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Markets at All-Time HIGHs…good or bad? What's an Advisor to do?

The first part of this *Benedict Report* is a replay of a Lunch with Benedict we did in early April. We say this, in case any attendee remembers anything we covered at the Luncheon, we DO realize this is a repeat! As we were preparing a topic for our Luncheon, we had to decide between highlighting some big megatrends that we see happening in the world today or to focus more on your day-to-day account concerns.

Overall, it seems to us that most people seem almost scared of the stock market right now. Thus, we will try to address that fear. But, it is a natural fear, so please do not expect us to erase, totally, the emotion that creates the fear.

SECTION I: Strategy for market declines

A question we have been asked a few times recently is: ***Does your office have a plan to avoid a big market drop?***

That seems like a very valid question and one all prudent investors should ask. However, think about it…what would our strategy be?

- Would our strategy be to know ahead of time that this market "decline" is going to be a big one and not one of those shorter-term market drops? AND, to know ahead of time when the end of the market "decline" will happen so we can get back in the market.
- Would our strategy be to invest part of the account in investment products that are structured to go up if the market goes down? Knowing they also go down if the market goes up. We generally do not use this strategy.
- Would our strategy be to invest your long-term investment account in an investment product that strives to be *market neutral?* This phrase is used a lot and generally means "will not go down significantly" if the market declines. Of course, that also means "will not go up significantly" if the market rises. These products generally use a lot of hedges and derivatives and are quite expensive, thus not something that attracts us.
- Would our strategy be to have a significant amount of each investment account sitting in the money market account? This may make you a little less fearful of the market; however, your earnings would be almost zero on these assets. And for this strategy to be really meaningful the money market has to be a significant portion of your account and you also need to know when to invest at the bottom of the market decline. Very few people know when that happens and even less have the discipline, or fortitude, to invest when the financial news is so scary.

None of these are strategies we follow to any large extent. We believe most of them are designed to appeal to the natural "fear" that people have of the market.

What is our overriding strategy? As we hope most of you already know, we focus on owning shares of financially solid companies that have growing revenues and earnings and pay a dividend to the shareholders, which should grow over time. This is a strategy that has been around almost forever. However, it requires that we, and our clients, be patient and allow it to happen. Most people in the financial world have trouble doing that.

As we have said before, we don't believe a long-term winning strategy is planning to correctly guess when the stock market is going into a down cycle and correctly guess again when that cycle is going to end. Such a plan is more of a hope than a strategy and is aimed at your emotion and not your longer-term investment success.

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Question: Do you ever consider a different strategy?

Response: We started focusing on this growing-dividend strategy starting in late 2002 because we believed at that time that we were in a long sideways, but very volatile, market cycle. We want our accounts to earn income whether the stock market is up or down. Most of our accounts are there to provide a retirement income stream…either now or in the future or for the next generation. Besides, do you know of a good alternative that passes the "common sense" test?

SECTION II: An all-time high

Based on most market indices, the stock market is near an all-time high.

Chart showing the history of all-time highs since 1950. (Dow Jones Industrial Average is an unmanaged index that cannot be invested into directly.) You will notice that during the 90's the market seemed to just make one all-time high after another.

DATA AS OF FEBRUARY 2015

Based on basic *valuations* the stock market is far from cheap but generally not at all-time highs. Valuations such as price-to-earnings ratios and overall stock market value compared to gross domestic product and others do not tell us that stocks are grossly over-valued; however, stock valuations are obviously not low either.

Quite frankly: **This IS a difficult time to invest.** The stock market is relatively high AND interest rates are at historical lows.

For some perspective, let's go back a few years to Spring of 2006 when the markets were at an all-time high and interest rates were much higher.

In 2006 Interest rates on savings were about 5.3%

If you had $100,000 to "invest" back then, you could put it in a simple bank account and earn about $5,300 or almost $450 per month. Fast forward to today and that same $100,000 would earn you about $22 per month. If you were living on that $450 per month back then, you are now living on a LOT less or spending principal or you have invested the funds somewhere else. (**Note**: These figures are for illustrative purposes only. Your actual results may vary.)

