SEPTEMBER 2011
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the BENEDICT *REPORT*

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IT SEEMS AS THOUGH EVERYTHING IS FALLING APART!

I wrote most of this shortly after the extreme markets of mid-August and updated it a bit on Labor Day. There will be a couple of weeks delay between my writing and when you actually receive your copy and a lot can happen during that time, especially with what's happening in Europe. And, September and October have a history of providing some exciting financial action.

The news seems terrible, the American public is both scared and fed-up and to some it seems as though the world is coming to an end. We are going to take a few pages and see if we can help you identify some of the big issues that are taking place and provide a little insight.

I have been doing this for a long time and because of that have lived through what seemed was going to be the end of the world many times, so I tend to have faith. But even assuming we dodge the fate that destroys us, history would tell me that for the next year or so our economic situation will be volatile, uncomfortable and sometimes downright scary.

I don't listen to television programming so I didn't get the full emotional impact of the financial news over the last few weeks. I don't listen to talk radio so I haven't gotten the full emotional impact of how terrible our political leaders are doing.

But I can read and I do speak with people…many people, some clients, some acquaintances and sometimes a stranger or two. It was some of those conversations that prompted this *Report*.

Now, let's take a look at the world as we see it today.

WHAT HAPPENED?

Two big economic and financial waves have almost drowned Europe and America:

- Governments elected to borrow rather than make the choices that should have been made. The elected officials get the blame, and they deserve a LOT of it, but the general electorate needs to shoulder some of the responsibility. There are a lot of voters who want to hear that the government will solve all their problems.

- Globalization has really changed the world economic scene, and until very recently both Europeans and Americans were in denial that it was really happening. We thought things would never change.

Because of all of this both America and Europe are in a financial crisis. The solution to such a crisis needs a strong, bold, technically sound plan that protects the basic social values of the people, but is fiscally sane. Right now there seems to be a shortage of "strong" and "bold" and an abundance of "blame" and "despair."

Why, seemingly all of a sudden, does it appear the economics of Europe and America are failing?

The recent stock market volatility may be a prediction that the economies of America and Europe are headed back into a recession. And, what is not making headlines is that there is concern among some that the Chinese economic miracle is getting ready to stumble because of over-construction, debt and too much government manipulation. Add to this a Japanese economy that has been in extreme deficit spending mode for way too long, and you can make a good case for an ugly economy for many years.

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We talk about another recession, but the reality seems to be that even though the United States has been *officially* out of a recession for many months, much of Main Street America never recovered. The housing industry is still in crisis mode, the huge overhang of debt is still hanging out there and people don't have the opportunity to get a job…not even a lousy job in many cases.

The multi-national companies are making record profits but are sitting on billions of dollars of cash, are expanding overseas, selling to the emerging economies and are literally doing everything except expanding in this country and hiring American workers. Like most people, they don't see any plans in place to solve our problems.

The recent debt ceiling debate was glaring evidence to citizens and employers that the economy is sick and the government is too dysfunctional to take positive actions.

In many areas housing prices have literally dropped in half. There are many places now, in good neighborhoods, where you can buy a very livable house for less than one hundred thousand dollars. But very few people are buying, because committing to a long-term mortgage requires a positive view of the future.

EUROPE

We won't spend much time on Europe, but the problems there may be the most immediate concern for the world financial markets. Basically, five counties that are part of the European Union are to the point where they cannot pay their bills without "aid" from the others. They have promised a lifestyle to their citizens they cannot provide. They have been borrowing to live and they are finding it very difficult to borrow.

In Europe most of the debt these countries owe is to the banks in their country and banks of other European countries. When the debts of these five countries become *officially* worthless, most of these banks will be bankrupt.

Will the non-bankrupt nations be willing or able to bail them out? Should they bail them out? Time will tell. But, right now this is a BIG thing in the global economy.

Another banking crisis? Time will tell, but if it happens, it could happen in a hurry. Be emotionally prepared. How exposed are we in this country? It's hard to tell. Apparently some money market funds have a substantial portion of their investments in European banks. That could certainly be a problem. And, maybe the biggest risk is the amount of exposure our banks have with credit default swaps. Very simplified, it means how much have our banks "guaranteed" the credit of the European banks.

