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End-of-Summer Investing Thoughts

2016's Stock Market Performance: At the time this is being written on August 23rd, all three of the major U.S. stock market indexes, the S&P 500, the 30-stock Dow Jones Industrial Average and the NASDAQ composite index of primarily technology stocks are each setting all-time highs. The broad-based S&P 500 is up 6.5% so far this year. This is a massive turnaround from the start of the year, where the market fell 10% on fear of declining corporate profits, low commodity prices and the stalling Chinese economy.

That proved to be a great time to be buying, but few did (more on that topic and what can be learned from it later). An explanation for the rising market is pretty clear. Her name is "Tina", which stands for "There is No Alternative." Low interest rates have been wonderful for the stock and bond markets. They are overwhelming the continuing sluggish economic growth and are prodding investors to seek alternatives to bonds. The 10-year U.S. Treasury bond is currently yielding only **1.55%**, which is high for the developed world. The British bond yields only 0.55%, and the yields on the German and Japanese bonds are actually negative! As interest rates keep falling, investors are turning to stocks (particularly dividend stocks) as an income alternative.

With the stock market essentially moving straight up since its mid-February low, U.S. stock valuations are back over 20 times company earnings (on average) for the first time in seven years. It's reasonable to get nervous and think we are due for another correction and that maybe we should sell some winners and lock in some gains. Unfortunately, trying to time the market's short-term moves is incredibly hard to get right, and we've long ago stopped trying. You can make the case that stocks are now over-priced. You can also make the case that they aren't, especially relative to bonds. Low interest rates and inflation will support stock prices, and earnings will begin to grow as the prices of oil and commodities rebound.

If you are tempted to sell, understand that it's not enough to correctly predict that a stock or mutual fund you own will fall. If it's an investment you want to own for the long term, you also have to buy it back before it rises up again above your selling price. Very few people can show they have done both of those successfully on a consistent basis. Peter Lynch, the Wall Street legend and manager of the Fidelity Magellan mutual fund during its best run had this to say about trying to time the market:

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"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections."

For Me, A Long-Term Investor, Buying Fine Companies That Are Well Managed, At Attractive Prices Remains a Sensible Strategy: Prior to 2016, the volatile technology stocks with little or no earnings seemed to rise the most. I do not know how to buy those volatile stocks before they rise and get out before they fall. Therefore, I no longer try. That is "speculating," and I prefer "investing."

"Investing" is Nothing More Complicated Than Laying Out Some Money Today in the Expectation of Receiving More in the Future: While that's easy to understand, the tough part is determining the amount and timing of the future stream of payments. If it's a bond, that's simple. If it's a stock, it's impossible to have much confidence in predicting the future numbers for most companies, as they are far too unpredictable. Therefore, I try to improve the odds and create a margin of safety by limiting my investing to pretty basic businesses that are less likely to change much over time. To amplify, I limit my investments to companies that I believe have all of these four wonderful qualities:

(1) Their businesses are simple enough for me to understand
(2) They have been, are, and are likely to remain quite profitable
(3) They are run by capable management I believe has integrity, and
(4) Their shares can be bought at prices low enough to give a good (say 10% or more) annual rate of return from my purchase price to the range within which I estimate the stock will be trading in 10 years.

[EDITOR'S NOTE: What follows is not meant as investment advice for any individual. Each reader must do independent research and consider his or her own situation and act accordingly. Your broker or advisor can order company annual reports, as well as Value Line pages and Standard & Poor's reports on each company for you to begin your research.]

"Patience" Is Now My Investing Mantra: It's been said that bull markets don't die of old age. They normally end in response to a bubble bursting or the resurgence of inflation. Since neither of these things appears imminent, the U.S. stock market continues to look relatively attractive. However, I am in no rush to chase stocks that have already risen. Frank J. Williams, an early 20th century stock trader, said it well: "The market is most dangerous when it looks best; it is most inviting when it looks worst." Of course that is a testament to how our emotions can mislead us.

