FOSTER & MOTLEY
Wealth Management

January 31, 2014
Volume 17
Issue 1

Review & Outlook

Market Notes

U.S. stock markets ended 2013 with their best performance in over 15 years, overcoming the "fiscal cliff," a government shutdown, and slowing growth in corporate earnings. The S&P 500 and Dow Jones Industrial Average surged, and small company stocks posted even higher returns.

International stock performance, on the other hand, was weaker. Developed country markets lagged domestic markets but still posted solid returns for the year, as Europe's economy appears to be on the mend and the crisis surrounding its debt problems has eased. Emerging markets struggled as investors became nervous about slowing growth in China, political crises in Syria, Turkey and Ukraine, and the uncertainty about the Federal Reserve's anticipated reduction in monetary stimulus.

While still historically low, the 10-year Treasury yield rose 1.3%, its largest single-year yield increase since 2009. The uptick in yields means bond prices fell last year.

Gold prices also fell in 2013, posting their largest annual decline since 1981.

Here are the numbers through December 31st:

Benchmark 2013 Total Returns	
S&P 500 (large US stocks)	32.4%
Dow Jones Industrial Average	26.5%
Russell 2000 (small stocks)	38.8%
Wilshire 5000 Index (total US stock mkt)	31.4%
EAFE (established international stocks)	22.8%
MSCI Emerging Markets Free	-2.6%
Merrill Lynch US Master (taxable bonds)	-2.3%
Merrill Lynch Municipals 1-12 years	-0.1%
NAREIT Equity REIT Index	2.9%

Inside this Issue:

Page 2:

Retirement Planning - How am I doing?

Page 3:

Profit Margins: A Hidden Risk in the Stock Market

Page 4:

News & Notes

If you would like to receive our newsletter electronically, please contact Jessica Holcomb at (513) 561-6640.

Retirement Planning - How am I doing?

by David A. Foster, CPA, CFP®

By far, the #1 financial planning question we get from clients is "Can I afford to retire?" For younger folks it's usually "How much should I save for a comfortable retirement?" and for those already retired it's "How much can I spend and not run out of money?" All revolve around the theme of retirement financial security.

In the media, considerable attention is focused on this theme; we have all seen the ING commercial urging you to calculate "your number." Every large financial services firm has their own calculator on their website to help you figure out what your number is. You think you are bombarded with this stuff? You should see the financial periodicals we get. There isn't a month that goes by without an article on "sustainable withdrawal rates in retirement." Every conference I go to has at least one session on that very topic. And they are by no means consistent in their

© 2014, Foster & Motley, Inc.

FOSTER & MOTLEY
Wealth Management

Retirement Planning - How am I doing?

continued....

advice. In this month's Journal of Financial Planning, I read a feature article by two respected members of the planning community, who, contrary to conventional thinking, were advancing the theory that you should start with a low allocation to stocks at retirement and increase it as you approach your 90's. Say that again?

"A good analysis starts with doing some serious homework… thinking about how your goals and your retirement spending relate."

Sorting through all this, a few key points ring true to us.

Calculating "your number" is complicated. A good analysis starts with doing some serious homework on your retirement goals; mostly thinking about how your goals and your retirement spending relate. Skipping that step means you'll have to fall back on rules of thumb like "retirees spend about 25% less than they do pre-retirement." It's just not that simple, and those "rules" can be misleading.

It really is personal. Ignore what your neighbor or brother-in-law is doing. There are no benchmarks to measure against. Your cash flow needs in retirement are unique to you. Your goals with respect to lifestyle, charity or family gifting are unique to you. This may sound elementary, but our human nature is such that we like to compare ourselves to others as a way of assessing how we are doing. In this case, it can be dangerous. Try to focus on you and your unique situation.

