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# Client Newsletter

Past market performance is not indicative of future results

## Parasites Who Would be Fiduciaries

Does it make sense to allow Wall Street to write the rules of the game for their own benefit?

*Article Courtesy of Bob Veres*

In the breakfast meeting that I reported on in this issue's first article, Ron Rhoades, almost as an aside, made an astounding statement. He said that 30-40 percent of the profits that are generated in this country go to financial services firms. Naturally, I checked on this statistic, and found an article written by Simon Johnson, former chief economist of the International Monetary Fund, which confirms the figures and takes them a bit further. "From 1973 to 1985, the financial sector never earned more than 16 percent of domestic corporate profits," Johnson wrote. "In 1986, that figure reached 19 percent. In the 1990s, it oscillated between 21 percent and 30 percent, higher than it had ever been in the postwar period. This decade, it reached 41 percent."

(You can find the article here: [http://www.theatlantic.com/magazine/archive/2009/05/the-quiet-coup/307364/?single\\_page=true](http://www.theatlantic.com/magazine/archive/2009/05/the-quiet-coup/307364/?single_page=true))

This is a number we should meditate on for a moment. Think of all the manufacturing plants all over America. Think of the aerospace and defense firms that make up the so-called "military-industrial complex," the pharmaceutical firms, oil companies and electric utilities. Think of the agricultural sector in its entirety, the food and beverage industry--including soft drinks and beer, wine and all the restaurants, everything you see in the grocery store and the grocery stores themselves. Consider the housing construction industry, all the mining and drilling operations, every TV and radio station and network, the movie industry, cell phone manufacturers and the computer industry, and then layer on top of that the entire health care industry.

All together, they and others I haven't mentioned (printing and publishing, the automotive industry, airlines, retail and internet sales) generate a little over half of all the profits in the U.S.--59% all taken together. The other 41% comes from the financial sector, and Johnson makes it very clear that your local banks and the lending institutions that service your home mortgage are only a small piece of that figure.

Most of it--very nearly all of it--is Wall Street.

In the debates over a fiduciary standard, the financial planning profession seems to be missing a bigger picture, a much larger issue that Rhoades was trying to introduce into the discussion. We've been talking about protecting the individual consumer from being misled into thinking somebody with a sales agenda is actually sitting on their side of the table.

But bigger picture, shouldn't we also be thinking about how to protect the American economy itself?

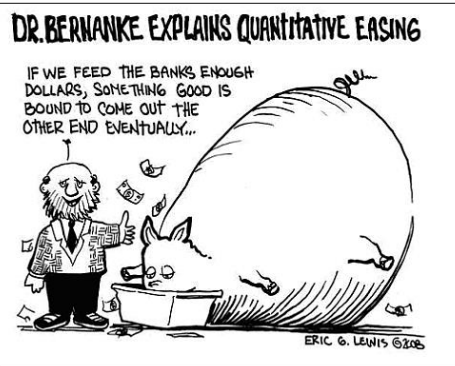
When you look at this bigger picture, it's easy to see that Wall Street has become a cartel that is far more powerful than OPEC ever was. You want to bring your company public? There are a limited number of firms that can and will handle this chore for you--for a hefty 7% of the total money raised. Same if you want to float a bond issue. Plus, when a new stock comes on the market, the company will price it at, maybe, 50% to 70% of its expected value, taking the difference (measured, often, in billions of dollars) into its own account or passing it on to cronies and prospective customers. This underpricing is so common that everybody deemed the Facebook IPO a failure because, a few days after the stock came on the market, it was trading at the same price it was issued at. What a disaster!

Of course, these companies also buy and sell for their own accounts, and there is no incentive for the company analysts to tell customers what they've learned ahead of the company's internal traders; in fact, there is every indication that brokerage firms routinely recommend, to unwitting customers, the stocks

that the company wants to unload out of its own account before the price tanks.

