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A Rather Simple Investment Strategy for a Seemingly Uncertain World

I spent a good part of last month traveling around speaking with people and listening to their comments. The government "shut down" was in progress during part of the time I was out-and-about, thus you would expect an increased intensity in some of the conversations, but I felt that most people realized that was just some high-drama coming out of the political process. It seemed to me that there was more concern about the longer-term than there was over the current bickering in the Capital. Most people I deal with tend to be quite conservative fiscally, thus the idea of spending what you don't have is not something they can get their arms around.

The small business owners I interacted with bothered me the most. These are the people who hire others and my conversations with a few of them did not make me feel they are in the hiring mood. Granted my sampling was just a few individuals and I hope my take-away is wrong.

And, people were worried because the stock market is so high.

I'll try to address some of these things in the *Report.*

First, here are some random notes and comments from my travels:

Washington, D.C. is out of control. We need some positive leaders.

The federal government and many states and cities seem fiscally out of control. It seems like everything is going broke.

Is it just me or is our foreign policy making us less safe?

I closed down my small business. I'm going to see if I can find a job working for someone else. I'm tired of dealing with withholding taxes, unemployment taxes and audits, workers compensation costs and audits, medical insurance plan changes and cost increases, wage and hour audits and rules that limit what I can put in retirement plans and who I can and cannot hire. I was in business twenty-seven years. I used to concentrate on getting business and serving the customers, near the end it seemed as though most of my energy was spent trying to obey somebody's rules and filling out forms.

The Federal Reserve continues to manipulate interest rates telling us it is good for us; is that the right thing to do?

It appears governments all over the world are trying to "depreciate" the value of their currency. That's not good, is it?

Can we really get richer by printing money and buying our own debt?

I wish I could just run my business without worrying what the government is going to do to me.

The solution is inflation? What if inflation doesn't happen? What if it does, will that make us happy?

When are the people in Washington going to tell us the truth?

It is downright frightening looking for a job out there.

[continued on Page 2]

Don't our leaders understand that when you borrow money you have to pay it back…with interest?

"When will these big companies start spending their hoards of money? When will people who are piling up money in the bank start spending it?" (**Phil comment**… Maybe when they feel good about the future.)

If the market is at an all-time high, isn't it time to sell everything?

Hire employees to expand? No way, I'll do what business I can on my own and get by. I don't want the liability of employees.

People complain…"the government spends too much, the government isn't realistic about future costs, the government has made big promises that it can't fulfill. (**Phil comment**…maybe the government reflects the majority of the people.)

"The Most Important Number?"

No one likes to watch their account value go down in volatile markets, but it's not the share price that is critical for *retirement income investing*; it is the **dividend** and the **reliability** and **growth** of that dividend.

Let's assume you buy a share of stock for $100,000 and it pays an annual dividend of $3,500, you would be getting a "yield" of 3.5% (3,500/100,000 = .035).

If you reinvest the dividend, the $3,500, then you begin your second year with an account balance of $103,500. If you earn 3.5% on this, the dividend would be $3,620. That is called "compounding."

You do this for ten years and your annual dividend is about $4,700. In twenty years the earnings would be about $6,400. Not bad based on your original investment of $100,000. With time and patience, and **compounding**, investing is easy.

Let's add another number to this equation, maybe the most important number, the annual rate of **growth of the dividend.**

Here are the annual dividends paid by this large global company over the last 10 years:

year	dividend
2004	$ 0.50
2005	$ 0.56
2006	$ 0.62
2007	$ 0.68
2008	$ 0.76
2009	$ 0.82
2010	$ 0.88
2011	$ 0.94
2012	$ 1.02
2013	$ 1.12

Look at the annual dividend payments in the box above. If you play with your calculator you will see that this company has increased its annual dividend on average about eight percent per year over the last decade. Let's add this dividend growth rate to our compounding example above and see what the dividend might be in the future:

Assuming the 8% annual growth of dividend, in ten years the growing dividend would be about $10,000 annually and in twenty years, nearly $20,000 annually. Note that both examples assume all earnings are reinvested. (**NOTE:** All numbers are rounded to try and make reading them a little easier.)

