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SENIORS/BOOMERS NEWSLETTER

"THE RETIREMENT EXPERTS"

May 2014

The beatings will continue until morale improves Capt. Bligh

Here we are, four months into the year and the markets are basically where they started…except for the sense that we've been running hard on the spot.

I have literally read hundreds of articles on why the market is due for a crash…and another hundred on why they are going to climb further from here.

In the end, we need to tune out the noise and focus on what really matters. Valuations. At some point, every company, even those that have stock prices today that look like a hockey stick on a chart, will be judged and priced by how much they earn for their investors.

Buffet said it best: 'The inescapable fact is that the value of an asset, whatever it's character, ***cannot*** over the long term grow faster than its earnings'.

The valuation principle is very simple. It involves

Price to earnings (P/E)

Price to cash flow (PCF)

Price to book value (P/B)

Price to earnings growth (PEG)

All of these are best for you, the investor, when the number is lower. If you can, try to find P/E and PCF ratios between 10-12, or less. Regarding your P/B and PEG's...the closer to 1 the better.

Having said that, be sure to do your due diligence. Some stocks are cheap for a reason!

The last valuation method I'd like to mention, which some would argue is the most important, is the **Return on Invested Capital (ROIC).**

The Motley Fool had one of the best summary definitions for this measure that I've come across:

"Return on invested capital (ROIC) is probably the most important metric in value investing. After a quick analysis, it seems very obvious why ROIC is such a critical metric in assessing a company's prospects.

If I were judging an investment, and I could only ask three questions, I'd probably ask: What kind of returns can I conservatively expect? How much do I have to invest to get those returns? And for how long can I get those returns? In other words, I want to know my return on invested capital, and I want to know how long that ROIC will last.

"Thus, earnings growth is a poor metric by which to judge a company. After all, if a company with $10 million in net income takes on $1 billion in debt and, after interest costs, earns an additional $10 million, that will increase earnings by 100%, but the ROIC on the additional investment will only be 1%. Clearly, this is not a great company, but an investor focused on earnings growth and not ROIC would miss this fact.

Think of this like a basketball player who doubles his points-per-game average from 10 to 20. This sounds great, but if it takes him 30 shots to do it, then his field-goal percentage will plummet, and he's actually hurting his team."

If you're interested in going a little deeper into the concept of ROIC, I would highly recommend a book titled "THE LITTLE BOOK THAT BEATS THE MARKET" written by Joel Greenblatt. He wrote this book to educate his five school age children (he explains it simply & beautifully) and it only takes a couple of hours to read. Excellent book!

So coming back to choosing stocks based on valuations: If you buy a company with a good valuation, you are giving yourself solid growth with downside protection…particularly in a bear market.

The market right now looks OK. Price to Earnings ratios are near historical averages…neither cheap nor expensive. U.S. companies are in the best shape they've even been in from the standpoint of their balance sheets. Ditto for our banks.

We are also approaching energy independence which means that we don't need to rely on our enemies to fuel our economic expansion. Finally, the housing and autos industries are contributing to growth rather than being a drag on our economy.

The Federal Reserve is still in a very accommodative mood. So, all in all, we're not in bad shape. But looking back on 2013 we saw stock market gains of around 30%, whereas earnings growth was only 5%. What may be best for everyone in 2014 is a 'sideways' kind of market. This might avoid violent swings while earnings catch up with market fundamentals.