UNITED STATES!

In the U.S., the government took on the recession with a vengeance to create a strong and quick recovery. It didn't work! Now the Government is out of good ideas and the Government is a definite drag on economic growth. We also continue to have a huge trade deficit, heavily impacted by oil imports, yet we will not move towards energy independence.

These types of economic crises take time to heal, but people want the Government to DO SOMETHING right away. And, there is an election right around the corner.

LET'S LOOK AT TAXES…

"I heard a former White House official say on television that lower tax collections are the main cause of the budget deficit. Is that true?"

Oh yes, low tax revenues are a definite part of the reason the deficit is so large. We have slanted our income tax system so the higher earners pay a larger portion of income taxes; however, what we didn't consider is that many of these higher incomes can become low income when the economy stalls. Some politicians blame the "tax cuts," but we have had no "tax cuts" since 2007, the tax revenues are down because a lot of people's earnings are down.

But don't take your eye off the spending ball!

According to www.usgovernmentspending.com, since 2007 our "total government spending" has increased about 35%. During the same period our "total government income" has decreased 14%. I don't know about your household, but if my revenues decline 14%, I certainly don't increase spending by 35%.

Let me put it a different way. Were you happy with the level of government ten years ago, in 2001? That year total government spending was about $2.1 trillion and total direct revenues were about $1.9 trillion. The 2011 budget shows total government spending of $3.8 trillion and revenues of about $1.9 trillion. Spending has almost doubled in the last ten years.

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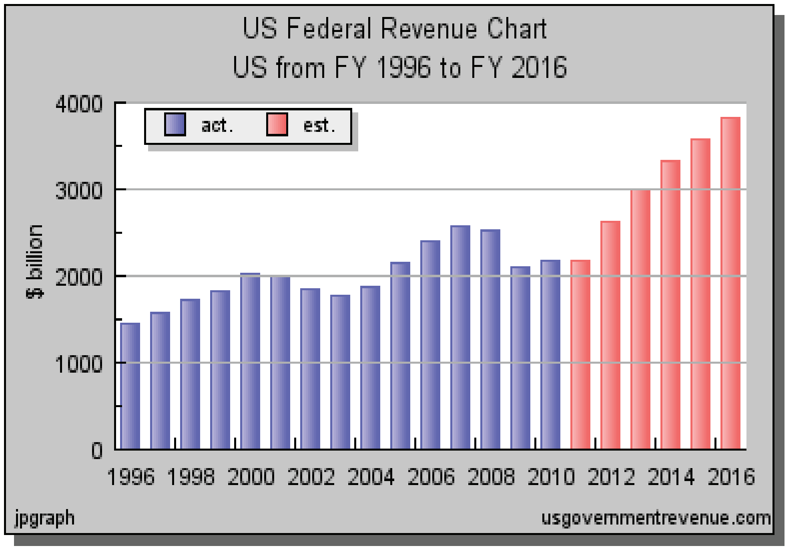
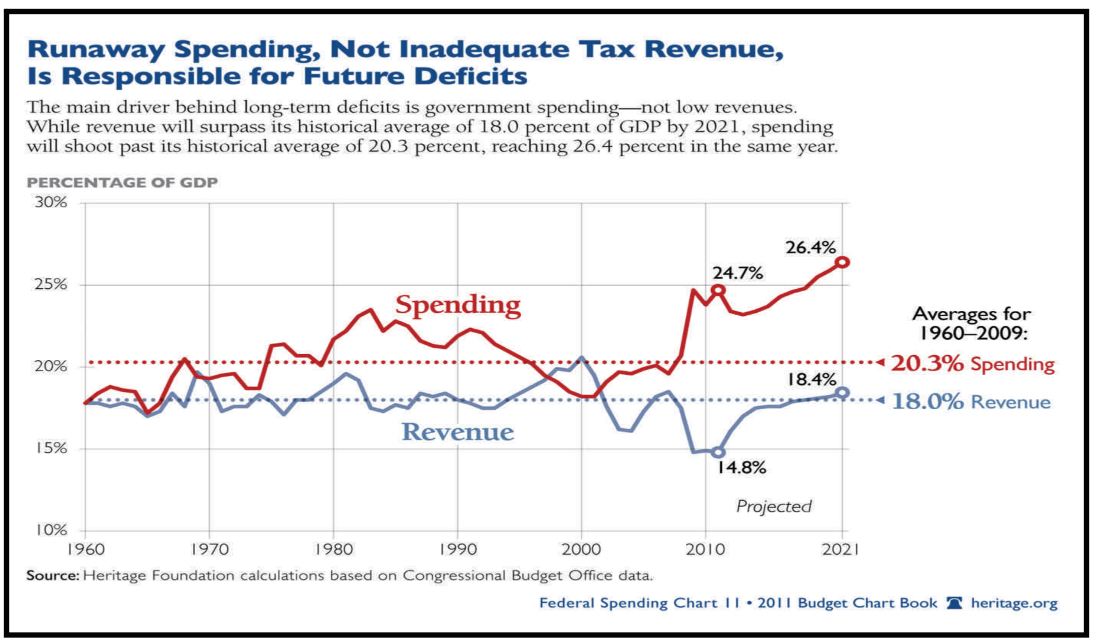
Here’s a chart of government revenues since 1996.Notice the decline in 2002 after the “Bush tax cuts” were enacted. Then the tax revenues increased quite significantly until the recession hit. What the government doesn’t want to accept is that you can’t keep increasing spending when income is down.



