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IT SEEMS SO UGLY OUT THERE

As I write this, fear in the stock market seems to be running high. And increased market volatility sometimes signals a change in the trend along with the fact that history shows us that aging "rising" markets may encounter corrections.

So is the market suffering from "old age" or is it something bigger?

No one knows for sure where the market is going until it goes there. So we try to spend very little time or emotional energy listening to market forecasters. However, some comments may be in order.

Major market declines can generally be attributed to one of two things: Sometimes the share prices have just advanced too much…compared to the operating results of the corresponding companies. Other times the market is reacting to, or anticipating, some significant economic stress.

Right now it seems to be both. The share prices, overall, have grown faster than the underlying revenue growth and earnings growth. That alone could trigger a market pull-back.

Also, most commodity prices have been in a decline for many months with the price of oil being the one many people relate to the most.

- Oil prices have dropped 64% since last year.
- Sugar is at a seven-year low price.
- Prices for aluminum and silver are at six-year lows.
- Natural gas is over one-third lower than last summer.

(*SOURCE: Casey Research, August 31, 2015*)

Lower prices are usually good for the users of that commodity. However, lower prices are certainly not good for the commodity companies and lower prices may also be the result of reduced demand which can be an indicator of economic slowdown.

Add to this the fact that we are seeing slower economic growth in most of the world's major economies and, in some cases, no growth at all or declining economic activity.

There is even another factor that may be adding volatility to the world's financial markets, but it's difficult to prove, and that is government involvement. We seem to be in a cycle where governments all over the world, through their central banks, are willing to do anything it takes to avoid an economic slowdown. And, while on the surface that seems like a very wholesome activity, there are a lot of investors who feel this sort of *artificial* monetary stimulus will eventually create a rough landing.

Since 2008 the investing world seems to have been lusting for market stability. Many smaller investors, especially, have been putting their investment money in bonds and insurance company sponsored contracts…things they deem "safe." Price volatility can be the friend of long-term investors, but it scares a lot of investors. See the quote below that shows what many investors do when the markets get scary.

"August 6: Investors in the U.S. poured $20.3 billion into low-risk money market funds during the week ended August 5th, marking the funds' biggest inflows since December 2013. Stock funds that specialize in U.S. shares posted their third straight week of outflows, at $5.3 billion…" (*data from Thomson Reuters' Lipper service*)

Here's more on what else may be causing this economic slowdown…

Is China a problem?

China is a big global economic force. The Chinese stock market dropped dramatically this summer, triggering concerns that the Chinese economy is weakening dramatically, which would severely dampen the global demand for most commodities. While it is doubtful that the economic conditions in the country are as dire as some fear, it does seem reasonable that their economic growth is moderating. But, there is a lot of emotion with China also. Just a year ago the media was full of predictions on how the country/ economy was about to control the world and the concerns of what that would do for the rest of us.

Is it the fear of rising interest rates?

The central bank in this country…The Federal Reserve…has achieved for itself an almost *rock star* status. Almost everyone in the country can name the lead "singer" and many can name two or three of the supporting members. Somehow this doesn't really make sense, but it seems to be happening.

Will rising interest rates destroy our economy? Maybe a bigger concern for the longer-term economy is *artificial* interest rates and not rising or falling interest rates. Our current market weakness may be a signal that investors are concerned that The Fed will stall our economic recovery.

Is it low oil prices?

As mentioned above, low energy prices are good for a lot of industries and people but the decline in oil prices has caused havoc in the oil industry. Workers are being laid off by the tens of thousands, companies will have trouble honoring their bond commitments and the number of new wells has declined dramatically.

But, the decline in oil prices may be even bigger than that, especially on a global perspective. A number of oil-exporting nations rely heavily on oil income to support their domestic programs. What happens internally when these governments can no longer provide the "benefits" their populace has become accustomed to?

Maybe investors are finally realizing what may be the real risk to the U.S. and global economies…

Too much credit.

