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Written by: Philip C Benedict, CFP®

OUR OFFICE:
Philip C Benedict, CFP®
Travis M James, CFP®
Mark A Beaver, CFP®
Ashley A Thompson, CFP®
Jean B Wilson
Jackie McAdoo

the BENEDICT *REPORT*

6000 Lake Forrest Drive NW, Suite 550, Atlanta, GA 30328-5901 • 770 671 8228 • 770 671 0232 *fax* • 800 678 8227

MAKING IMPORTANT INVESTMENT DECISIONS...

The beginning of 1980 was a very challenging investment environment. The shock of spiking oil prices reverberated throughout our economy, inflation was high, interest rates were high and rising, income tax rates were onerous and our elected leaders seemed to be focused mostly on non-economic areas of our society.

President Carter was busy ordering a grain embargo on Russia and forbidding our athletes from attending the Olympic Games. He also imposed sanctions on Iran for taking our embassy staff hostage in November. The world seemed full of tension. During early 1980 the government approved loan guarantees that "bailed out" Chrysler. Then in April we sent a commando mission to Iran to rescue American embassy hostages that was aborted after mechanical problems ground the rescue helicopters. Eight United States troops were killed in a mid-air collision during the failed operation.

If I remember the time correctly, our country and the world seemed out of control. It seemed that whatever our government tried to do did not work out well. Prices of essentials seemed to rise almost every week.

The stock market had a rather severe decline in the spring and then rallied, but the average for the year was about 850. [The Dow Jones Industrial Average][1] Maybe I remember that year better than some others because that was the year that I started, what became two years, later Benedict Financial Advisors, Inc.

In 1980 it was difficult to see that in a couple of years a lot of things would change. Income tax rates for individuals and corporations would be cut dramatically. The Federal Reserve stopped controlling bank interest rates in the fall of 1979 and natural market forces caused the rates to rise dramatically and then start declining in a trend that continues until the present time. Lower taxes, tax incentives and lower interest rates plus a much better attitude towards business created a significant amount of business expansion with employment growth following.

Now thirty-five years later I again find this a very challenging investment climate, but for different reasons. Interest rates are low, at least compared to most of the post-World War II years, thus difficult for savers or bond owners to make much income on their investments. The news media shouts that the stock market is at a record high.

In 1980, we had high interest rates and a low stock market following a decade of relatively poor economic growth. In 2015 we have relatively low interest rates and a relatively high stock market and a seemingly strengthening economy.

In 1980, if we could have seen the future, we would have been confident and upbeat, but we could only see the economic past, which was dark and gloomy. It is 2015 and we can't see the future, but we can see the past and I believe it is giving us all sorts of conflicting signals about the future. But, is this any different from most other times? Let's look at a few causes of economic tension.

Interest Rates HAVE to go Up!

I read one person's thoughts on the future...interest rates HAVE to go up, he said. Another offered that we are headed into a deflationary recession which means interest rates will drop, maybe rather dramatically.

We try not to make our investment decisions dependent upon us *accurately* guessing/predicting the future. But, I might add that I can see an interest rate environment in which the rates on lower-quality investments head upwards while the rates on what investors perceive as high-quality investments go down.

The stock market is at an all-time high, it HAS to come down!

Yes, No, Maybe. Of course, the stock market will suffer major declines in the future. Whether the declines start soon or much later is unknown. The market index is at a record high, but so are corporation profits. The "price-to-earnings" of the current market is at a level that is about average for the last fifty years. And, you could argue that in an era of low interest rates, one would expect a much higher market than during times of higher interest rates. (For those of you having trouble grasping this last statement, let me see if a little story helps. Remember the days in which you could earn ten percent on your money in the bank? You were less likely to invest in the stock market than today when your money in the bank earns literally nothing. Low interest rates should be times of relatively high stock market valuations and high interest rates should be times of relatively low stock market valuations.)

Economies of countries all over the world seem to be in a recession or headed into a recession.

This statement seems quite accurate based on the recent economic news reports. The economy in this country seems to be strengthening; however, can that strength continue if the rest of the world is struggling economically? I don't know.

Lower energy costs should help our overall economy a great deal, but the slowdown in energy exploration will certainly mean fewer jobs in that area and less major capital expenditures.

What things over the next few years could happen that might ignite our economic growth?