Focus on cash flow. When it comes to investing during retirement, focus on cash flow, not benchmark returns (such as outperforming the S&P 500). Many investment plans are focused on matching or beating benchmarks. That may be OK when you are in the accumulation phase but most of us should shift our focus to generating cash flow at retirement. Borrowing a metaphor from an excellent article I read many, many years ago, investors can be either chicken farmers, mostly concerned about the price of chickens, or egg farmers concerned about egg production. At retirement, think about becoming an egg farmer. You want eggs (interest and dividends from your portfolio). You understand the price of chickens (the value of your portfolio) will be volatile, but that's not your primary concern; you aren't selling them today anyway. My advice: ignore all the daily clucking about chicken prices, focus on steady and consistent egg production and you should sleep better at night.

"I urge you to understand the cash flow from your portfolio and the role it plays."

As you review your own retirement planning and investment strategy, I urge you to understand the cash flow from your portfolio and the role it plays. We are happy to discuss how cash flow impacts our investment process, how the cash flow from your portfolio has changed over time and how it might behave in a bear market or rising-interest-rate environment.

No matter where you are in the process of retirement planning, we want you to be able to answer the question "how am I doing?" with a "pretty well, thank you." It's not easy, but it's certainly doable if you stick with your plan, execute your strategy through good times and bad and strive to achieve your unique goals.

© 2014, Foster & Motley, Inc.

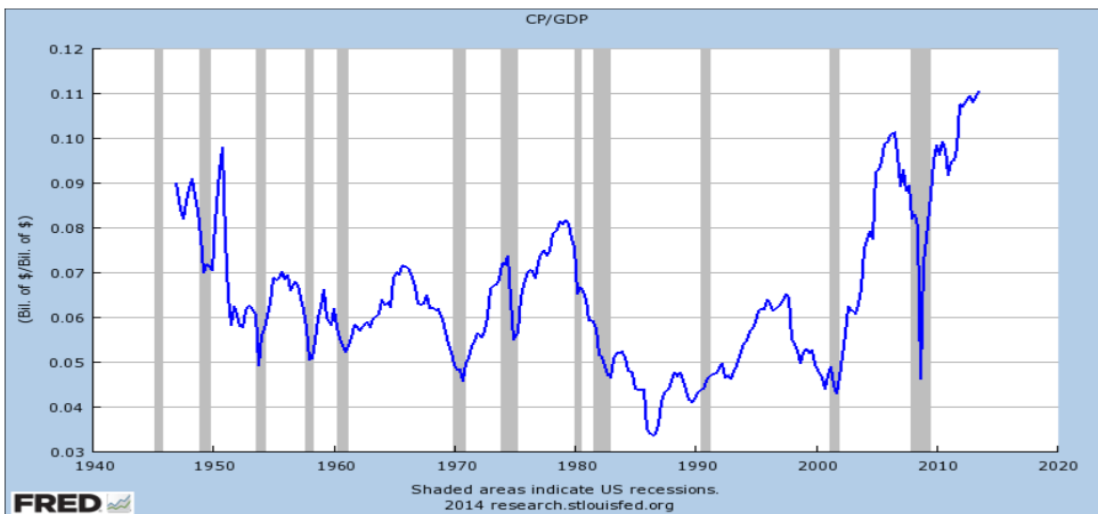
Profit Margins: A Hidden Risk in the Stock Market

by Ralph J. Scherer, CFA, JD

For some time we've been focused on the defensive characteristics of client portfolios because of what we view as an environment of higher-than-average risk. Many of these risks are fairly obvious such as the slow pace of economic recovery from the recession, the Fed's aggressive use of quantitative easing, and the high and growing levels of government debt in developed economies around the world. However, one of the larger risks to the stock market comes from a much more subtle source: unusually high corporate profit margins.

