

# RKM Advisors, Inc.

## Newsflash

*Spring 2009*

### **INVESTMENT PARALYSIS**

In his most recent article, Jeremy Grantham describes seemingly reasonable people, armed with terrifyingly accurate data, foretelling of the end of the world. Investors with lots of cash become inert objects, mired in cement, and too terrified to invest. Those investors who are fully invested move from fear to denial and finally to panic, at the end becoming catatonic.

Grantham encourages all investors, before rigor mortis sets in, to evaluate where they currently are, where they want to be, and how they can get there. A clear “battle plan”, developed by taking motivation from both your head and your stomach, he says, should clear the way for investors to overcome “investment paralysis”.

Grantham calculates the “fair value” of the S&P500 at 900, approximately 30% above where the index sits now. Although he believes that the index has a 50/50 chance of dropping below 600, he also thinks that many stocks and funds will post a double digit return per year above inflation for the next seven years. This might not be the absolute bottom of the market, but it is so close to a bottom, prudent investors are now investing.

- RKM

### **INVESTMENT CONFIDENCE**

As you can imagine, it's not very easy to write something inspired given the markets current sullen state. Or is it?



Elaine Garzarelli, formerly a Prudential analyst, called the market correctly in 1987, when shortly before the market crashed in October she put her clients into cash, where they stayed until the mid 1990's, ultimately missing out on much of the rally in the stock market during the Clinton administration. She was only half right. In other words, you have to be right twice about something that no one knows with any certainty.

For those who are waiting for the tide to turn before they purchase stocks, remember that human nature is hard to overcome. For instance, you decide to invest when the market moves up 10 percent. That day comes, but you think, “is this a groundless rally?” So you decide to wait until the market moves up another 10 percent – just to be certain. At that point, you decide to wait for the market to pull back a bit and then buy because you've already missed 20 percent. As you wait for a better day the market advances another 20 percent and now with current investor psychology very bullish (a condition usually evidenced somewhere near the top of the market) you decide to jump back in having missed 40 percent of the market's appreciation. Unfortunately, at every signpost, the future is no more predictable than it was at the last one.

- CPB

## WHAT GOES DOWN MUST GO UP

“Though the path has not been smooth, our economic system has worked extraordinarily well over time. It has unleashed human potential as no other system has, and it will continue to do so. America’s best days lie ahead.” This quote by Warren Buffett from his letter to Berkshire shareholders sums it up quite well. It is worth noting that since market records have been kept, stocks have outperformed every other investment category – including the period of the Great Depression, when they lost nearly 90 percent of their value!

If you have substantial cash you will need to (re)invest at some point. There is motivation to start now (confidence), as long as you are willing to risk the possibility of short-term declines in return for long-term profits. Remember, the future is not foreseeable and the fundamental goal of equity investing is to buy lower and sell higher. RKM has long advocated a strategy of buying into market declines, given that the biggest risk for many investors is to over-allocate to cash, missing upward movements in the market, which normally happens rapidly and abruptly.

## YEAR OF THE OX (aka Bull!) – COINCIDENCE?

We don’t know when the market will bottom. But whether it’s this month or December of this year, we are confident it will. In the meantime there is a strategy for the equity portion of a portfolio that offers high current income with the potential for long-term appreciation. We suggest adding high quality equity/income funds or “dividend aristocrat stocks” to the portfolio, as this likely increases current income with appreciation potential.



The S&P 500 dividend “aristocrats” are the 52 companies in the S&P 500 index that have followed a policy of consistently increasing dividends every year for at least 25 consecutive years. The current yield on several equity/income funds averages about 5 percent. That’s comparable to starting a 100 yard dash on the 50 yard mark, given that large cap stocks returned on average about 10 percent annually over the last 70 years. Investment income, whether from dividends or interest provides a cushion in down markets and many top-quality stocks have higher yields than the 30-year Treasury and better appreciation potential.

During periods of rapid economic expansion these value oriented stocks usually underperform growth stocks but value has a longer in-favor phase than growth. If the market continues to bounce around near the bottom, income of around 5 percent annually certainly helps. Again, this strategy focuses on blue-chip stocks with sound balance sheets, strong free cash flow and a history of periodically increasing dividends. If you have interest in discussing this in further detail please see our website for our contact information at - <http://www.rkmadvisors.com>

Sources: The Wall Street Journal; Bloomberg LP

- CPB

## **INFLATION IS COMING BACK**

Twice before in the last hundred years, we had surges in inflation.