We have written about this before and will probably write about it again. We won't include any of those charts that show government borrowing has spiked the last few years. And this has happened to most major governments all over the world - not just in this country. World "leaders" have opted for the easy fix for many years…easy credit…rather than do the things that make an economy stronger over the longer-term. But, who cares about the longer-term if my term is over in a few years? And, maybe it is really the voters who are not willing to do without today for a better tomorrow.

The answer?

We believe the answer is to invest in high-quality assets that pay you a decent income each year.

You need a strategy, one that passes the common-sense test and makes sense to you…this allows you to stay-the-course when the markets are causing your investments pain.

Most long-term investors will tell you that real risk is not the short-term decline in the price but the permanent loss of your investment. But, the decline in market value is NOW and the pain we feel is NOW.

You also need to focus on the assets you own much more than the change in price of your overall account. Huh? This is a very important concept but one that seems to go against human nature when changes… especially declines…in your investment account value is on your computer or your phone every hour of the day. But, what you are viewing is the emotion of the marketplace, not the true underlying value of your holdings.

Let's use an unrelated story to try and illustrate this idea. Assume you are a farmer and own one hundred acres of the finest soil in the area that you bought several years ago. If your neighbor sells his land for five thousand dollars per acre, you would naturally feel your land is worth…five thousand dollars per acre. You feel good. It is like the market gave you a pat-on-the-back for a smart financial decision. Then a few months later your other neighbor sells his land for $4,000 per acre. Ouch, that means you just "lost" one hundred thousand dollars. You feel almost angry. Now, you start to worry that it may go to three thousand dollars per acre, which means you will "lose" another one hundred thousand dollars.

Anyone who is not standing in the farmer's shoes would simply yawn at the event…"what difference does it make" the bystander would ask. You still have the same dirt. It still raises the same crops. The market value going up had no meaning and the market value going down has no meaning.

But, your emotion will say, my investment account is different than a farm. There is no vague value based on an occasional sale by some neighbor. I get to view my exact market value…to the penny…every minute of the day. There is nothing vague about that!

Besides, you may challenge, how do I know the real intrinsic value of my account?

Those of us in the investment world use all sorts of numbers, formulas and ratios to answer that question, but there is no absolute right answer. But sometimes a little common sense helps. Take our farmer above. He owns some of the finest farm land in the area. It has provided him good crops in the past and it appears that it will continue to provide him a good harvest for many years in the future. He is very glad he owns the land, BUT he still doesn't like to see it "lose" one hundred thousand dollars of market value. Thus, we have the rational farmer who knows he owns a high-quality farm versus the emotional farmer who focuses on the decline in estimated market value.

What is the solution? There is no trick that we know of to make him immune to his natural emotions. He just needs to be aware of his emotional feelings compared to his rational knowledge. He needs to focus on the quality of the land, which should continue to be good quality for many years to come and not the estimated market value…which is a very temporary number.

<u>What are we doing?</u>

We believe you best handle market declines ahead of time and not during the panic that is always in the air during periods of declining markets.

Most of our accounts have a strong focus on providing a current income that has a history of growing. We try to own assets that can keep providing that income even during times of turmoil. This means we own companies that have strong revenue streams, reasonable debt and a history of good management.

We also diversify our holdings by company and by industry. (This industry diversification helped us greatly in 2008 when the banking industry collapsed and again the last few months when the oil industry changed course rather markedly.) We also have a regular regime of "taking gains" on our holdings. Meaning, if we want a particular holding to be three percent of the account and it grows to five percent, we sell enough shares to bring it back to the three percent range. This also helps us from getting too concentrated in a few holdings. (An opposite strategy is to "let your winners run" as the saying goes in our industry. That is not a bad strategy, but our focus is on a disciplined approach to keeping our position sizes within range. Generally, when a stock increases a lot, it can fall back a lot also. We try to avoid that.)

<u>Summary:</u>
There are a lot of evils; economic evils, market evils and government action evils out there right now that can have a major impact on our investments. But, even though we don't think this way there have always been a lot of things happening that have caused worry in the investment marketplace. Some of those things we worried about in the past came to fruition and some disappeared.

