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Strategies for Where to Put Your Money in Our Zero-Percent World

(NOTE I: We are using the phrase zero percent to indicate very low interest rates; we understand that most interest rates are not actually at zero, at least not yet. NOTE II: This was a presentation we did at our February Lunch With Benedict.)

BACKGROUND

1. Our Federal Reserve has decided that we need very low interest rates for the foreseeable future.
2. Individuals and corporate chieftains are frightened and worried about the future, and are "hoarding" money, thus creating more money supply than there is loan demand which also keeps interest rates very low.

TWO STORIES:

- A lady, age 67 came in. She has $300,000 in her retirement account that is earning almost nothing. She doesn't need any income now, but will after her husband, who has many health issues, passes away. Her mother is still alive. But, her husband will not let her put a dollar of it in anything that is not *guaranteed.*

- After speaking to a small group, a gentleman comes up to us and says, "My wife and I are ninety years old and retired and have been getting by pretty good with the income from our savings supplementing our social security, but that income has literally disappeared. What do we do now?"

We didn't have good solutions for either of these situations. That is what motivated us to present this topic. And, after considerable energy and thought, we still do not have any really good solutions, but we felt the discussion was very necessary.

TRADITIONAL STRATEGIES

We have been taught that "bonds" have historically provided predictable income with less market risk than some other types of investments. Thus, it was common to see accounts, either individual or pension, that had about 60% in stocks and 40% in bonds. That was sort of "par" for investment thinking for decades.

But, those were the good-ole-days when bonds actually earned a decent rate of interest. The simple mathematical retirement solutions of the past are long gone. Retirees and would-be retirees are trying to find strategies in a rapidly moving unknown target.

Here are the interest rates for government bonds today (April 1, 2013):

US Treasury Bonds Rates

Maturity	Yield
6 Month	0.08
2 Year	0.23
10 Year	1.85
30 Year	3.12

Let's focus on the 2 year Treasury Bond. If you have $100,000 invested in this bond earning 0.23% interest, you will earn $230 per year. If you reinvest those earnings, your money will double in a mere 302 years or in the year 2315. Just think, assuming your heirs don't spend the money along the way (ha, ha), your great, great, great, great, great, great, great, great, great grandchildren will inherit $200,000. Of course, at an assumed 3% inflation their inheritance will give them about $27of purchasing power.

Thanks, Pops!

We believe we essentially have no good choices available today when it comes to "traditional income" investments. And, while this is going on our government continues to run huge fiscal deficits and has to continually "print" more and more money to fund the spending.

THE TRADITIONAL SAVER IS GETTING CRUSHED.

Let's look at this another way. The chart below shows the amount that you needed historically to generate interest income of $1,000 per month. (The interest rates are from www.bankrate.com for January of each year.)

Year	Interest rate	Account value needed
1980	8.9%	$135,440
1990	9.1%	$131,868
2000	6.8%	$175,695
2006	5.2%	$229,446

In 1980 you had to have $135,440 in savings to generate $1,000 of monthly income.

Now let's add April 2013 to the chart using the 2 year Treasury yield of 0.23%

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2000	6.8%	$175,695
2006	5.2%	$229,446
2013	0.23%	$5,217,391

To generate $1,000 of monthly income, you literally need to have millions and millions of dollars of savings. This is not a sustainable trend.

"If a trend cannot continue indefinitely, it will stop." [Herbert Stein]

We can understand that, but when, where, how, etc. is the mystery.

This impacts many facets of our economy in addition to us savers. Very low interest rates mean that many pension plans will earn far less on their bond holdings than they have projected. It means that the reserves that insurance companies hold will earn far less than what they have factored into their planning. This list can go on and on…it can get ugly.

But, you may ask, won't interest rates return to 'normal' pretty soon?

We don't know, but we think it is dangerous to make your financial decisions based on the fact that you think interest rates will 'normalize' in a year or two. We can look at Japan which has had almost zero interest rates for more than a decade. Or refer to a study done by Hoisington Investment Management's, ("Quarterly Review and Outlook") that shows considerable historical precedent that, "*government over-indebtedness and its resultant slowing of economic activity supports the proposition that prolonged very depressed levels of yields is probable*."

Look at your own financial situation and maybe that of your family and heirs; can you survive ten years of zero percent interest rates?

What if you earn zero and your purchasing power loses three percent per year, what does that do to your wealth over the next ten years?

Example: Assume you have $100,000 earning zero and inflation of 3%. In ten years your purchasing power has declined to about $75,000. Below is a story that we told at the Luncheon.)

> Story of Louie (fictitious name): I met Louie in 1986. At that time he was a little paranoid and feared what was going to happen in the future. He also hated taxes and didn't trust the government. (By now half the people reading this think I'm talking about them, but please keep reading.)
>
> Louie took me out to his garage and among a pile of valuable *things* was an old safe. He opened the door wide for my viewing and

opened the door wide for my viewing and proudly told me that I was looking at 4,000 one hundred dollar bills. (That's $400,000 for those of you who are money challenged.) He had that money…*just in case*.

