# AMERICAN MONEY MANAGEMENT, LLC

*SEC Registered Investment Advisor*

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## THE BIG PICTURE ~ GROWING INCOME WITH DIVIDENDS

The pursuit of portfolio returns is often clouded by an over emphasis on capital appreciation and an under appreciation of the importance of dividends. Consider that from 1926 through the end of 2013, stocks in the S&P 500 have annualized returns of 9.8% per year with approximately 40% of this return coming from dividends. This ratio has varied over time with dividends only accounting for 14% of total returns in the 1990s while contributing more than 70% in the 1970s.* The primary drawback of capital appreciation as a component of total investment return is the issue of timing. Stock returns are lumpy and inconsistent, and even the most astute market observers have great difficulty in predicting when returns will actually materialize. Investing in companies with a commitment to growing their dividend over time can help compensate for the inherent uncertainty related to price returns.

Exhibit A below shows the annual price performance (blue line) and dividend payout (blue bar) of Pepsi Co since 1990. Pepsi is a current holding in our firm's dividend growth strategy. While the price performance has been good over the very long run, the returns have exhibited all of the ups, downs and volatility to be expected from the ownership of a common stock, including a few very large draw downs. However, the dividend payout has grown every year for the last 25 years. Compounding income at this rate represents a doubling of income every 6 years. While long-term capital appreciation is an important component of an investors total return, we feel it is equally important to consider dividend growth prospects when making an investment in common stocks.

**Exhibit A**

*Source: Capital IQ, American Money Management*

*Data points in this section provided by: Standard & Poor's, Ibbotson & J.P. Morgan

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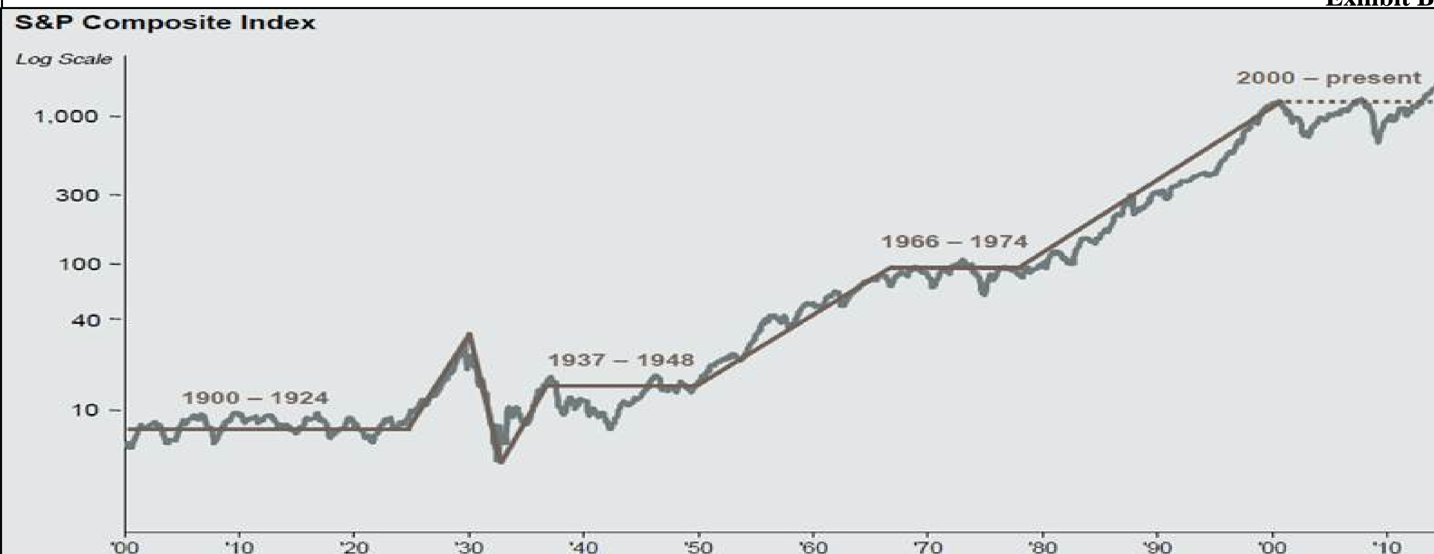
## Current Outlook

The great irony in investing is that the *best* opportunities come at precisely the time that we are hard wired to avoid risk. Scientists have determined that the amygdala, a small almond shaped tissue at the end of our brainstem, governs our instinctual fight or flight response to danger. In scenarios of real physical danger, this critical function may be life-saving. In investing, however, this function is at odds with the non-emotional rationality required to make sound financial decisions. When prices are falling and volatility spikes, our amygdala could flash danger and keep us sidelined from investing at very favorable prices, or even worse, lock in losses by selling low.

The inverse of this theory is that the worst time to invest is when we *feel* most willing to take risk. This complacency effect seems to numb our amygdala to the financial danger of overpaying for an investment. The roaring 20s, late 90s and housing bubble of the last decade were all accompanied by the tendency of risk takers to focus primarily on what could go right rather than what could go wrong. These are examples of some of the most dangerous times to invest in modern history.

