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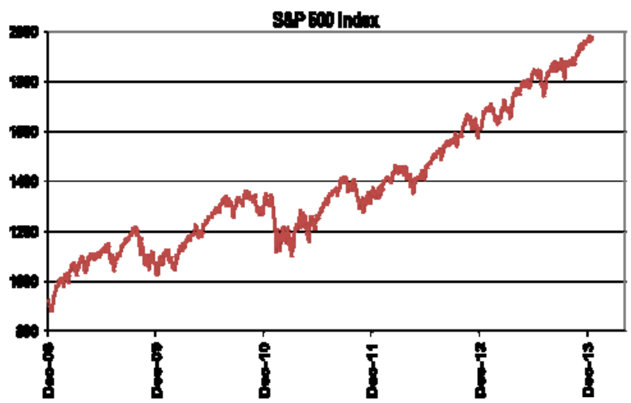
Trusted Investment Advice Since 1979

Investment Matters

For the quarter ended June 30, 2014

The Stock Market: T.I.N.A.

A casual glance at the path of stock prices in the last five years reveals an interesting pattern. As the stock market has advanced it has become less volatile, suggesting that investors have become more and more confident. In 2010, the year after the recession officially ended, the market experienced a 16% correction. In 2011 the correction was slightly higher at 19%. In 2012 it was only 10%. In 2013 it was less than 6%. In 2014 it was again less than 6%. It has been two and a half years since there was a market pullback in excess of 10%. This is unusual. Investors who have been waiting for a significant pullback to re-enter the stock market have seen the market nearly double without getting a good chance to buy.



IT'S BEEN MORE THAN TWO YEARS SINCE THE LAST STOCK MARKET CORRECTION

But how can investors be getting more and more confident in the stock market while the economy grows at an anemic 2% annual rate, unemployment remains stubbornly high, profit margins appear unsustainably inflated and stock valuations are no longer cheap.

First, 2% growth is better than it appears. Not only is the economy expanding but it is not in any immediate danger of over-heating. An over-heated economy usually causes the Federal Reserve to step on the monetary brake pedal and cause a recession. Not much danger of that.

Second, the inflation beast is in its cage and acting very tame. A weak labor market keeps wage gains under control and makes it unlikely that any spark of inflation will grow into a conflagration. With little concern about inflation, the Federal Reserve is free to continue their very aggressive monetary policy.

Third, the Fed has our back. Not only have they stated their desire to see more money flowing into risky assets (i.e. stocks, high yield bonds, etc.) but by keeping both short and long term interest rates below normal, they have produced the condition known as TINA, There Is No Alternative.

Although stocks are not cheap, they look far more attractive than money market funds which pay 0% and offer no growth potential or inflation protection. Bonds may be worse. They promise return-free risk. The annual interest payment on most bonds barely covers the loss in purchasing power at the current low level of inflation. If either inflation or economic growth return to normal levels, bond prices are likely to fall, resulting in capital losses. Additionally, many stocks offer dividend yields which are higher than interest rates on good quality bonds. And stock investors know that dividends, unlike locked-in bond yields, tend to rise over time. Lastly, stocks offer the prospect of capital growth.

The problem with TINA as an investment thesis is that it can't last forever. If stocks get more expensive, as they are now doing, or if interest rates rise as everyone says they will, TINA will cease to exist.

The Wealth of States

A new book by noted economist Arthur Laffer and associates, "An Inquiry into The Nature and Causes of the Wealth of States", examines the relationships between various state government policies and prosperity within a state.

The study looks at policies such as income tax rates, right-to-work laws and minimum wage laws to see how they correlate with population migration, economic output, personal income levels and government tax receipts. The authors attempt to show that lower tax and regulatory burdens lead to more prosperity for a state.

