Demming Financial Services Corp.

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2nd Quarter Newsletter

Spring 2014

Special Notes…

Thank you for your continued patience as we progress through our transition to TD Ameritrade Institutional.

Currently, we are upgrading our technology systems to enable us to better serve our clients more efficiently and effectively.

If you have any questions or concerns about the transferring of residual accounts, please feel free to contact us.

Also, if you are a resident of Cuyahoga County you can now register your Living Wills and Durable Powers of Attorney for Healthcare on their Recorded Documents Office website at http://fiscalofficer.cuyahogacounty.us/en-US/LivingWills.aspx.

Finances and the Aging Brain

Article Courtesy of Jason Zweig of The Wall Street Journal

BRUCE MARTIN IS nobody's fool. The former chairman of the chemistry department at the University of Virginia is the author of more than 200 scientific papers and a textbook on biophysical chemistry. After a lifetime of diligent saving, Martin, 84, is also a wealthy man, with several million dollars in assets.

Even sophisticated investors like Martin can end up victims of financial predators…

Last year, however, a home aide hired by Martin allegedly began forging checks and using his credit card, ultimately filching approximately $50,000, according to the professor's attorney, Michael Gilfix, an elder-law specialist at the Palo Alto, Calif.-based legal advisory firm Gilfix and La Poll Associates. While the case is still under investigation, and most of Martin's money has since been recovered, according to both Gilfix and a police department spokesman, Martin says he still feels burned by the incident. "I gave her access to my private affairs willingly, because I trusted her," he says.

Even sophisticated investors like Martin can end up victims of financial predators, and new findings in psychological and neuroscientific research are helping to explain why. As people age, they become more focused on maximizing positive emotions and social interactions—and more determined to block out negative experiences. This process, which experts call socioemotional selectivity, leads older people—including the affluent—to pay more attention to those who make them feel content and comfortable. At the same time, they are more likely to neglect warning signs that might have been obvious at a younger age. (For his part, Martin says he doesn't think cognitive impairment of any kind played a role in his situation.)

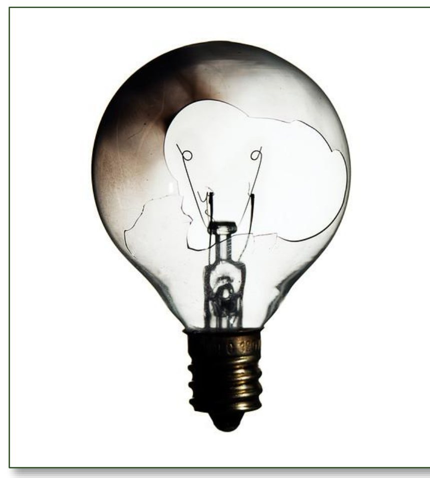
Some recent research has shown that highly intelligent retirees—even those with no signs of dementia—find it harder to distinguish safe investments from risky ones. Compared with younger investors, those over the age of 65 "showed striking and costly inconsistencies" in their financial behavior, according to a study of 135 subjects led by Ifat Levy, a neuroscientist at Yale University who has conducted experiments on this topic.

For example, older investors tend to make simple errors that younger investors avoid—and such problems only worsen with dementia. Those individuals who are elderly—but still mentally fit—maintain a healthy sense of caution when confronted with a complex or risky investment. But someone who has long made sensible financial decisions and is now declining cognitively is likely to remain self-confident "even if he has lost his reasoning capacity," warns Robert Willis, an economist and professor at the University of Michigan who studies financial decision-making among the elderly.

What's more, new research on mental health and aging also shows that people in their 40s and 50s have little insight into the trajectory of their future decline. In other words, just when they are the most capable of planning ahead for a time when their judgment might fail, investors are at an age when they're unlikely to believe that they actually need to plan ahead.

What are the implications for wealthy families? Monitor the financial health of parents as closely as their physical health, says Gilfix, and ask whether there's anyone new in their life and how they go about paying their bills.

