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Client Newsletter

Past market performance is not indicative of future results

Occupy the Big Picture

article courtesy of Bob Veres, Inside Information

If you look hard enough, you can find a lot of silliness in the Occupy Wall Street movement. This is unfortunate because, somewhere behind the tents and weird finger communications and alleged drug use, there's a real story to be told. And the story seems to be bigger than the media can get its arms around.

For example? Financial insiders and those in the financial planning profession have watched the brokerage industry fight furiously--and successfully--against having to register their brokers with the Securities and Exchange Commission as registered investment advisors. Why? Because that would require the registered brokers to give advice that puts the interests of their customers ahead of their own and also (*quel horreur!*) ahead of the companies that employ them.

Perhaps more to the point, those in the financial profession have to live with the fact that the major Wall Street firms are rarely held accountable for crimes and other actions that would be severely punished if you or I committed them.

Such as? Consider the recent settlement of an enforcement case that goes back to the 2008 market meltdown. The Wall Street Journal reported that U.S. District Court Judge Jed S. Rakoff is questioning how diligently the U.S. Securities and Exchange Commission enforced securities law when it investigated Citigroup (parent company of brokerage giant Smith Barney) regarding its sale of some of those infamous toxic mortgage-based debt instruments. Smith Barney brokers were selling the subprime mortgage instruments to their customers as highly-rated, safe bond instruments at the same time that the company's traders were betting heavily that the same packaged bonds would spiral down the toilet. In

internal e-mails, one chortling trader described betting against the investments the company was selling, at a commission, to its customers as "The best short ever!!"

This once-in-a-lifetime short bet, combined with selling the dog investments in the first place, resulted in what the SEC estimated to be \$160 million in fees and trading profits to Citigroup's bottom line.

The SEC's proposed fine, questioned by the judge: \$95 million.

It gets worse. In the SEC's boilerplate language when it settles with major Wall Street firms, Citigroup and Smith Barney were allowed to neither admit nor deny the charges that they would be paying fines to settle. Judge Rakoff questioned whether there wasn't "an overriding public interest in determining whether the SEC's charges are true." Indeed.

Our regulators' very careful, very gentle admonishment of Wall Street's nastiest crimes has become such a routine part of our professional landscape that most of us in the financial services business have lost sight of how outrageous it really is. To put this in perspective, suppose you decided to go out and steal a neighbor's flat-screen TV set. If you were caught, would the justice system require you to pay back a portion of the cost of it, never have to admit guilt, and promise to watch yourself more carefully in the future?

Might people in all walks of life behave differently if they knew that the routine consequences of their crimes would be so lenient?

While the financial press is reporting on Wall Street crimes gone unpunished, the consumer press is groping to figure out how the rise of enormous, greedy financial gatekeepers is impacting the American economy as a whole. No doubt you've read accounts

of how the large investment banks took hundreds of billions of dollars in taxpayer bailout money and then refused to lend money back into the American economy as it was teetering on the brink. But Time Magazine recently took a deeper look, in a cover article that concludes that America is no longer the world's leader in upward mobility--the land of opportunity--that it once was.

The magazine rightly calls America the "original meritocracy," where people were never supposed to be prisoners of the circumstances of their birth. Hard work defined the destiny of Americans. Those who were diligent were able to move out of poverty.

But then the magazine cites research by the Pew Charitable Trust's Economic Mobility Project, the Brookings Institute and the Organisation for Economic Co-operation and Development, all of whom found that today it is harder for a person in America to move up out of his/her current economic status than it is in (I hope you're sitting down) Europe. Today, 42% of American men with fathers in the bottom fifth of the earning curve remain there--and you know that at least SOME of them were hard-workers. Only a quarter of comparable men in Denmark and Sweden, and only 30% of men in Great Britain do. France and Germany ranked higher on the opportunity scale than today's America. Sweden and Finland ranked much higher.

How did this happen? The magazine found that the financial sector in America now takes up about 8% of the American economy--a historic high--and this has been correlated with a stall in American entrepreneurship. Meanwhile, the people who run America's companies today earn more than 400 times as much as their lowest-paid worker, while the comparable number in Europe is around 40. Oddly, perhaps coincidentally, Europe's gap between CEO and lowest paid worker is almost exactly where it was in this country when America was still being called the Land of Opportunity.

To round out the Occupy Wall Street picture, some researchers are actually starting to question whether the economy needs the banking sector, and what for. In what may be the most accessible report on this wonkish debate, London School of Economics professor Wouter den Haan notes that when the U.S. economy was emerging as the world's leader, in the decades after World War II, the large investment banks generated about 1.5% of the total profits in the economy. Today, that figure is around 15%--ten times as much.