I've lost track of Louie, but my guess is that his safe still holds his wealth; the only difference is that his *wealth* will only buy about $190,000 of things today. www.usinflationcalculator.com) By the time his children inherit Louie's *wealth*, assuming they can find the combination to his safe, it may look more like pocket change than real *wealth.*

We have a HUGE printing press supporting our economy. We cannot see the politicians ever volunteering to turn off this easy flow of new dollars. The more dollars they print the more dollars it will cost to buy things in the future. **Be prepared.**

Here is a chart of 10 year U.S. Treasury bond yields since the early 1960's.

A basic rule of bond investing is that longer-term bond prices ***rise*** as interest rates ***fall*** and bond prices ***fall*** if interest rates ***rise***. We are not going to try and explain why that happens here, but if you don't fully understand that financial truism, then you should be very, very careful being a bond investor in this economic environment. You can see from the chart above that interest rates have been in a declining cycle for over thirty years, thus most of today's investors have never experienced a significant rising interest rate cycle. **Be careful.**

INTEREST RATES WILL EVENTUALLY RISE

It seems likely that interest rates will eventually rise. It may happen in a matter of months or it may not happen for many years.

- Stronger economic activity should increase the demand for loans.
- Investors may see their fear of the future decline and be willing to commit funds to other investments.
- Inflation may finally rear its ugly head and literally force higher interest rates.
- Or, some crisis happens that causes the Fed to reverse its low interest rate stance.

We doubt that all of this will happen in a calm economic environment and we have no idea when it will happen or what will cause the trend to change, but be prepared. Or we could have the alternative, which would be continued low interest rates and rising inflation, sort of the worst of all worlds for a saver.

WHAT SHOULD YOU DO?

First, you should be very careful about going into higher yielding investments that you do not understand. This does not appear to be an environment where "chasing higher yields" will end well, especial higher yields coming from investments you do not understand.

Then, try segregating your investments into:

- **Shorter-term**: May need to use all or some of the principal over the next few years.
- **Longer-term**: Not likely to use the principal for several years, or hopefully never, but want to have it just-in-case.
- **Income need**: You do not plan to spend the principal, but you do need your investment to provide you an income now or possibly in the future, say when one spouse dies or maybe when your heirs inherit the assets.

Then ask yourself whether you want this money relatively "safe" for financial reasons or psychological reasons.

There is no right or wrong answer to this, but it does help if you can identify what is going on in your brain regarding the investing of these funds. And, if you discover that it is your strong emotions rather than your financial needs that rules these funds, then be very careful in moving to any investment that fluctuates in value, no matter how appealing the benefit. But, sometimes just consciously thinking about this, can open up options for you.

WHAT ARE WE DOING WITH NON-STOCK MARKET MONEY?

In a nutshell, we are treading rather cautiously. We think we are near the end of a decades-long interest rate cycle and this is not the time to be daring. But we also realize this interest-rate trough may last for several years.

In our accounts, most of our non-stock market money is in some sort of bonds.

In general, we want most of our bonds to be relatively short-term and we want them to have a fixed maturity date. Here are some generic examples:

- Bank bond maturing February 2016 with a yield-to-maturity of 3.05%. The bank agrees to pay your interest until the maturity date and then redeem the bond. Your main risk is that something happens to the bank and they cannot honor their obligation.
- Insurance company bond maturing September 2016 with a yield-to-maturity of 3.15%.

(NOTE: All interest rates are shown for illustration only and do not necessarily reflect any actual bond.)

We also use what is called *bond-ladders*. This strategy allows us to diversify our bonds by maturity date and also to have bonds maturing on a regular basis to take advantage of higher interest rates, if that situation occurs. Here is an example:

- Bank bond maturing in 2016 with a yield-to-maturity of 3.5%
- Computer manufacturer bond maturing in 2017 with a yield-to-maturity of 3.3%
- Auto company bond maturing 2018 with a yield-to-maturity of 3.6%
- Industrial company bond maturing in 2019 with a yield-to-maturity of 4.2%
- Diversified company bond maturing in 2020 with a yield-to-maturity of 4.8%

(NOTE: All interest rates are shown for illustration only and do not necessarily reflect any actual bond.)

Here we have bonds maturing in different years, or laddered. If interest rates start to rise, each year we will have bond maturing and we can use the proceeds to invest in the new higher rates.

Finally, a good portion of many of our accounts are invested in **high-quality, dividend paying stocks**." These are stocks of very high quality companies that we feel can weather almost any economic environment and stay in business, stay profitable and are expected to continue to pay dividends. They are stocks, thus will tend to be volatile in price, just like the overall stock market and they do not have a fixed maturity date. But we feel these companies are our best chance of maintaining and growing wealth over longer periods of time. And, in many cases the current dividend yield is as much as, or sometimes even higher, than we can get from bond alternatives.

Here are some qualities we look for in stocks:

- Relatively stable, growing revenues
- Good profit margins
- Growing earnings
- Modest debt
- Shareholder friendly (pay dividends/buy back shares)

We are very skeptical to have any account that does not have a reasonable allocation to these types of stocks. This may sound contra-intuitive but we feel that positioning a portion of your portfolio for potential growth is the solution to this zero-rate economic environment. By that we do not necessarily mean stock market growth, but owning some assets that are expected to grow revenues, earnings and dividends.

