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OUR CURRENT DILEMMA

(NOTE: The first section of this Report is a portion that was covered at **"Lunch with Benedict"** *in March, 2014.)*

There are times, many times in a lifetime, when your investment account is going to decline in value, sometimes the decline will be greater than others, and every market decline comes with emotionally packed economic and financial news.

If market declines are a given, let's see who actually gets hurt **financially** by market declines:

I. The "future retiree" who plans to retire in a few years on the income from his investment account?
II. The "retiree" who is using the income from his investment account to provide some of his retirement income?
III. The "withdrawer" who each year withdraws substantially more from the investment account than it earns in income?

What we sometimes forget is that the "future retiree" who is reinvesting the quarterly dividends will increase the number of shares if the share prices decline, because each quarter he is buying more shares because of the lower price. And if he is adding to his investment account the share price he pays will be lower also.

The "retiree" who is withdrawing the income, but not principal, probably likes to see his account value increase rather than decrease, but it really doesn't matter. What matters to him, or should matter to him, is the predictability…and growth…of the income.

However, the "withdrawer" who is withdrawing substantially more than the account earns in income is setting himself for potential financial ruin because a decline in account value means he has to sell more shares to provide for his withdrawals. It is analogous to a farmer who is selling some of his land each year to pay his expenses. In both cases, this is called growing broke.

We believe we are in an extended, volatile, sideways market cycle, meaning that most stocks have been experiencing neither an uptrend nor a downtrend. In this kind of market real "wealth" is the creation of "income," especially "income" that grows to maintain its purchasing power over time. This is the crux of our account management approach. We think that this is a practical, common-sense strategy that is well positioned in this economic/political environment or most any other environment for that matter.

OUR STRATEGY

We cannot create an investment account that never declines. By definition, investing is the ownership of an asset. Asset prices are volatile…they can go up AND they do go down.

However, being volatile is not the same as losing all its value. Our strategy is not to try and avoid volatility, but it is to try to avoid *total loss of value*. Here's how we try to do that:

Account structure:

- Position size: We do not want any one company to dominate, thus we have a lot of company diversification.

- Industry risk: We do not want any industry to dominate our accounts, thus we diversify by industry.

- Allocation by asset type: We have more equity (stock) exposure in most accounts than we have ever had in the past. This is because longer-term we see more potential "value" in owning stocks.

NOTE: We can have programs that will tell us historically, on the average, how an account allocated like yours has performed in relationship to the overall market. For example, the historical relationship may have been that your account is 65% sensitive to market changes…or whatever the figure may be. We used to focus on this, but no more. Why? The next period of market volatility will be different than the last. And, we have found that no one likes to see their account value go down, so it doesn't make anyone feel better if we tell them, "well, your account value ONLY went down 10% while the overall market went down 15%." A down is a down is a down. Instead we want to focus on owning high quality, profitable companies and are willing to ride out the market declines. Of course we have to tell you that there is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio and diversification does not protect against market risk.

An example:

Here is the share price chart of a hypothetical company since 1990.

The chart shows the volatility of this company's share price.

Yahoo Finance

This hypothetical company has roots back to the 1870's. The current yield on this stock is 3.2%. It has increased its dividend each year for over twenty years. Ten years ago the dividend was $1.43. Today it is $3.80. Ten years ago the earnings per share were $3.57. Today they are $12.33.

Do we wish we had sold at point "A" on the chart?
Do we wish we had sold at point "B" on the chart?"
Do we wish we had sold at point "C" on the chart?
Do we wish we had sold at point "D" on the chart?"

Are we planning to sell now?