The first followed the New Deal spending and was amplified by the cost of the second world war. In 1937, inflation reached a Stage One high of almost 4%, high for the thirties, only to retreat. It surged again by 1942 reaching the level of 10.7% for that year. Finally, the blow off inflation arrived in 1947, reaching the level of 14% before reversing.



The second followed the Vietnam conflict, which was fought at the same time that LBJ was building his Great Society program. This combination led to the inflation of the 1970's, starting with inflation of 5.9% in 1970, leading to Nixon's wage/price controls. That retreated only to come back 4 years later in 1974 with inflation at 11%. Retreating again, the surge came in 1980 when inflation finally reached 13.5% before reversing.

In 2008, mainly on the back of rising commodity prices, we reached our first inflation milestone of 3.8% for the year, having been at more than a 5% pace during the year. Having backed off, our current concern with deflation is prompting the massive stimulus and bailouts in the trillions of dollars. Still fighting wars in Iraq and Afghanistan, we are putting massive amounts of money into the global economy. Would it be unreasonable to expect a reenactment of the inflation stories of yesterday? No. If the script remains the same, we should about double the 2008 rate by 2012-13, and see the cyclical inflation peak by 2018.

This argues for an investment orientation much more biased toward hard assets and tangible assets, things that do well in an inflationary environment; commodities, precious metals, currencies in natural resource rich nations, agriculture, energy, and companies that can pass along costs more easily to customers. Anecdotally, we just read that the new manager of Singapore's sovereign wealth fund is not a typical stock and bond guy, but the former CEO of BHP/Billiton, the Australian conglomerate that is the largest natural resource company in the world.

So where to look.....???

**AT MORE ALTERNATIVE ASSETS WHERE OUR CLIENTS HAVE HAD PAST SUCCESS!!!** Buy more things that produce income that one can depend upon; maybe residential realty in stable areas - Lancaster, PA or West Chester, PA or Arlington, VA; for example. Or buy stakes in small businesses that provide essential services (gains from which would be taxed at 0% under the proposed new tax law). Perhaps invest in companies such as grocery wholesalers or other businesses in the food chain; or utilities that have low cost structures that provide heat to urban areas. Additionally look at new or improved technologies in energy efficient cooling or heat recapture systems. And investors should continue to look for opportunities in alternative energy and/or infrastructure companies.

## **TAX CHANGES NOW AND FUTURE**

- Employees will get a credit via lower income tax withholding of \$10-\$20 extra per week. Instead of a rebate check the IRS will distribute the credit by lowering the federal withholding over the next nine months. Retirees will receive a one time \$250 check.
- The first-time home buyers credit has increased to \$8,000. You can elect to take the purchase of your home in 2009 on your 2008 tax return. The other major difference is this credit, unlike the prior one, does not need to be paid back if you keep your home for at least three years.
- College tuition credit will increase up to \$2,500 per student. It will also cover the cost of books. The phaseout has increased to higher levels of AGI. Singles \$80,000 and couples \$160,000.
- If you purchase a new vehicle you can deduct the sales tax paid. The sales tax will be added to the standard deduction.
- Energy efficient home improvements are larger for 2009 and 2010. The credit triples to 30% with a new ceiling of \$1,500. The caps for solar panels, geothermal, and wind energy are removed.
- The tax hikes will take place in 2011. Obama's plan is to reinstate the 36% and 39.6% income tax brackets. This will effect couples with AGI of more than \$250,000 and singles with more than \$200,000.
- Starting in 2011 the current 15% capital gain and dividend rates will increase to 20% for filers above the 28% tax bracket.

- VLG

## **STATEMENT ADDRESS CHANGES NEEDED**

A note to our clients who have duplicate statements sent to us by mail. Please contact your various brokerage firms to let them know that we have moved and the address needs to be changed. The brokerage companies need the account holder to contact them directly to make the necessary changes. Examples of statements we receive are Vanguard, Merrill Lynch, Fidelity, TIAA-CREF, and T. Rowe Price.

You do not need to contact Schwab to change the address as we have access to these accounts and have made the necessary changes.

### **FOR YOUR INFORMATION**

The S.E.C. rules require that we advise our clients that trades placed through "client-selected" brokerage firms as opposed to the RKM Advisors, Inc. selected firm of Charles Schwab & Co., may incur higher transaction fees or less favorable net prices.

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Pursuant to SEC Rule 204-3(c) of the Investment Advisors Act, we offer our clients a copy of our FORM ADV, Part II. Any clients who wish to receive a copy of this filing by mail should call our office to request one.