And then you have the whole derivatives market. Is anybody reading this willing to bet that the brokerage firms don't have billions and perhaps trillions of dollars worth of hidden--and highly-profitable--derivatives-related guarantees that will turn on shifts in interest rates or currency flows? The regulators and the government have no way of assessing the extent of these obligations--to hedge funds, European banks, corporations, private investors--because, even after the debacle in 2008, they are not tracked by any agency or regulator.

I think Rhoades is right to suggest that our fiduciary argument is a small piece of something much larger. The core activities that are performed by the banking sector are as necessary to the functioning of our daily lives as the activities of the electric utilities. We need the orderly flow of currency and credit the same way we need the orderly flow of power through our appliances. But ask yourself: what would happen if your local electric company was permitted to withhold electricity or conduct bidding wars for who should receive it? Suppose utilities were allowed to speculate in oil or coal futures markets for their own profits, or charge exorbitant



fees to any oil driller who wanted to sell fuel on the open market. How long would it take before these companies were raking in half or more of the total profits in the U.S.? Who would be able to deny them whatever they asked for?

Of course, we would never allow such a thing to disrupt the orderly flow of electricity through our economy. But why should we allow these activities to intrude on the orderly flow of credit and financing that is just as vital to our economic system?

There was a time, with the Glass-Steagall Act, when lending institutions were required to be lending institutions, and perform their necessary function in our society without mixing in a lot of other activities. There was a time, in the decades after the Investment Advisers Act of 1940 and the Securities Exchange Act of 1934, when stock touts, brokers and securities salespeople represented a distinct profession from investment advisors, and held themselves out accordingly. It may be too long ago to remember, but there used to be broad competition for IPO business, rather than the cozy cartel arrangement we have today. So it is not impossible to imagine ways in which we could stop Wall Street from engaging in a lot of activities that are unrelated to its primary function in society.

The fundamental argument is easy to frame. Back in the days when the financial sector was earning 16% or less of the profits of the

American economy, it was doing a fine job of performing its essential function. Today, Wall Street is engaging in activities which are clearly not enhancing America's competitiveness or overall prosperity. A brokerage firm trading for its own account or speculating on the direction of interest rates, I would argue, is taking valuable human capital and using it in a way that is not benefiting society. Any transaction where the broker is paid extra to recommend expensive, crappy funds that have paid for shelf space doesn't represent a net gain for America either.

A shorter version of this elevator speech would describe Wall Street as a growing parasite on the productive activities of our economy, diverting some of the smartest minds in the country away from all those other industries I listed at the top of this column, so that they can creatively, innovatively, sneakily suck as much money as possible out of our wallets and pocketbooks into the largest bonus pools ever created.

These are the organizations that want to rewrite the 6,000-year-old definition of a fiduciary standard to conform to their business model. They seem to have gotten whatever else they want from Congress and the regulators. Does it make sense to let them have this too?

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## The Long Mystery of Low Interest Rates

*Article Courtesy of Kenneth Rogoff*

As policymakers and investors continue to fret over the risks posed by today's ultra-low global interest rates, academic economists continue to debate the underlying causes. By now, everyone accepts some version of US Federal Reserve Chairman Ben Bernanke's statement in 2005 that a "global savings glut" is at the root of the problem. But economists disagree on why we have the glut, how long it will last, and, most fundamentally, on whether it is a good thing.

Bernanke's original speech emphasized several factors – some that decreased the demand for global savings, and some that increased supply. Either way, interest rates would have to fall in order for world bond markets to clear. He pointed to how the Asian financial crisis in the late 1990's caused the region's voracious investment demand to collapse, while simultaneously inducing Asian governments to stockpile liquid assets as a hedge against another crisis. Bernanke also pointed to increased retirement saving by aging populations in Germany and Japan, as well as to saving by oil-exporting countries, with their rapidly growing populations and concerns about oil revenues in the long term.

Monetary policy, incidentally, did not feature prominently in Bernanke's diagnosis. Like most economists, he believes that if policymakers try to keep interest rates at artificially low levels for too long, eventually demand will soar and inflation will jump. So, if inflation is low and stable, central banks cannot be blamed for low long-term rates.