This is a financial disaster for conservative investors who want/need most of their longer-term investments in guaranteed savings accounts.

And because interest rates are very low, thus the **yield** on high-quality investments which are alternatives to longer-term savings accounts…dividend paying stocks and bonds…are also quite low because investors have pushed the prices of these assets higher, which makes their current yields lower.

Thus, "income" is very dear right now and this is the story that is driving today's markets…money is trying to earn higher income.

SECTION III: Let's review the causes of market ups and downs…what is called Normal Market Volatility.

What causes the stock market indices to go up or down? (Or what causes the share price of the individual components of the index to go up or down?)

> **Short-Term:** The emotion of the marketplace. We have talked several times how only a very small percentage of the total outstanding shares trade hands between sellers and buyers. BUT it is the price of these few shares that determines the current market price. Much like the sales price of the last home sold in a subdivision pretty much dictates the "market price" of all the homes in the area.
>
> **Longer-Term:** The financial success of the company and competition from other passive investments.

We have talked before about the importance of a company's earnings and the generation of a growing Free Cash Flow; today let's focus on the competition.

Let's look at what options individuals and institutions have for their "passive" income-paying investments:

- Interest-bearing bank accounts
- Bonds
- Dividend paying stocks

Maybe you would consider some insurance products in this category of "passive" investments, but their underlying value is dependent on the investments above. You are simply paying the insurance company a fee to provide you with some sort of guarantees.

Let's look at some interest rates:

Average one-year Certificate of Deposit in U.S. 0.27%^

Let's look at some government bond yields:

U.S. two-year Treasury Note	0.73%^^^
France two-year Government Bond	-0.14%^^^
Germany two-year Government Bond	-0.21%^^^
Belgium two-year Government Bond	-0.15%^^^

What? You didn't know that interest rates were actually negative in many countries of the world? Look at the German two-year Government bonds. If you invest $100,000, two years later it is worth several hundreds of dollars less...guaranteed by the government. How's that for growing your retirement savings? Also, think about the impact of these very low...or negative... interest rates on the value of the account behind your pension benefits!

Can you see why the U.S. stock market is relatively high? Look at the competition for your passive investment dollars. You can see why money is flowing into our markets from all over the world?

(Footnotes: ^ from www.bankrate.com,
^^^ from www.barrons.com)

SECTION IV - More on market fear

Question: With the market at such a high level, shouldn't we "cash-in" a big chunk of our investments and hold them for a "buying opportunity?"

Response: I guess if you can accurately sell at the right time and then buy back in at the right time, you could improve your investment performance IF the market cooperates and drops at the right time and recovers at the right time. What if you "cash-in" and the market keeps going up? Do you continue to earn nothing on your investments or do you finally decide you had better buy in at the higher level.

Let's look at this from a different angle. These are actual figures I discussed with a client very recently. We purchased the shares in early 2010 and we continued holding them. All the dividends have been withdrawn to provide his retirement income. Here is how we look at his holdings: (We have rounded the actual numbers so your concentration is on the overall concept - not trying to guess which company we are focusing on.)

Company #1- Giant consumers product company

Original purchase price was $65 per share and dividend per share was $2.00. Today the dividend is $2.80 per share, thus the *Yield-to-Cost* is now about 4.4%. (Today's dividend of $2.80 divided by the original cost of the shares $65.) Do you want to sell a very, high-quality asset that is paying you 4.4% on your cost and that dividend has been growing every year?

Company #2- Large beverage company

Original purchase price $22.50 per share and dividend per share was $0.75. Today the dividend is $1.35 per share, thus the *Yield-to-Cost* is now almost 6.0%. Do you want to sell a very, high-quality asset that is paying you 6.0% on your cost and that dividend has been growing every year?

Company #3- Global restaurant company

Original purchase price $60.00 per share and dividend per share was $2.15. Today the dividend is $3.50 per share, thus the *Yield-to-Cost* is now almost 5.8%. Do you want to sell a very high-quality asset that is paying you 5.8% on your cost and that dividend has been growing every year?