Our core stock investment strategy:

- We want to own companies that are growing their *REVENUES* and *EARNINGS*
- We want to own companies that have a lot of *FREE CASH FLOW*
- We want to own businesses that have very manageable *DEBT* outstanding
- We want to own companies that have historically paid a decent *DIVIDEND*
- We want to own companies that have the ability and the history of *GROWING THE DIVIDEND* on a regular basis.
- We want to own businesses that have the ability to keep paying that dividend, thus we want a reasonable *DIVIDEND PAYOUT RATIO* (the percent of profits that is paid out as a dividend to shareholders).
- We try to own companies that understand that the *SHAREHOLDERS* are the owners of the company and manage the company in a shareholder friendly way.

SUMMARY: We will again state our belief that we are in an extended, volatile, sideways market cycle. In this kind of market real "wealth" is the creation of "income," especially "income" that grows to maintain its purchasing power over time. We think that this is a practical, common sense strategy, but it WILL NOT eliminate the market volatility from the stock ownership in your accounts. Additionally, the payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time.

We also believe that we all emotionally hate to see our account values decline, but it is the person who is withdrawing significant principal from his/her accounts that is typically most at risk.

We want you to be confident that you own a "portfolio" of high quality companies that we believe will weather whatever storms the financial markets hand us over the next few years. You can FEAR those unknown storms or you can sit back and ENJOY the drama as they happen. The choice is yours.

"… the poor are not poor because the rich are rich.

The two conditions are generally unrelated."

Robert Samuelson, February 3, 2014

WE MADE IT TO SIXTY-TWO… WE'RE DONE!

"We have friends and family members who worked at one place for years and have retired. We were never that lucky. Between the two of us we have had so many jobs we lost count years ago. We worked for small employers that went out of business. We worked for large employers that sold their operations or moved overseas. I don't think either of us ever had a period of time in which we were not looking for work or wondering when we would have to start looking again."

"I think we are good people. I think we were hard workers, but the workplace was not a fun journey for us."

"We both just turned age sixty-two and are officially living on social security along with a modest pension that covers most of our house payment. I think this is the first financial security we have ever known."

~ ~ ~ ~~

For a lot of people knowing a check was going to be there at the first of every month…no matter what… is very reassuring. However, I can think of a couple of things that I believe would greatly increase your standard of living over the remainder of your lifetimes. Otherwise in a few years I'm afraid you will again start to feel some financial stress.

There must be something you two enjoy doing, either individually or together. My encouragement would be to find some way to "enjoy" making a little additional income. If this only averages a few hundred dollars a month, it could mean a lot. Maybe it is a seasonal thing you do, maybe part-time, maybe whatever that feels good and you enjoy doing it. Just structure your enjoyment so it makes you a few dollars. And, you may find it also adds to your social life.

With these "extra" dollars I would consider using them to pay down your home mortgage. My guess is that, with a little effort, you could have it paid off by about the time you turn age seventy. That will also be about the time your lifestyle is really feeling the pinch of inflation. Eliminating your house payment at that time will give you the "raise" you need.

And, at some point one of you is going to die leaving the survivor living on one social security check. The lower your expenses are at that time the easier it will be for the survivor. Plus the equity in your paid-for home may be available to help replace the lost social security income.

You are only sixty-two; bright and energetic… go for it.

It seems that most Americans have a very difficult time actually "saving" for their retirement. And, retirement may not be a pleasant era if you are not prepared for it. Get out of debt and start creating your *retirement income* today. Every year you wait will make it more difficult to create the lifestyle that you envision for your retirement.

IT IS SO MUCH MORE DIFFICULT THAN FIFTY YEARS AGO!

Emotion is so much stronger than wisdom. Think of some of the big issues you hear about almost every day that almost everyone has a strong, very strong in many cases, opinion on the topic that is generally a strong emotion and a scattering knowledge of real facts. I'll list some of the issues and as you read them my guess is that you have a rather strong opinion…one way or the other…on most of them. Here goes: "climate warming," "our health care laws," "fossil fuels," "income-inequality" and "how tough it is today compared to the past."