In fact, I strongly suspect that if one polled investors, monetary policy would be at the top of the list, not absent from it, as an explanation of low global long-term interest rates. The fact that so many investors hold this view ought to make one think twice before absolving monetary policy of all responsibility.

Nevertheless, I share Bernanke's instinct that, while central banks do set very short-term interest rates, they have virtually no influence over long-term real (inflation-adjusted) rates, other than a modest effect through portfolio management policies (for example, "quantitative easing").

A lot has changed since 2005. We had the financial crisis, and some of the factors cited by Bernanke have substantially reversed. For example, Asian investment is booming again, led by China. And yet global interest rates are even lower now than they were then. Why?

There are several competing theories, most of them quite elegant, but none of them entirely satisfactory. One view holds that long-term growth risks have been on the rise, raising the premium on assets that are perceived to be relatively safe, and raising precautionary saving in general. (Of course, no one should think that any government bonds are completely safe, particularly from inflation and financial repression.) Certainly, the 2008 financial crisis should have been a wakeup call to proponents of the "Great Moderation" view that long-term volatility has fallen. Many studies suggest that it is becoming more difficult than ever to anchor expectations about long-term growth trends. Witness, for example, the active debate about whether technological progress is accelerating or decelerating. Shifting geopolitical power also breeds uncertainty.

Another class of academic theories follows Bernanke (and, even earlier, Michael Dooley, David Folkerts-Landau, and Peter Garber) in attributing low long-term interest rates to the growing importance of emerging economies, but with the major emphasis on private savings rather than public savings. Because emerging economies have relatively weak asset markets, their citizens seek safe haven in advanced-country government bonds.

A related theory is that emerging economies' citizens find it difficult to diversify the huge risk inherent in their fast-growing but volatile environments, and feel particularly vulnerable as a result of weak social safety nets. So they save massively.

These explanations have some merit, but one should recognize that central banks and sovereign wealth funds, not private citizens, are the players most directly responsible for the big savings surpluses. It is a strain to think that governments have the same motivations as private citizens.

Besides, on closer inspection, the emerging-market explanation, though convenient, is not quite as compelling as it might seem. Emerging economies are growing much faster than the advanced countries, which neoclassical growth models suggest should push global interest rates up, not down.

Similarly, the integration of emerging-market countries into the global economy has brought with it a flood of labor. According to standard trade theory, a global labor glut ought to imply an increased rate of return on capital, which again pushes interest rates up, not down.

Surely, any explanation must include the global constriction of credit, especially for small and medium-size businesses. Tighter regulation of lending standards has shut out an important source of global investment demand, putting downward pressure on interest rates.

My best guess is that when global uncertainty fades and global growth picks up, global interest rates will start to rise, too. But predicting the timing of this transition is difficult. The puzzle of the global savings glut may live on for several years to come.

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# Strong out of the Gates

## Dear Clients,

The investment markets offer no guarantees; you lay your money on the table and take your chances. In the first quarter, those who placed their bets that U.S. stocks would enhance their wealth--plus, of course, those of us who stayed the course with our investment portfolios--were rewarded handsomely.

The Wilshire 5000--the broadest measure of U.S. stocks and bonds--rose 10.91% for the first quarter--more than half of the strong gains it made last year.

The other U.S. market sectors were also up strongly. The widely-quoted S&P 500 index of large company stocks gained 10.03% for the quarter and celebrated a new closing high of 1,569.19 on the last trading day of the quarter. (Its all-time high was an intraday peak of 1,576.09, set back in 2007.)

The Wilshire U.S. Mid-Cap index was up a robust 13.51% through the end of March after gaining 16.25% all of last year.

Small company stocks, as measured by the Wilshire U.S. Small-Cap, gained 13.11% in the first quarter. The technology-heavy Nasdaq Composite Index was up 8.21% for the quarter.