But, he may say, I don't want to see my account go down in value. We understand that; however, we have to respond that what you really need is retirement income and your account is positioned very well to keep paying you the income you want and need.

The share price of these companies would have to drop almost 40% before you would be below your cost.

To focus almost exclusively on the market value of your account and your individual holdings is a focus on something that no one has any control over. You are hoping that **Normal Market Volatility** doesn't exist.

Let's go back to our three companies above and look at them in another way:

Company #1 - When we acquired the shares the dividend yield was about 3.1%. The dividend has grown and the share price has increased, thus, today the current dividend *yield* is about 2.8%.

Company #2 - When we acquired the shares the dividend yield was about 3.3%. The dividend has grown and the share price has increased, thus today the current dividend *yield* is about 3.1%.

Company #3 - When we acquired the shares the dividend yield was about 3.5%. The dividend has grown and the share price has increased, thus today the current dividend *yield* is about 3.5%.

Think about this. Interest rates are almost zero (negative in much of the world) and you can buy shares of these companies at almost the same yield that investors were getting over five years ago.

If you have a longer-term financial need, you need to focus on the longer-term. We believe you need to own high-quality assets that reward shareholders with growing dividends.

I'm still afraid!

If you can't get over worrying about a decline...which we call Normal Market Volatility*...you may need to take action. You may need to build up your short-term savings at the bank, you may need to reduce your withdrawals from your investment account and/or you may need to pay off any outstanding debt you have. Definitely if you are going to withdraw any principal over the next two or three years, make sure that money gets in a bank account right now. That money is not a longer-term investment.*

WHAT'S AN ADVISOR TO DO?

We can't avoid Normal Market Volatility but we do try to focus on things we can control and that focus is on investments that pay an income that is not directly impacted by changes in market values.

OLD JOE

"It just doesn't seem right. Back in the 1980's I had a one hundred thousand dollar house mortgage that cost me 14% annual interest, which was $14,000 per year in interest. Now I've finally saved one hundred thousand dollars to give me a little extra retirement income and they are paying me $22 per month. What is going on anyway?"

I thought of that conversation with Old Joe as I was staring out the window as the leaves on the trees seem to grow right in front of my eyes, which makes spring such a magical time. I had just seen headlines about the declining oil prices, the "money printing" that so many Central Banks are doing all over the world, the negative interest rates on government bonds in many countries and the low prices of copper and iron ore.

What is going on, I wondered?

I remember the decade of the 1970's. It seemed we had shortages of everything. We had gas rationing, we had electrical brown-outs in some major cities and one year the office where I worked in Ohio had to limit the thermostat to a maximum of sixty degrees during the winter by dictate of the mayor, or somebody, due to limited supplies of natural gas. I bought a vacuum cleaner for the office from RJ's. I started to use it and the cord was only six feet long. I took it back to RJ. "That's the way they all are manufactured now; there's a big copper shortage, don't you know." (I don't remember the details but I guess the carpet was only clean near an electrical outlet!) My memory tells me we even had a period of beef shortage.

It is now 2015 and we seem to have an abundance of everything. We have too much oil, or at least plenty; we have plenty of natural gas; we have no electrical brown-outs; we have plenty of food and as a federal government we have plenty of money. When is the last time you heard the federal government say "we can't afford that?"

Some home borrowers in Spain had their adjustable rates on their mortgages fall below zero and the banks have to pay them each month. Wait, you have a mortgage on your home and the bank PAYS you each month...I'm still having trouble with this negative interest rate thing. (SOURCE: Wall Street Journal)

Some people pine for the good-old-days. Sure seems to me that today is a lot better than forty years ago. Before you are too critical of me, I do realize that in many places in the world bad things are happening, but my memory remembers a lot of ugly things happening in the early seventies...ever hear of Viet Nam? ...the social tensions in many major cities? ...the ugly worker strikes in some industries?

