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INTRODUCTION . . .

A new year is on us, unfortunately most of the economic and political problems we had last year will not be left behind.

And, this is an election year and it appears it is destined to be ugly. The incumbent leaders do not have a track record they can be proud of, thus they will be in attack mode. The opposition party seems much better at that, opposition, than in framing constructive, workable solutions to our various problems.

And, the economic "tiger" that has propelled us to much of our greatness seems more mired than ever in regulatory minutiae, political waggling and a lack of confidence in our system.

Change and crises seem to be in the air . . .
HANG ON!

WE ARE LIVING THROUGH HISTORICAL TIMES!

You may not realize it or may not appreciate it or may not even like it, but I feel we are all living through some major world events. It is usually difficult to recognize the really big things that happen in life, unless it is a spectacular event, something like the bombing of Pearl Harbor, the oil embargos of the 1970's and September 11, 2001, but even these events were just the tip of the iceberg that has been building for many years.

Let's sit back and turn off the television and reflect on some of the big things that seem to be happening in the world as we enter this New Year. I'm going to skip some obvious giant things that are likely to dominate the world political news, such as: the Middle East, the Iran/Israel potential conflict and, of course, the election.

It is likely the big, really big, economic news this year will probably be out of Europe and we will discuss that, but first let's look at some other less thought about things.

A CHANGING OF THE GUARD?

For decades the world economic scene has been dominated by the "developed nations" of the United States, Europe and Japan. The "less developed countries" would overspend and run into economic and leadership problems and the "developed nations" would toss them a bone much like we create government programs for the poor to keep them on *the other side of the tracks.*

But times may have changed. Japan has been borrowing heavily to try and "stimulate" its economy to the point that its national debt is about twice as large as its Gross Domestic Product. (That is somewhat similar to your household having credit card debt equal to twice your gross income.) We hear how countries like Italy and Spain have debt that is well over 100% of their Gross Domestic Product, which many experts tell us almost always leads to economic problems down the road. And even the good old "rich" USA will soon be in the same debt boat.

Do you think the world economic powers of the future will be the heavily indebted, slow growing, aging countries where the populace is looking to be taken care of or the lean, hungry, young, cash-rich countries where the populace is looking for opportunity? It looks to me as though the tide is turning - if it hasn't turned already.

Why would the leaders of the "developed nations" allow this to happen? Why would the people of the "developed nations" elect leaders who allow this to happen? Are we all asleep at the wheel?

WHERE ARE YOU FROM?

Where do you live? Where are you from? Remember the good ole days when we identified a lot of our being by where we live or where we grew up? Our friends were our neighbors and members of our church. We subscribed to a local newspaper to keep track of local events and local people. On Friday nights we cheered on the local football team as we sat in the bleachers with our "friends."

It feels as though things are changing. Now days a lot of people consider their "friends" to be their contacts on their Internet *social network*. Many could not tell you the names of their physical neighbors because their "friends" are all over the state, the country and even the planet. They interact daily or even hourly with their "friends" and rarely even say "hi" to the neighbor who lives in the apartment or house next door.

Many people today know little about local political leaders, needs or events. And, if they do not have children in the local school, many have little interest and even less loyalty to their physical community. If they follow any *news* outside their *social network* it is more likely to be national or world news than local events and happenings.

At the same time this localness is rapidly decreasing we are finding out that many of our cities, counties and states are struggling financially. The governments have promised far more than they can ever collect in revenues. They do not seem to have the political backbone to limit promises, thus to maintain services and honor their promises it will require the residents to pay more taxes, in some cases a lot higher taxes. This risks forcing the reasonably affluent to leave, leaving only those residents with less ability to pay additional taxes.

It looks to me that over the next couple of decades we will see significant readjustments of all sorts of state and local governments. Cities will have to merge with other cities and counties and many will literally disappear as separate entities. "Where are you from?" will have to be answered with an asterisk.

Will this transition be painful and politically difficult? Of course. A lot of people and factions will try to shape the future to their own advantage and many people will fight tooth-and-nail to keep from losing their *identity*. But, do you think the *social network* residents will care? It will be interesting to watch and maybe even participate in this new world...I didn't say pretty to watch, I said interesting.

THAT'S A LOT OF PEOPLE!

The exact number is unknown but many population predictors tell us that over the next 12 to 14 years the global population will add another "China," meaning increase equal to the number of current Chinese citizens. And, a lot more of these new residents will be born into the ranks of middle class, than in the past. It is also estimated that hundreds of millions of current residents will see their standard of living increase as they strive to become part of the middle class.

