It has been almost flat for many quarters and lately has been drifting downward.

Thus, the all-time high of the share price isn't as big of a concern to us as the lack of earnings growth. We are keeping a close eye on this company. This company has a lot of international exposure so we realize that the dollar's strength compared to most other currencies is a drag on the earnings. However, if the company can't get the earnings moving upwards, it seems likely that we will see a decline in the share price. And, without growing earnings, it is difficult to keep raising the dividend.

Is this called *Financial Engineering?*

In the previous article we expressed concern with the lack of earnings-per-share growth. Here we will look at the same thing from a somewhat different perspective.

Here are the ten-year performance figures for this large multi-national corporation:

Revenue Growth	93%
Earnings-Per-Share Growth	23%

So far, so good. Revenues are growing and earnings-per-share are growing. But, let's look at another number, actual growth of net income during this ten-year period of time…-4%. What? How can earnings-per-share grow so much when the actual earnings of the company actually declined?

Let's look at one other figure…shares outstanding. Actually the number of shares outstanding declined by 22% during the last ten years. So, the good earnings-per-share numbers were because of a declining number of shares and not because the company was more profitable.

Let's say this a different way. The company has been buying back its own shares, thus reducing the number of shares outstanding, which, when divided into the income, makes the earnings-per-share look better.

Is this good or bad? Isn't this deceiving the shareholders? A company buying back its own shares isn't necessarily good or bad, although we prefer that a company "invest" in new research and things rather than constantly buying back their own shares. Is it a deception? It only deceives the investors who don't peek at the financials of the company. The information is not hidden; it is in plain sight of all investors.

But, ten years of no actual income growth is not a very good sign. We are watching this company very closely also.

How do I Enjoy my Retirement without Financial Stress?

" Retirement is in my relatively near future. I watched my parents, who didn't have much money, seemingly live quite financially secure during their retirement years. But, more recently I have watched my older sister who retired several years ago and is now basically broke, unable to pay her bills. I don't want to be my sister, what do I do. I am not rich."

There are many financial calculators available on-line. You may find one of them very helpful, however, I have found that a lot of people just don't gravitate to that type of planning. They want a 'big picture' to follow more than the details.

Here are some general guidelines :
You are not rich, so you do not have the luxury of spending anything you want…not many people have this luxury, especially in retirement. Thus, you need to know what it costs you, approximately, to live each month. I know this sounds like I am preaching a 'budget,' and maybe I am, but what you really need to know is your spending patterns.

Then I would classify the expenses into two categories:

"Need to Have:" These are expenses for things you need-to-have. Of course, this includes the so-called fixed expenses of mortgage payments and other debt payments. But, it also includes basic utility bills, basic food bills, etc. I'll give you an example: Your basic food costs are what it costs you to eat, but not some of the eating 'extras' we enjoy…eating at a fine restaurant, buying fancy prepared foods, etc.

"Enjoy Having:" This is for the things that you do over and above basic living. For some people, this is modest and for others this is the majority of their monthly expenses. For some this would include travel and leisure and for others it may be the "premium" cable television service.

Then, look at your income during retirement. Remember this is your "take home" income and not your gross income. This can include the income from your long-term investments. (Long-term investments do not include the amount you have put-away to buy a new car or otherwise spend the principal. This is your long-term income generating wealth.)

Big Red Flag - Your retirement income is less than your Need-to-Have expenses. This seems to common-sense that you cannot let this happen, but this is the biggest problem we have witnessed happening to
retirees. Many got used to spending far more than the *income* from their investment accounts during the good markets of the 1990's. Then when market reality struck and interest rates plunged, their retirement plan was toast. Others are continue spending in retirement as though they still have a fairly large check coming in from their employment.

Solution to Red Flag

You obviously have to increase your retirement income or reduce your need-to-have expenses.

"OK, I'll work a couple of years longer." That will help…a little, in that it delays when you will have to withdraw from your investment income, however, this probably won't solve the problem

"But I can't cut my expenses. I live rather frugally already." Well, you may HAVE to cut your monthly cash outlay needs. Maybe work a little longer to pay off the house mortgage to eliminate that cash outlay. Maybe work a little longer to pay to have a separate entrance put in so you can rent out the upstairs of your home. Maybe it means moving to a lower-cost housing area. Now may be the time to focus on what is really important to you. I don't have the answer, but spending more than your income makes for a financially stressful retirement. If you think getting hired for a job at age 66 is difficult, try it at age 76.

I'm a Millionaire…

He explained that all his life he had heard that if he could ever achieve *millionaire* status, he would be financially set for life. "I'm going to retire."

"That's not a very important number," we offered

"But, now I'm a Millionaire, I have assets that total one million dollars," he bragged. Then he pulled out his list of assets which totaled slightly over the one-million-dollar figure he kept flaunting.

"But, do you know what that means in regards to your retirement," we asked?

"It means I have enough to retire. I'm a Millionaire."

We decided not to focus on the assets that added up to his million dollars. We didn't think focusing on the home, the time-share ownership, the two cemetery plots, or the one-third ownership of the lake house would accomplish much at this point.

When you go into retirement, what most people need is a sustainable, growing income. We suggested he divide his one million dollars of assets into two categories…those that produce income and those that don't. And, then he needs to decide if he plans to sell any of the non-income producing assets and convert them into income producing

After all of this, we can start to determine approximately how much retirement **income** they will have. Because, assets values aren't very important in determining your standard of living in retirement. It is the cash-flow that you receive in retirement that is important. And, some assets, like an interest in a lake house, actually cost money, thus become an expense during your retirement years.

For your retirement planning, focus on accumulating **Retirement Income Investments**, which are investments that will produce the cash-flow you will need during your retirement years. Keep you "net worth" statement only as something to show your buddies on the golf course…it is probably as meaningless as your golf score!

BENEDICT
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6000 Lake Forrest Drive, Suite 550
Atlanta, GA 30328-5901
770.671.8228
www.benedictfinancial.com

The Perfect Investing Environment....

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.