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Investment Matters

For the quarter ended June 30, 2015

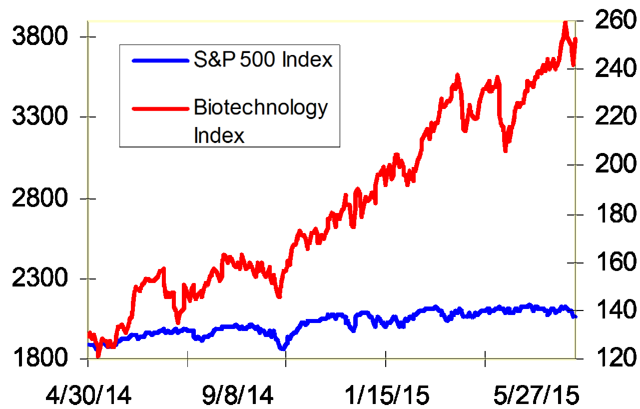
Biotechnology Is Booming

Health care stocks are beating the market. Since the stock market bottomed in early 2009, the S&P 500 has tripled in price while the healthcare sector is up nearly fourfold.

Much of this is due to an explosion in prices of biotechnology stocks. While the established drugs stocks such as Johnson & Johnson, Pfizer and Merck have done well during the economic expansion, biotech has done much better. The S&P Biotechnology Index has gone from a low of $43 in March, 2009 to $250 today, nearly a six fold increase.

Traditional pharmaceutical companies develop new drugs by testing many substances to determine which have medicinal qualities. When they find a new substance which relieves a health problem in a majority of people, they bring it to market as a new drug.

Biotechnology companies, drawing on extensive knowledge of biological processes developed by researchers over the last few decades, create new, more natural drugs from scratch. The drugs are designed to harmonize with the natural workings of our physiology at the cellular level. This includes interacting with the genetic material and the possibility of fixing inborn errors of metabolism. The potential of these methods for improving



BIOTECHNOLOGY STOCKS HAVE BEATEN THE S&P 500

health is enormous and has been recognized for decades.

What's different now is that the miracles we imagined years ago are finally coming true. Gilead Sciences has made a drug which permanently cures Hepatitis C. Other companies are coming up with new ways to attack specific cancer cells without causing any serious side effects. Still others are making progress on Alzheimer's and other intractable diseases. It's no wonder the stocks are booming.

This difference is now being expressed in the market prices of biotechnology stocks. In just the last 13 months, as the S&P 500 Index climbed 16%, the S&P Biotechnology Index shot up 115%. Looking back one can see that this out-performance trend began in late 2006, before the last recession.

As stock prices have soared, valuations have become more stretched. The S&P Biotechnology Index which includes 105 stocks, has a price earnings ratio of 26.3, somewhat higher than the slow growing S&P 500 Index. Biotech sales and earnings however are growing much faster than the general market. If this high growth can continue for a few more years, the stocks may still be reasonably priced.

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Is 4% Growth Possible?

Economist Glenn Hubbard recently suggested that with the right policies, the U.S. economy could return to 4% annual growth.

The size of any economy is the product of the number of people working and their productivity, i.e. their average output measured in dollars. Economic growth is the result of an increase in the number of workers, an increase in average productivity or both. If the number of workers rises by 2% in a year and productivity rises 3%, the economy will grow by a little more than 5%.

The number of people working is dependent on the size of the population and the percentage of people working. From 1960 until 2000 the U.S. population grew about 1.3% per year, but increasing worker participation rates (mainly women entering the labor force) caused the workforce to grow faster, at 1.8%. Since 2000 it has averaged only 0.4% per year as both population growth and workforce participation rates have fallen. Experts calculate that our population will grow less than 0.5% per year over the next 20 years.

Productivity growth is far more complex. It is clearly dependent on new discoveries but also on how quickly they are integrated into the work-a-day world. People are often reluctant to accept new methods. There is usually a

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4% growth: continued

need for capital investment which involves financial risk. Training is often needed. Work rules may need to be changed. Fewer workers may be needed. Jobs may be at risk.

From 1960 until 2000 U.S. worker productivity grew an average of 1.7% per year. In combination with 1.8% workforce growth, this produced 3.5% average economic growth. Since 2000, economic growth has averaged only 2%. This is almost entirely due to slow labor force growth.

Looking forward it seems unlikely that the labor force growth can grow at more than twice the rate of population growth for very long. It also seems unlikely that productivity growth can exceed 2% for more than a few years. Combining these rates produces an optimistic long term growth rate of only about 3%, lower than the historical rate and not approaching 4%.

The inescapable conclusion is that despite better policies, economic growth will remain subdued as long as population growth remains slow.

Living on Your Retirement Nest Egg

Congratulations! After decades of working, saving and investing you are finally ready to reap the rewards during your retirement. But before the big day arrives make sure you have a plan for investing and drawing down your retirement funds to provide a secure income for the rest of your life. We'll assume here that you have enough money for a comfortable retirement but not enough to leave a substantial estate.

Although spending your retirement funds seems easier than building them up, it is anything but. If you withdraw too much money each year your nest egg may not last as long as you do. If you take out too little you may be depriving yourself of the many freedoms and opportunities which retirement offers. Although an investment and spending plan cannot eliminate these risks, it can reduce them considerably.

Before you spend a dime of your retirement funds you should formulate your plan. This plan should specify how much money you will withdraw each year, how your money will be invested over time and what adjustments you will make if your plan goes off course.

The first thing to consider is how long you are likely to need income from your funds. This will vary by age, health and philosophy. Whether you decide to spend all the money while you are healthy enough to enjoy it, parcel it out evenly over your expected lifespan or leave a cushion for late life health care expenses, is a decision you need to make up front.

Next, consider how much you have invested. Count only those investments which are easily marketable, mostly stocks, bonds and income producing real estate. Your home, your car, your jewelry and your valuables should be excluded.

What are likely investment returns? If your estimates are too optimistic, your money may run out long before you expected. Unrealistic return estimates are the most common reason retirement plans fall short.

Your willingness to take risk is also a big factor. Take too little and you will almost surely fall short. Take too much and the possibility of a fatal market decline may be destroy your nest egg.

Inflation is another imponderable which can ruin your plans. At the current low 2% rate it can cut your purchasing power in half in the 30 years you might live in retirement. At 7%, which was the average rate during the 1970's, it will cut your purchasing power in half in just 10 years.

Lastly, you need to allow for unexpected events, most importantly the need for expensive health care services at any time but especially later in life.

All of this sounds like a complicated math problem with no solution. One way to simplify the problem is to focus on the biggest risk, i.e. the risk that you will run out of money. If you leave a substantial sum behind, at least you can arrange for it to go to someone you love.

In the next installment we will discuss the development of a plan which addresses the most common risks of retirement investing.

The Bottom Line: 6/30/2015

Market Indicator	Current Value	One Year Change
Large company stocks *(S&P 500 Index)*	2063	7.6%
Small company stocks *(S&P Small Cap Index)*	719	7.1%
Short term interest rates *(3 Month T-Bill Yield)*	0.1%	No change
Long term interest rates *(10 Year T-Bond Yield)*	2.3%	From 2.6%
Inflation *(Consumer Price Index)*	237.0	0.0%
Energy *(West Texas Intermediate Crude Oil)*	59.096bbl.	-44.0%
The economy *(Inflation adjusted GDP)*	$17.7trillion	2.9%

QUOTABLE

"Reversion to the mean is the iron rule of financial markets."

John Bogle , Founder of Vanguard Group

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