One of the reasons this risk gets overlooked is because, on the surface, high profit margins are a very good thing. Indeed, one of the markers of a strong company is robust profitability. While high profit margins are positive in the short run, in the long run they are very difficult to maintain, let alone grow. In a free enterprise system, high margins attract increased competition (think of the explosion of cheaper smart phones to compete with Apple's very high margin iPhone), which eventually brings margins down, just as low margins cause firms to exit markets, eventually bringing those margins up. In other words, there's a natural gravitational pull bringing high margins down and low margins up. This gravitational pull applies to the entire corporate sector just as it does to individual companies. In statistics this tendency to return to the middle of a range is called "mean reversion," and profit margins have historically had a particularly strong tendency to revert to the mean. In the graph below, one can see the modern history of corporate profit margins. At the end of the third quarter of 2013, margins exceeded 11%, while the average or mean over this history has been between 6% and 7%.

"There's a natural gravitational pull bringing high margins down and low margins up."



"Corporate profit margins are at or near record levels."

There are a number of ways to measure corporate profit levels. Common metrics include comparing gross profits to revenues (operating profit margin), net profits to revenues (net profit margin), or corporate profits as a share of the US gross domestic product (as shown above). Whatever the measuring stick, the results are the same; corporate profits are at or near record levels. It's also apparent in the graph above that profit margins ebb and flow with the economic cycle. In the

© 2014, Foster & Motley, Inc.

FOSTER & MOTLEY
Wealth Management

Profit Margins: A Hidden Risk in the Stock Market

continued....

current cycle, margins have had a sharp cyclical rebound from the lows of the last recession to a level above past cycle peaks. So, they are higher because of where we are in the cycle, but they are also high compared to past cyclical peaks.

We look at the implications of this for stock prices from two different perspectives. From a valuation perspective, this leaves us with skepticism about assurances from some quarters that the price to current earnings ratio (P/E ratio) for the market is within normal ranges when the earnings part of that ratio is being inflated by unsustainably high margins. From an earnings growth perspective, we know that earnings are determined by the interplay of revenues and margins. So, if there's very little room for margins to grow, then revenue growth must drive earnings growth. Given that revenue growth has been very tepid recently (averaging less than 3%), the risks are high that earnings growth disappoints. None of this means that earnings can't continue to grow or that stock prices can't rise, but it does tell us that market risks are elevated.

News & Notes

Foster & Motley's Board of Directors is pleased to announce the following appointments: **Paul Staubach, CPA, CFP®,** as Director of Financial Planning, **Beth Green, CFA,** as Director of Investment Management, and **Mark Motley, CFA,** and **Ralph Scherer, CFA,** as Co-Chief Investment Officers. Congratulations!

Congratulations to Zach and Lindsay Horn, who welcomed their first child, **Zion**, on November 17th! Given that Zach is a life-long Red's fan, we won't be surprised to see Zion in the line-up 25 years from now!

Join our Team! Foster & Motley is currently recruiting for a full-time Trader/Investment Analyst position, and 2 full-time Financial Services Administrative Assistants. Please contact Zach Horn regarding the Trader/Analyst position, and Larry Bernhard regarding the Administrative Assistant positions.

John Melville, CFA, recently spoke at the Northern Kentucky Estate Council's annual luncheon. John provided an overview of the securities markets, including a discussion about inflation and interest rates.

Mark Motley, CFA, attended the AQR University last fall. This was a conference presented by one of the industry's thought leaders, AQR Capital, manager of the AQR Managed Futures Fund, which we use widely.

Tony Luckhardt, CFP®, attended the AICPA Advanced Personal Financial Planning conference. The event covered the latest in estate, investment, retirement and insurance planning.

Redstone's Parking and Handicap Access. With these snowy, cold days please remember that our building offers covered parking, and handicap access in the back of the building.

7755 Montgomery Road
Suite 100
Cincinnati, OH 45236

Phone: 513-561-6640
Fax: 513-272-7527
Toll Free: 800-532-2962

Email:
Firstname
@fosterandmotley.com

Website:
www.fosterandmotley.com

© 2014, Foster & Motley, Inc.