If I start writing about most of these issues about one-half of you will immediately throw the newsletter in the fireplace…no matter how factual my presentation and no matter which "side" I ended up taking on the topic after I had done my homework. So no one in his right mind would choose to tackle them. Except…

I heard it again the other day, "It is so much more difficult for our recent graduates than it was fifty years ago." I hear the whining…but it is generally from the parents and not from the younger generation; of course, it may be because my contact is limited with the younger generation. "Oh, they have student loans, they have trouble finding a *good* job…it is just far more difficult than in the past."

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The same day I received an invitation to my Fiftieth High School reunion. I am not one to spend much time thinking about yesterday, especially when this yesterday is a long time ago, but I did start wondering, "was it so much easier way back then?" Let's look:

I don't remember what the unemployment rate was, but I do know that starting that year and lasting for several years in the future almost every reasonably healthy male was given…not offered…**given** a government job. That's right; almost every male was literally guaranteed a government salary for a minimum of two years and, in many cases, much longer. This salary included health care, meals and lodging. It also included paid-for travel to exotic places. For me there were two major negatives to such a situation 1) the males had no choice, the government called it a job, but to me it resembled slavery more than a job and 2) you were generally required to crawl through the jungles of Southeast Asia carrying a rifle and doing your best to avoid being killed by the other side. Thus, unemployment wasn't much of a worry to the graduates fifty years ago.

I was thinking about this while driving down the road and missing a turn. To reverse my course I pulled into a rural "trailer park" and realized that I had been here before. A friend who was in school about the same time as I was had moved here with his new wife after he returned from Vietnam. I don't remember what his wage was at that time, but I'm pretty sure it was near the low end of the wage spectrum.

I thought about another situation from way back then when someone close to me took a job as a public school teacher. Back then most teachers only got paid for the months they were in the classroom and most, if they were the main family bread-winner, supplemented their teaching income with summer employment and/or part-time employment year round.

I personally took a job four years after that, right out of college, for a minimum wage. I found the job very interesting, educational and rather stimulating. I ended up working for that firm for a decade, moving rather rapidly up the corporate ladder. I would never have found that "job" if I hadn't taken the minimum-wage position. Instead of spending a decade…the very formable decade of my twenties…with a rather free-spirit company I may have ended up working for a bureaucratic conglomerate…which would have made me feel like a slave.

As I graduated from college most of my male friends were still being called away for "government service." The good news for those that were not working in the jungles is that back then gasoline prices were low and the avalanche of government regulations had not swept the country…yet.

By the time my friends returned from the jungles…those who returned…and got their careers going it was time to "settle down" and buy a house. By then mortgage rates were in double-digits and high inflation had pushed the home prices up dramatically but we thought life was good.

Fifty years ago I was offered a four-year scholarship at Duke University. I remember the coach telling my parents, "This scholarship is worth ten thousand dollars." (To verify this, I went on-line and couldn't find the Duke information, but found an old site that listed the cost of a year of schooling at Penn State in 1964. Tuition $1,570, General Fees $180, room and Board $1,000 and Books $100. (From the Penn State University archives)

The average price of a new automobile fifty years ago was $2,350. Isn't it interesting that the cost of a year at college way back then was about the same as the cost of a new car? The price of an average new house was $20,500 or about 8-10 times the cost of a new car. (SOURCE: www.ask.com) Wonder how these figures compare to today?

"In 1964, President Lyndon B. Johnson declared a **War on Poverty** pledging that the government would end poverty in less than a decade. At that time the official poverty rate was about 19%. (Today, 29% of Americans live in households receiving "Federal means-tested public benefits." In 1964, 80% of males ages 20-64 were employed. Today that figure is 68%. (Source: Washington Post, May 18, 2014.)

"Marlboro Country ads were first seen in print and on television. Sales for the cigarettes jumped almost immediately by ten percent. At the time, **60%** of the American population smoked cigarettes.