Last January Serves as a Good Model for Gauging Our Emotions and Whether They Helped or Hurt Our Investing: The problem is that it's always easier to buy when everyone's optimistic and prices are rising, while it's emotionally hard to buy when everyone's worried and prices are falling. We naturally don't want to buy in a falling market and see prices drop further. But, as a long-term investor in the kinds of companies described above, I've learned not to let those emotions scare me off if prices have already fallen to mouth-watering levels (like last January). I realize that even discounted prices below fair values can fall further. But I have learned to buy in that situation and not worry much that the price could fall further. I have found that the deeply discounted prices tend to recover nicely, and that five years later I'm thrilled to have bought when I did, even though prices fell further after my purchase.

Take This Test: Think back to last January as the stock market tumbled. How did it make you feel? Did you feel the way most people do - nervous or frightened and tentative - and sell or do nothing? Or, even if you felt those emotions, did you overrule them with your intellect by (1) asking yourself whether the events causing the tumble were going to adversely affect the businesses you own on a long-term basis, and if not (2) pounce at the opportunity and pick up the bargains that were available? As investors, most of us are betrayed by our emotions. At times of market falls, our emotions make us want to sell or they make us freeze up. Few people in that setting will analyze the situation and sell or buy based on intellect instead of emotions.

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If Your Emotions Betrayed You Last January, Try to Learn From It: Remember how you felt as the market fell. Remember how that made you react. The market will inevitably tumble again for some reason. It always does at unpredictable intervals. Since we are humans, we will likely feel the same way (nervous or frightened and tentative). When you sense that is happening, try to let your intellect overrule your emotions. Ask whether the events causing the market to fall will actually have any long-term adverse effect on your businesses? If not, then stiffen your backbone (take something to settle your stomach) and consider buying. If you are right, you will have likely acquired shares at what will later look to be great prices.

These tumbles always come for a scary reason. As humans, our emotions tend to react the same way whenever this happens. It's an interesting phenomenon that stocks are the only commodity in the world that when you lower the price nobody wants them. Of course that's silly and a wonderful time to be a buyer. Learning to recognize (1) when we are getting emotional, (2) whether our emotions are misleading us, and (3) when to let our intellect overrule our emotions, is part of the maturation of an investor that few ever reach.

As for Specific Stocks, My Approach Remains Quite Simple - There is a List of Companies I Want to Own More of, And I'll Periodically Add More Shares When Their Prices Fall to Attractive (Preferably Mouth-Watering) Levels: My problem is that I have not found enough companies I think meet the first three criteria I mentioned on page 2. And those that do tend to be already recognized and their share prices have been bid up to reflect their fine qualities. So the trick is to be patient and buy when their prices are at fair or, preferably, below-fair values. Currently the companies (and I wish there were more) that make up the core positions in my family's portfolios are:

Berkshire Hathaway (Ticker Symbol: BRK.B) - The holding company run by Warren Buffett
Henry Schein (Ticker Symbol: HSIC) - Dental, medical and veterinary supplies
Honeywell (Ticker Symbol: HON) - diversified industrial
Johnson & Johnson (Ticker Symbol: JNJ) - health care products
MasterCard (Ticker Symbol: MA) - credit cards
Pepsi (Ticker Symbol: PEP) - drinks and snack foods

Of Course a Key Question Is: At What Price Should These Be Bought? While I have frequently shared the names of companies I own and occasionally have mentioned when I think fire sale prices are available, I have never written about my method of calculating the prices I find attractive for them. How I value companies is easy to understand, but takes a couple of hours of working with examples at our **2-day Investment Seminars**. Just giving prices without that background is not sensible. If you are interested in learning more about investing, plan on attending one of these seminars. They are great learning experiences. The next one is at the **Ritz Carlton in Chicago**, December 9-10. That meeting is preceded by our **1-day Practice Transition Seminar** on December 8. If interested in either (or both) seminars, simply call our office or go to www.CollierAdvisors.com for information.