We believe we need a strategy. That strategy is to try and create a reasonably stable income that is competitive to other yields available in the financial world and to grow that income as much as possible. It is having a plan that greatly reduces the behavioral biases and emotions that are a big part of investing.

We believe we have great businesses in our accounts and because of that we do not get overly excited when the markets decline in value. We believe these companies will continue to grow revenues, grow earnings and generate a lot of "free cash flow" that allows the management to pay dividends and sometimes buy back their own company shares.

WHY DO WE OWN STOCKS?

As mentioned earlier in this *Report* most people I've encountered over the last many months have a rather somber view of the economy in general and the investment markets in particular. Naturally, this somberness intensified greatly with the market scare in August.

I do not watch the television pundits but I am quite certain they are using this "fear is in the air" to dictate their programming. The investment media knows well that *fear sells* and the investment markets are giving us plenty of fear.

And, I have written before on what is probably a coming debt crisis, maybe one of rather substantial proportion, one that may really rock the stock markets of the world. I have written how it appears that the world's economies are slowing down, sometimes rather dramatically. I have also written how the slowing economic growth, especially in China, has led to a rather dramatic decline in various commodity prices and the share prices of companies involved in that industry.

Given the things I have written about, why you may ask, are a large portion of most of our managed accounts invested in common stocks. Let's see why:

First of all, we believe investing is a multi-decade long process. If you are going to need to withdraw and spend principal over the next few years, please…withdraw it

NOW. Owning shares of common stock, no matter how successful the underlying company, is no place for short-term funds. This type of money belongs in the bank until it is spent.

Secondly, we believe investments should provide you with an income. You can spend the income to maintain your standard of living or you can reinvest the income to give you a greater income in the future. If you die, that income will be there for your heirs or other beneficiaries. Thus, in our minds, the name of the game is not to maximize the market value of your investment account (your asset) but to try and create a sustainable, growing income stream from that asset…one that is not directly impacted by fluctuations in market value.

And, as we have stated many times, we believe the best way to create a growing, sustainable income is from the ownership of high quality, dividend-paying common stocks. But, let's look at some history and see if it helps us see the future:

As mentioned many times before, I started this business thirty-five years ago.

So, let's use that thirty-five year history, which takes us back to 1980. (I know many readers are uncomfortable with too many numbers, thus I have taken the liberty to round most of these numbers for simplicity.)

Dividends on the Dow Jones Industrial Average[1] in 1980 = $60

Dividends on the Dow Jones Industrial Average[1] on October 2015 = $430

Earnings of the Dow Jones Industrial Average[1] in 1980 = $140

Earnings of the Dow Jones Industrial Average[1] on October 2015 = $1,075

SOURCE: www.macrotrends.net

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

Now if we try and put all these numbers into some sort of context, the dividends and earnings have increased about 7 times over the last thirty-five years. Let's compare that to the change in the rate of a first class postage stamp.

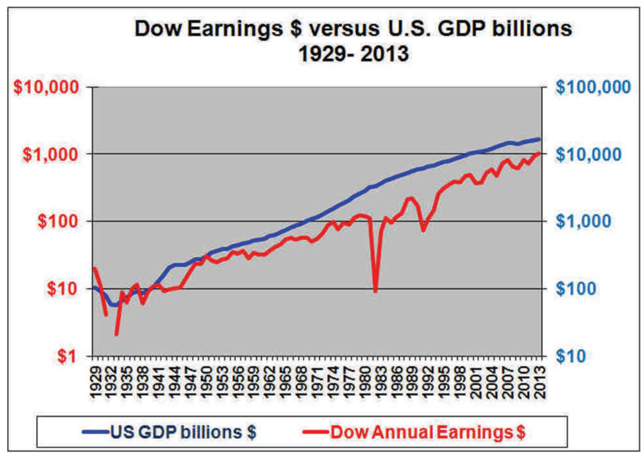
First Class Postal Rate 1980 = $0.15

(On a side note: You may remember the 1980 summer Olympics were in Russia, and the post office issued special stamps with Olympic objects on them. Then, our President, Mr. Carter, boycotted the Olympics that year in protest of Russia's occupation in Afghanistan.)