"The average annual income was about $4,600." (From the *Albany Herald*, December 2013 edition)

I'm not sure we have answered the question, "Is it so much more difficult today than fifty years ago?" My memory is that, other than Vietnam (a huge biggie), life was pretty good fifty years ago. You could walk down the

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sidewalks of almost any city and see the signs clearly directing you to the closest FALL-OUT SHELTER should the need arise.

Maybe every generation is supposed to have their struggles and how the members of that generation respond to their struggles will have a big impact on their destiny.

WHAT IS THE RIGHT "VALUE" OF AN INVESTMENT?

My neighbor told me...(this is a tale of fiction)

My neighbor wandered over and during the conversation told me that the house across the street had been sold...again. The person who bought it for $100,000 in 2009 was lucky enough to sell it for $200,000. "He sure was lucky!"

I was thinking that almost anyone who bought almost any asset in 2009 could probably sell it today for a big profit. I suggested to the neighbor that we go across the street and meet the new owner.

He said he bought it as a rental house and plans to use the rental income to supplement his retirement income. "I estimate the rental income, after all expenses, will be about $10,000 per year. I realize I need to leave some of that in a reserve account to pay for future maintenance and the like, but it still gives me a good return on my money, especially compared to most alternatives today."

My neighbor mentioned how lucky the seller was to make that much money in just five years. "Maybe," offered the buyer, "but I don't know where he is going to invest that money in today's marketplace to give him more income."

The neighbor mentioned that he would be worried that we may have another crisis and the value of the house would decline back to the 2009 level. The buyer responded, "That could happen, but it really doesn't matter much to me as long as I can keep the property rented to a good tenant. I feel I'm getting a good return on my investment and I am quite confident that I can gradually increase the rents on the property. I believe in ten years I will be very pleased with this purchase."

The "value" of this house for our investor is the income it will generate and the growth of that income. As an investor, you estimate how much "income" the investment will make you and make a decision as to how much you are willing to pay for that income.

WHAT ABOUT THE STOCK MARKET?

In some ways the stock market works in a similar fashion. Investors are paying for the earnings of a company. Sometimes investors are optimistic and they will pay a higher price for the earnings and sometimes they get scared and will only pay a low price for the same earnings.

I just opened the file on a large U.S. retailer. In 2005 investors were willing to invest in this company's shares and paying a share price equal to twenty times the annual earnings. However, in 2012 investors were in a different mood and the share price was only ten times the earnings. In other words in 2012 investors were willing to pay less than one-half as much for the earnings of the company as they were willing to pay in 2005. This is a big difference. It seems rather extreme since the company has been very successful and shows no signs of slowing down. But, this is the emotion of the marketplace.

Summary: Most investments go up and go down based on the underlying earnings and what buyers are willing to pay for those earnings. With a little thought you can see how the short-term emotions of buyers can change the share price a great deal in a short period of time.

HOW CAN THE "VALUE" OF A STOCK CHANGE SO MUCH?

Let's change the question to: "How can the "market price" of a stock change so much?"

In the previous article we discussed how the share price people will pay for a stock compared to the company's earnings can vary. Let's look at little deeper at the same company.

The "insiders" and "institutional" owners own about 80% of the shares of this company. As a general rule we wouldn't expect most of these shares to trade frequently.

Over the last three months, on the average, only 0.2% of the total shares changed hands on any particular day. Remember, it is only the shares that change hands that dictate the market price for all the shares. Theoretically, if only ONE share was traded yesterday out of the billions of shares this company has outstanding, that ONE trade sets the market price for all the billions of shares.

Can you see how the emotion of the market place has such a big impact on the daily share price of any publically traded company?

OUR CURRENT DILEMMA

The overall stock market and most of our holdings have appreciated significantly over the last few years. You would think this makes us happy. Well it doesn't make us sad, however, we are quite well aware that a market that rises because investors are willing to accept a lower annual earnings rate will likely be a market that declines when investors change their minds and want a higher earnings rate.