We seem to have spent the last few years "fixing" the problems created by the mortgage crisis and "fixing" things in our society that may make our lives better. But, we have also raised income taxes rather significantly, we have also lowered interest rates rather dramatically which sounds like a good thing and maybe it is/was, but it also has deprived our *savers* of hundreds of millions of dollars of interest income. I imagine at least part of this *interest income* would have been spent in our economy probably providing more of an economic boost than the "fiscal stimulus" of the last several years.

From my little perch, what seems to be missing most in the economy is the creation of new small/medium sized businesses. These are the businesses that provide the bulk of our new private jobs. As I go around the city I see new home offices for multi-national companies and the Class A office buildings seem almost full of tenants, same for the shopping centers that have the large, major tenants. But the Class B office buildings seem to have a lot of vacancies as do the shopping centers that would normally house the start-up retailers and service businesses. Just my observation.

Why is this? For one thing, ask almost anyone in the health-care, energy, or financial industries if the time spent on *regulatory obligations* has increased over the last few years and I think you will get an ear full. My guess is it is the same in many other industries. To a non-business owner this doesn't seem like a big thing, but try opening up your own business and hiring a few employees and see if you still agree.

I'm also guessing that the prospective new business owner just doesn't feel good about taking the risks involved in starting up a business right now. Why? I think the ups and downs of the economy and stock market over the last fifteen years is still fresh in everyone's memory. I think many of the potential new business start-up owners feel like something is artificial in our economy and at some point the economy is going to pay the price. I realize this last statement is rather vague, but I'm hearing something like it almost every day from people in various walks of life.

> OPEC cartel members have had it VERY good for the past decade. Steady production, lots of cash flow, ability to drastically expand government handouts and subsidies - for all intents and purposes it's been a party-like atmosphere backstage at OPEC. It is headed for a stunning break-up.

What is it going to be? INFLATION or DEFLATION?

This question seems to be getting a lot of attention in the financial news. And, of course, people have written books predicting extreme economic crises and go around the country promoting their epistles by appearing on various news programs.

It is an important question and if you have an extended period of either deflation or inflation it will impact our investments and our lifestyle.

Most of us have lived through nothing but inflation.

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And, we read how our government, Japan's government and most of the European governments are trying to create inflation. Thus, inflation must be good. Well, it usually is to the debtor who owes money. One dollar in value thirty-five years ago, when I opened this business is now worth about thirty-five cents of purchasing power. (www.usinflationcalculator,com) That doesn't sound particularly good, but it has been a fact of life during this three and one-half decade time frame.

It would be easy to see moderate deflation for a few years followed by some nasty inflation. However, my guess is that we will have both. Some areas of our economy and our lives will experience declining prices and some will see rather rapidly increasing prices. Things…including economic changes…move rapidly in today's times.

Enough rambling, what is a person to do?

- The person who has a home with no mortgage will probably feel less pain during times of financial turmoil than the person who has large monthly mortgage payments.
- The person who has her/his investments diversified among different industries and different types of companies should feel less vulnerable to an economic stress, than someone who is totally dependent on one company or one industry.
- The person who has as their investment focus the creation of income that grows over time, will probably feel less emotional pain during times of market stress than the individual who is just "playing the market."
- The person who needs the market to perform well every year will suffer the consequences.

Get a plan or a strategy. Keep it simple and understandable. Be realistic.

[1] The Dow Jones Industrial Average is an unmanaged index that cannot be invested into directly.

THE OIL PRICE CRASH

I've always been amazed at how informed and emotional people are about gasoline prices and the changes in those prices. I'm quite certain that things like milk, bread and beer also go up and down in price but I never have people talking to me about them.

But gas prices…

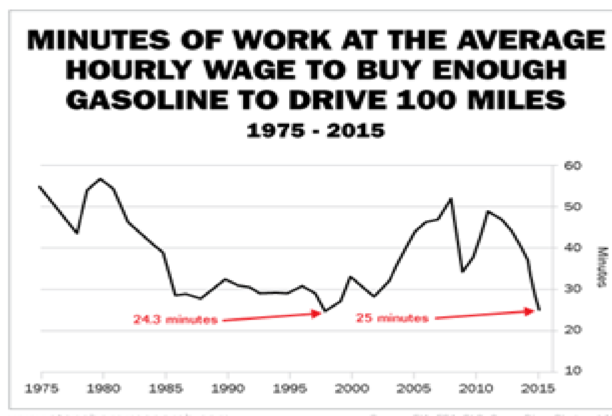
"I read that the declining oil prices are bad for the economy. How can that be, other than the giant oil companies don't make as much money?"