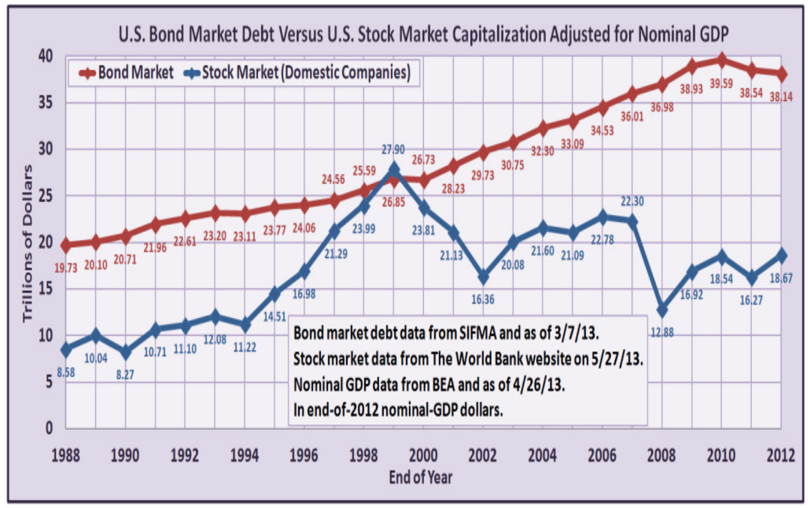
But, will the market correct? No one knows. There many are indicators that the pro's watch, but to keep this simple, the most effective one is the **10-Year Treasury.**

To be sure of hitting the target, shoot first and call whatever you hit *the target*.

This is the case for so many analysts. They latch onto a fact that they claim to have prophesized first, and then build their thesis around it. The 10-Year Treasury, however, happens to be one of those indicators that almost everyone can agree on its importance in gauging the markets. Why?

The 10 year became the long bond when the government stopped issuing 30 year bonds back in 2001. (The government has recently begun issuing the 30 year once again in order to fight the current deficit… and keep the interest rate that they pay our creditors lower than it would otherwise be).

For this reason the 10 year note is the benchmark that bondholders look at in determining the yield and direction for all bonds. Most people are not aware of this but the U.S. bond market is ***twice*** the size of our stock markets. This explains why most investors believe that bonds matter most. (see chart below).



When the 10 year moves, almost all fixed income products have moved as well. Interest rates have a huge effect on corporate expenses, which affects earnings…which ultimately affect stock prices.

We all know that bond prices and interest rates have an inverse relationship. Therefore, when rates rise the underlying security falls in value. This can be especially troublesome for retirees living on fixed incomes.

It is equally troublesome for the real estate market. There are approximately 70 million homes in the United States, of which, about 50 million are carrying mortgages. This all means that U.S. housing is worth about $10 trillion to the economy, and very susceptible to interest rates…once again the 10 year rate comes into play.

To put the importance of the 10 year in its simplest terms. When rates fall it generally means a flight to quality because of fear in the markets. Rising rates usually signify a strengthening economy.

For fixed income investors low rates mean getting a lot less to live on and because we don't know which way rates are going to go, the best strategy is to build a bond ladder.

A bond ladder means buying individual bonds and holding them to maturity. As the oldest one is redeemed, you purchase a new one. This gives you protection when rates rise. The oldest security with presumably the lowest rate will then be replaced with a newer one at a higher rate. With a bond ladder you may actually look forward to rising rates.

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"If past history was all there was to investing, the richest people would be librarians"....................... Warren Buffet

As every holder of an IRA knows, it is important to look at all three dimensions of time when it comes to trying to grow wealth.

Most Americans have believed that we were being given a fair shake by the IRS in trying to accomplish a comfortable retirement, and that the rules were both fair and equitable for all.

As background, the IRS 'bible' of rules governing IRA's is contained in their IRS Publication 590. Since the inception of IRA's, the rule has stated that an individual has 60 days to rollover IRA funds into another IRA account, and that this applies to each IRA account held by the owner.

The Publication states, "Generally, if you make a tax-free rollover of any part of a distribution from a traditional IRA, you cannot, within a one year period, make a tax-free rollover of any later distribution from that same IRA. You also cannot make a tax-free rollover of any amount distributed, within the same one year period, from the IRA into which you made the tax-free rollover".

In a very recent ruling, the U.S. Tax Court has changed its interpretation of the rule to mean that this can be done once-per-year….PERIOD. So, if you have two or more IRA accounts, you can only do a rollover *one time for one account only.*

Not only that, there has also been a change in what ONCE PER YEAR means. It means once every 365 days.

Failure to live up to the new ruling will result in the IRA holder being fully taxed on the 2nd distribution, and, if under age 59 ½ will be given a 10% early withdrawal penalty.

