



Demming
Financial Services Corp.

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1st Quarter Newsletter

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Special Notes...

Thank you for your patience through our transition to TD Ameritrade Institutional. Residual accounts remaining at other institutions should be transferred within the next six months.

Also, if you have not yet received your credentials for online access to your TD accounts, and you wish to do so, please send an email to info@demmingfinancial.com.

IMPORTANT!

Due to the transition, please be sure to keep all tax reporting forms you receive from various institutions!

As a friendly reminder, please be sure to forward your 2013 tax returns to us by mail, fax or email.

How to Beat the Market

Article Courtesy of Bob Veres

Chances are, you've read articles saying that it is impossible to beat the market--that is, to consistently earn higher returns than the stock market averages. At a recent conference for industry professionals in Dallas, the distinguished economist Dr. Horace Brock offered a deep dive into economic theory, and told the audience that there are actually multiple ways to beat the market.

Your secret sauce is thinking and reading--or investing with very thoughtful money managers who take a long-term view of gaining returns.

The first and most obvious way is cheating. If you have inside knowledge about a stock that nobody else possess, then you can make more astute trades than everyone else. The Securities and Exchange Commission has managed to catch a number of these criminals. You may have heard of Ivan Boesky, or Martha Stewart's famous phone call to her friend the founder of ImClone. Quest Communications chief Joseph Nacchio dumped more than \$50 million of company stock in 2005 before his company went into decline. More recently, police are pursuing a massive insider trading case against a French doctor and FrontPoint Partners, who are accused of netting \$30 million while trading on nonpublic knowledge.

Until they were caught, these "investors" (and Galleon Group hedge fund manager Raj Rajaratnam, Charles and Sam Wyly and certain Bear Stearns hedge funds) were making a lot more money in the markets than you and I ever will.

If you're not especially good at cheating, then you can rely on the second way to beat the market: luck.

Don't laugh; there's evidence that most of the mutual funds that outperform the overall market in any given year just happen to be lucky.

Their luck tends to lead to bad luck for investors, however. Investors have a tendency to assume that the fund managers who had great performance this year are brilliantly astute, move their money out of less-lucky funds, and then lose money when the managers' luck runs out and their funds underperform by roughly what they were outperforming before. Net-net, these managers had exactly as much bad luck as good luck, but many more investors were exposed to the bad luck period than the good luck period. Ouch!



“When you come to a fork in the road, take it.” - Yogi Berra

You can also win the lottery, and some people are lucky enough to do so. Their "investment" return on that lottery ticket is astronomical; nobody can deny that. Brock offered three other ways to beat the market, all of which rest on sounder footing. By way of background, he cited very complicated research by Mordecai Kurtz at Stanford which showed that almost 95% of the short-term market movements can be explained by two things: news and expectations. The news is pretty simple; suppose Intel beats the consensus estimate of its earnings next quarter by two cents a share. This can either send the stock price soaring or tumbling, depending on whether most investors expected the stock to miss its earnings estimate (therefore, the news is better-than-expected and the stock rises), or to beat its earnings estimate by more than two cents (bad news, the stock plunges). Bigger picture, the news might be that Greece has tumbled into default, causing a short-term plunge in stocks around the world.

But longer-term price movements depend on how the world changes more gradually, based on trends that are not obvious and seldom in the news. To take some of the more obvious examples: China abandons communism and gradually becomes the second-largest economy in the world. The Internet is born, and creates entirely new market dynamics. Europe adopts a new common currency, which sets in motion a lot of other changes for good or ill.

So how do you beat the market? If you are slightly more astute about understanding the business implications of these trends than the average person, Brock told his audience, then it is possible, over the long-term, to position your assets more advantageously. Your secret sauce is thinking and reading—or investing with very thoughtful money managers who take a long-term view of gaining returns.

You can also beat the market by not following the herd. Brock said that new mathematical models of market bubbles and busts allow for what he called "the uneven distribution of mistakes," a world where most investors can be wrong about their expectations or evaluations, all in the same direction. Remember how people were flipping houses in 2007 and Wall Street firms were betting the world that housing prices would never go down? Remember the technology mania leading up to the 2000 Tech Wreck?