How can this be?

Let's go back to our example above: Earning 3.5% on a $100,000 investment. We reinvest the annual earnings, thus our principal is $103,500 at the beginning of the second year.

If our annual earnings rate is **growing** at 8.0% per year, then the earnings for the second year will be 3.78% (3.50% increased by 8.0%). We have created a situation of literally *double compounding*…the earnings are reinvested each year and the earnings rate is increasing each year. Our beginning yield, 3.5% growing at 8.0% per year would equal about 7.5% in ten years because of the growth of the dividend or about 10.0% if we also reinvest the income.

For those people who are somewhat number-challenged this can be overwhelming and I wish I had a simpler way to explain it. It is so important, because

[continued on Page 3]

it is a concept that many people just do not understand and because they don't, investing for a retirement income stream is much more stressful than it should be.

Let's try and say this without using as many numbers. A beginning dividend of 3.5% growing at 8% per year will be a dividend of about 7.5% on the original investment amount in ten years and more if the earnings are being reinvested. In twenty years the dividend would be about 16% or more if the earnings are being reinvested.

In our office we keep a close eye on the rate of dividend growth for specific investments and for overall accounts. **This may just be "The Most Important Number" in retirement income investing.**

NOTE: If you are interested, the dividends listed above are for a company that has a share price slightly lower today than it was in 1998. It's not the share price that makes a great retirement income investment.

NOTE: As always, we have to mention that in the world of investing, nothing is guaranteed. Companies do not have to pay a dividend, dividends do not always grow each year and if they do, the rate of growth will vary. And, of course, if a company is not doing well it will be unable to pay a dividend as the dividend is a portion of the annual earnings distributed to the shareholders.

NOTE: The average dividend growth for the S&P 500 Index has been 5.3% over the last fifty years. (SOURCE: www.multipl.com)) Of course there is no assurance that the dividend growth in the future will be at this rate or any particular rate...this is called "investing." In the example above we used 8%. There is no basis for using this rate other than we have found in the past many companies have increased their dividends at this rate or higher.

This example is not representative of any specific situation. Your results will vary. The rates of return used to not reflect the deduction of fees and charges inherent to investing. Past performance is no guarantee of future results. Stock investing involves risk including loss of principal.

What is a Dividend?

If you own a share of stock in a company, you are a "shareholder" and actually own a percentage of the company...you are an **owner**. As an owner you are entitled to the profits of the company. A dividend is the portion of the profits that the Board of Directors (who are elected by the shareholders) decides to share with the owners. The remainder of the profits are retained by the company to use for other purposes. Let's see if this little diagram helps:

Total Income or Gross Revenues	$100,000
Less: Expenses	$-75,000
Equals: Profits	$ 25,000
Less: Taxes	$-10,000
Equals: After-tax Profits	$ 15,000

$7,500	$7,500
Paid as Dividend	Retained

Can dividends go down?

Dividends are dependent on a company making a profit. Growing dividends are generally dependent on a company increasing profits. And, in most cases, to have growing profits a business needs growing revenues. Thus, a successful dividend investing strategy is based on owning financially successful companies.

Please note that I did not say that it was necessary for a company's share price to be increasing. The share price is dependent on the mood of the buyers and sellers of the publicly-traded shares and not necessarily dependent on the operations of the company.

During the last ten years 315 companies raised their dividends every year, which included the stock market rout of 2008-09. (SOURCE: Oxford Income Letter, November 2013)

Let's go back to some conversations during my recent travels.

Question: Don't you worry about the government's problems and the inability of the people in Washington, D.C. to get along?