It is politically popular to promise the masses that we can solve our fiscal problems by merely raising the taxes on the rich. Look at the chart below. Spending, as a percentage of our Gross Domestic Product, has averaged about 20% for the last fifty years. It is now about 25%. Revenues have averaged about 18%, but you can see it is currently much lower.



But, look at one more thing. How often have revenues exceeded 20% of our GDP? Just once and that was the era of the IPO (initial public offering) Internet stocks and all those taxable stock options. However, even during the 1970’s when individual income tax rates got as high as 90%, we still could not get our revenues above 20%. The bottom-line in my opinion is, don’t ever count on revenues higher than 20% of GDP.

Also look at the spending line. It seems to me that almost every time it turned upwards (increases), we encountered an economic slowdown.

America's need is GROWTH!

We can get our growth back, but we need to take strong, bold action.

We need a national energy policy that virtually ELIMINATES importing oil from outside North America in a few years. I yearn for the day when we can get our energy from the sun and the wind and maybe the stars, but in the meantime we need cheap, abundant energy to fuel our growth engines. We don't need to approve trillion dollar bullet trains; we need to approve the pipelines and infrastructures to process and transport energy we have. We need bold actions today, not pie-in-the-sky dreams.

We need to make sure basic health care is available for all our citizens, but we cannot promise what we cannot afford. People need choices, they need available care and they need it affordable but they also need to expect to pay for some of their care. People also need a great deal of education on healthy living choices.

Our younger adults need confidence that social security will be there when their hair is gray and their thinking a little slower.

Neither Europe nor America currently seems to have any growth strategy. Our leaders seem to be focused only on the next election. We need leaders who can truly educate the population on what is really happening, without turning everything with political *spin*. AND, we also need a few more citizens who take the time to give-a-damn!

The "Intrinsic Value" of a Business

Enough of the "end of the world" talk. We still need to live in this real world and most people we deal with need investments that can withstand bad events. We have been stressing that you need to focus on *the company* and not *the stock (price).* Here is another look at how to focus on *the company.*

If you can grasp this concept that the "intrinsic value" of a business is different than short-term "market value," you will understand how longer-term investing has very little to do with the day-to-day market movements.

Great businesses are living, breathing, revenue generating, profit making enterprises that build wealth for their owners. But when a business is a publicly traded company, it is easy for people to think that the share price accurately reflects the value of the enterprise. The share prices does reflect what a buyer and seller are willing pay for shares at that particular time, but to say that it accurately reflects the true, or intrinsic, value of the business in the longer term, misses the point.