We don't have to know what the exact numbers will be but anyone with a bit of common sense and an eye to what is happening throughout the world can see that there will most likely be a lot more people living on this planet over the next few decades. And more and more are seeing their standard of living improve, meaning they will want and consume more things.

More people means we will need more food, more fresh water and more usable energy. It means that, in addition to more stuff, we will need to be more efficient in what we use, more efficient in how we transport it and more efficient in how we dispose or reuse it.

This additional demand might be very good for global business, but...

Can we produce enough food? Will we have enough fresh water? What will we use for energy?

These new people will come into a world that is very inter-connected, where information on almost anything is readily available and where boundaries are more mental than physical.

This huge population increase will test the ability of our industries to produce, our leaders to effectively govern and the world to adapt. It might be downright exciting...probably even a tad stressful.

WILL WE FINALLY GET IT RIGHT?

In this country many of us will argue over what needs to happen, but few think we can continue on the course we are on...borrowing to pay our daily bills is not a sustainable way to run an economy.

Tax the rich says one side. I say that is a political statement and not an economic statement. We simply cannot raise income taxes enough to pay for our current spending and, if we could, it would likely inevitably lead to a significant economic slowdown.

Cut our spending dramatically says one side. This may be more political than economic also, at least without wholesale changes to our system. The public, with the right leadership, may be willing to tighten its belt a little, but not willing to suffer any major hardships.

We are at the crossroads where we need to put our governments through major reorganizations. Think about it; witness how major corporations have had to literally remake themselves several times to remain competitive. And, think of major corporations that did not or could not change with the times. Most are no longer viable businesses. Our government just seems to add on and add on to the old chassis, but the time has come where new focus, new efficiencies and new thinking is necessary. This will be an epic battle and emotion will overrule rational thinking much of the time, but it has to happen for us to remain a world economic leader. We need to turn our economic "tiger" loose again.

How is this going to play out? Will we reorganize and again become a lean, efficient, growth machine? Or will we continue to plod along making more promises we cannot keep while trying to squeeze more taxes out of the system and printing more dollars in hopes that future inflation will cover-up our current problems? It will be interesting to watch this play out.

STRESSFUL YEAR. . . INVESTING BASICS!

So many times over the last few weeks people have commented to us something like…"I bet this has been a very stressful year for all of you?"

It really hasn't and let me try to explain why. This is a chart of the Standard & Poor's 500 Index[1] for 2011. The Index ended the year at the same level it began the year. But, what did it feel like to you? Did it feel like a year of no gain/no loss, or did it feel like the period from mid-July to October when the Index declined 22%? For most people the emotion of the bad times overwhelms reality.

[1] The Standard & Poor's is an unmanaged index that cannot be invested into directly. (Source: finance.yahoo.com)

Many people think that investing is about accurately guessing the future of the stock market and then using that information to take advantage of the ups and downs. That is not investing. Other people want to "invest" but they don't want to see their account value decline. Yeah, right!

We believe investing is buying great businesses at a fair price and reaping the potential rewards as the company grows and pays us part of their profits in dividends. If you think like this, then last year was a great year.

We divide our holdings into five major categories:

- Growing Dividend Companies: These companies are the foundation of most of our accounts.
- High Current Dividend Companies: We use these to increase the current income of an account.
- Special Situations: This varies greatly from one account to another, sometimes with an emphasis on high current income and other times on longer-term growth.
- Bonds: These provide a relatively high current income.
- Dry Bullets: These are assets invested in relatively stable holdings to be used when in our judgment it is time to "fire," meaning take advantage of some situation…frequently a major market decline.

Of course, every account has some sort of cash reserve holding,, but we generally don't plan around this.

When we look back at 2011 we feel good, very good, because almost every company we owned for its *growing dividends* actually increased (grew) their dividends. We don't expect as much dividend growth from our *high current dividend companies* but we feel good that we saw many smaller dividend increases and almost no dividend decreases.

The current economic environment is full of headwinds and potholes for investors, but because of this it allows us to own what we consider many of the finest businesses in the world at reasonable prices. And, by owning these great companies we have been historically rewarded as they pay us part of their profits in dividends and we also have a chance to see our investment increase in market value as the companies prosper.

We manage most of our accounts with a focus on the potential dividend income and the growth of that income and not on trying to maintain a constant account value, which is literally impossible to do, thus the ups and downs of the daily market are not a big part of our focus.