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There is a Double Tax Trap for the Unwary Who Over-Defer into a 401(k) Type Account and Don't Remove the Excess in a Timely Manner: The Feds are very strict about this. The annual salary deferral limit is $18,000 for 2016. If you are age 50 or over in 2016, the so-called "catch-up" contribution takes this up to $24,000. If you defer more, then the excess deferral is taxable in the year it is made. The excess must be pulled out, along with investment earnings, by April 15th of the next year. **If you miss the April 15th deadline, then the excess is taxed again in the next year**. This double taxation is unfair, but shows how serious the federal government takes this issue.

Remember that we are all limited to $18,000 or $24,000 of salary deferral per year, even if, during the year, we participate in multiple plans. Also, salary deferrals that are made to SIMPLE IRAs and 403(b) plans offered by academic institutions count towards the annual deferral limit.

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If you over-defer to a single plan or among multiple plans, the excess over $18,000 or $24,000 should be pulled out by year-end but no later than April 15th of the next year.

AXA Equitable "Structured Capital Strategies" Variable Annuity: Readers have asked for our opinion of this annuity product offered by AXA Equitable. After reviewing the prospectus, we cannot recommend this product and advise doctors not to purchase it.

This is a single premium deferred variable annuity which means that the investor makes a lump sum payment up front for the promise of receiving annuity payments starting years later. In the interim build-up phase, the investment will rise or fall according to a pre-selected stock index like the NASDAQ or S&P 500. The pitch is that this is a great way to preserve your wealth because there is a built-in protection against losses. For example, you might choose a 10% "buffer" whereby you will not be credited for losses in a given year if the stock index you choose fall up to 10%. If it falls over 15% for the year, you'd be credited with only a 5% loss.

However, there is one big negative in this deal. Should the index go up, your gains will be capped, and you won't get full credit for the growth. If, for example, your cap is 10% and the index goes up 15%, you only get credit for the first 10%. In addition, you do not get credit for dividends, which if reinvested over time would be significant.

The fundamental problem here is that while you get to select the buffer percentage (on the downside) the insurance company gets to select the cap (on the upside). The three companies we're aware of who sell this (AXA, Allianz and MetLife) all set the cap at far too low a percentage for this to be a good investment relative to the investor's purchase price. In other words, if you were to pay $100,000 for AXA's annuity and choose the S&P 500 with a 10% buffer, in order for this to be a fair deal (according to a complicated valuation process called the Black Scholes model), your cap may need to be set at 25% in order to compensate you for your exposure to the underlying index and loss of dividends.

For the insurance company to make a suitable profit on the transaction, however, your actual cap rate will be substantially less. You will be far better off simply buying the underlying index outside of the annuity product.

Dentists should avoid this product. Like every annuity product we've seen, it is terribly complex and skews the benefits too heavily in favor of the insurance company.

Saving Money When Renewing Your Homeowners' Insurance Policy: It's worth asking your agent to scour your policy to see where he or she can create some savings for you. If your annual premiums are increasing only modestly, it's best to stay with your current carrier and not open the policy up to competitive bidding. The idea is to build a long-term record of few or no claims in order to keep the premiums down. But there may still be ways to cut some fat out of the policy. Here are a few suggestions that will likely save you hundreds of dollars:

Other Structures - the policy provides that a percentage of the dwelling coverage, say 20%, is available to cover detached structures on the property like garages, sheds or gazebos. If your home has no such detached structures, then it doesn't make sense to have a high percentage allocated to them. This coverage should be eliminated or reduced to the bare minimum.

Personal Property - the policy probably assigns too high a percentage of the dwelling coverage for personal property, for example 70%. This limit is for all of the personal contents and does not include any items which are scheduled or itemized. Consider reducing this limit from 70% to 50% if this will still provide sufficient coverage of several hundred thousand dollars.

Deductible - raising the deductible from $2,500 to $5,000 is a no-brainer if you would not consider making a small claim to begin with -- and risk the higher annual premiums that it would cause.

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