Virtually all of their results suggest that their thesis is correct. For example, the eleven states which instituted a state income tax after 1960 subsequently performed more poorly than the remaining states in almost every measure of prosperity. Also, the nine states with the highest income tax rates have consistently underperformed the states with no income tax, not only over time but virtually every year. A comparison of the 23 states with right-to-work laws with the 27 states which allow unions to require membership as a condition of employment shows that such practices hurt economic performance.

As with all real world social science experiments, it's

Continued on page 2.

States: continued

impossible to know how much other factors may have impacted the results. The eleven states which enacted an income tax were generally located in cold weather states with a reliance on mature, heavy industries. Did those states lose population and economic output because they imposed an income tax or because globalization reduced employment opportunities in their industries and air conditioners allowed people to move South?

Other examples are more convincing. Texas and California, neither of which is a cold weather state nor relies on heavy industry, are clearly going in opposite policy directions. As the authors demonstrate, California, with more taxes and regulations is losing the battle for people and prosperity. Even the truck rental companies understand what is happening: they charge far more to rent a truck going from California to Texas than from Texas to California.

Retirement Income: Stocks or Bonds

Which assets, stocks or bonds, are the best for producing retirement income?

Bonds, which are much less volatile than stocks and usually offer a higher initial income payout, are nevertheless subject to some risks which could devastate your retirement plans. While the initial level of interest payments from bonds may provide a comfortable income, beware - it cannot last.

First there is reinvestment risk. At the time a bond matures the market rate of interest may have declined, perhaps a great deal. New bonds of the same type may be paying far less than the ones you started with. This may force you to cut your spending.

Second, there is inflation risk. At an inflation rate of only 2% per year, a bond will lose more than 18% of its purchasing power in just 10 years. Inflation is guaranteed to depress your lifestyle if you depend entirely on fixed income for retirement.

Stocks pay a portion of their profits in the form of dividends. Although dividend yields at any particular time are usually somewhat less than bond yields, dividends are far more reliable as a source of income. Also, stocks do not have a maturity date and hence no reinvestment risk.

The dollar amount of dividends paid by companies in the S&P 500 Index has declined only eight years since WW II, and only once, more than 3%. Contrast this with bond yields which have gone up and down substantially many times over. Even better, dividend payments tend to rise over time. Dividends paid by companies in the S&P 500 Index have outpaced the negative effects of inflation for nearly all ten year periods since measurements began in 1926. Even during the high inflation decade of the 1970's, when stock and bond values were ravaged by inflation, dividend payments grew at 7% per year, nearly keeping pace with cost of living increases.

You may have noticed that, in terms of income production, stocks and bonds complement each other. Bonds provide high initial interest income but reinvestment risk and inflation risk are very likely to reduce it over time. Stocks offer a lower initial yield but dividend income is likely to be more stable, especially when inflation risk is considered.

For optimum retirement income you need both, and this mix comes with an extra benefit. Stock and bond prices often go in opposite directions. Thus the combination is not only far less risky than stocks by themselves but as a result of periodic rebalancing back to long term target percentage weightings, may provide some extra return with no extra risk.

For a complementary review of your investment portfolio please call our office at (716) 633-6555 to schedule an appointment at your convenience.

Next year Medicare will have over 140,000 diagnostic/billing codes, including nine for injuries caused by turkeys.

The Bottom Line: 6/30/2014

Market Indicator	Current Value	One Year Change
Large company stocks *(S&P 500 Index)*	1960	24.6%
Small company stocks *(S&P Small Cap Index)*	681	26.1%
Short term interest rates *(3 Month T-Bill Yield)*	0.1%	No change
Long term interest rates *(10 Year T-Bond Yield)*	2.7%	No change
Inflation *(Consumer Price Index)*	237.1	2.1%
Energy *(West Texas Intermediate Crude Oil)*	105.76bbl.	-12.6%
The economy *(Inflation adjusted GDP)*	$17.0 trillion	1.7%

QUOTABLE

"Bull markets do not die of old age, they die from excesses and recessions."

Leon Cooperman,: professional investor

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