At first this would probably have you saying…"well just get-out-of-the market when it is high and get-back-in when it drops." This concept is what makes up a considerable amount of the *noise* on the daytime television financial shows.

In reality it is not always easy to tell if the market is at a "high" or just moving higher. And when it eventually declines from the peak is it then "low" or just moving much lower. These peaks and valleys are very easy to recognize using the rear-view mirror but much more difficult looking through the windshield. And, as I have written many times, even after all these years the market increases are usually way more than I would ever expect and the market declines are far worse than I would ever dream, but that is the short-term momentum and emotion of the stock market.

We do not generally try to guess when the market is at a peak but in the past there have been times when we tried to accumulate what we call around the office, some *dry bullets* in our accounts. We have done this by gradually moving some assets away from stock market risk having them available to move back to stocks during a down market. We look at this more as "taking advantage" of a down market than we do "avoiding the down market."

Why is this a dilemma?

Let's look at this example: Here is a giant consumer products company. It pays a current dividend of 3.2%. And over the last decade its dividend has averaged 10% annual growth. Nothing is guaranteed in the future but IF this company can grow its dividend an average of 8% per year over the next ten years, then ten years from now the dividend will be about 7.0% of today's value, much more if the dividends were reinvested. The payment of the dividend and the growth of that dividend are dependent on the continued operational success of the company but are NOT at all dependent on the ups or downs of the company's share price.

Do we continue holding the shares of this company… feeling quite confident that in ten years our annual dividends will be in the 7% range…or do we sell the shares and move the funds into something that will not decline in value, but earns literally nothing?

At this point, we are leaning much more towards keeping our potentially growing dividend positions than we are accumulating any *dry bullets.*

MORE ON THE 1%

You probably have either read or heard enough whining about the top 1% or you are cheering on the dialogue either because you have a touch of envy in you or you think maybe the government will give you a bit of their spoils.

But we are in the investing business so how do we invest to take advantage of different groups. Let's start with the 1%, how can we, as investors, make money on them?

First and this is VERY important, my experience tells me that there is a very BIG difference between the top 1% of income earners and the top 1% of wealth owners. Most people think that the very high income earners naturally have a lot of wealth. This has not been my experience. Many of the top earners might have a lot of fancy "things" but "things" does not equal enduring wealth. In fact, many "things" cost money to own… insurance, maintenance, storage, etc.

As we think about the high spenders of our society, how do we invest to take advantage of their desire for "things"? Do we invest in high-end retail stores, foreign auto makers (what pretty person would be caught driving a lowly domestic automobile?), diamond mines, etc.

What about the people who have created a large amount of wealth, how do we invest to benefit from their wealth? Now this is a real challenge because my guess is that these people are generally NOT prolific spenders, they are savers.

But now let's have some fun and possibly make some real money with investments that benefit from the lower rungs of society's economic ladder. This area has a lot of investment potential because: the number of people in this strata is far, far greater than the exclusive 1%, most of these people spend all of whatever income they have and most of what they buy they consume, thus have to re-buy it again tomorrow. These are just "normal" people and they shop at the large discount retailers and they also shop at the much smaller "general stores" that are popping up all over. They buy gasoline, liquor and beer. They may smoke cigarettes, eat fast-food and packaged foodstuffs and enjoy soft drinks. They watch television (large screen), sometimes patronize the local rent-to-own and some fix their own cars. Forget caviar and crepes, they want pizza or hot dogs.

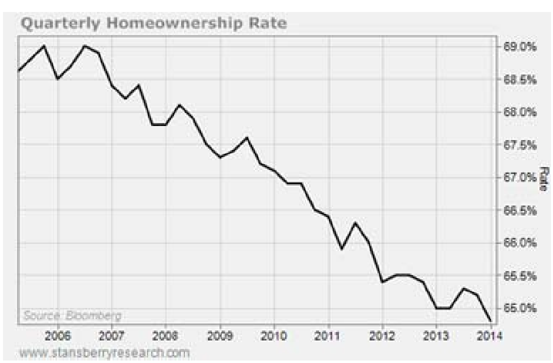
The list can go on and we would all recognize the things this group buys and the places they shop, unlike the goings on of the rich-and-famous of Hollywood and other hot spots.