First Class Postal Rate October 2015 = $0.49

The price of mailing a first-class letter (some of you younger readers may not know what that is) has increased a little over 3 times during this same time period.

The chart below shows the history of the earnings of the Dow Jones Industrial Average compared to the trend of the U.S. Gross Domestic Product. It does appear that, at least based on history, that if the U.S. Gross Domestic Product increases over the years that the earnings of the Dow Jones companies could increase and if the earnings of these companies increase, there is a good likelihood that the dividends could increase as well.



SOURCE: InvestorsFriend

A lot has happened over the last thirty-five years, some of it has been very, very good and some of it has been very, very bad. Many, many projections were made over that time period also, some of them were reasonably correct but many of them were outlandishly bad.

Some people retiring now might just see another thirty-five years on this earth, if not I'm quite certain their heirs will. What most people will want over those thirty-five years is an income that has the ability to grow to keep up with the rising cost of staying on this planet. We try not to let the short-term scares of the market take our focus off of this growing income need/want of our clients and their heirs or beneficiaries.

SO EUROPE-LIKE

Why do so many of our aspiring political candidates want to make us more Europe-like?

Oh, I do realize the emotionally charged phrases of "income equality" and "government protection" resonates with part of our populace and seems to be something we should strive for. But I have to ask why?

In a previous *Report* we showed a chart of the declining number of new small business that are being created. How can this be good? The businesses that are not created do not hire people, do not pay taxes and do not create products that customers value.

But, you may challenge, if a new business is not started then maybe an old business can stay in business and not shut its doors, which would cause it to fire workers, pay no taxes and no longer provide customers with wanted goods or services.

But, I would challenge, many businesses need to go out of business. They have let themselves become obsolete or the products or services they provide are no longer in demand.

It is this disruption that makes for a dynamic, healthy economy. Granted it is also this disruption that displaces some workers, boards up shops and factories and creates stress for all involved.

The alternative is more of what I consider Old Europe Thinking in that the government, generally through bureaucrats and regulators, should decide the fate of businesses and "protect" the jobs for the workers. Have you followed the struggle of the new "ride-sharing" apps and the traditional taxi-cab companies all over the world? The Old Europe Thinking tells us that our government regulators are better at policing the taxi cab industry than the users are in the new ride-sharing apps. Your age may influence your answer to this question, but what do you trust more?

> A. A government sponsored regulatory system that licenses all the taxi cabs, collects an annual fee and requires certain signs to be in each cab. Maybe they run background checks on each driver. Maybe. Maybe they keep a list of all complaints against specific drivers and make the comments public knowledge. Or, maybe they don't?
>
> B. The "ride-sharing" companies want none of that. Right on their website/app is the name of the driver and the ratings of all the passengers he has served. You can see the ratings yourself and make a decision whether you want to use him or not. Is this better than a government bureaucracy doing the regulating? I don't know, but I do know which service the younger people here in the office trust and use.

In my mind Old Europe Thinking is nothing more than trying to protect the status-quo…at the expense of new technologies, new services, and new efficiencies.

I played a little basketball in my younger days and I think even today the players can tell you that some referees have a knack of controlling the game but letting the play flow in a free and easy manner. While another set of referees seem to find fault with everything and stall the game and inhibit the true nature of play. There are also a small number of referees who have no control over the flow of the game and it becomes a mob scene that is difficult to play in or to watch. Over-regulation or ineffective regulation is just as much of a problem to our economy as no accountability.

Playing athletic games did a lot for molding my view of the business world and our economy. As messy as the capitalistic system is, it creates a strong, dynamic economic system that provides incentives, innovation and change. It creates new businesses, new jobs and new opportunities.

My view of Old Europe Thinking is that it is like playing basketball in the church league, where everyone gets "equal" playing time, where it is only "fair" to allow the poor shooter to have more shots and where a "good intention" is more important than a successful result.

Obviously, the political candidate that is playing the "fair" and "equal" tune is not getting my vote. I love the two words, but, for the most part, I believe they are meaningless in the real world.

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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®. 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.