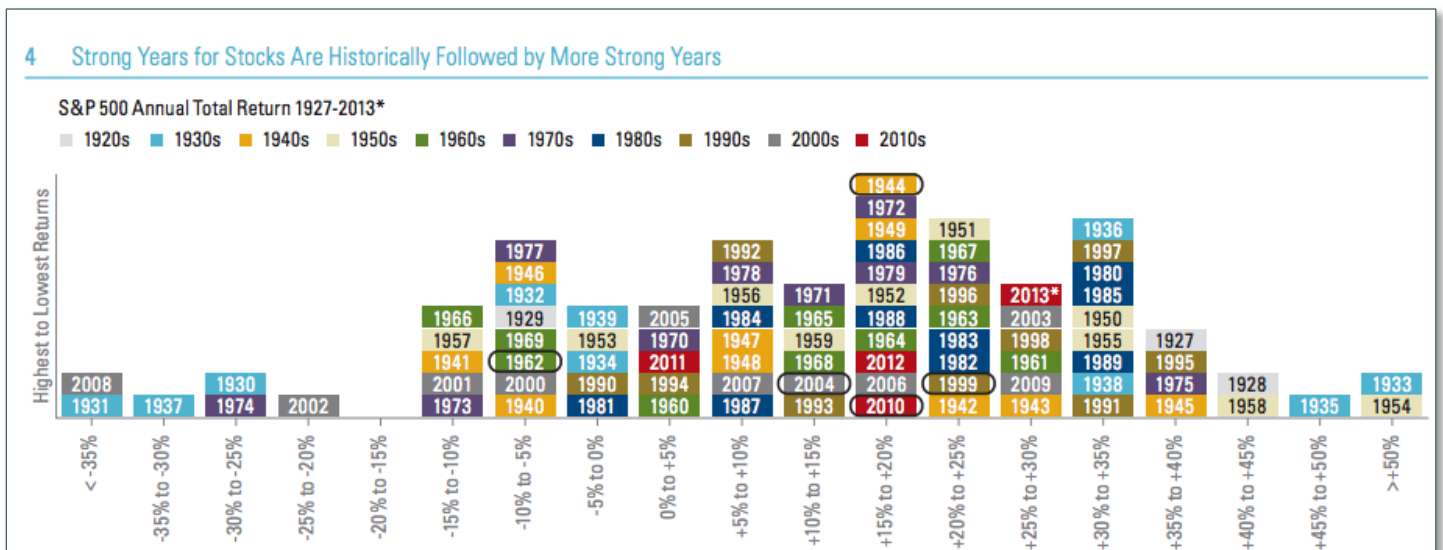
You can beat the market by holding a diversified portfolio (which will keep pace with the market) and systematically rebalance your investments regardless of what fearful or euphoric cries other investors are screaming outside your window. That way, when the distribution of mistakes is nearly 100% on the side of euphoria, you will be holding fewer stocks than the

average investor and participating less in the inevitable bust. And when the distribution of mistakes is on the side of fear and nobody wants to own stocks, you're participating in the market and benefiting from the inevitable recovery.

These last two methods of beating the market are not nearly as exciting as cheating or winning the lottery. So if you want excitement, you can turn to the last way that Brock said markets can be beaten. Every Wall Street firm has active traders who stare at six or eight computer screens all day long, with their finger hovered over a buy or sell button. They house their trading servers in the same building as the mainframe servers that process orders for the New York Stock Exchange and Nasdaq, so their buy and sell commands will arrive milliseconds ahead of the competition. They study expectations, and then, as soon as news arrives, that instant, they make a trade that will be thousandths of a second ahead of other quick-twitch traders--and, probably, a few days ahead of the trade that you and I would eventually be tempted to make.

This quick-twitch trading arrangement doesn't always work out exactly as planned, however, which greatly adds to the excitement. Bruno Iksil, otherwise dubbed "The London Whale," managed to trade away more than \$6.2 billion (with a "b") of the assets of JPMorgan in 2012, while Brian Hunter's quick reflexes on the keyboard ultimately cost hedge fund investors in Amaranth Advisors a total of \$6.4 billion in 2006. Baring Brothers Bank collapsed in 1995 thanks to the fast and furious futures and options trading activities of Nick Leeson. Yasuo Hamanaka at Sumitomo Bank (\$2.6 billion in losses), Jerome Kerviel at Societe Generale Bank (\$6 billion), Toshihide Iguchi at Daiwa Bank (\$1.1 billion) and Kweku Adoboli at UBS (\$2 billion) all generated their share of excitement for the institutions that employed them.

The good news here is that it appears, based on sound theoretical evidence, that people CAN beat the market in a variety of ways. Some of them are legal, but only a few are safe. The safest methods also happen to be pretty boring--and, alas, they don't come with guarantees.



There is an old saying, "the trend is your friend." 2014 could very well continue average returns. Only time will tell!

A Year to Remember

Dear Clients,

The U.S. stock market punctuated an extraordinary year with gains on the last trading day, moving many of the American indexes to record highs on the final trading day for only the sixth time in history. Despite all the uncertainties that we faced (the government shutdown, Boston bombings, the ongoing Syrian uprisings, debt ceiling debates, NSA revelations, the lingering economic aftershocks of superstorm Sandy, nuclear standoff with Iran) people will look back at 2013 as one of the most profitable years for investors on record.

The Wilshire 5000 index--the broadest measure of U.S. stocks --rose 33.07% in calendar 2013, with 10.11% of the gains coming in the final three months of the year.

Large cap stocks, represented by the Wilshire U.S. Large Cap index, gained 32.33% this past year, with 10.22% gains in the fourth quarter. The widely-quoted S&P 500 index of large company stocks gained 29.60% in 2013, with 9.92% returns in the year's final quarter.

