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IF YOU DO THIS, YOU ARE GOING BROKE!

A Prediction Because Everyone Loves to Know the Future

Most of us are pretty normal and fear the unknown. Given a choice most of us would chose security over the unknown. Political leaders feed on this desire for "security" by making promises and creating programs. Marketers feed on this desire for "security" by making promises about their products. Sometimes we get married to give us "security." Some young women have a baby to get the basic "security" offered by the system. Some of us choose our employer based on potential job "security." Some of us save in an attempt to create our own "security."

In most cases, this is called *a false sense of security*; however, we still choose that over the alternative…no guarantees of anything.

The same emotions compel us to want to know the unknown. Why is the "weather" one of the highest rated news programs? We can't just stick our head out the window, we want to know what to expect over the next several days. We want to know what tomorrow will bring…to eliminate the unknown.

This same emotion, many times amplified, impacts our "wealth."

"Phil, I just heard this expert on television who predicted that the stock market will have a terrible crash within a few weeks. What do you think about that?"

Response: I understand his thinking and I can envision many things that could happen that would cause a panic among the traders and speculators in the stock market. It would not be surprising to see a major decline.

"Phil, I just heard this expert on television who predicted that the stock market will explode upwards from here and more money will be made in the next couple of years than has been made over the last five years. What do you think about that?"

Response: That is definitely a possibility. Overall, stocks are not "cheap" based on historical valuations, nor are they overly "expensive." However, *relative* to most other alternatives, they still seem to have considerable upwards potential.

* * * * *

Now, if you just read the above four paragraphs you may be saying that I said a lot, but said nothing. I think I did! My best prediction is that the stock market could easily decline twenty or more percent and/or it could also go up fifty percent…maybe both.

We have governments all over the world trying to "stimulate" their economies and central bankers "printing" money by the bushels. They have almost all over spent and over promised and need high inflation which make their debts and promises easier to honor. As I have written before, we do not see how this can end without a major crisis or a series of crises. And, it appears the situation may get worse before it hits the crisis stage because the voters may keep voting to keep the punch bowl full.

My best guess is that we are going to be disappointed by the lack of inflation over the next several years. That, of course, may exacerbate the problems and make the *solution* much more difficult. It would not surprise me to see a massive world-wide devaluation of currencies at some point in the future. It will not be pretty, especially for those who are on the receiving end of government promises…pensions, bond holders, etc.

There, I made a prediction. I have no idea whether it will come true and, if it does, I don't know if we are talking months, years or decades. The voters, the leaders and the recipients of benefits are fighting to hang on to "yesterday" and they will not give up that fight without a serious crisis.

But, I can't live my life worrying about a crisis that may not happen or may not happen during my lifetime. Life is a series of crises with money and wealth being just part of them.

We believe we are in an extended or secular sideways stock market much like we experienced from the late 1960's through the early 1980's. Or like the early 1920's through the early 1940's. This is not a time to be relying on stock market growth to provide for your retirement income. Since 2000 it has not been a good time to be invested in products that merely follow the standard market indices although we do not know what the future holds.

We also have historically low interest rates, which is when stock market prices have historically been generally high. (The opposite, high interest rates, usually corresponded to low stock market prices.) This is not a perfect time to invest; HOWEVER, the alternative of leaving your money sitting on the sidelines earning literally nothing doesn't seem very wise either.

What we are doing is trying to own shares of the strongest, best managed companies around the world that seem to have the best chance of positioning themselves during bouts of deflation, inflation, devaluation and the like. We do not want a large part of our accounts in static holdings that cannot adapt to whatever the global economy throws at us over the next few decades. We will write about this more in the future.

Shouldn't we be selling everything?

This did not happen exactly as the story below but bits and pieces of it happened in many conversations over the last several weeks.

"Phil, I'm concerned. The stock market is near record highs and is bound to go down; shouldn't we sell and wait until it crashes?"

"You are definitely right that the stock market is at or near an all-time high, but so are farm land prices, so are you planning to sell your farm land?"

"But that is different."

"Just how is it different?"

"I'm not sure, but it is. I guess it is that I don't know who controls stock market prices. I don't trust those guys on Wall Street - whoever they are. It is so mysterious. **And land, especially farm land, is real.** *We will always need food, thus it is enduring whereas it seems the value of a stock can go to nothing in no time."*

* * * * *

I grew up on a small farm, which doesn't make me a farmer, but we tend to retain many values and perceptions from our childhood. Thus, it is easy for me to feel good about owning farm land as it is so tangible and the crops produced by the land are so real. But on my travels back to Atlanta I got to thinking about farm land as an investment, especially for a non-farm operator, thus a "passive" investment.

