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the BENEDICT *REPORT*

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Isn't the stock market too high?

"The stock market is at an all-time high. It has to crash. Give me one reason why that won't happen."

We totally agree that stock market valuations are relatively high, especially based on historical valuations. However here are two reasons that the current market valuations may be justified:

Reason ONE:

U.S Treasury Bond Yields

1 year	1.4%
5 year	2.0%
10 year	2.4%
30 year	2.9%

(US Treasury Daily Treasury Yields as of October 25, 2017.)

Low or falling interest rates are generally good for share prices. Rising rates are probably not good for share prices unless the rising rates are because of a very robust economy. Low interest rates have money looking for other places to earn a higher return. Thus, during a low interest rate cycle you would expect to see higher market valuations.

Reason TWO:

Investors have far fewer choices because there are a lot less publicly-traded companies today.

In 1983 there were 12,075 public-traded companies

In 1996 there were 8,090 public-traded companies

In 2007 there were 5,109 public-traded companies

In 2016 there were 4,331 public-traded companies

(World Bank)

There are probably many reasons for this. One is some large companies elected to take themselves private. Dell Computer and H.J. Heinz are two that come to mind.

Also, there have been relatively fewer Initial Public Offerings the last few years.

The reasons for staying private or going back to being a private company are many. It is a lot more efficient not to put up with all the costs and regulations of being a publicly-traded company.

In addition, the low cost of borrowing and low interest rates have made Merger & Acquisition activity a hot area the last several years. If two companies merge, that eliminates one publicly-traded company.

SUMMARY:

Over the longer-term, stock market returns are mostly determined by three factors: interest rates, corporate earnings and current market values.

Interest rates: Think of businesses like homes in your neighborhood. If the interest rate of a new mortgage was 10% do you think home values would be as high as they are now?

Low interest rates make it cheaper for companies to borrow money. And, low interest rates cause investors to look elsewhere for a place to put their money.

Corporate earnings: As a rule, total corporate profits will grow at a rate about equal to the growth of the U.S. Gross Domestic Production. It will be difficult for total corporate profits to grow at six percent per year if the GDP only grows at 2% annually. We try to focus on companies that are showing good earnings growth.

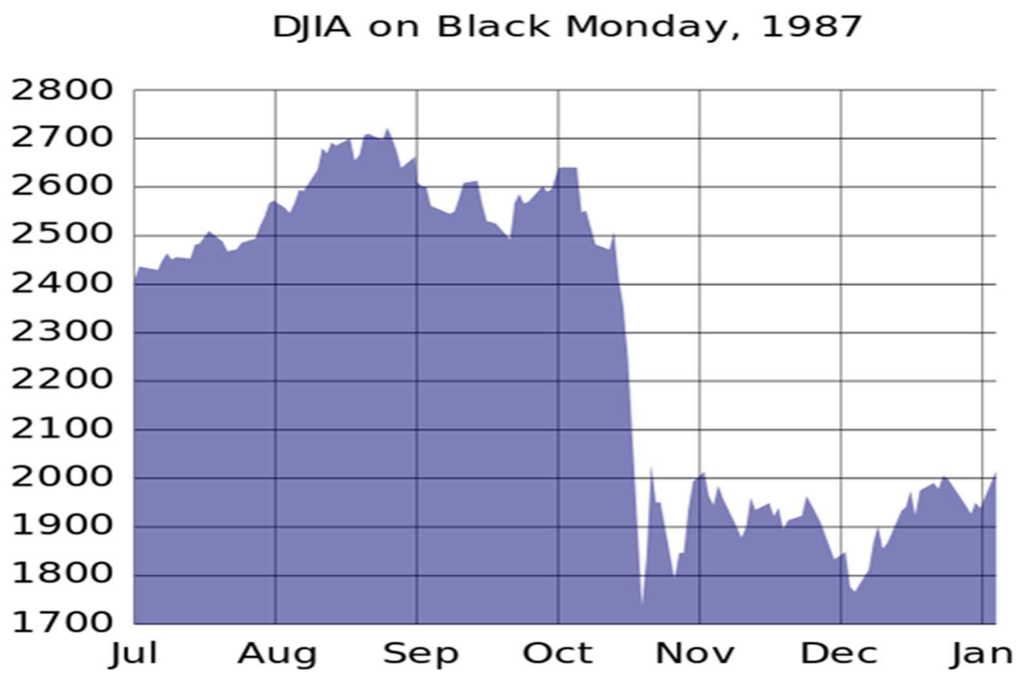
Current market values: A current high market valuation usually means lower long-term returns in the future. We try to have less exposure to companies that have high valuations, but this is getting more difficult.