Response: When you are an individual, a family, a company or a government that is constantly living beyond your means, and you won't change, then normal, common-sense solutions do not work, thus everything becomes a struggle for power accentuated with strong political overtones and volatile emotions. You have no "rudder."

Question: Isn't it really impossible to not have deficit spending?

Response: We don't "have" to have deficits. You mean there isn't 2% "fat" in most every federal department that could be cut without serious repercussions? You don't even need to fire any workers to cut 2% a year. Over a decade this reduces our cost of government by over 20%. This is impossible? It is not impossible; whether it is the wisest policy, I don't know.

[continued on Page 4]

Question: What is the biggest problem?

Response: I believe the biggest long-term threat to our wealth is that the U.S. Government's long-term finances are in terrible shape. We have made and continue to make promises that we cannot possibly keep. It appears things will only get worse as there seems to be no will-power in Washington, D.C. to make the "adult" decisions that need to be made. The Congressional Budget Office in their recent "The 2013 Long-Term Budget Outlook" stated quite simply, "government spending is on an unsustainable path."

The Federal Reserve, and many other central bankers around the world, is "printing money" out of thin air to try to encourage consumers to spend to help the economy while they are taking the money away from savers, who are earning literally nothing on their savings. They are actually forcing many people to spend less in order to not deplete their savings.

Question: What is the solution?

Response: There is no solution until we admit we have problems. Our government has taken on debts and made other promises and commitments and there will not be enough revenues to honor these obligations. We are fighting with one side saying we need more revenue and the other side saying we need to reign in our spending.

To me the long-term solution to our *forever deficits* is for our leadership to become fiscally responsible and adopt policies that foster strong economic growth. At this point most of our actions seem destined to mute our growth.

Question: How can you invest so calmly when you know a crisis is inevitable?

First of all, even though I personally disagree with a lot of the fiscal actions that are coming out of our federal government, I don't see a big financial catastrophe on the immediate horizon. I believe we are jeopardizing our future growth more than we are creating imminent pain. And, of course, that is why it is easy to kick-the-can-down-the-road, which probably means some sort of crisis in the future.

We don't know what the crisis will look like, we don't know when the crisis may happen and we don't know whether the crisis will hit us like a big bang or a long series of whimpers. In other words, it is easy to say something is going to happen, but no one really knows. And, if we look back it seems to me there has always been a crisis about to happen…some were real and some never happened and some happened much differently than we could have imagined.

Question: How are you preparing for some kind of crisis?

Response: First we accept that "crises" happen in the investment world much like "storms" happen with weather. We accept them as part of the environment in which we work.

We try to focus on what we can control, which for most accounts is attempting to create a solid, growing stream of income, hopefully, one that will grow faster than inflation erodes our purchasing power.

Also, we understand that we could go many years without a financial crisis happening, even during times in which it seems the government is not following fiscally sound policies.

It is easy to forget that uncertainty is probably the only certainty.

IT'S BEEN OVER SIX YEARS!

I hadn't seen him since 2007 and I remember our conversation quite well. He was in his late thirties and doing quite well financially. "Phil, I've got an easy $1,000 per month to invest that I will not need before retirement. What should I do?"

I suggested he invest $200 per month in the Dividend Reinvestment Plans of five different companies that are in five different industries: telecommunication, energy, consumer products, retail and technology. Then forget about them and let the plans take your money automatically and reinvest the quarterly dividends. Do this for twenty years and you will feel almost rich.

We reacquainted the other day and while talking I mentioned that he should be quite pleased with his retirement investment assets. "What do you mean? About a year after I started the market crashed and I lost a big chunk of my money, so naturally I stopped doing that. I'm not stupid."

So I asked where he has been investing if he isn't in the stock market.

He went on a mini-rant about the government and the banks and offered, "There isn't anywhere to invest that is safe. The banks are not paying anything."

[continued on Page 5]

I indicated that if he was not saving this money, then he was probably spending it.

