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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

We are back to square one, as they say. One might also say that it has been much ado about nothing. However, when you are in the middle of a shake out, it doesn't seem like nothing. I was cleaning out some of my old files last week and ran across some articles from 2010. My first thought was: "Things were so cheap back then, why didn't I bet the farm"? Then reality set in. The answer was pretty simple, it was because the global financial system was shaken, it was a matter of just hanging on to what you had. It wasn't as dire in January. The talk was about a possible recession, not a possible depression, and the market declined by 11.5% in January. It appeared that it could easily be down -15%, maybe even -20%. If there was a recession, a 20% correction is almost a given. By March the economy was once again showing some resilience, and now the losses are gone and we are back to where the year started. A few thoughts on volatility.

Having some cash is always a good thing, however, it ultimately is a bad thing if you want to make money. In the era of 1% interest rates, cash should be a vehicle to either - fund emergencies or fund short-term liquidity needs. Or, it should be in a portfolio to give you the ability to take advantage of lower prices. The exact amount of cash is a personal choice, but it is kind of like betting against the casino. Eventually the casino beats almost everybody, cash eventually loses to the market. There is probably one more reason to hold some cash. If it lets you hold more of your portfolio in the market than you might otherwise invest, it can be argued that your cash is in fact earning a return.

In the last 145 years, half the market's return has come from dividends, which has been 4.6%. Since 1976, dividends have grown by 6% annualized. If you start with a dividend yield 3% and it grows by 4.6% annually, you will have a yield of 4.7% on your portfolio at the end of 10 years. If your 3% dividend portfolio grows by 6% annually (the last 35-year average), your portfolio earns 5.3% at the end of 10 years. Maybe the focus should be less on prices and more on your income stream. The other great thing about a growing income stream is that it eventually solves the lower price issue.

Buying an income can be tricky. The more predictable it is, the more it costs. A 10-year treasury bond is very predictable, but it only pays 1.9%. The safer the stock dividend is perceived to be, as a rule, the lower the yield. Companies that have shown the ability to increase their dividends over time also tend to start with a lower yield as opposed to companies that have not. However, there are also the cases where companies begin to borrow money to increase their dividend, and that game only lasts so long before the money runs out. You thought this was going to be easy.

Barry Ritholtz, a chief investment officer who manages $225 million, is quoted as saying: "I can tell you from my personal experience that most of them (the media) haven't the slightest idea what they are talking about. The general advice they give is for entertainment purposes only … Market experts know nothing about you, your portfolio or your risk tolerance … Their forecasts amount to nothing more than marketing. Treat them that way." The Fed, who has access to more economic data than anybody, is having difficultly figuring out what to do next. If they aren't sure, nobody else knows either.

There is no one right answer to the dilemma of investing. One possibility is to focus on the income, not on the daily price. If Mr. Market begins to get a little pessimistic, that is what your cash is for.