Let's Go Back in Time…

Let's take our minds back thirty years, to the year 1987. Overall it was a rather *normal* year. Ronald Reagan was President. The Minnesota Twins played the St. Louis Cardinals in the World Series. We had some international incidents with Iran. Politically, Congress was investigating the Iran-Contra affair and, economically, Kentucky Fried Chicken opened their first store in China. The U.S. and the Russian leaders were trying to get along but couldn't. Nothing very out of the ordinary, until "Black Monday" hit the financial markets.

On Monday, October 19, 1987, the Dow Jones Industrial Average plunged by almost 23%, the steepest one day decline ever.

Here is a chart of the DOW that day from Wikipedia.



Could it happen again?

Well, it certainly could. The current market environment has some similarities to thirty years ago, in that stock prices compared to earnings are at a relatively high range. Also, technology has made trading so quick and easy that money can move into and out of the market very rapidly. If you have a good memory, you may remember that a new concept called *program trading* was blamed by many for the severity of the 1987 market decline. And, of course, shortly after the market crash, the powers-to-be passed rules and regulations attempting to reign in that action. But, generally, government/industry efforts to avoid the natural forces of a down market will be unsuccessful.

We still have various forms of *program trading* and the new regulations and rules have not eliminated down market cycles, however, maybe the biggest outcome of the stock market *crash* of 1987 was the change in the Federal Reserve.

You will probably remember Alan Greenspan as a long-time Federal Reserve Chairman and his use of many multi-syllable words. When the stock market *crashed*, Mr. Greenspan immediately flooded the banking system with money. His objective was to keep the economy from falling into a recession. It seemed to have worked and ever since then the Federal Reserve has been trying to influence the economy. Has this been good or bad? I don’t know. But, it does seem as though the actions of *The Fed* are having less and less impact on the overall economy, but I don’t think that will stop them from acting in the future.

Let’s go back a little further to 1980

Let’s look at a list of the largest public companies, by market value, in 1980.

- IBM
- AT&T
- Standard Oil of Indiana (now Exxon)
- Schlumberger
- Shell
- Mobil (now Exxon Mobil)
- Standard Oil of California (now Chevron)
- Atlantic Richfield (now BP)
- General Electric

Does that list make you think of cutting-edge, twenty-first century thinking companies? Do you see a high weighting of oil companies?

Times have changed. Here are the largest companies in 2017, by market value:

- Apple
- Microsoft
- Facebook
- Amazon
- Johnson & Johnson
- Berkshire Hathaway
- Exxon Mobil
- J. P. Morgan
- Alphabet (Google)
- Bank of America

Do you notice an overweighting of information services/technology companies?

If you want to exercise your mind a bit, then pull out a piece of paper and make of list of what you think will be the largest companies in thirty-seven years, 2054.

Maybe it would help your thought process if we look what the tech companies on the 2017 list were doing thirty-seven years ago. Whoops, only one was a public company. Does this mean the largest companies of 2054 aren’t well-known today or maybe don’t even exist yet?

By the way, do you think paper will still be around in 2054?

Apple, Inc. stock IPO created 300 millionaires 33 years ago today
By Daniel Eran Dilger
INSIDE APPLE, December 12, 2013
Apple's initial public offering on December 12, 1980 sold 4.6 million shares at $22 each, generating more capital than any other IPO since Ford Motor Company in 1956 and instantly creating 300 millionaires.