We believe we are in an extremely volatile sideways market cycle that will probably continue for several years in the future. To be a good investor in such a cycle you need a solid foundation. We believe that foundation is to own great businesses and to take the quarterly dividends that these companies are expected to pay to use for your retirement income or to compound for your future retirement income…or your children's retirement income. In fact, if you are reinvesting your dividends by buying more shares of stock, volatile markets actually work to your advantage. Learn to enjoy while the others are frightened!

"Wealth is hard to accumulate and easy to lose."
Warren Buffett…Snowball…

The EURO

I went to the mountains over Thanksgiving thinking that when I returned on Monday morning the financial news would be bleak as everyone finally realized that the EURO zone was breaking up and each country would have to revert back to their individual currencies.

Obviously my fear was somewhat incorrect and I say only somewhat because it appears that, while my timing was wrong, the future is still very uncertain. I am certainly no expert on Europe, whether we are talking its culture, its history or its currency. I have never felt that the primary European social/economic model was sustainable over the long run, especially in the larger more heterogeneous countries. My feeling is there are too many disincentives to succeed and too few incentives for taking chances. Some European governments seem to try and eliminate too much risk for their residents, which is something that sounds so wholesome, but I don't think will work over the longer term.

As I see the future of the world's economy I see much of Europe falling further and further behind. I see a future that will be dominated by the quick, the nimble, the adroit, the visionary. The most successful regions will likely have the most adaptable economics and businesses and labor forces of the world. I don't see much of this in the current European culture.

THE BACKGROUND

For all you Europhiles and you news junkies this will be very elementary and some may say incomplete, but here is a brief summary of the Euro problem from my perspective.

Starting about a decade ago, seventeen countries agreed to use a single currency, the EURO. They also agreed to eliminate a lot of trade barriers and other impediments to inter-country trade. And, it seemed to work, actually, worked very well…until it didn't.

By joining the Eurozone even countries that had a very spotty record of running a tight fiscal ship found they could borrow money at very low interest rates just like their fiscally responsible members. And, guess what, just like a teenage daughter with your credit card, they borrowed and spent and showed their electorate that times were good.

The European Central Bank told their banks that all loans they made to a country of the Eurozone were safe because the loans were to *sovereign* countries, so there was no way they could default. If times get tight, they can simply raise taxes to get the money necessary to repay their loans. Thus, the regulators required NO reserves on these loans. (Does this sound a little like our "Fannie Mae" saying we need to make mortgages available to everyone…it is only *fair?* Fannie Mae is a government agency *closely* supervised by Congress.)

The borrowing countries…mostly what we call the wine drinking countries…loved it. Times were good. If they needed more money, they just borrowed it from the banks.

The lending countries…mostly the beer drinking countries…loved it. These are the manufacturing countries and they found a hungry market for their autos, appliances and other things they manufactured. They loved all the loans their country's banks were making to the other countries residents to buy their BMWs and Mercedes and the like.

But alas, the good times have come to an end. Countries like Greece simply cannot pay their bills, let alone repay the German and French banks that have loaned them billions of EUROS during the good times. This is not a new phenomenon for Greece, being unable to repay their debts, but in the old days they would simply devalue their currency. At that time the lenders would be stiffed and the savers would lose but the masses would be happy and the cheaper currency would make their country a real bargain for tourists all over Europe, Asia and the Americas and their economy would improve. However, as part of the Eurozone, that is not an option. The solution thus far is for the "rich" countries to "bail-out" the indebted countries, but only if they "promise" to make it miserable on their populace with severe cutbacks. Now the fact that this bailout is not actually being done with real money, but with newly issued debt may concern some people, but what choice do they have? Let's face it, if they let Greece and others default on their loans to the banks in France and Germany and other countries, then the banks are bankrupt. Ouch! (Is it only me or does it always seem as though it is the banks and the government together that are in the middle of almost every financial crisis?)

What does the future look like? I expect for now we will keep reading about new and more creative "bail-outs," that is until the financial markets finally say STOP.

There do not seem to be any good solutions. To let the Eurozone dissolve would create tremendous economic disruption, especially for the debtor countries. It would also mean those countries would no longer be good customers for the manufacturing countries.

To hold the Eurozone together means in one way or another, the solvent countries must "bail out" the insolvent countries. However, they have to be sort of sneaky about how they do it because most of the leaders have elections coming up in the relatively near future. And, it isn't likely that the typical German, who considers himself very hard working, would look favorably upon paying more taxes to bail out the partying Greeks.

It is going to take a lot of money to keep the Eurozone together. Whether this can keep the area from suffering a severe recession is unknown. Whether the employed and unemployed workers will let their leaders do what they feel is necessary is unknown. Whether the International Monetary Fund (IMF) gets involved is unknown, but doesn't this seem quite likely? And, guess what, a lot of the IMF money is/will be from the good old USA.