For younger investors, experts recommend consulting with a group of trustworthy people, like a spouse, a wealth adviser and an accountant, before making any important changes to a financial plan—and doing so before the ability to judge who is and who isn't honest becomes compromised by old age. By that point, sudden and major changes to a financial plan tend to be associated with big mistakes. "Train yourself not to make a lot of fast decisions," says Laura Carstensen, director of the Stanford Center on Longevity at Stanford University. "Set up a simple plan and stick to it."



Photograph by Christopher Griffith

Source:
http://online.wsj.com/news/article_email/SB10001424052702304185104579435470263886360-lMyQjAxMTA0MDAwODEwNDgyWj

High Returns – for Who?

Article Courtesy of Bob Veres

Insurance companies are supposed to be in the boring business of pricing the risks that, for example, a certain percentage of people will get into an auto accident, and calculating the average cost of fixing the car and paying the hospital bills. They also calculate that a certain percentage of people of a certain age will die each year, or have their houses flooded or burglarized. Then they have everybody pay in an amount which, in aggregate, will pay for the expected losses, plus their administrative costs. Some people won't get into an accident, and their money will pay the repair costs for those who do, and theoretically it all evens out in the end.

How boring is that?

But some insurance companies offer products that are far more exciting and creative--and complicated, and profitable. Consider, for example, equity index annuities, where you give the insurance company your money to invest, and the company guarantees that you will get at least all your money back at the end of a certain period of time even if stock prices fall into a black hole and never re-emerge back into the space-time continuum.

If stock prices go up--according to the promotional literature--you get to participate in that growth. Heads you win, tails you don't lose. What could be more exciting than that?

Despite the raging popularity of these products since the market downturn in 2008, here are a few problems with this wonderful offer. The first is that you pay dearly for the privilege of not losing your money, in a variety of ways. The first cost is the sales commission, which can be as high as 25% of the money you invest, more typically 12% to 15%, and which shows up as a surrender charge if you want to get your money back in the next decade or two.

Your investment money may also be paying for sales reward trips given to the people who are most successful at selling these exciting products and pocketing 12-25% of your money off the top. Curiously, investors are never invited along on these trips where the successful salespeople are high-fiving each other.)

Heads you win, tails you don't lose. What could be more exciting than that?

There may also be high fees and expenses larded onto the investments, but these will pale in comparison to the really big profit driver of equity index annuities: the clever way that the company calculates how you participate in market returns. Typically, you will be told that, in return for the guarantee that you'll get your money back, you have to give up some of the upside. The contract may specify that you'll get 80% of the upward movements of the stock market.

What's wrong with that? First of all, since the market has historically gone up roughly 70% of the time, you are leaving real money on the table--or in the insurance company's pocket. But the clever (or sly, or downright misleading) thing you may not realize is that you also don't receive the dividends that the stocks are paying, since you don't actually own the stocks that you are participating in. Those dividends--approximately 2% a year for the S&P 500 index currently--fall right to the insurance company's bottom line. This is why some people think equity-indexed annuities may be the most profitable investment products ever devised--for the issuer, not for the investor.

A research report by two Ph.Ds in 2006 compared a sample equity-indexed annuity with a simple stock and cash investment, and found that the annuity would turn out less beneficial to its policyholder more than 96% of the time. They noted that they may have erred generously on the side of the annuity, and they may be right. A recent (and very creative) article by Alan Roth on the CBS News website (http://www.cbsnews.com/news/risk-free-stock-investing/) suggested that investors could become their own insurance companies. That is, they could build their own guarantee by dividing a $10,000 investment into roughly equal parts. $5,659 would be invested in a 10-year CD paying 3.3% a year. The remainder would be invested in the S&P 500 index. Total cost: 0.02% a year.

The results are interesting. If the U.S. stock market were to lose half its value over the next ten years--which has never come close to happening in the real world--then you would get all your money back. If the market rose just 4% a year--about half of historical average returns--you would get back 3.61% a year--the equivalent of a 90% participation rate on the upside.

Comparing the do-it-yourself annuity with the insurance industry's exciting alternative makes it clear just how profitable these equity-indexed annuities are for some of the world's most boring companies. Exciting for them; not so much for the poor investor.