The good news is that most of the time we don't operate in either of the extreme investment scenarios described above. While it would be seemingly nice to have more "crash" opportunities to invest in great companies on the cheap, the negative consequences of a shortened boom bust cycle are severe and would likely lead to a world of less risk taking, slower growth and higher unemployment. In contrast, the investment landscape of the last 100+ years in the U.S. has been represented by long periods of appreciation followed by extended periods of price consolidation where the financial excesses that built up during the previous boom are purged from the system. Exhibit B below provides an illustration of this since 1900.

**Exhibit B**




*Source: Robert Shiller, FactSet, J.P. Morgan Asset Management.*
*Past performance is not indicative of future returns. Chart is for illustrative purposes only.*

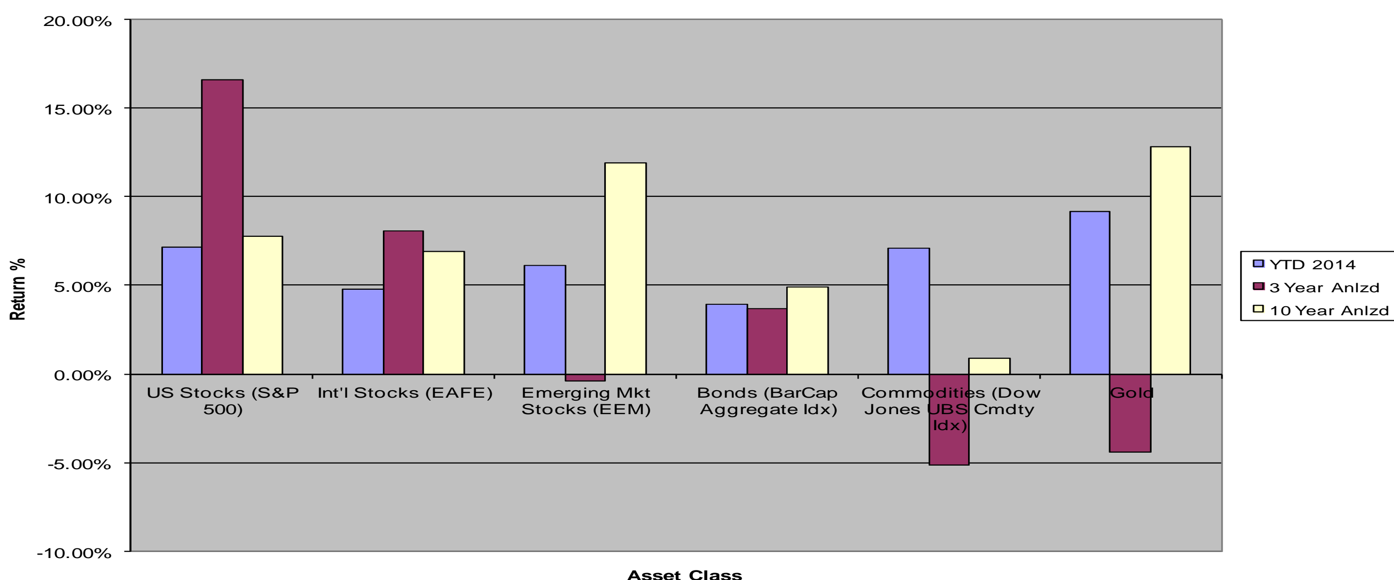
Our assessment of the current investment landscape suggests that we are neither in an environment of extreme fear or complacency. Reasons to be cautious include:

- Stocks At All-Time Highs: New highs alone are not reason enough to be bearish. However, the forward P/E ratio on the S&P 500 is currently above its average over the last 10 years and roughly equal to the average over the last 25 years.
- Volatility Near All-Time Low: The average daily volatility of the Dow Jones Industrial Average is near all-time lows and approximately 40% below its long-run average. We view low volatility as a sign of investor complacency.
- Profit Margins Near Cyclical Highs: Corporate profit margins tend to be cyclical over time. With corporate profit margins currently near all-time highs, there is concern about an inevitable correction from these levels which would reduce profits and could, by extension, cause stock prices to fall.

While the above points indicate reasons for caution, especially in the deployment of new investment capital, we still see some reasons for cautious optimism. These include:

- Global Central Bank Policy Remains Easy: Interest rates in developed markets remain at historically low levels; and, although the Federal Reserve began tapering asset purchases earlier this year, their commentary has consistently suggested that they would keep rates low for an extended period of time.
- Inflation Remains Low: At 2.1% and 1.9% respectively, both headline and core (excluding Energy and Food) consumer price inflation (CPI) remain well below their 50 year averages of 4.2% and 4.1%.
- Household Balance Sheets are Strong: According to estimates from JP Morgan Asset Management, the household debt service ratio (debt payments as a % of disposable income) remains at 30+ year lows, while household net worth is at all-time highs. These figures suggest room for consumer confidence expansion which has historically been positive for stocks.