THE STOCK MARKET LOST OVER THREE HUNDRED POINTS BECAUSE OF FALLING OIL PRICES…

No one in our office considers themselves experts on the relationship of energy costs and the economy, but we do read. So let's see what we have been reading:

If you drive a car, you want low oil prices forever, if you are a trucking company, you want low oil prices, if you are an airline, you want low oil prices. In many countries around the world the cost of energy is "subsidized" by the government, because the people want cheap energy. However, if you are an oil field worker, you want prices to go back to "normal," if you are a land owner depending on your oil royalties for your retirement income, you want prices to get back to "normal," if you are a shopkeeper or motel owner in the oil patch area, you want prices to get back to "normal"…right away.

What is "normal" anyway?



What about the economy?

The price of oil was above $100 per barrel in mid-summer and currently below $50. When oil prices were "normal" at around $100 the get-rich testosterone was running high in the oil patches of our country. It seemed as though everyone was doing everything they could to acquire more and more drilling rights. Even though we think of the oil industry as the dozen giant oil companies, in reality a lot of the "shale" drilling was/is done by companies with a relatively small number of employees AND companies that had a relatively small amount of their own capital to invest. Thus, a lot of the

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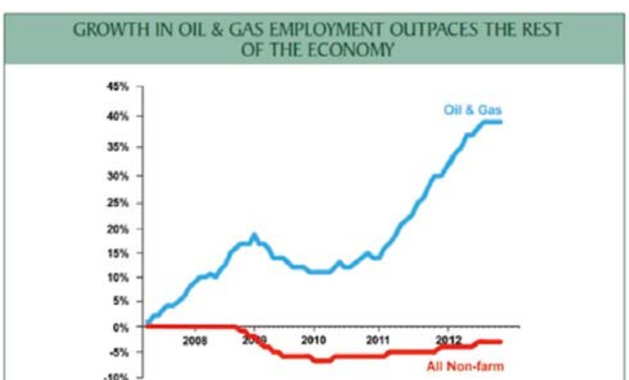
money that was used to acquire new mineral rights, build the infrastructure necessary to create an oil well and pay the operating costs was borrowed money. The borrowed money came from three major sources: venture capitalists, corporate bonds and bank loans. My guess is that the venture capitalists invested in the best of the breed and the remaining companies had to go to the debt market through bond sales or bank borrowing.

It is estimated that between $5 and $6 trillion (that has a T on it) was spent on drilling and related infrastructure over the last five or six years. Most of this was spent in North Dakota, Texas and Pennsylvania and most of this "shale" drilling was by smaller companies, frequently financed with corporate bonds and bank loans. And, my guess is that most of this lending assumed a price per barrel much higher than the current price. Thus, there is probably a lot of debt outstanding that may never be repaid.

Who holds this debt? A lot of it was corporate bonds… lower quality bonds or what are sometimes referred to as "junk" bonds. A lot of it was bank loans from banks that are located in the oil patch areas. It looks to me as though a lot of these loans could go bad. Maybe this could be one trillion dollars or more. I'm making this number up, but who knows what it will be. Probably smaller if the price of oil quickly rebounds, probably larger if the price stays at the current level or drops even further. This is BIG folks. It is estimated that the sub-prime mortgage crisis resulted in losses of about $200 billion (that has a B on it). If a lot of your wealth is invested in shares of oil patch banks, beware.

U.S. Steel has already announced they will idle their plants in Lorain, Ohio and Houston, Texas that make the steel pipe for oil exploration and drilling. This will directly impact over seven hundred workers. What's next?

What about jobs?



Job growth in the oil & gas sector has boomed even as the overall employment picture has lagged.

Data source: FRED Economic Data, Federal Reserve Bank of St. Louis

Whoa, it appears as though the growth in oil & gas employment has been the main event driving our jobs growth for the last several years. Most of these were high paying, middle-class jobs…the ones we moan about are no longer being creating in our economy.