Sources:
http://www.forbes.com/2009/06/05/equity-indexed-annuities-personal-finance.html
http://investor.financialcounsel.com/Articles/Investment/ARTINV0000268-Equity-IndexedAnnuities.pdf

Cautious Pessimism

Dear Clients,

The U.S. stock market reported very modest gains in the first quarter of the year, and it was actually uncertain until the final trading day whether the quarterly returns would be slightly positive or negative. In the end, the Wilshire 5000 index--the broadest measure of U.S. stocks and bonds--rose 2.04% in the first three months of the year.

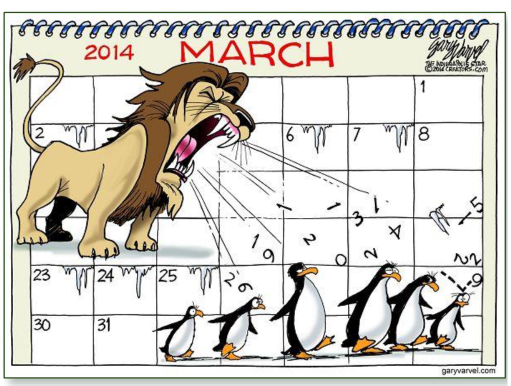
Large cap stocks, represented by the Wilshire U.S. Large Cap index, gained 1.95% in the first quarter. The widely-quoted S&P 500 index of large company stocks gained 1.30% in the first three months of the year.

We regret that we were not astute enough to bet the farm on the quarterly performance of the troubled market in Egypt, which unexpectedly delivered a robust 21.7% return through March 31.

The Wilshire U.S. Mid-Cap index index rose 3.75%, while, small company stocks, as measured by the Wilshire U.S. Small-Cap, gained a remarkable 2.57% for the quarter. The technology-heavy Nasdaq Composite Index lost half a percent over the same time period.

Looking abroad, the broad-based EAFE index of large international companies in developed economies--Europe, the Far East and Australia--was exactly flat for the quarter, with 0% returns. The Eurozone markets reported a 1.89% gain year to date, but the Asian markets did not fare well in the most recent three months. Japan was down 9.8% in the first quarter of the year, and China's markets have lost 7.5% of their value. Meanwhile, the less-developed nations continued their slide, with the EAFE emerging markets index down .80%.

We regret that we were not astute enough to bet the farm on the quarterly performance of the troubled market in Egypt, which unexpectedly delivered a robust 21.7% return through March 31. But we also managed to avoid a high concentration in Russian stocks, which are down 17.8% so far this year, in part due to well-deserved sanctions over the invasion of Crimea, but mostly due to persistently low oil and gas prices.



Bonds are still yielding far less than their historical averages, and the trend has been interesting. Treasury bills with 3-month and 6-month maturities are yielding less than they did at this time last year, with rates of 0.03% and 0.05% respectively. Longer-term Treasuries have seen rates drop modestly to 0.12% (1-year), 2.73% (10-year) and 3.52% (30-year). Corporate bonds have also dropped a bit; you can now buy 10-year AAA rated corporates and get a 3.13% yield, or go out 20 years and get 3.97%. This, of course, confounds the experts who have been predicting for more than five years that rates are going to rise dramatically, decimating bond portfolios.

Commodities, as measured by the S&P GSCI gauge of 24 commodities, gained 2.6% over the quarter. Real estate investment trusts, a proxy of real estate investments as measured by the MSCI US REIT Index, were up 9.13% in the first quarter, despite losing ground in the month of March. The Wilshire REIT Index rose 10.13% for the quarter.

When you look at the returns of 2014's first quarter in the context of the long bull market recovery from the Great Recession, you can't help but seeing a bit of a slowdown. The markets did rise for the quarter, but it was a pretty choppy ride,