Since farm acreage is not nearly as "liquid" as other types of assets, we would expect the price-per-acre changes to happen much less dramatically.

Some land owners believe, especially now since the farm land values have increased rather dramatically, that there are no risks to owning farm land. Let's challenge that and list some risks:

A big one is…government involvement and regulation. This could be anything from changing the farm subsidies and price supports to discontinuing the requirement that gasoline must contain ethanol. Roughly forty percent of corn production goes to manufacture ethanol. Another risk is government policy regarding foreign trade as well as the strength or weakness of the dollar compared to other currencies. In many parts of the country the government can dictate water use and restrictions. These seem like big uncontrollable risks to me.

Let's look at some more risks to the price of farm land. The weather seems a little uncontrollable to me. Add to this the price of oil which impacts the cost of production. Rising interest rates make financing land purchases more expensive and the list of risks goes on.

But, to offset these risks seems to be a lot of potential benefits to owning farm land. The rising global middle-class population that is demanding more and more good food is a biggie. Also, land that is not dependent on irrigation would appeal to me a great deal.

Who Controls Stock Prices?

First of all let's ask ourselves, who does "control" stock prices?

Is it the big Wall Street brokers, the Federal Reserve, the government, the Middle Eastern oil barons, the pension plan managers or Warren Buffett and Bill Gates? Who is it?

Since literally anyone in the world can buy a share of stock and anyone who owns a share of stock can sell it at any time at any price that is agreed upon, no single person or group or institution controls the stock price. However, the actions of many of these groups can influence the thinking and emotion of both the buyers and the sellers.

Next let's ask ourselves, "How can the share price of the stock of a big company sometimes drop twenty or thirty percent in a matter of weeks?"

What many people do not understand is that the vast majority of shares of most companies seldom trade hands. It is not uncommon for pension plans, endowments and many individuals to own the same shares of stock for decades. These would be considered long-term investors. There are also groups that are actively trading the shares of stock, sometimes buying and selling several times in one day. They are in essence "betting" on the short-term direction of the share price. This creates a lot of volatility and adds considerable emotion to the stock market. Since this group of "speculators" will usually be following the short-term trends and since only a small percentage of the total shares outstanding change owners on any given day, a few traders "betting against" the share price can push the price down rather dramatically.

Next, let's ask what are some of the other "risks" of the stock market?

If you think about it there is no end to this question. Literally, potentially everything can have an impact on the short-term price movement of a share of stock. Bad weather, good weather, higher oil prices, lower oil prices, war in the Middle East, peace in the Middle East, flu outbreak in the Northeast, new drug break through, interest rates going up, interest rates going down.

But we must also remember that this rising global middle class has created a huge market for many of the products manufactured by our large corporations.

SUMMARY: "Investments" don't come with guarantees and all have risks. If I were a farmer, obviously I would own my farm acreage, and I would consider using the profits to fund my investment account that would be, at least in some part, probably a substantial part, in common stocks.

THE ONE PERCENT

I was forwarded one of those forwarded emails showing a chart on how a very small percent of the population controls a considerable amount of the nation's wealth. The email challenged me…"What do you think of this? Isn't it terrible?"

I didn't bother responding because I didn't know how to "yawn" in an email.

Why is this not important to me? I guess because I'm quite certain it has always been that way and it is that way throughout our entire society.

Let me explain:

Millions of young people learn to play baseball in leagues starting at a very young age. How many of these players eventually end up playing professional baseball? My guess is about 1%. And how many of these professional players really make the huge salaries. My guess is it is a very small percentage of all professional players.

Millions of young people learn to play a musical instrument. How many end up getting paid to play? How many of them actually make big, big salaries? Again, my guess is that it is a very small percentage.

How many of the elected officials in this country sit in Washington D.C. and make the rules that impact our lives, take our money and sometimes lessen our freedoms? My guess….less than 1%.

Think of all the time and energy that goes into the game of golf. How many golfers make the big time? You guessed it…probably about 1%.