When the profits were at 1.5%, bankers circulated money efficiently around the business landscape in the form of loans that were carefully researched. That, clearly, provided an enormous net value to society. But the professor wonders whether it

is equally valuable when those firms began to extract "huge fees from the rest of the economy to construct opaque securities that were so complex that only a few understood how risky they were." If the prices had accurately reflected the true value of the products, he says, then those fees would have been negative, "since many such products were not beneficial to the buyer or to society as a whole."

The article doesn't consider the economic value that is created for society when a brokerage firm makes its profits betting against the toxic securities it created and sold to its customers.

Very little of these various issues are understood specifically by the people who are squabbling with police over whether they can pitch their tents in parks near the largest financial offices. The Occupy Wall Street crowd is acting on nothing more than a strong instinct that something is terribly wrong in America, and that the large banks are somehow at the center of the problem. The press can only seem to get its arms around little individual pieces of a very big picture.

But that picture, if we can see it clearly, is troubling. The American Dream is at stake. So, too, is the fairness of our legal system. What Wall Street fears more than anything else is a debate that asks whether much of what goes on in the largest investment banks--perhaps as much as 90% of it, based on current statistics--is doing our country and our economy more harm than good. Even more, it fears the idea that its hired representatives should have to give advice that primarily benefits their customers--which would immediately put an end to both the lucrative sales of creative new toxic securities and the revenue streams that would come from betting against them.

If we can start that debate in earnest, maybe the tents can come down. Or, at least, the people living in them could tell the reporters who cover them exactly what it is they're protesting.

Rakoff and the SEC:

<http://blogs.wsj.com/law/2011/10/28/sec-may-have-to-get-admissions/>

[http://www.cbsnews.com/8301-501369_162-20126566/ny-judge-challenges-\\$285m-citigroup-settlement/?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+CBSNewsTravelGuru+%28Travel+Guru%3A+CBSNews.com%29](http://www.cbsnews.com/8301-501369_162-20126566/ny-judge-challenges-$285m-citigroup-settlement/?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+CBSNewsTravelGuru+%28Travel+Guru%3A+CBSNews.com%29)

Time magazine article:

<http://www.time.com/time/magazine/article/0,9171,2098586,00.html>

Wouter den Haan blog: <http://pragcap.com/why-do-we-need-a-financial-sector>

TIMING OUT OF GAINS

article courtesy of Bob Veres, Inside Information

Let's say you're looking at a stock market that has lost 81% over the past 2.7 years during a time of severe economic contraction. The headlines are not encouraging: the country is mired in depression, and so, too, is the rest of the world. Are you feeling bullish, or is this a great time to unload your stocks and stop the bleeding?

If you decided to unload, then you would have missed at least some of the dramatic market increases that started in 1937-47 years of annualized 32.1% gains, for a total gain of 266%.

Okay, suppose the market has dropped a total of 63% over a torturous 13.6 year period, and Business Week magazine has just proclaimed "The Death of Equities." Buy? Sell?

Again, the correct answer would have been "buy." After 1982, the S&P 500 gained a remarkable 666% over the next 18 years.

The accompanying chart, created by Doug Short for the Advisor Perspective services,

shows a number of market ups (blue) and downs (red) since 1871, and the thing you notice is that virtually every major market move, up or down, was unexpected. The bull markets came as a surprise, and the bear markets came at times when the markets seemed to be on a long-term roll. (The scale here is logarithmic, which means that if the chart were expressed in absolute terms, the long-term rise would look much steeper.)