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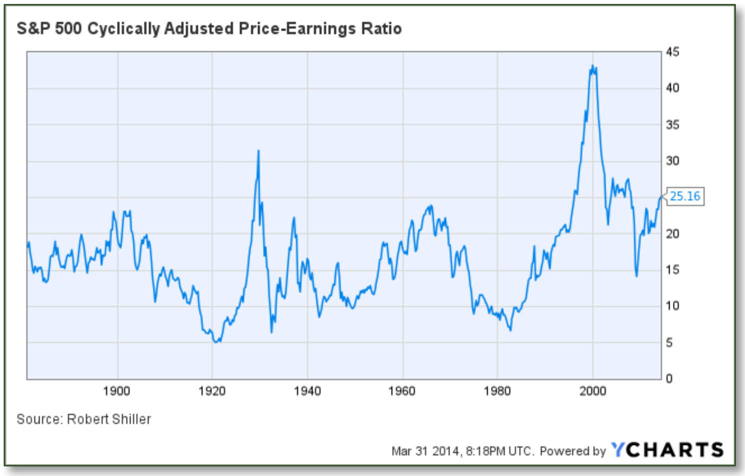
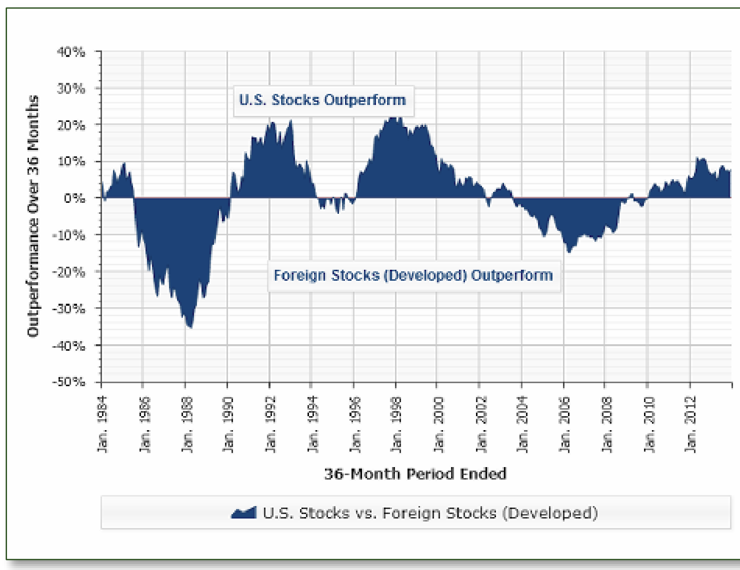
and it's hard to find any reputable commentator who is predicting another 30+% return this year. You are, instead, hearing a lot of speculation about whether the bull market is about to end, and the markets will "correct"--Wall Street vernacular for a 10-20% downturn.

The evidence for a correction is that, compared to some traditional measures, stocks are at least fairly priced and they may be trading at above prices we consider to be historical norms. The chart below showing the 10-year normalized PE ratio shows that the S&P 500 is a little bit above an average figure of 16.53, but it is clearly not at the top of one of those mountains that you see in the 1929 and 2000 market tops. Others worry that certain drivers of U.S. economic growth may be slowing down, even though the most recent economic reports show continuing gains in employment and growth in factory orders. Housing starts and sales have come down modestly from this time last year, and wages are not rising.



On the other side, you are seldom near a market top when many people are speculating that you are. Market tops seem to have the magical ability to silence doubters precisely when they should be most doubtful, and investors are seldom cautious near the peaks. Moreover, the fact that small and midcap equities outgained large caps suggests that the companies that depend on the U.S. economy are strengthening a bit, while the least strong U.S. firms are those which are dependent on profits overseas.

This leads to another type of speculation. Some analysts wonder if foreign stocks will provide higher returns than the U.S. markets over the next cycle. As you can see from the chart on the right, where the mountains above the line are time periods when U.S. stocks outgained their foreign counterparts, there is an ongoing see-saw, where American returns beat the rest of the world, and then the rest of the world returns the favor for sustained periods of time. The U.S. has been winning lately, and is clearly winning so far this year, but how long will that last?



The problem with all of this analysis is that it is really speculation about the unknowable future. When markets get slightly overvalued, history tells us that they can get much more expensive as markets climb rapidly toward frothy tops, and those who trimmed back on their stock exposure are kicking themselves for missing those extra returns. History also tells us that corrections and bear markets never announce themselves in advance. If stocks go on sale in the next quarter or two, it will give us a chance to buy more on the cheap. If they go up, we will report the good news and experience a renewed sense of caution while less seasoned investors grow more enthusiastic.

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As a friendly reminder, please be sure to forward us your 2013 tax returns as they are completed.