"Wait," my above-mentioned friend would probably say, "wealth is different, it should be owned more equally." I think he is exposing his political views more than any economic reality, because he forgot to mention that the top "1%" that he hates so much pays approximately 37% of the income taxes.

SOURCE: www.taxfoundation.org)

Besides, it seems to me that the vast majority of people never really do much of anything to try and get into the top ten percent of anything let along the top one percent. They show up at the little league game, swing at a few pitches, listen to their fathers yell at the umpires and then go home and watch television or play on their little devices. The exceptions, the ones that practice throwing, hitting, running, etc. for hours at a time are a very small percentage of the total players, probably closer to one percent.

Another group takes a few lessons on a musical instrument, they practice a little and that is it except for a very small percentage who can be heard practicing their music hours at a time.

In many ways the creation of massive wealth is very similar. Oh yes, there is a lot of plain old "luck" involved, but I believe there is a lot of luck to make the big leagues, etc. However, without the practice and determination the "luck" will seldom do it on its own.

Other than possibly the purchase of a lottery ticket, some of the masses do literally nothing to attempt to amass even the smallest amount of wealth. They don't save any money. They don't continually work at bettering their skills. They don't look for opportunities. There seems to be a lot of people out there who simply take the easy way out and get by. I think it was Earl Nightingale who in referencing a fireplace said something like…"Give me heat and then I will add some wood."

The friend who sent me the email has done nothing to make himself valuable to an employer and he has done nothing to create even the smallest amount of wealth but he thinks it is unfair that others have more than he has. He doesn't have the satisfaction of trying to be a lot better than he is and he certainly shows no drive to be the 1%, but he does want the benefits. In a way I feel a little sorry for him…not because he isn't near the top, but because he doesn't even try.

MORE ON THE ONE PERCENT

What a country we live in! Think about it, what are the real differences between how the top 1% live and the majority of the rest of us live?

* * * * *

I read about this 1% guy who had chartered a private jet to take his family to Aruba for the holidays. They will stay in a posh hotel and all their needs will be attended to by others. I guess that will make the entire family happy.

I spoke with the couple who was pulling their RV behind their ten-year old truck and planned to stop at several craft shows over the next few weeks. Their time will be spent selling some of their creations, enjoying the camaraderie of other people with similar lives and seeing parts of three states. I truly think they are happy.

I read an article about the 1% guy who has seventeen houses. (Really…seventeen?) I guess it took the seventeenth one to make him happy.

I spoke with the couple who lives in a nice, but plain, three bedroom home in a nice, but plain, neighborhood. Their home is warm in the winter and comfortable in the summer. It has a garden area, a nice lawn and a fence to keep the puppy from running away.

Their annual income is probably far less than any of the household help of the rich guy's seventeen houses. They enjoy putting up seasonal decorations and conversing with the neighbors who walk by as they are doing their creative work. They enjoy doing this.

Our 1% friend contracts out his holiday decoration displays, thus it is very skillfully done and each home has a different theme.

Sit back sometime and think about how much different the lives of the 1% people are compared to most of the rest of us. With the exception of a relatively small percentage who are really struggling, most of us live a lifestyle quite similar to the very rich.

We all have decent homes, dependable cars, modern clothes, good food, heat in the winter and cool in the summer. If we get sick we all pretty much go to the same hospitals and receive care from the same people. Most of our children have the opportunity for a good education, avenues for creative activity and the same communication gadgets.

The really rich can play golf in foreign countries on plush courses but the rest of us can enjoy the same game on a local course. "They" may enjoy the theater in New York and Paris but "we" generally have more arts and leisure activities available to us than we can ever experience.

"We" may never be able to experience what it is like to visit Singapore and Hong Kong, but a few clicks on the Internet or the purchase of an inexpensive DVD can bring us closer to the other side of the world than we have ever been before.

The 1% people can hire experts to design proper, healthy diets and to design and help them follow an exercise routine. But, the same information is available to the "rest of us" with a few clicks of our mouse.

My experience is that many of today's very successful people came from very middle-class backgrounds. And, many of the children of "affluence" struggle to make it on their own.

Most of us live lives really quite similar to the 1%. Many of us are very happy and content with what we have...I guess that makes us "rich" in a way. And some of us always want more....I guess that makes us "envious."

Let's enjoy our riches.

WHY DID THEY DO IT?

I felt sad, really sad. Why did they do this?