"In recent years, America's oil & gas boom has added $300-$400 billion annually to the economy. Without this contribution, GDP growth would have been negative and the nation would have continued to be in recession." (SOURCE: "The Power and Growth Initiative Report," by the Manhattan Institute.)

Whoa again. Are we headed for an economic recession? I don't know. Obviously, if oil prices stay at the current level, many parts of the economy will greatly benefit. But, as we can see, many parts could see massive problems.

Why did prices suddenly drop so much? I'm no expert on that either, but the world price of oil is based on supply and demand. Right now the new technologies have created a lot of new supply. AND, during a November OPEC meeting, Saudi Arabia announced they will NOT cut production and thereby support the price of oil. This is a rather monumental change because since the early 1970's, this desert country has had significant ability to "support" the world oil price by producing more or less oil. Suddenly, they decided to not "support" the price, but to keep pumping out more supply. Was it to hurt the U.S. "shale" production? Was it to hurt Iran and/or Russia? Was it because they feel there is so much "new" oil that reducing their production would not have much impact? I don't know.

What created this tremendous growth in oil exploration? If I remember it correctly, a lot of venture capital money went into oil exploration after the tech-crash of the early 2000s. This money created, within the energy industry, the ability to much more accurately locate underground oil deposits and also to use new techniques to harvest far more oil from the new wells and from older wells that many thought were mostly depleted.

After that it became the Wild West again in the oil patch. Investors were looking for high yields and loaning money for oil looked like a sure thing. It might have been helped along by the *money printing* of the Federal Reserve. High school drop-outs were making six figure wages driving trucks or laying pipes. Was it truly a new prosperity or was it just the easy money of the Fed that we experienced over the last several years? Don't know that either.

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But, it is estimated that the current price of oil is worth about $750 of "extra" money to every household in America. That's a nice "raise."

"I don't care about all that stuff, I just want cheap gas."

(SOURCES: "Why Falling Oil Prices is a Bad Thing", by Steve Sjuggerud, January 8, 2015, "Oil, Employment, and Growth", by John Mauldin, December 16, 2014, "5 Min. Forecast," by Agora, January 7, 2015, "What in the World is Going on in the Oil Markets?", by Byron King, Laissez Faire Letter, January 2015, "What you're Not Hearing About Oil Stocks", by Daily Wealth Trader, January 8, 2015, "The Stansberry Digest", January 7, 2015, "The Daily Reckoning," by Addison Wiggins, January 8, 2015, "Ponzi Finance and $50 Oil", by Jim Rickards, January 8, 2015)

Phil: *Is seems to me that what you really need for the rest of your life is a monthly cash flow.*

Friend: You are right about that.

Phil: *Then why aren't you invested with that focus?*

THE STOCK MARKET IS AT AN "ALL-TIME HIGH"

First, a personal story. I have lived in the same house for several decades. It backs up to a commercial development, thus about once every decade some real estate agent filters through the neighborhood and tells the residents he has a *possible* commercial buyer for the entire neighborhood who will pay a price way above market value, so the resident needs to sign a listing agreement right now.

Obviously the neighborhood is still residential. However, because of the proximity to the commercial development, when the economic cycle goes down, I imagine the potential sales prices of the houses decline dramatically, because who wants to have their home near a commercial development.

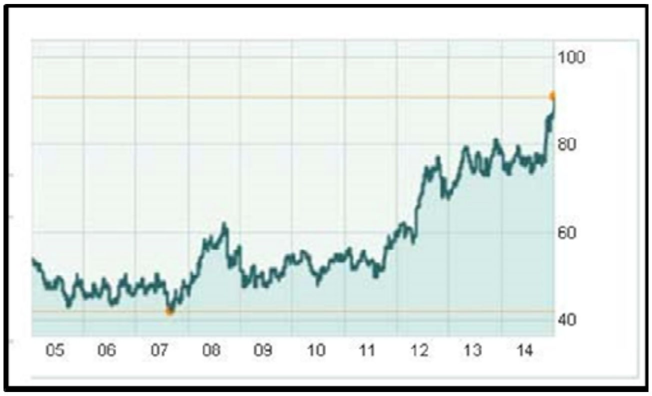
I say all of this and it is sort of speculating on my part, because I have never paid any attention to what the house may sell for because I don't plan to sell. As long as the house keeps me dry from the rain, warm from the cold and cool in the heat and is close to the office, I'm quite satisfied with owning it.