## WHERE WE ARE INVESTING CAPITAL NOW*




We have updated our asset class return chart (Exhibit C) to reflect Year to Date 2014, as well as 3 and 10 year annualized returns. Year to date through June 30th, domestic (S&P 500), international developed (EAFE) and emerging market stocks were up 7.1%, 4.8% and 6.1% respectively. Perhaps the most surprising performance year to date was from bonds (BarCap Agg Idx) which were up 3.9% through June 30th. Heading in to 2014, many portfolio strategists, including us, had expected a further rise in interest rates this year which would have resulted in lower bond returns. Instead, yields on the 10-year Treasury note fell from near 3% at the beginning of the year to below 2.5% at the low. Another example of how difficult short-term timing is in practice. Finally, gold and commodities were up 9.2% and 7.1% respectively.

**Fixed Income (Bonds):** The role of fixed income in investment portfolios has historically been to 1) provide stable portfolio income, and 2) provide some safe diversification away from more volatile assets like stocks, commodities, etc. It remains difficult to find fixed income investments to meet these dual objectives. For example, $100,000 invested in a 6-month CD (the ultimate safe investment) provided a scant $390 in annual income in 2013 vs. $5,240 in 2006. An investor willing to take more risk and invest in a 10 year investment grade corporate bond may earn as much as $3,000 in annual income on their $100k investment. However, this investor is taking enormous interest rate risk since a 1% rise in interest rates would equate to a 6.6% decline in the principal value of the bond, essentially wiping out 2 years of interest income. So, while volatility in this asset class is still well below that of stocks, the risk reward profile in fixed income remains challenging.

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Our four legged approach to fixed income investing hasn't changed in the last quarter. This strategy involves: 1) Keeping maturities relatively short (< 5 years). Shorter maturity bonds are exposed to less interest rate risk than long-term bonds; 2) Investing in alternative fixed income sectors including floating rate bank notes and absolute return bond funds. Both investments should do better than traditional bonds in a rising rate environment; 3) "Hedging" a portion of our bond exposure via an exchange traded fund (TBF) that shorts treasury bonds (i.e. as interest rates rise, this security should rise in value); and 4) Investing in low volatility merger arbitrage strategies with limited correlation to the equity and bond markets.

**Stocks:** What stands out the most in Exhibit C is the very strong 3 year returns in the U.S. vs. the very weak 3 year returns in emerging markets, commodities and gold. Over time, we expect the returns on broad asset classes to trend towards their long run average. In the case of US stocks, we would expect returns from here to moderate from the elevated levels of the last several years. Still, we continue to see opportunity through the ownership of high quality dividend growth stocks. Unlike bonds where your yield is "locked in" at the time of purchase, stocks that increase their dividend on an annual basis provide shareholders with a "raise" every year.

While the broad US stock market is likely due for some consolidation over the next few years, valuations and recent underperformance suggest that better opportunities may exist in developed international and emerging market stocks. For asset allocation portfolios, we increased exposure to both markets in Q1 and intend to shift more of a portfolio's stock allocation to these markets over time.

**Diversifying Assets:** The relatively subdued levels of headline inflation over the last few years have coincided with sub-par returns from traditional inflation hedges like gold and commodities. We continue to feel that an inflation scare is a risk that hasn't been properly discounted by many investors. Since the Federal Reserve embarked on their experiment with quantitative easing and extended periods of low interest rates, we have felt that if they were to make a policy error, it would be tilted towards higher inflation as opposed to deflation. The brief but strong deflationary spiral that hit asset and credit markets in 2008-09 was enough, in our opinion, to scare policy makers in to erring on the side of inflation. We continue to view modest exposure to both gold and commodities as a reasonable way to hedge inflation risk.

**Individual accounts will vary based on the client's stated objectives, risk tolerance, and time frame. We manage several different portfolio strategies, so not every client has exposure to the securities or asset classes listed above. In addition to growth and/or income oriented asset allocation strategies, we also manage more concentrated equity portfolios that generally carry a higher degree of risk and volatility. Please contact us if you want to discuss your portfolio strategy in greater detail.*

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Should you have any questions regarding your investment account(s) or, if there have been any recent changes to your investment and/or retirement objectives, please do not hesitate to contact our office. We can also provide you with a current copy of our SEC Form ADV Part II, at your request.

As always, it is a great privilege to be entrusted with the stewardship of your retirement and investment assets.

***Your Portfolio Management Team***


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| Gabriel Wisdom<br>*Managing Director* | Michael Moore<br>*Chief Investment Officer* | Glenn Busch<br>*Portfolio Manager* | Vicki Ohara<br>*Operations Manager* | Jim Rhodes, CFA<br>*Executive Director* |
| Mike Green<br>*Portfolio Manager* | Adele Canetti<br>*Portfolio Manager* | Robert Frazier<br>*Investment Advisor* | John Nyaradi<br>*Investment Advisor* | Bryan Case<br>*Investment Advisor* |

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