The numbers vary, sometimes it is tens of thousands of dollars, sometimes it is hundreds of thousands of dollars and sometimes it is several millions, but too frequently the result is the same.

It is the financial dream of many people...to become "rich" without having to earn it and save it. As one friend told me years ago when he learned of an unexpected inheritance, "our ship has come in." Unfortunately, like most "ships" that were not earned the old fashioned way, their "ship" went out almost as quickly as it came in...they spent it, all of it in a few months. And, they really needed this money to produce income, but they still spent it.

Most people don't want to hear this, most do not believe it and most think it would never be them. My decades of experience dealing with people and their money is that very few people who receive a "lump-sum" of money that they did not earn and save, can keep it as real "wealth." In most cases it becomes "money" and is spent...sometimes spent quite quickly and it is gone. Generally the "lump-sums" I have seen are inheritances or payouts of employer pension plans or sometimes the sale of a property. But, too frequently the result is the same...it gets spent.

I felt sad when Travis told me we just sent out the final check to the beneficiaries. Their father had accumulated a very nice "nest egg" and it served him well during retirement. Together we experienced the sharp market drops and surging market booms from the late 1980's until his death about ten years ago.

His account size would not put him in the Forbes 400 Richest People List, but I imagine in his circle of friends he would have been considered "rich" if they had known his account value. How did he get "rich?" He simply had his employer put ten percent of his gross pay into an investment account for him AND he never spent the principal.

His two children had never saved anything on their own. I don't know how they survived before father died because they kept asking us to send out large chunks of money each year. Yesterday we sent out the balance of the account...overnight mail, of course. My guess is that they have nothing to show for the money. Both of them are now approaching retirement age with nothing but a government check to provide their standard of living.

Why did they do it? Why did they spend what could have been/should have been a lifetime nest egg?

I don't know. We thought we were very clear along the way in our warnings that they were spending their principal and their account would go to zero.

I am sad for them.

Should father have done things differently? Maybe, but that was not his nature. He was a simple man and, like most people who accumulated wealth from earnings and savings, he assumed his two children would treat that wealth like he did. That is an assumption that most people make who have accumulated some wealth...that others would appreciate it as "wealth," something that lasts forever. They usually totally misjudge the inability of their heirs to keep "wealth." Thus, if you are planning to leave an inheritance to someone who has not mastered his/her own financial life, do not think your bequest will solve their problems.

"But, what should I do?" We will offer some ideas and comments in future articles, but there is no simple, easy solution.

PAY ME NOW, OR PAY ME LATER

When evaluating the dividends of different companies, there is usually a trade off between a higher current dividend and a lower initial dividend that is growing faster.

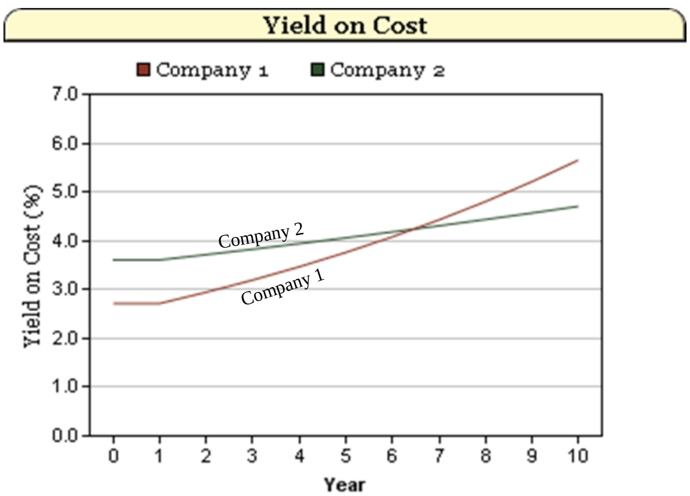
Let's look at this hypothetical example:

Company 1 is paying a 3.8% current dividend and over the last five years has seen its dividend grow by 4.0% per year.

Company 2 is paying a 2.7% current dividend and over the last five years has seen its dividend grow by 8.0% per year.

Assuming the dividend growth of each company is the same for the next ten years as it has been over the last five years, here is what their dividends would look like over this ten year period.

You can see that in this example, the dividend of Company 2 catches up with the Company 1 dividend during the sixth year.



This is a hypothetical example and is not representative of any specific situation. Your results will vary. The hypothetical yields used do not reflect the deduction of fees and charges inherent to investing.