There is a group of economic and financial thinkers who are constantly warning that we have created a false prosperity and it will all come crashing down...probably soon. I frequently lean this direction myself.

There is another group that says, "What do you want? We have low interest rates, very low inflation and economic times are good; thus, whatever we are doing must be the right thing to do."

My college economics teachings were along the lines that low interest rates are good because if people can't earn much on their savings they will spend on things, which will be good for the economy. Life has taught me that is not true. "Savers" do not spend their principal just because the earnings on their savings are low. They most likely will save more. I believe we saw this happening after the big economic wash-out of 2008-09. People with money quit spending money. (Looking back, a lot of the other stuff I supposedly learned in college wasn't worth much either.)

Well, now we have record amounts of money sitting in very low interest earning deposits accounts. The "MZM Money Stock" published by the Federal Reserve shows over $13 trillion dollars sitting in accounts with "zero maturity," which does not even count things like certificates of deposit and short-term bonds because they are a commitment for a number of months. To put that figure in perspective, the Gross Domestic Product of our entire country was in the $17 trillion range last year. (Source: Wikipedia) Maybe if interest rates finally go negative in this country, like much of the world, all those trillions of dollars will suddenly be removed from their comfy savings account and be used to buy new cars, sofas, vacations and face-lifts. Maybe.

What's my take on all of this? What is going to happen, is some sort of economic crisis on the horizon? I don't know. But, you don't have to be much of a financial guru to predict that we will have an economic crisis in the future and another one after that and another one after that. It is human nature to want things to be good and never bad, but we all know it doesn't work like that. Your favorite team will lose some games, your picnics will experience some showers and your husband will disappoint you and forget your birthday. It's a real world and two things are almost inevitable: crisis and change. We believe we must focus on what we can control and spend less energy on what we can't. We also believe that those people who have sound strategies, in their financial world as well as other aspects of their life, will survive the crisis and adapt to change far better than those who are just riding the wave of life.

EMOTION IS SUCH A BIG FACTOR IN THE WORLD OF INVESTING

In the investing world so much energy is focused on the *level of the market* or the *daily change* of the market that sometimes we forget that if we invest, we actually own a piece of an asset or many assets. Market values change a lot faster than the quality of the underlying assets.

And, the biggest risk for most people is not a decline in market value…it is that they spend it. They sell an asset and it becomes money and what do you do with money? You SPEND it!

There are some people who can hang on to "wealth" by not spending it, but they are generally the ones who earned and saved to create the "wealth." Far too frequently people who acquire some "wealth" by virtue of an inheritance, maybe a payout of a retirement or maybe some sort of settlement, see this as "money" and it is soon spent just as you read how most lottery winners spend their good fortune.

Remember, most people will die either the richest they have ever been…or dead broke!

THE FUTURE OF THE DOLLAR…Maybe

I (Phil) had started this article a few weeks ago and then a client asked us if the talk about the International Monetary Fund (IMF) creating a global currency comes true, will it strengthen or weaken the U.S. Dollar. Thus, I pulled out my notes and finished this.

Up until the last year or so I thought one of the "solutions" (political solutions, not good economic solutions) to the world's debt bubbles would be a new world, multi-country currency.

I also assumed that the U.S. Dollar would lose its status as the world's reserve currency…at least during non-crisis times. We are seeing more trade among countries using their own currencies and bypassing the need to convert everything to U.S. Dollars in the world trade arena.

However, the falling apart of the EURO, I think, takes some of the potential "luster" off of a world currency. It does not appear to be working that well in Europe. Or, maybe the EURO will survive the current crisis and regain its footing of strength. Time will tell.

However, that's not what you asked. When we get a world currency will it make the U.S. Dollar weaker or stronger?

I don't know. For many years the leaders of this country seem to have done many things that should make the dollar weaker…mainly, deficits and future unfunded promises. In fact, I would argue that the U.S. Dollar is considerable weaker, however the value of a currency is only strong or weak compared to alternatives.

Other than maybe the Swiss Franc, most other major currencies are backed by countries in far worse economic shape than the United States. Some would say Australia and Canada are in better economic shape… I think they were until the oil prices collapsed.