How does this impact the rest of the world?

Taken as a group, the seventeen countries of the Eurozone is one of the largest economies in the world. They are the biggest customer for the Chinese and the Japanese and a decent sized customer for the United States. If Europe goes into a deep recession it has to impact manufacturing and commodities all over the world.

Another risk, especially to this country, is the exposure our big banks have by "guaranteeing" the European banks. This is part of the derivatives market in which one bank will agree to "guarantee" that another bank will not fail. How much exposure to this our banks have is unknown to me…and I think almost everyone else.

Europe is a long way away, but what is happening there is big time stuff. We could wake up any morning with some crisis happening. And remember, generally, markets do not like uncertainty, so prepare for significant market volatility.

HOME, SWEET APARTMENT!

"He was a delivery truck driver and she worked as a teacher's assistant. Four years ago they bought a three hundred thousand dollar house next to me with no money down. In their driveway were two new Lexus for themselves and two new Hondas for the boys. They finally left after nine months of making no mortgage payments or mowing the lawn or maintaining the home and needed some government program to provide them their first month's rent." *A friend's story.*

"I was done in by Countrywide Mortgage and had to file bankruptcy." Actually, he had maximum mortgages on two homes and he didn't want to make the payments any longer. *A friend's story regarding her neighbor.*

We had a generation of politicians who encouraged home ownership through all sorts of schemes. We had financial intermediaries that encouraged zero down payments and *no proof of income or employment* loans. And, we had a Federal Reserve that kept interest rates artificially low. Thus, we built way too many houses and the prices of those houses were inflated due to these non-market interferences.

We hear all about foreclosures in the media and we see neighborhoods that are littered with abandoned houses. Shouldn't the government do something?

Actually, the government has sponsored various deals to modify mortgages but, for the most part, they have failed. The millions of mortgages in this country that will never be repaid need an orderly demise. And it is unlikely the government is smart enough or has the willpower to solve this problem. The solution is to let the system cleanse itself and the more we try to slow down the process, the longer it will be before the healing begins.

We are getting closer to the turnaround. Houses have become much more affordable.

HOW DID WE GET HERE?

The governments of the United States and Western Europe have made, and are continuing to make, promises to the people that the governments can't possibly honor. At least not honor without inflating their currency to outlandish levels.

In 1965, payments to individuals, were 28% of the federal budget. In 2010 payments to individuals were 66%. (Source: *The Wall Street Journal*, July 28, 2011)

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Buried deep in the 849 pages of last year's Dodd-Frank financial overhaul law is a provision that has begun turning a financial regulator into a human-rights policy force. Congress ordered the Securities and Exchange Commission to require companies to properly disclose whether raw materials essential to their products include minerals from the Congo or neighboring nations.
Source: Jason Zweig, *The Wall Street Journal,* December 17, 2011)

How many securities lawyers will the SEC have to hire to figure out how publicly traded companies should demonstrate whether they have scrubbed their global supply chains of any taint of human rights violations?

How many securities lawyers will private industry have to employ to respond to the SEC?

How will this help us grow our economy? Will this help us attract and keep manufacturing in this country?

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In 1988 the total federal debt was 41% of Gross Domestic Product (GDP). It was 40% in 2008. It is now 72%.
(Source: *The Wall Street Journal*, July 28, 2011)

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It's the U.S. Federal Reserve cutting short-term interest rates to essentially zero. This is a manipulated interest rate…It is below normal. The goal is to encourage people and businesses to borrow to get the economy going again.
(Source: Daily Wealth July 26, 2011)

"…evidence suggests very low interest rates encourage companies to substitute capital for labor, thereby destroying jobs…"
(Source: Martin Hutchinson *Money Morning,* July 15, 2011)

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"More Americans work for the government than work in construction, farming, fishing, forestry, manufacturing, mining and utilities combined. We have moved decisively from a nation of makers to a nation of takers. Nearly half of the $2.2 trillion cost of state and local governments is their tab for pay and benefits of state and local employees.
(Source: Stephen Moore *The Wall Street Journal,* April 1, 2011)

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Illinois, the Land of Lincoln, boasts the 17th largest economy in the world. But let's see how it has been managed recently.