You may look at this and say, "In six years I may be dead, thus I want the higher dividend right now."

Actually we feel there is a place for both types of dividend paying companies in a balanced investment account.

Generally, the company with the higher current dividend has a higher Dividend Payout Ratio, the percentage of profits that is paid out as a dividend, thus the dividend may be more sensitive to economic downturns and it may also be more sensitive to changes in the overall interest rates.

Don't underestimate the impact of rising dividends. There are many large, stable companies that have raised their dividends by over eight percent per year for decades. This can have a big, big impact on your lifestyle in the future.

Look at the trends and picture and you can see how much higher and faster growing dividends might be in twenty years. The "dividend growth" of your investment account is critical, if not for you then for your children and grandchildren.
(NOTE: Past history helps give creditability to the concept of dividend growth but naturally you have to look at the future and make some judgments. Past performance is no guarantee of future results..)

Is a farm a good investment?

Back to our farmer discussion.

Let's assume we buy an acre of this farmland for $6,000. Let's also assume we can rent our farmland for $150 per acre and we have costs, primarily property taxes, of $20 per acre, thus we "net" $130 per acre.

The net rent of $130 divided by the market value of $6,000 means we are earning about 2.2% on the market value of our investment. Or, to say this another way, our land is worth about 46 times our annual earnings.

Will this be a great investment? Of course we don't know but if we can increase the rent on a regular basis it has the potential to be a fine investment.

It seems to me the real value in farmland is for the owner/operator. For a *passive* owner who receives just the rental income, he needs to expect rent increases on a fairly regular basis to make it look attractive, at least given the assumptions that were made at the beginning of the article.

Does this common stock have the potential to be a good investment?

Let's see if this common stock looks like a good investment, one that we want to own even if it may decline in share price for a period of time.

- Ten years ago revenues were $40 billion annually and now $70 billion.
- Ten years ago "free cash flow" was $700 million and now $3 billion.
- Ten years ago the dividend was $.25 per share and now $1.50.
- There are 30% less shares outstanding, due to share buy-backs, compared to ten years ago.
- The company's return on equity is about 15% annually.

The numbers are rounded to hide the identity of the company as that is not the purpose of this piece, which is to try and illustrate just how much value there can be in some of the large, well-managed, publicly traded companies.

There are no assurances that the future of this company will be as bright, but don't let the volatility of a company's share price blind you to the value of the underlying company.

IF A FARMER WERE A COMMON STOCK...

Let's look at Farmer Young. He is in his mid-thirties and owns and farms one thousand acres of land. He has debt on most of his land of about three million that he plans to have paid off in about twenty years. He also has debt on most of his large equipment. His profits are rather modest because of all of the debt payments and, during years in which the crop prices or yields are down, he seldom makes a profit at all. However, this doesn't deter him from having big plans of acquiring more and more land in the future. He wants to "grow" to be the largest farmer in the area.

Let's look at Farmer Older. He is in his mid-fifties and owns and farms one thousand acres of land. He has no debt on his land or on his equipment. He acquired most of his land when prices were a lot lower, thus his profits on his original investment are rather large. And, because he has no debt payments, he is still very profitable during the years when crop prices are down.

Now, let's assume that the two farmers above are publicly traded corporations and you could buy shares of stock in them. Which "company" should you most likely buy if you are looking for a solid investment to pay you a potential current or future retirement income?

Obviously, you would choose Farmer Older because his has the ability to be profitable even during tough times and to pay part of his profits in dividends to his shareholders.

When deciding which company to invest in it is good to think about your expectations. Do you want to own Farmer Young (a growth stock) and, if everything goes right, own part of the largest farmer in the area. Or do you want to own a Farmer Older (a dividend paying stock) that can potentially remain profitable even during the tough times, but may never be the largest. The payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time.

WHAT IS THIS MONEY REALLY FOR?

I made up this story based on several conversations over the last few months.

"I was just at the bank and they are only offering me 0.25%. That is terrible, what shall we do?"

"What is the money for?"

"We just don't want to lose it?"

"Do you think you will be spending it in the next few years?"

"No."

"Well, I know enough about your financial situation to say that you will never need to spend this money during your lifetime. Do you agree?"

"Well, yes, but we have always worried about the future and it is difficult to say out loud that we will never need this money. We have always saved."