The Wilshire U.S. Mid-Cap index index rose 36.78% in 2013, buoyed by an 8.69% rise in the final quarter.

Small company stocks, as measured by the Wilshire U.S. Small-Cap, gained a remarkable 39.01% for the year; 9.10% of the returns came in the final quarter. The technology-heavy Nasdaq Composite Index gained 38.32% for the year, after posting 10.74% gains in the last quarter of the year.

By any measure, these returns were remarkable. The S&P gains were the highest since 1997, and the 3rd highest since 1970. The small cap returns are the 3rd highest since 1980, and the Nasdaq returns were the seventh-highest ever. What makes the year even more remarkable was that nobody was predicting a rampaging bull in 2013, and many economists and pundits didn't think returns like these would be possible.

If anything, the five-year gains since the market downturn have been even more extraordinary. The Wilshire 5000 has posted an average 18.58% gains over the last 60 months, and the midcap (23.08%) and small cap (23.86%) indices have fared even better. Investors who got out of stocks during the market crisis of 2008 and worried ever since have missed out on one of the best 5-year bull market runs in American history.

Is this a bull market? Commentators, investment strategists and economists don't agree on whether we are experiencing a temporary rise in the midst of a long-term bear market, like we experienced during the Great Depression, or the strong early stirrings of a long-term bull like the one which started in 1982. The truth is, nobody knows, just as nobody knew that the U.S. stock markets would reel off such strong returns after the near-collapse of the global economic system.

Long-term investors can be compared to farmers, who plant seeds with no foreknowledge of the weather during their growing season, and no belief that what happened this year has any impact on what will happen in the next one. There will be bad years, and good years, but over time, the good years have tended to outnumber bad ones, which is why it makes economic sense to continue planting the seeds each Spring--or staying invested in the stock market when each coming year is a mystery.

Around the world, the harvest was mostly excellent in 2013, even though returns lagged the booming U.S. market. The broad-based EAFE index of developed economies rose 19.43% in dollar terms in 2013, aided by a strong 5.36% return in the final quarter. European stocks were up 21.68%, giving them a strong year despite the constant threats of sovereign debt default and internal trade imbalances.

Emerging market stocks were a very different story. In 2013, the EAFE Emerging Markets index of stocks in Latin America, the Middle East, Eastern Europe, Africa, India and Russia was down 4.98% for the year, despite a 1.54% rise in the year's final quarter.

Long-term investors can be compared to farmers, who plant seeds...

Other investment categories also lagged their long-term averages. Real estate, as measured by the Wilshire REIT index, gained just 1.86% for the year, after a modest 0.83% drop in the last three months of 2013. Commodities, as measured by the S&P GSCI index, experienced a price collapse, losing 26.73% in 2013. Gold investors, meanwhile, experienced the precious metal's worst annual loss in 32 years, dropping 28% in value over the past 12 months.

Bond yields remain low by historical standards, but a slow rise in rates caused bond holders to experience paper losses. Investors in the Barclay's Global Aggregate bond index lost 2.60% in 2013, and 2.02% in the U.S. Aggregate index. Investment grade corporate bonds are currently yielding an aggregate 3.87%. In the Treasury markets, 10-year bonds now yield 3.03%; 5-year bonds are yielding 1.74%.

What's next? Who knows? Long-term, stocks tend to reflect the overall growth of the economy. One possible reason why so many investors remain nervous about stocks is the persistent--and erroneous--belief that the U.S. economy is still mired in a recession. You hear words like "sluggish" in the press, but in fact, the total output of the American economy has grown steadily since the 2008 meltdown, and the pace of growth seems to be accelerating. The Bureau of Economic Analysis statistics show an annualized increase of 4.1% in the third quarter of last year (the most recent period for which we have statistics), following a 2.5% rise in the second quarter.

Other economic signs are also encouraging. Total corporate profits rose \$39.2 billion in the third quarter, following an increase of \$66.8 billion in the second. Individuals and corporations are carrying less debt than in the past; total public and private debt in the first quarter of 2010 was up above 3.5 times U.S. GDP; today it stands at 1.07 times GDP. U.S. home prices recently posted their largest one-month rise in more than seven years, and some markets have seen housing values reach their pre-recession levels.

Even so, many investors will continue to wait on the sidelines, looking for "proof" that the market recovery is finally for real, while others will keep their money from working on their behalf in expectation of a crash. The former will finally get back in when prices have peaked, and will, in fact, be our most reliable indicator that the market has become overvalued. The latter will miss the next downturn, but also lose out on the positive returns that have, historically, outweighed the losses suffered in bear markets. The past five years have given us a useful lesson: that you plant your seeds in the expectation that there will be bad crops from time to time, but these unexpected booming years will more than make up for the losses.



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Introducing the Newest Member
of Our Family...

Soren
Williams
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Born December 22nd, 2013



All of us at Demming Financial Services Corp. would like to wish you, and
your family, a happy, healthy & prosperous 2014!