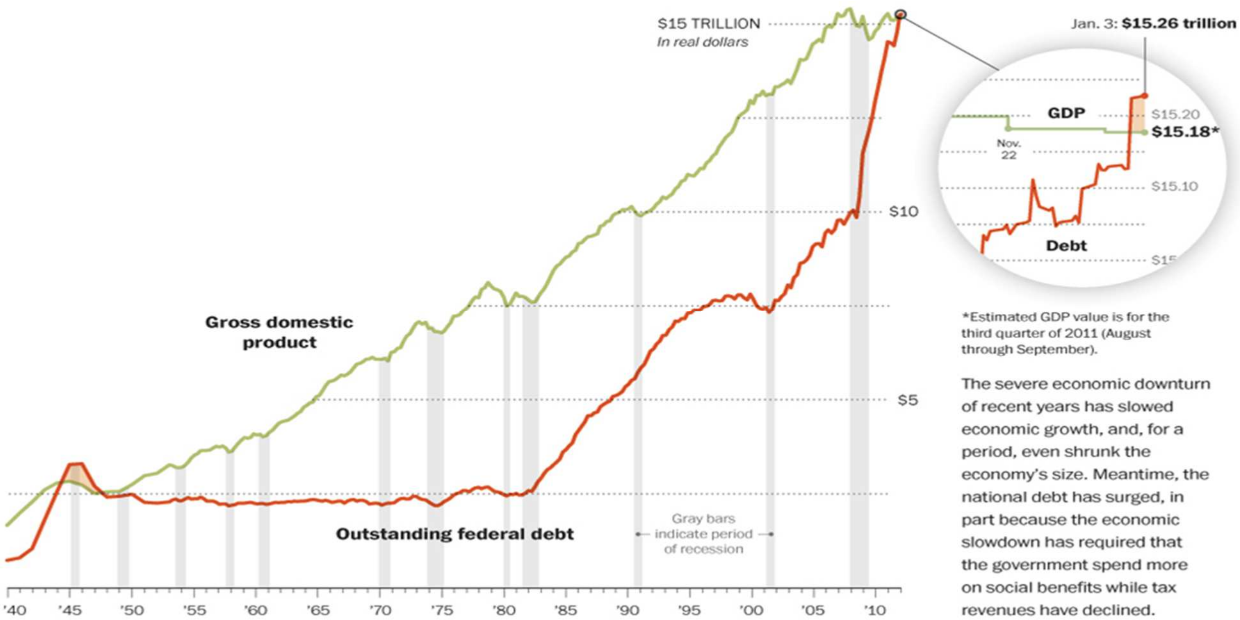
Let's Examine the Year 1980 a little further…

In 1980 the U.S. Debt was 32% of our GDP (Gross Domestic Product)

In 2017 the U.S. Debt is 104% of our GDP

Do you think we may have been *priming the pump* at little the last thirty-seven years with debt?

Here is a chart showing the increase in debt since 1980



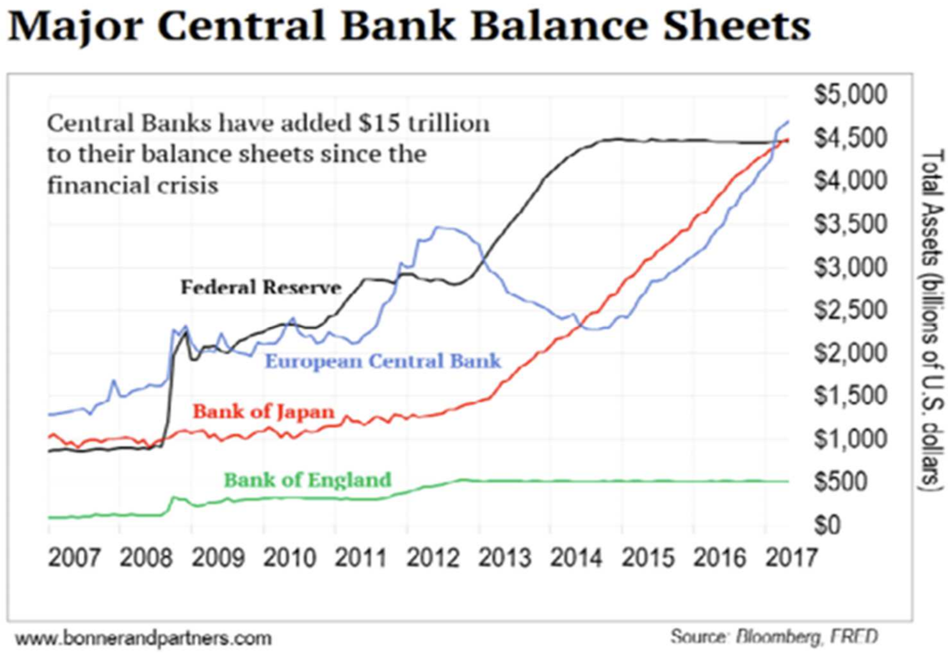
www.mygovcost.org

This chart only goes through 2011, but the trend has been about the same except the current debt is now approximately $20 trillion.

Have we maybe reached the point where additional debt does NOT lead to additional economic growth? Notice how much faster our debt has accumulated the last several years. Since 1980 the debt had increased about the same rate as the growth of our GDP, until…

Look back a little further to prior to 1980. Many argued that the economic stagnation of the 1970's was at least partially due to not having enough *money* being created by the government. I would tend to agree with that view.

Here is another chart showing how three of the world's four major Central Banks have increased the supply of money (money printing).



Has this *money printing* increased our cost of living?

If you had $10,000 in 1980, about how much would you need in 2017 to have the same "value?"

Simply, the Consumers Price Index (CPI) would tell us that you would now need $29,100 to buy what ten thousand dollars would buy in 1980.