There was remarkable consistency across the industry sectors that make up the S&P 500. Energy stocks rose 9.57%, materials were up 4.17%, industrials gained 10.08% for the quarter, consumer discretionary stocks rose 11.76%, consumer staples were up 13.77%, health care companies rose an aggregate 15.22%, financials gained 10.92%, utilities were up 11.84%, and even telecom services and information technology companies gained value, up 8.20% and 4.21% respectively.

When you look at global returns, it becomes clear that U.S. stocks delivered standout performance compared with the rest of the world. The broad-based EAFE index of larger companies in developed economies rose 4.38% in dollar terms during the first quarter of the year. The stocks across the Eurozone economies eked out a 0.63% gain for the quarter, reflecting continued uncertainty over whether Spain and/or Italy will require restructuring help on their government bonds. Meanwhile, the Far East economies rose 9.18% in the first three months of the year. In the only truly negative investment news, the EAFE Emerging Markets index of lesser-developed economies fell 1.92% for the quarter.

Looking over the other investment categories, real estate investments, as measured by the Wilshire REIT index posted a 7.43% gain for the quarter.

Investors who retreated to the safest bond categories deserve our sympathy, especially if they are using the coupons for retirement income. Treasury bonds continue to post near-record low yields. Today, if you lend the U.S. government money by purchasing a 2-year Treasury bond, your coupon rate is 0.24% a year; lend them a hundred dollars and you get back less than a quarter every 12 months. Five-year yields are still below 1% (0.76%), and 10-year (1.85%/year) and 30-year (3.10%) T-bonds are not in danger of enriching their purchasers. Muni bonds are sporting aggregate yields of 0.24% (1-year), 0.36% (2-year), 0.92% (5-year) and 1.96% (10-year).

It's hard to believe that the U.S. and global economies are still suffering a hangover from the Great Recession, but the fact that the Federal Reserve Board is keeping interest rates artificially low, coupled with still-high unemployment, makes the case. So, too, does unusually slow and sporadic economic growth; the U.S. economy, measured by the Gross Domestic Product, rose at a 0.4% annual rate

in last year's fourth quarter, after a 3.1% gain in the previous three months.

However, there have been some optimistic signs. Consumer spending, which accounts for roughly 70% of the U.S. economy, rose in February by the highest rate in five months, according to the Commerce Department. Although the gain was still a modest 0.7%, the fact that people were spending more surprised many economists, who expected that the two percentage point increase in the payroll tax would cause Americans to feel poorer when they received their paychecks.

Rising home values and wage gains across the economy have made it easier for households to repair their finances. Incomes were up 1.1% in February and the overall U.S. savings rate managed to climb from 2.2% to 2.6% despite the increased spending and higher taxes. Home property values, measured by the S&P/Case-Shiller Index, rose 8.1% over the past year, the biggest year-to-year gain since 2006. Inflation is still low; the core measure which excludes food and fuel costs rose 0.1% from the prior month, in line with the 1.3% jump in the year since February 2012. And unemployment is finally trending downward. Employers added a net 355,000 workers in the first two months of the year. Rhode Island, Vermont, California and New Jersey showed the biggest declines in unemployment rates.

Does this mean the economic recovery will accelerate, boosting stock prices to ever-higher levels? Or are today's record stock prices a sign that the market is about to take a plunge? Alas, only somebody with a working crystal ball can answer these questions. What we DO know is that the most successful investors are fearful when everyone around them is greedy, and greedy when other investors are fearful. For the past year, investors have been extremely nervous about U.S. deficits and the continuing debt crisis in Europe, yet stock market returns were excellent last year and unusually high in the first three months of this year.

All we can say for certain is that eventually the U.S. economy and the global markets will recover their mojo, and the Great Recession of 2008 will become a distant memory. Historically, the markets have delivered positive returns about 70% of the time, which is much better odds than you are likely to find in a casino.

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*As a friendly reminder, please send in your 2012 tax returns if you have not already done so. You may mail them into the office or email them to [info@demmingfinancial.com](mailto:info@demmingfinancial.com).*