Others say China is rapidly becoming the dominate economic force in the world. My guess is that they will get stronger until…until their demographics catch up with them, until their controlled economy starts to fall apart and until the masses rebel against the few in power.

What do I think we should do? I still believe owing the best run companies in the world is the best option most of us have. Many of these companies have a long history of surviving world wars, bad governments, currency manipulations, economic melt-downs and climate disasters.

Are there better alternatives?

Real estate? I don't think of this as an alternative to owning a group of high quality common stocks, but it might be a good supplement to such a portfolio. The problem most people have with real estate is that they are not very diversified…by property type and by geography and by government (meaning not being dependent on a government going bad, thus owning some foreign real estate). And, since the properties cannot be financed and still be a good hedge it takes a lot of wealth to get a diversified group of properties. Also, owning real estate is not a passive investment…it must be managed by someone.

Gold and silver? Maybe. But, it pays no dividends; however, it probably would be a go-to investment during times of economic crisis. It is more of insurance against everything going wrong. When that happens will gold and silver be the answer? Don't know. I am pretty sure that if everyone around me is starving and I'm sitting on my porch sipping fancy drinks and eating fine food, the masses will quickly relieve me of my gold and my good life.

Also, there are many reports on how the Russia and China governments are buying gold and stockpiling it. What does that mean? Not sure, it may be to hedge what they feel will be a U.S. Dollar that loses its purchasing power in the future. Or, maybe they are going to try and corner the market for gold and silver and use that to make themselves the premier global economic powers.

Another interesting thing is that prior to 2012 almost no gold had been shipped from the Federal Reserve Bank of New York since the 1970's, but look at the chart below and see what happened last year.

I'm not sure why the Federal Reserve is selling gold, but it must mean something since it is a big change from the last several decades. Who makes the decision that we should sell our gold?

Gold Shipments Out of the Federal Reserve Bank of New York

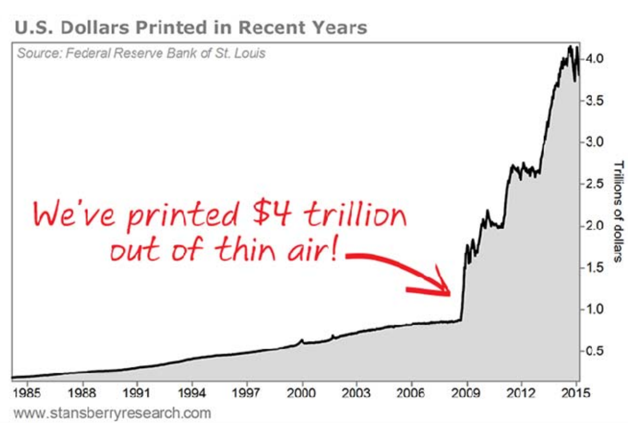
In Tonnes	FRBNY Total Foreign Gold Deposits	Change
Jan-14	6195.60	0.00
Feb-14	6185.29	-10.31
Mar-14	6175.71	-9.58
Apr-14	6175.71	-5.16
Jun-14	6165.39	-5.16
Jul-14	6141.08	-24.31
Aug-14	6125.61	-15.47
Sep-14	6118.25	-7.37
Oct-14	6076.25	-41.99
Nov-14	6029.11	-47.15
Dec-14	6018.79	-10.31
	Total:	-176.81

Source: Bullion Star

What do I think will happen?

Most countries of the world have a huge amount of debt. They have more debt than they can ever repay. How will they get out of debt? Devaluation? In some cases yes…much like Greece is attempting to do and will probably end up doing…after they leave the EURO.

However, I think the United States and Japan are going at it a different way. (This is just speculation on my part, I have no knowledgeable source to quote on this.) The Central Bank (in this country we call the central bank the Federal Reserve) is buying up almost all the bonds the Treasury is issuing. Some wags call this "printing money" but that doesn't seem to bother political leaders.