A more advanced comparison, by the website *measuringworth.com*, would calculate that you would need $65,100 to have the comparable **economic power.** This figure seems more reasonable to me if I just look at wages and home prices in 1980 compared to the current time.

In general, it is in the government's best interest to keep the CPI as low as possible because so many government payments and programs are based on this figure. But, I don't think the government is intentionally misleading the public about the real rate of inflation. More likely it is a typical government figure that has never really been challenged.

Financial Planning Scenarios

We have kept some notes over the last couple years of individual scenarios or comments from people about their financial situation. Our finances are full of hope, emotion, fear and ignorance. If we are married, then the mixture of emotions and events gets more complicated. What follows is fictitious situations or comments patterned after events we have witnessed.

"We are set for retirement. I have worked until I turned age sixty-six to get my full social security benefits and I have over one million dollars in wealth. We have it made. My father would be proud of me."

I'm not so sure your father would be that proud or confident of your retirement situation. As I look at your assets, it appears to me that the vast majority of your assets are in your home and your vacation home. These "assets" USE cash-flow from other sources, they do not PROVIDE cash-flow for your retirement years.

Assets are not the key to a successful retirement, CASH-FLOW is. That cash-flow can come from social security, from a pension or from investments. Are you prepared to live on your social security benefits?

"*What do you mean suggesting we use up some of our extra savings to pay off the mortgage. That is terrible advice. Our mortgage rate is only 4.5%, which is less than half the rate we were paying twenty years ago, and we get an income tax deduction for the interest paid."*

You have plenty of savings in the bank earning almost nothing. Let's look at the numbers:

Mortgage: $150,000 x 4.5% = $6,750 in annual interest cost
Savings: $150,000 in the bank x 0.6% = $900 annual earnings

Summary: Your savings is earning about $900 and your mortgage interest is costing you about $6,750 annually. Multiply this difference by the ten years remaining on your mortgage and the numbers get very large. Most people don't have the excess liquidity that you have, but in your case I can't see how keeping the mortgage makes sense. (I realize you may lose an income tax deduction, but I think you are greatly overstating what that saves you.)

Here again what you need in retirement is CASH-FLOW. By eliminating the monthly mortgage payment, you are greatly **reducing** your cash-flow needs from other sources.

"*We never planned it would turn out like this."*

You didn't plan.

"What do I do? I don't want to take too much risk. I'm retired and will have no new savings to be added to my investment account."

"I've always been in the most aggressive funds available in my retirement account, but suddenly I feel very differently. Maybe it is my age. Maybe it is the news, the government or the world. Everything seems so unsure."

"I can't afford, mentally or financially, to lose 30% or 40% of my retirement account. I have no confidence that the market will recover next time if that happens."

You are asking for certainty in an uncertain world.

I hear your fears and feel a lot of your emotion. I would suggest what you need is a strategy…a plan. Start with: what do I really need from my investment account? Financially, do you need it not to go DOWN in value? Or, do you need it to provide a consistent monthly income?

From what you have told me, financially, you need it to provide you with a consistent monthly income. I believe if you get a plan, a strategy, to generate that consistent monthly income that you need, and you understand how it works, then I believe a lot of the fear will go away and the emotion will at least be less intense.

"I'm ready to retire. I just turned age sixty-two. I will get my social security and if I withdraw just five percent from my savings, I think I can get by." "What do you think about this?"

All my years of experience in this area tells me that it doesn't matter what I think, because once you get the *retirement bug* in your system it is usually permanent.

But you asked, so here goes. By electing to take your social security at an early age you are giving up a lot of monthly cash-flow for the remainder of your life. (NOTE: Most people still make this election at age sixty-two.)

Let's talk about withdrawing five percent per year from your retirement account. I assume that means you will withdraw each year what the five percent amount is today, even if the account declines in value. I have hardly ever seen anyone do it differently.

The way your account is invested now, it is following a market index and generating almost no income. Thus, during times the market is down, you will be withdrawing principal from a smaller base. (Which means your withdrawal will be more than five percent…but most people have trouble understanding this.) Using the five percent, then three years of a flat or down-market cycle, means your account would be at least 15% less in three years. (Five percent withdrawals times three years.)

The markets may recover, but your base is at least fifteen percent lower.

The other "hole" in your plan is that I believe you will have many *unexpected* costs that come up as the retirement years go by. Your only option will be to spend some of your principal for these events. Thus, again, reducing your base that is providing the monthly distributions.

I would strongly encourage you to find something you really enjoy doing that can provide you an income and remain financially productive for several more years.

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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