You may be wondering "what does this have to do with anything?" The house provides me a similar benefit as shareholders who own great companies. The companies may continue to generate revenues and profits and give benefits to the shareholders. No one has any control over the share price. Think about it a little.

"Shouldn't we sell everything and get out of the stock market since it is at an "all time high?"

Instead of responding to this using the entire stock market, let's look at a single stock that is at an "all-time high" and see if it really is as scary as it sounds. The name of the company is not that important, but it is a very large, well-known company.

Here is the company's share price chart for the last ten years. You can see that the share price ended 2014 at an "all-time high." But, let's look into the company a little deeper.



Now, let's look at some of the "numbers."

Year	Average Share Price	P/E	P/BV	Div	P/FCF
2005	$ 49	18	3.9	$ 0.52	13
2006	$ 47	17	3.3	0.60	10
2007	$ 47	15	3.0	0.67	10
2008	$ 53	16	3.4	0.88	11
2009	$ 52	16	3.0	0.95	8
2010	$ 52	13	2.9	1.09	8
2011	$ 54	13	3.0	1.21	9
2012	$ 67	14	3.1	1.46	9
2013	$ 75	15	3.5	1.59	11
2014	$ 80	18	3.5	1.88	11

We are quite aware that this is too much "about numbers" than some of you want to endure, but we hope a few of you find it informative because it just might ease some of your market concerns.

(P/E) Ten years ago, in 2005, you will see that this company had a P/E (**share price** divided by the **earnings per share**) of 18 times earnings. At the end of 2014 the P/E was about 18 times earnings. This rather simplistic valuation metric would tell us the company is valued about the same as it was ten years ago, even though the share price is much higher.

(P/BV) Let's look at the next column. The **share price** divided by the **book value** per share. (In a very simple way, the book value is the value of the assets the company owns). Ten years ago the share price was 3.9 times book value and now it is a little less than that.

(Div) This column shows the cash dividend that was paid on each share of stock.

(P/FCF) Now the last column. The **share price** divided by the **free cash flow** per share is shown. The term "free cash flow" is generally all the "cash" the company has left over after paying taxes and expenses…money that is available for distribution to shareholders or to be reinvested in the company. This is an important number for shareholders.

These numbers are probably a far better way to judge whether the share price is reasonable for this company. Is it selling for a reasonable P/E? (Price divided by Earnings) Is the Free Cash Flow healthy and growing? And, is the company paying a decent dividend and is that dividend growing over time?

Something could spook the stock market and the overall market indices may fall twenty percent next month, but we want to own shares of this company. It is growing its revenues and its earnings and it seems to sell for a reasonable price. If the share price declines it means all our dividend reinvestments are buying in at a lower price. This stock is in almost all of our accounts and we feel it will most likely reward us well over the next decade. In some ways, it is like owning a paid-for house!

FREE CASH FLOW of your household

In a previous article we referenced a company's "Free Cash Flow", the money that is left over after paying all ongoing expenses and taxes. It is the money a company has to pay to shareholders or reinvest in the company now or in the future. It is one of the most important numbers you can follow.

What about your household? What is your "free cash flow?" How much money do you have left over after paying all ongoing expenses and taxes? It is the money that you put into your retirement accounts and add to your bank and investment accounts. Is it a healthy amount? Is it generally growing each year?

This is probably a much more valuable figure than the monthly change in the balance of your brokerage statement or your 401(k) balance. Your "free cash flow" is something YOU control - not the whims of the marketplace.

Several years ago I was talking with a friend and he told me how at the end of each month he writes down the total of his investment and savings accounts. I suggested to him that maybe a more important number would be his "free cash flow" each year, thinking that I was giving him a little more insight into his wealth accumulation. I was proud to have just given him that important financial wisdom. I don't think he was impressed!

Most really bad financial mistakes (decisions or lack of decisions) that people have made in retirement have had nothing to do with the stock market. Quitting work too soon, a big new house and a big new mortgage, high fixed expenses, needy adult children, trying to keep up with the rich "Joneses," spending principal.