Think of some of the larger, established companies that you know, do they cater to the top 1% or the masses on the lower end of life's economic ladder?

And, it sure looks to me like there are millions and millions of people all over the world that are moving up their economic ladder and what do a lot of them seem to want? Seems to me they want the sodas, fast-food, cigarettes and satellite television. Who cares about the 1%, we are investing in real people!

Where did we get this fascination with HOME OWNERSHIP?

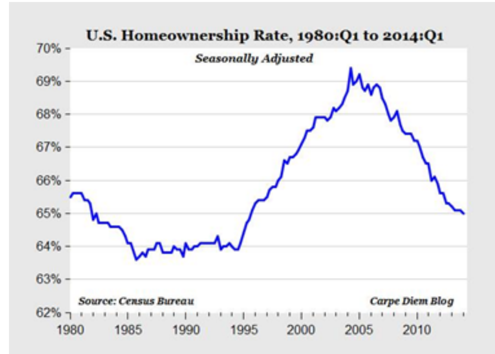
The chart below came in an email. The sender wrote a note about how terrible this is..."Why, people don't even own the home they live in any more. What is this country coming to?"



I looked at the chart and re-read his comments and started thinking. Why do we think that taking on thirty years of debt is such a good thing? Why do we think that taking on the debt which limits greatly our ability to accept employment outside a certain radius around the home is such a good thing?

If I own my home and some jerks move in next door, my options are quite limited. I can't just move. What if the entire neighborhood starts going down-hill quite quickly?

I dug around and found another chart of home ownership starting in 1980.



This chart shows that home ownership is at about the same level it was thirty-five years ago. Maybe we just got back to the "normal" home ownership range.

But, it appears that something happened about 1995 that changed the rate of home ownership...rather dramatically.

In digging around looking for the catalyst in 1995 that sparked the rather dramatic increase in home ownership, I kept coming back to the "Community Reinvestment Act of 1977." This was the law that tried to eliminate discriminating against low income individuals qualifying for home mortgages. This joined the "Fair Housing Act of 1968" and the "Equal Credit Opportunity Act of 1974" which tried to eliminate discrimination on the basis of race, sex or other personal characteristics. The "Home Mortgage Disclosure Act of 1975" required the public disclosure of mortgage lending and application data. But these were all 1970's acts, what about 1995? (SOURCE: Wikipedia)

According to a speech by Mr. Bernanke (March 30,2007) the "Financial Institutions Reform, Recovery and Enforcement Act of 1989" greatly increased the ability of advocacy groups to perform sophisticated analyses of banks' records thereby influencing lending policies of banks. Over the next few years these community groups and non-profits had more and more influence over bank mortgage lending.

Does this mean that the "Community Reinvestment Act of 1977" actually caused the surge in mortgage lending around 1995? From my readings it seems to me it was probably an influence, but I have no idea how substantial the influence was. And the opinions of others tend to be very strong...on one side or the other.

Home ownership is considered to be so wholesome in this country. A friend of mine, "Women never took my relationship with them seriously until I bought my home." Really? Taking on debt of hundreds of thousands of dollars makes you more appealing? Maybe so.

And the moral to this story is? I don't have one, but I enjoyed writing the article...besides whatever I say you aren't going to change your emotional belief anyway!

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OUR CURRENT DILEMMA

WHAT WE DO...

We prepare retirement income plans, which are essentially blueprints to help our clients achieve their long-term retirement goals.

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**, 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 McAdoo handle the layout and editing of the newsletter.