I should point out here that this new rule does not apply to trustee-to-trustee transfers and that there are in fact a few exceptions (which I won't go into here).

If you need help, please don't guess! Please check with a retirement specialist.

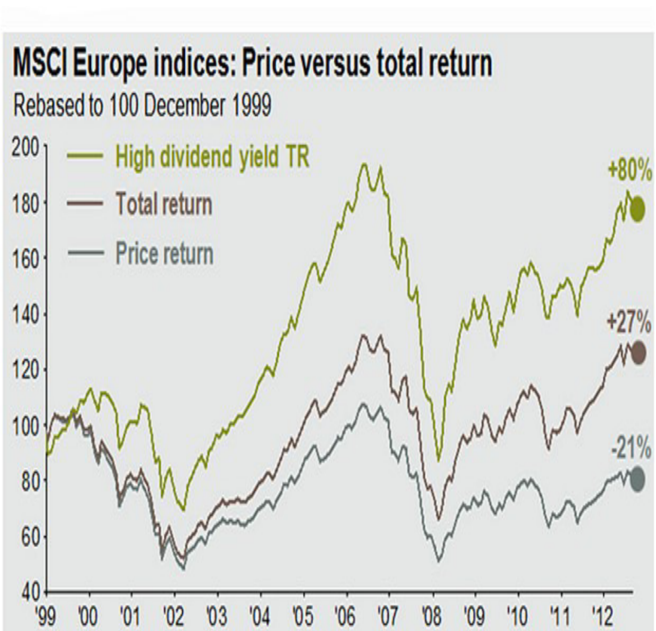
The secret to building real wealth.

For the ‘passive investor’, you too can build a long-term fortune by following two simple steps:

1. **Buy the best dividend-paying stocks, and**
2. **Reinvest the dividends.**

(N.B. Not every company offers a DRIP program {Dividend Re-Investment Program}, however; if this strategy is available with a company you own, go for it).

The best chart I found on either side of the Atlantic comes from Europe. It’s simple and very straight-forward.



Sources: MSCI, FactSet, J.P. Morgan Asset Management as at 31 August 2013.

What a difference. Dividends really do matter. As you can see stocks didn’t do so well from 1999 through 2012 based on price return. Total return however wasn’t bad at 27%! Dividends reinvested however blew the doors off the barn.

6 Secrets of Dividend Investing: How You Can Earn Great Returns with Less Risk

Finding the best dividend stocks takes some legwork and careful analysis. But here's how you can find the best long-term winners:

1. **Avoid the Highest Dividend Stocks —** You can't pick stocks by dividend yield alone. Above-normal dividends are often a red flag for a company in distress. Studies have consistently shown that you will earn higher long-term returns by avoiding risky stocks with overly high dividends.

2. **Beware the “Dividend Time Bombs” —** Not all dividends are created equal. Even if a company has a generous dividend, it must be able to maintain it. A "doomed-to-be-cut" dividend can be worse than no dividend at all. Once a dividend is cut, it's likely to make the share price fall also.

3. **Cash Is King —** Free cash flow (FCF) is the true health of the business. Find the companies that generate tons of it. Even in the worst of times, those flush with greenbacks have options. Firms with cash can buy back their shares to raise stock prices, make their debt payments, increase dividends, and buy other profitable businesses. That's why cash flow is the single most important factor that determines value in the marketplace.

4. **Don't Focus on Income without Growth —** Only growing businesses are truly healthy. So cash flow needs to be strong enough to not only pay a healthy dividend but also generate enough cash to grow and stay strong.

5. **Don't Forget Value —** An investment's total yield depends on both the dividend amount and the stock price. Stocks of companies making real products, and real profits, often don't make the headlines. So dividend stocks can also be a great source of hidden value. Finding value by focusing on dividends first can help you avoid catching the "falling knives" that trap some value investors.

6. **Have a Longer-Term Focus —** Many brokerage houses make investment recommendations based on a very short-term view of the world — often a maximum 12-month timeframe. Individual investors should have at least a three- to five-year view when considering investments. More time helps you fully realize the true power of compounding dividends.