SUMMARY

- You need to look inside your head and see whether it is an emotion or financial need that is driving your decisions about your investments.
- You need to be sure to have a decent amount of assets that can hold-their-value in case of another 2008 type of crisis, but beyond these assets, you probably need to focus on maintaining the purchasing power of your wealth.
- Consider focusing on strategies that seek to generate a growing income in this very low interest rate world.
- You need to make sure your expectations are in line with your actions.

There is no perfect solution, especially when normal supply and demand forces are being influenced by the Federal Reserve, but thinking that 'yesterday' will return is not the answer.

INFLATION wanted…

After the February Federal Reserve Open Market Committee (FMOC) meeting, it announced its goal to devalue the dollar by an average of 2% per year over the next twenty years.

Take a minute and think about this and I realize that numbers in general and percentages especially are difficult for many people to understand, but I'll try and generalize and make it understandable.

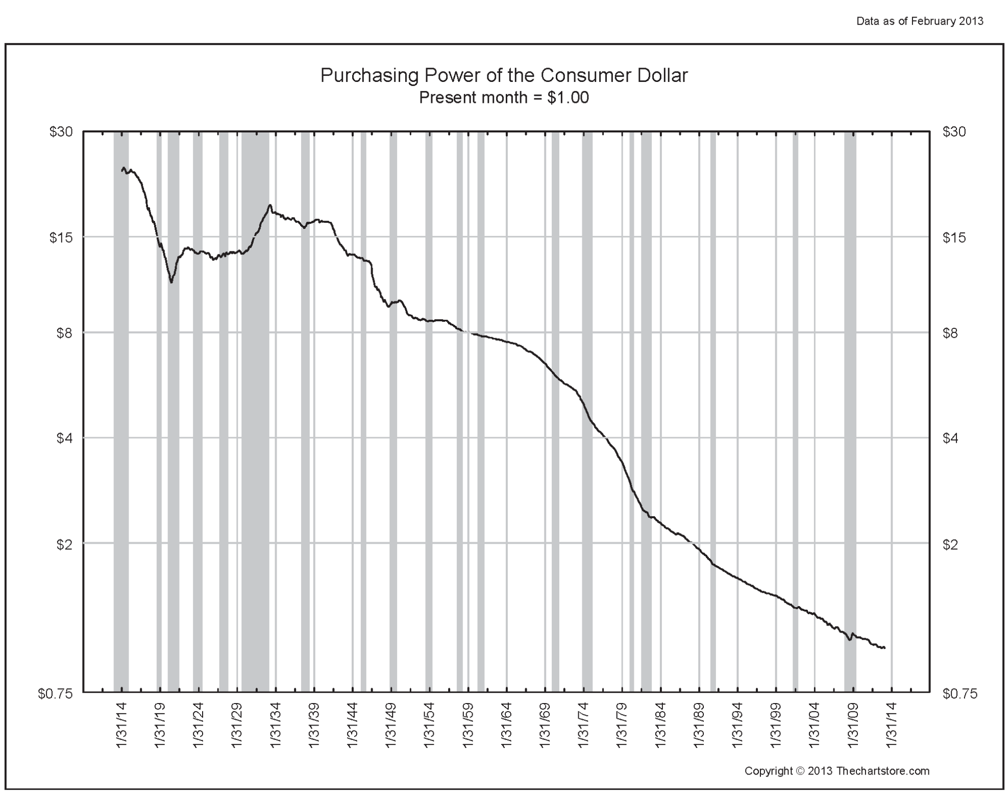
This means that if the Fed is successful the $1,000 per month that things cost you today will cost about $1,500 in twenty years. In essence the Fed has announced it will be their **official policy** to take purchasing power away from your household…sort of sounds like stealing to me. Even over just the next four years it means we will lose about 10% of our purchasing power.

In a long paragraph, the FOMC participants basically said…*a slow destruction of the value of the dollar is the best we can do.*

If you read further into their announcement they, the committee, feel that inflation and artificially controlled low interest rates will reduce unemployment.

Really? They think that their manipulation of the forces of economic balance will give business owners and managers the confidence to go out and expand, take on debt and hire a lot of new employees. Personally, I think they need to visit the real world of the business owner for a few days.

But, then again, does it really matter what they say. Here is a chart of the purchasing power of the dollar since the creation of the Federal Reserve in 1913. See a pattern here? We believe your only rational investment objective for retirement is **growth of income.**



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 authors of The Benedict Report are Philip C Benedict, CFP®, an Investment Advisor Representative and Registered Principal with LPL Financial and Mark A Beaver, CFP®, an Investment Advisor Representative with **LPL Financial**, a registered investment advisory firm and member of FINRA/SIPC. Travis M James, CFP® and Ashley A Thompson, CFP® provide technical assistance. Jean B Wilson and Jackie Thompson handle the layout and editing of the newsletter.

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