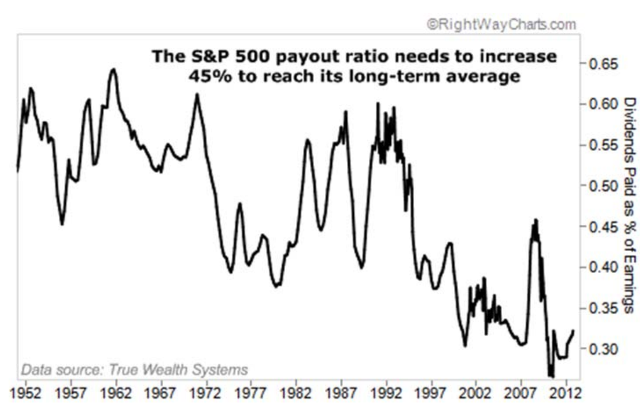
"Well not foolishly. We needed the kitchen updated, which has increased the value of our house and we got a nice new car because we needed the new safety features to protect the children."

When I got back to the office I put some figures in my computer: Invest $1,000 per month, assume beginning dividend of 3.5% and assume the dividend grows at 8% per year. Nothing is guaranteed in the world of investing, but based on the last several decades of history; these figures are not outlandish assumptions especially since we chose stocks that had a long history of dividend growth and seemingly promising futures.

Given these assumptions, if he had followed the original plan, his account would be generating almost $400 per month of income today. More importantly if he stopped investing today and allowed the investments to compound, by about his age 65 the monthly income could be in the range of $2,000 per month. (**NOTE:** When you are compounding over long periods of time a small change in the assumptions can make a big difference in the outcome, thus we have to view this more as a concept and not a specific likely outcome.

I guess that twenty years from now as he approaches his sixty-fifth birthday the memory of driving that new car will have faded and he will be eating breakfast in his kitchen that will be outdated again instead of having the extra retirement income.

ANOTHER IMPORTANT NUMBER



In an earlier article we mentioned that maybe the rate of dividend growth might just be "The Most Important Number." That may be true, but another number is also important when creating a retirement income from dividend paying stocks. That is the "Dividend Payout Ratio."

How much of a company's earnings are being used to pay the dividend? Or, simply, dividends divided by earnings. If a company earns $10 per share and pays a dividend of $5, then it has a "Dividend Payout Ratio" of 50%. All other things being equal, a lower Dividend Payout Ratio is better because it means the company can easily pay the dividend. It also means the company is keeping plenty of cash to invest within the company. However, as shareholders, we do WANT our share of their earnings…our dividends!

The chart above shows the Dividend Payout Ratio of all the companies that make up the Standard & Poor's 500 Index and you can see that the current Dividend Payout Ratio is about as low as it has ever been. Generally we would view this as a good thing because it says companies should be able to continue to pay dividends and increase the amount of dividends. However, we would like to see the companies pay larger dividends to us shareholders and keep a little less for internal use!

It is fun…the struggle to get to "tomorrow"

We are living through very interesting times…it is like watching a drama or maybe opening a history book and reading how different views played out in the past. As I listen to the "war" going on between the people who believe that the government can solve all our problems if it just continues to spend money it doesn't have versus the people who feel this out-of-control spending is not working and will ultimately cause us big problems, I read the quote below from the CEO of Amazon. Substitute the word "taxpayers" for "customers" and see how it reads to you.

"FRUGALITY"

"We try not to spend money on things that don't matter to customers. Frugality breeds resourcefulness, self-sufficiency and invention. There are no extra points for head count, budget size or fixed expenses."
(BloombergBusinessweek, October 14, 2013 in an article on "Secret Amazon.")

Some of you will disagree with me, but I dream of the day when the people working in the leadership positions of the government finally realize they are really working **for** the taxpayers, which is saying for the citizens, because almost everyone pays some form of taxes into the system.

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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, CFP® provide technical assistance. Jean B Wilson and Jackie Thompson handle the layout and editing of the newsletter.

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