First Quarter 2008 Commentary
Recessions, Bear Markets & The Dividend Solution

It is impossible to turn on the news these days and wonder if our world is truly slipping over the edge. Every day there are multiple stories analyzing whether or not we are in a recession, a bear market….or worse. From our perspective, we are probably in a recession and do not look for much improvement until the end of 2009. However, before we start running around like our hair is on fire it might be helpful to discuss the realities of this economic environment.

Since 1950 there have been nine recessions—an average of one every six or seven years. And, ***since 1950 there have been nine "bear markets"*** (a 20% or more decline in the stock market). These events happen with great regularity—so we might as well get used to it. Despite these occurrences, ***the stock market still averaged about 10% a year during this same time frame***. It's just that it is not a steady 10% per year.

Some years we will have gains and some will have losses. In fact, since 1834 the stock market has averaged 10% per year. During that time the standard deviation (the annual volatility) of the stock market has been about 15%. This means that on any given year we should expect that the stock market will produce a return between +25% and –5%. For almost 200 years it has been this way—and there is little reason to believe it will change.

If it is this volatile, why do we continue to position our clients in the stock market? Why don't we jump out and wait for things to get better? While that sounds easy enough to do, it is nearly impossible in practice. Again, going back through historical returns, ***90% of the market returns have come from a mere 1.5% of the days***. If you are going to jump in and out you had better be one heck of a great jumper. No one has ever proven to be able to do this with any consistency.

The stock market has proven to be a superior asset class for investors with the right time frame (10+ years minimum). Even our fully retired clients need to be in the stock market for a couple of reasons.

Generally, a retired investor thinks more about cash flow generation as opposed to growth. Some spending money might be nice. For those investors we have advice from a study done 40 years ago. The conclusion of this study was that ***if an investor limits their withdrawals to 4% of their portfolios value per year they stand a very high chance of their money lasting 30 years***.

A retired investor has the choice of putting their money in fixed income (Treasury Bonds, CD's) or the stock market. Currently, a 10 year Treasury pays a slim 3.44%. After subtracting one point for taxes and factoring in another 4% for inflation your portfolio is losing purchasing power of at least 1.5% per year. If our analysis is correct about inflation being more in the 6% to 10% range currently, then the negative number is far worse.

A different approach (and the one we embrace) is to invest in diversified stocks that pay dividends—that nice little cash bonus you get for owning a stock. It is quite possible to build a diversified portfolio of household names that collectively average a 4% dividend. That dividend immediately satisfies our withdrawal rate for our retirement portfolio.

There is also a large income tax benefit to this approach: CD's and Treasuries are taxed at your marginal tax rate (up to 35%) whereas ***qualified dividends are taxed at a low 15% rate***.

Furthermore, there is an interesting phenomenon associated with blue chip type companies that pay handsome dividends—the rate you start with is rarely the rate you will receive going forward. ***Many of these household names increase their dividends with great regularity so that an investor not only increases their cash flow over time, but also battles the effects of inflation***.

We did a simple study looking at the dividends paid by a well known group of companies from 1991 through 2007. For this study we looked at the dividends paid by Pfizer, Anheuser Busch, Johnson & Johnson, Proctor & Gamble, Wal-Mart, AT&T, Home Depot, Bank of America, US Bancorp, Wells Fargo and Philip Morris. (It is also worth noting that while we analyzed these companies, there are hundreds of others that would have allowed us to make the same point.)

If you invested the same amount of money into each of these companies in 1991 you received an average dividend of $0.261 per share of stock owned. However, by the end of 2007, these companies collectively raised their dividend per share to $1.75—an increase of 573% or 11.2% per year. In comparison, there is no way the bank is going to call you to tell you they are going to increase the rate on your CD just because they like you.

The increasing dividend of the blue chip company is an amazing thing. It can give you money to live off of or reinvest. It also gives an investor the flexibility to ride out a recession or bear market and wait for the underlying stock to appreciate--while not sacrificing cash flow.

We are certainly experiencing some difficult times and probably will hear more bad news before all of this is over. There will be more talk of recessions and bear markets and everything else that goes "bump" in the night. However, that does not mean that your individual investing or cash flow needs should be derailed.

If you have questions about this or anything else please don't hesitate to call, email or stop by.

Finally, please ***put Thursday April 24th on your calendar***. We will be having our annual client appreciation party at ***Fossati's (302 S. Main) starting at 5PM***. We look forward to seeing you there for drinks and snacks.

Sincerely,

Dave

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™