EXCITING TIMES, HISTORICAL TIMES

As far back as I can remember I have loved to read. Reading opened up the world to me even while I was living with my family on a small farm in Michigan. And, I loved to read about the past…history, we sometimes call it. The founding of the country was chronicled in various books, the Henry Clays and the Daniel Boones of the world struggling against "the establishment" leaders and so on. Different books can give you a much different viewpoint of the same topic. A few years ago I read several books on FDR and his time in office. I will tell you that different authors certainly have differing viewpoints of his career, his accomplishments and his life.

But, I am wondering if we are not living in an era that will be looked backed upon as exciting, scary, tumultuous and borders changing…the things that make history.

We are seeing entire nations disappear. We are actually seeing major territories be "taken" away from their *rightful owner*? Wait. Is there such a thing as a *rightful owner* of a group of people?

I read about entire provinces in Spain and Italy, even Scotland, Ireland and the Ukraine talking about breaking away from their country to join another country or start a new country. Is this right or wrong? I don't know. If a country cannot secure its physical borders, are they really still a country? Are many of the countries of the Middle East really still countries? What really is a country? Are they eventually going to be divided by lines in the desert sand or by groupings of ethnic groups or along religious beliefs?

How do you function if you have no "state law" to create the rules-of-order of a society? Do you have elected leaders? Do you have an organized military or are gangs of people the ones who dictate the rules?

I remember reading about the post-World War II Middle East and how the leaders of the victorious coalition sat around and drew up some of the borders of Northern Africa and the Middle East with seemingly no thought of ethnic backgrounds, religious beliefs, or common language of the inhabitants of the newly created country boundaries. Some of the other borders were created during the days of British occupation. Now it appears we have strong movements in those areas to redefine what they never believed in from the start. Many of the dictators are gone and power groups are filling the void in power. And, without the dictators some of these areas seem to have no civil society, but they DO have modern communications, guns and ability to make bombs and You-Tube videos.

Some say, we…the United States or maybe the UN… need to step in and stop the bad things that are happening. I say "how do we know who are the good guys and who are the bad guys?" The participants do not seem to follow the old rules of cowboy westerns on television of wearing white or black shirts so we could tell the hero from the villain. What are the "rules" anyway?

I suppose eventually these groups will have to agree to cooperate in some manner, but they will likely remain tribal. This conflict between the necessary cooperation and the tribal instincts may continue for many decades.

I doubt this chapter in history has come to a finish. Think of all the other territories/countries that currently appear vulnerable to political or territorial change?

- The Afghanistan/Pakistan border?
- The Baltic countries?
- The ethnic groups of Russia and China?
- The continued turmoil in parts of Africa?

Modern communication has eliminated many secrets and has removed many dictatorial regimes, but it appears that the days of shedding blood for power and territory are not a thing of the past.

THIS IS A VERY DIFFICULT ENVIRONMENT TO BE AN INVESTOR

Very low interest rates and relatively high stock prices, what could be worse for a "retirement income" investor?

As I mentioned in the opening, I opened the doors to Benedict Financial Advisors in 1980. Everything was dismal in the world of investing. Looking back, it was actually a great time to invest. The Dow Jones Industrial Average[2] was around 800 and the interest rate on the Three Month Treasury Bill was almost 15%.

Our economy was then dominated by the young "baby boomers" who wanted to buy things: houses, cars and the like.

Now it is almost the opposite. Interest rates are close to zero, the stock market is relatively high and the "baby boomers" are old(er) and graying and slowing down their consumption. Their *Playboy* magazines have been replaced by the *AARP Newsletter*.

Many have not saved enough and they still have a lot of wants and needs.

Most will withdraw more from their investment account than the true "earnings" of the account. That will most likely turn out to be a bad decision but for most people *today's wants* are a far stronger emotion than *tomorrow's needs*.

What should they do? They should revamp their lifestyle so they can "live within their means." This is very difficult for a group that has lived on borrowed money most of their lives and has elected government leaders who followed the same path. However, I know of no other way for them to live a financially stress free retirement…other than dying early.

[2]The Dow Jones Industrial Average is an unmanaged index that cannot be invested into directly.

BENEDICT
FINANCIAL ADVISORS, INC

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6000 Lake Forrest Drive, Suite 550
Atlanta, GA 30328-5901
770.671.8228
www.benedictfinancial.com

MAKING IMPORTANT INVESTMENT DECISIONS

WHAT WE DO...

We prepare retirement income plans, which are essentially blueprints to help our clients pursue 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®, 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 McAdoo handle the layout and editing of the newsletter.