Let's use the example below to explain how a business can create "intrinsic value" irrespective of its short-term market value.

Let's assume that ten of us each invest $50,000 into an office building. So in total we invest $500,000 and take out a mortgage for $500,000 to purchase the building for $1,000,000. Here's what the numbers look like:

Cost of building:	$1,000,000
Less mortgage balance	-$500,000
= Equity in business	$500,000
Divided by TEN owners =	$50,000 each

(Note to all accountants. I realize this is way too simple and leaves out some important accounting concepts, but hang in there.)

During the second year our mortgage payments reduced our loan balance by $15,000 and we used $20,000 of our profits to renovate some unused space and it is now a café to serve the tenants. We also used profits to buy out one partner who needed to sell his interest.

What is the "value" of our business at the end of the second year?

Cost of building:	$1,000,000
Plus cost of renovation:	$20,000
Less mortgage balance	-$485,000
= Equity in business	$535,000
Divided by NINE owners=	$59,444 each

From a simple accounting standpoint, the "intrinsic value" of each owner's share is now $59,444.

But, what if some hot-shot appraiser comes by and tells us his *appraisal* of the building is less than our "value?" We don't care what he thinks. As long as our building is performing well, we are increasing the "intrinsic value" of our business for the owners.

That does not mean that we don't think that there will be times when the market will not pay as much as the "intrinsic value" of the business and there will be times when the market will pay more. However, we can't control what the market says, but we feel we know how to increase the "value" of the business for the owners. And, we feel quite confident that over time the market value will likely reflect the real "intrinsic value" of the business.

We frequently use individual stocks as part of an investment account. In most cases what we are trying to find are companies that are creating "intrinsic value" for the shareholders. This "intrinsic value" may be in the form of dividends or it may be the buy-back of outstanding shares, thus lowering the total number of shares thereby making all shares a little more valuable. "Intrinsic value" can also be created by using some of the profits to expand capacity or purchase other businesses or funding research and development.

There are many companies that have a proven record of adding considerable "intrinsic value" for the shareholders, but during times of market turmoil, their share price drops along with most other companies.

Also, there are many companies that look successful on the surface, but the overuse of debt or untimely acquisitions or short-sighted management decisions create an environment that literally destroys the "intrinsic value" of the enterprise over time.

Think of a company that you know that has been dominating for decades. It is likely that this company is managed to create value for the shareholders because they are generating good profits and using those profits to make the company stronger and stronger. This is the type of company you want to count on for your retirement income.

In the shorter-term, "market values" can be important. But for retirement income investors we look for real "intrinsic value."

Brief Summary…

The economic news seems depressing if not totally scary, but most of us still need our investments to provide us a retirement cash flow, either right now or a few years in the future.

In addition to the scary economic news we earn almost nothing on our savings because of very low interest rates.

Bad news and no earnings is not the perfect scenario for any retirement income plan.

Fortunately, in most cases we have been able to maintain the "cash flow" levels of our accounts, primarily because we chose to rely heavily on the dividends paid by large companies and not interest earned on short term savings. And, despite the negative news environment that seems so pervasive, we think we will be able to continue to generate a decent amount of income.
It certainly feels as though we are going to continue to be mired in a stagnant economic quagmire with conditions remaining weak. On the federal level we cannot continue to borrow 40% of what we spend. Our politicians seem to want to postpone action…maybe that is what the citizens want also.

Despite all this gloom our longer-term outlook is that at some point in the future we will see an up-cycle that will exceed any sane expectations. We will write more about this in the future.

"It seems so scary out there. I don't know how you can invest in these times?"

If you only invest in the great times, you are destined for poor investment returns.

WHAT WE DO…

We prepare financial plans, which are essentially blueprints for what our clients are trying to achieve in the future. Much of our planning involves creating a Retirement Income Plan for our clients.
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®, an Investment Advisor Representative and Registered Principal with **LPL Financial**, a registered investment advisory firm and member of FINRA/SIPC. Travis James, CFP®, Mark Beaver, CFP® and Ashley Thompson provide technical assistance. Jean Wilson handles the layout and editing of the newsletter.

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