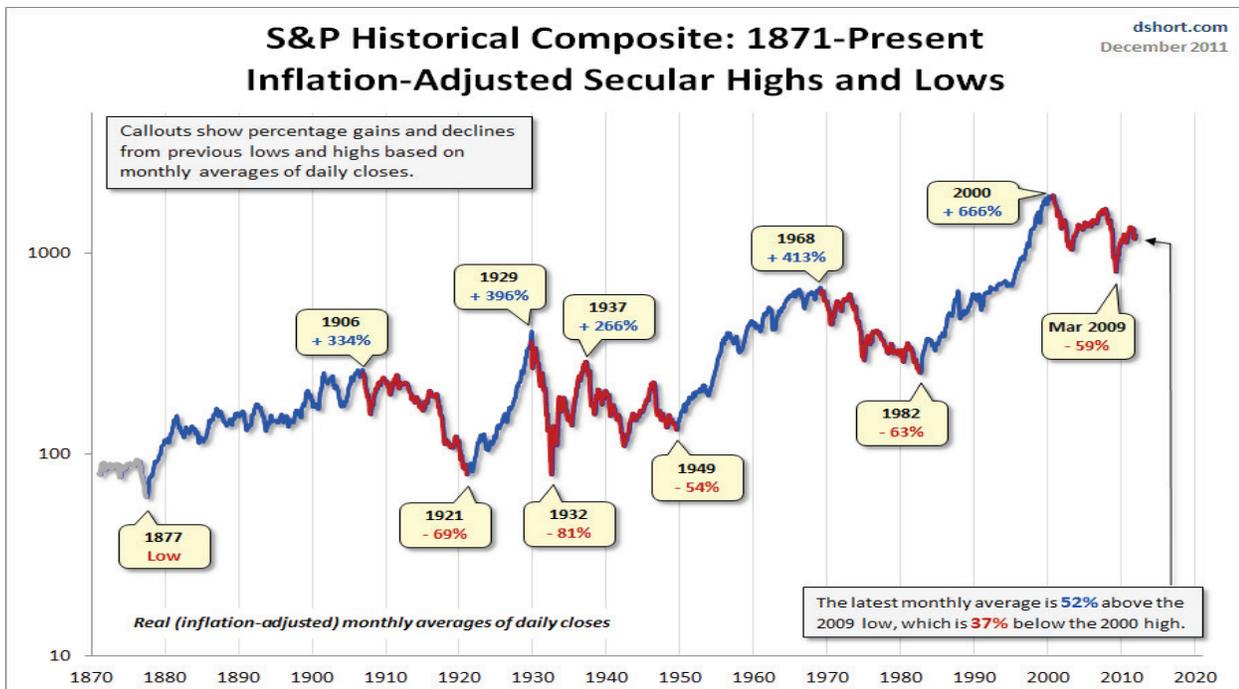
In truth, the decision that faced most investors in 1921 (market down 69% over the previous 15 years) or 1949 (market down 54% over the previous 12 years) was not whether to make some kind of dramatic move into stocks. The decision, made daily as the newspaper carried discouraging news over and over again, was whether to stay invested in stocks and eventually reap the gains (396% and 413% respectively) that nobody could have predicted in advance.

The most important long-term statistic to come out of this analysis may be the

dramatically different size of the gains and losses. Taken together, the various bulls since the market trough in 1877 brought investors gains of 2,075%--an average of a 415% gain per bull market. The bear markets, in aggregate, cost investors 329%--an average downturn of 65%.

Nobody knows when the markets are going to suddenly take off after a bearish period, and the longer and deeper and more discouraging the downturn gets, the less likely the next bull market seems. But history suggests that patient investors get more return during market upturns than they lose when the markets drop. Long-term, trying to outsmart the market and sidestep losses would have led to missing even bigger gains.

Source:
<http://www.advisorperspectives.com/dshort/updates/Secular-Bull-and-Bear-Markets.php>



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Dear Clients:

This year has been a series of contrasts. Although major capital markets have not done well, the U.S. economy is slowly recovering and it appears no double-dip recession is imminent. As we review 2011, we've seen increasing momentum in parts of the U.S. economy, e.g., consumer spending and manufacturing growth is up, unemployment rate is down, etc. Ironically, domestic corporate earnings have been among the most robust we've seen in many decades (Q1= 20% growth, Q2= 19%, Q3= 14% growth). Ten-year treasuries are paying below 2%, yet the S&P dividend payout is about 2½ %. Is that an indication that interest rates are incredibly low? It's likely. Is that because valuations of correspondent large cap U.S. companies are quite low and profitability and dividend yields are quite attractive? We think so. The last time we saw an inversion in this relationship was 1962.

It appears that 2011 is going to limp to a conclusion. The first-half momentum has been derailed by political incompetence and the government's inability to get anything done. Coupled with European problems, capital markets have suffered declines (Vanguard Total World Stock Index was -11.51%, S&P 500 was -2.2% as of 12/19). Quixotically, U.S. T-Note prices went up as interest rates went down even further. This was an irrational response if you believed the U.S. Treasury contemplated defaulting on its debts. Global investors believed the U.S., even with all its warts, was the safest place in the world to park their money.

We go into 2012, an election year, with few expectations of anything constructive being done politically, but out of this comes a few good things --

- ♦ Interest rates are being sustained at lower-than-normal levels, making it easier for people to refinance or fund businesses, among other things.

- ♦ We think that corporate institutions, at least in the U.S. and other parts of the developed world, have gotten leaner and meaner and, as a consequence, are much more profitable. This was a windfall year for both corporate profits and executive compensation, and for those employed, a return to some degree of normalcy in terms of pay, incentives, and upside potential.

When will this translate into the capital markets? We don't know. Effectively, the theme we have been espousing for the better part of three years or so is that if you are patient, there are significant opportunities available, both domestically and abroad.

Looking back over similar periods of distress (the economic recession of 1980-81, the market panic of 1987, the first Iraq war, the tech bubble, the 2009 recession), attractive valuations provided the opportunity for high rewards if one had patience as an investor.

As the year ends, we are thankful for the relationships and the genuinely good people we serve at DFSC. For everyone's sake, we look forward to an uplifting and prosperous 2012.

Happy Holidays and best wishes for the New Year!

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