"Then, if you will not spend it I assume you want it to help your children and grandchildren. Do you want them to spend it or do you want this money to create an income for them that will make their life a little more secure?"

"We definitely don't want them to spend it. We worked hard all our lives to accumulate this money. They need to use only the income and pass it on to their children."

We have three major issues going on here.

- One is the "wishing" that their children and grandchildren will treat this money/wealth in the way the parents think they should.
- Second is the desire for the heirs to use the "income" and preserve the principal for future generations, but it is not invested to earn any meaningful income.
- Third is the fear of losing it.

First of all, I do not think the children will ever treat the inherited funds as "wealth" if the investments are not generating a decent annual income. Thus, I would focus on the earning of a good potential income and the compounding of that income with these assets. And, in today's interest rate environment you cannot earn much income without accepting some account value volatility.

The "how to keep the children from just spending it" is a much tougher struggle. Here are some ideas which we will expound on in the future:

- ♦ Give the beneficiaries the income now...to *teach* them.

- Write a "Letter of Wishes" to be read by the children now or upon your death…this is to give you *hope*.
- Create some sort of formal structure for your wealth to assure your heirs spend only the income…this is sort of a "*gotcha*."

IF YOU DO THIS, YOU ARE GOING BROKE…

You are relying on your investment account for part of your standard of living. If you withdraw only the "income" of the account it most likely will last you for decades even though your account "value" will rise and fall with the natural market cycles.

If, however, you are withdrawing far more than the "income" of the account, then you are withdrawing the "principal" and one major market decline may devastate your account to the point of which it may never recover. This type of withdrawal strategy has the potential to lead you to go broke.

Let's put some sample numbers into this story:

> Assume you have $100,000 in an investment account that earns $4,000 in "income" annually, but you are withdrawing $20,000 per year. If the value of your account drops 25%, to $75,000 you should stop your withdrawals immediately. However, I have rarely ever seen this happen. Your account may still be earning the $4,000, but the "extra" $16,000 that you are withdrawing is "principal." By the end of the year your $75,000 account balance less the $16,000 principal withdrawals means your account value is now worth about $59,000.
>
> With your account balance at $59,000, even IF you change your strategy and only withdraw the $4,000 annual income, it would take your account growing at 10% per year for six years straight to get your account value back to $100,000.

If you are taking withdrawals from your investment account, what SHOULD you do immediately? Calculate just how much consistent "income" your investment account has the potential to generate in a year's time. If you don't know how to do this, please call us. Then look at your withdrawals…not just the monthly withdrawals, but ALL your withdrawals during the year. If your withdrawals are substantially greater than your income, then you will most likely deplete the account balance.

But, you may say, I'm old and I may not be around a lot more years, what do you say to that? I say, you HOPE you won't be around when your money runs out.

But, you may say, my children are having a hard time and I need to help them, what do you say to that? I say you are still likely going to eventually go broke and I doubt your children will be there to help you.

But, you may say, I see others struggling so much that I feel guilty having this money, thus I use it to help others, what do you say to that? I say that is very nice of you, but you are still likely going broke.

DID YOU JUST PRINT THESE?

I handed two nice, crisp twenty dollar bills to the dry cleaner. "Did you just print these, they look new?" Yes, I responded. I figure if the government can print money at will citizens should have the same rights. (The remainder of this story is fiction, so please do not call the FBI.)

Besides, it will be good for the country's economy. If I print money and then spend that money on a new car, then I have helped the car dealer make a profit along with the car manufacturer and when they make profits they can hire more workers or expand and build new plants and pay the shareholders more dividends, etc. If I use my newly printed money at the grocery store, the store will have more revenues some of which will be spent with various suppliers who have more revenues, etc.

I could print some money and give all the employees a raise. Then they would have more money to spend buying groceries and automobiles.

Why I could even "print" the extra money I need to pay my income taxes. That way the government would take in money and would not incur the cost or printing it themselves.

This sounds like a win-win-win to me.

"But, if a lot of people start printing money, won't it take away from the value of the existing money?"

You would think it would, but no one in charge seems to worry about that so why don't we all take advantage of it. "This still doesn't sound right to me."

Wouldn't this be a more effective way of *stimulating* the economy than increasing the bank reserves and hoping that they will lend it out to someone who will spend it. I will spend it as soon as it comes off the presses.

"This still doesn't sound right to me."

What is money, anyway…?

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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®, a Registered Principal with LPL Financial. 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.