- $9 billion of unpaid bills. Most small business vendors have to wait upwards of twelve months to get paid.
- $62 billion of unfunded state pension obligations
- In the last half century five of the nine Illinois governors have been indicted

(Source*: Investor's Business Daily*, June 25, 2011)

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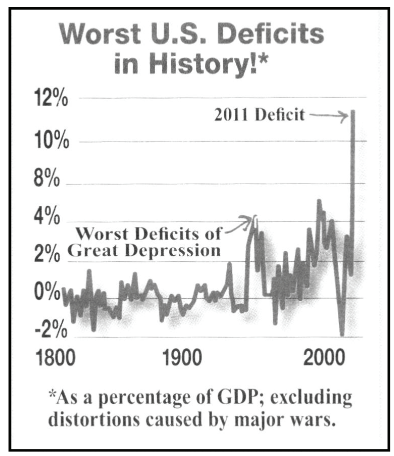

Here is a chart that shows the annual spending deficit as a percentage of Gross Domestic Product; excluding the distortions caused by major wars.
(Source: American Financial)

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In all, nearly 40,000 laws were enacted in 2011, according to the National Conference of State Legislatures. Most take effect on New Year's Day
(Source: CNN, December 31, 2011)

Did we eliminate 40,000 old laws at the same time? This is just laws passed, not new *regulations* issued by the various federal and state regulatory bureaucracies. **Say again, how will this help our economic recovery and help us create jobs?**

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Cost of remedial classes climbing. About 20 students sat through a recent lesson on contractions and other basics of grammar, but they weren't in an elementary, middle or high school class.

They were in a class for college students at Georgia Piedmont Technical College. Nearly half the students who enter the Technical College System of Georgia need remedial classes in reading, writing or math. The system spent about $36 million of its $718.6 million budget last year teaching students what they should have learned in high school. And those costs are rising.
(Source: The Atlanta Journal-Constitution - Sunday, November 13, 2011 by: Laura Diamond)

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What we need to do is to make it easier for businesses to start and find capital. Reduce the regulatory burden that small businesses face. When **small local banks need 1.2 employees** to deal with regulations and compliance for every 1 worker they have making loans, something is seriously wrong.
(Source: *The Wall Street Journal*, July 28, 2011)

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The Department of Agriculture no longer serves as a life-line to millions of struggling homestead farmers. Instead, it is a vast, self-perpetuating, post-modern bureaucracy with an amorphous budget of some $130 billion—a sum far greater than the nation's net farm income this year.
(Victor Davis Hanson, June 24, 2011)

WE NEED ECONOMIC GROWTH!!

It seems to me that what we need is a restraint on spending and focus on economic growth. We do not need to take away all the safety nets, all the government benefits, especially the ones for which people have been contributing for decades, but we do need some reasonable spending restraint.

We need a C.E.O. (Chief Executive Officer) type of leader who can educate the public in a candid and truthful manner about our spending and what needs to be done. We need a CEO who can lay out the various alternatives available to us and what needs to be done. We need a CEO who can then confidently outline what steps we need to take to accomplish what needs to be done and bring together the various factions to create an environment for economic prosperity.

We need strong economic growth. Economic growth of 7% per year will double our economic output in one decade. If we combine that with spending decreases of 2% per year for the next decade, the results will be very impressive. To get that kind of economic growth we need to do several things, but maybe the most important is:

Congress should be forced to tell the public how each action they are passing will help us achieve our 7% annual growth and if they can't, then do not pass it. Each regulatory body will have to balance economic growth and effective regulation, with a strong emphasis on economic growth.

> I never did give them hell. I just told the truth, and they thought it was hell!
>
> Harry S Truman, in *Look, April 3, 1936*

Who are THE RICH?

The elections are still months away but it appears that some of the candidates see their best chance for a victory is to position themselves for the *common people,* the *working people,* the *non-privileged* or whatever other title comes from their campaign consultants against the *rich*, that vile group of *lucky* people who are insensitive to the needs of the many.

As I tune into this topic it seems that the definition of *rich* almost always centers around their annual income. Apparently, if you make more than $XXX you are rich in the eyes of the public, or at least in the eyes of whomever is speaking.

Most of us in our industry would laugh at such a definition. In our minds if you make one dollar and spend more than one dollar you are basically poor, no matter how many dollars you make. You had cash flow but nothing stuck. About all you have is "show."

I know a lot of people who are *rich* who never made a lot of money. In fact, some of them don't have big savings or big investment accounts, but they are still *rich.* They live within their means and enjoy what they have and don't spend a lot of energy lusting for what they don't have. ***Rich* is almost as much of a mental state as it is a financial position!**

I hope you have the luxury of being *rich!*

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 M James, CFP®, Mark A Beaver, CFP® and Ashley A Thompson provide technical assistance. Jean B Wilson handles the layout and editing of the newsletter.

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HANG ON!!!