The Treasury pays interest on the bonds to the Central Bank, which turns the "excess" (meaning interest received less expenses of running the Central Bank) back to the government. If you are having a little trouble seeing how this passes the "common sense" test, join the club.

I think the "solution" will be for the Central Banks to someday "write-off" the bonds...meaning simply wipe them off the books. Wala! The debt is gone and life goes on and no one suffers and the politicians get reelected...maybe.

The future is very easy to predict, but much more difficult to know.

RETIREMENT INCOME INVESTING SHOULD BE FOCUSED ON GENERATING CASH FLOW

Thirty-five years ago, the year I started this firm, if you had $100,000 in a one year government bond, you would have earned $16,470 of interest or $1,375 per month. It is difficult to phantom today, but the interest rate on that bond on March 31, 1980 was 16.47%. Now, or at least on March 31, 2015, if you had $100,000 in a one year government bond, you would have earned $280 or $23 per month. (SOURCE: The Chart Store)

But, you say the purchasing power of a dollar was a lot greater in 1980. You are right. Actually, to have the same purchasing power today as $100,000 had in 1980, you would need $286,000 today. And, to have the same purchasing power per month as you had in 1980, you would need almost $4,000 today. (SOURCE: US Inflation Calculator) But even if you have $286,000 today, your monthly earnings would be only about $65. To earn $1,375 per month today in a one year government bond you would need to have about $5,882,000 invested.

If you are just retiring or plan to retire in a few years, there is a chance you will still need a retirement income thirty-five years from now. Or at least your heirs will need an income from your wealth. Can you picture what life will be like in thirty-five years? What interest rates will be? The level of the stock market? Stay flexible!

If your investment account is primarily there to provide a retirement income, now or in the future or for your heirs, then you must focus on the "cash flow" that it produces and not the dollar value of the account itself.

You don't have to be a financial guru to understand that someone who retired in 1980 and thought he would continue to earn high rates of interest has had a disappointing retirement

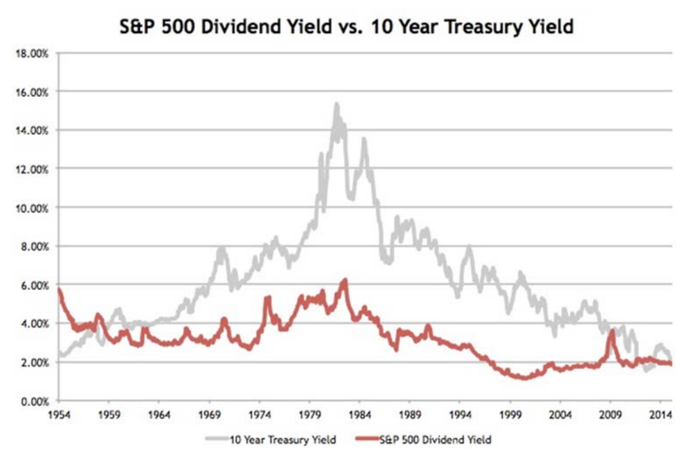
What is the moral of this story? We think it is that you must focus on the cash flow generated by your investments and not on the value of the investments.

WHICH MAKES YOU MORE INCOME - STOCKS OR BONDS?

One more chart on interest rates...

As I write this the yield on the Ten-Year U.S. Treasury Bond is 2.1%, which is about equal to the yield on all the stocks in the Standard and Poor's 500 Index. (The Standard & Poor's 500 Index is an unmanaged index that cannot be invested into directly.) If we only include the dividend paying stocks in the Index, the yield would be 2.4%. (SOURCE: Barron's, May 4, 2015.)

This is a rather historic event...the yield on stocks equaling the yield on the Ten-Year Bond. Look at the chart below and see how many times it has happened over the last sixty years.



Is this good news or bad news? We are not totally sure whether it is good or bad, but we are pretty sure that we know it takes a lot larger investment or savings account to generate any material amount of earnings.

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MARKETS AT ALL-TIME HIGHS... GOOD OR BAD?
What's an advisor to do?

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.