The Yield Curve Inverted: Time to Panic?

If you have been reading the financial papers or watching *CNBC*, you have seen the news that the U.S. yield curve has inverted. Typically, this is a sign of a coming recession, and that could be the case today. If, though, you have been following my advice, there is no reason to panic. Have patience and rely on the diversified, counterbalanced portfolio you have built for generating dividends and compound interest. In August of 2013 I explained the power of counterbalancing in your portfolio:

> *Managing a common stock portfolio takes— above all else—patience. Your goal should never be what to sell next; rather, it should be what stocks you can hold through thick and thin. It is true that portfolio activity, for most investors, runs inversely to consistent long-term performance. How should you measure performance and how should you construct an all-weather portfolio? First, "all-weather" means you do not want to be jumping in and out of the market attempting to predict bull and bear markets. For five decades, I have been investing my own money as well as advising conservative investors saving for retirement. As such, I have invested through many gut-wrenching bear markets and disastrous single years like 2008, which ended with the speculative non-dividend-paying NASDAQ down a frightening 40% for the year. Through all the years of turbulence, I have remained fully invested in a balanced, widely diversified securities portfolio featuring a counterbalanced approach.*
>
> *I have firsthand experience of what happens when counterbalancing is not in force. The Harleys I rode back in the old days had engines bolted straight to the frame. Talk about vibration and calamity. The constant vibration caused nuts and bolts to loosen and fall off. When you're on a long-*

distance road trip, a breakdown in the middle of nowhere is cause for concern. I have found myself in just such a situation and it's no fun. Today's Harleys feature counterbalanced engines offering both a smooth ride and a minimum of road trip calamities.

A 2008 Test Kitchen

Counterbalancing simply makes common sense. Let's look at 2008 as a test kitchen. All the broad averages got hit. High ground, so to say, was achieved by owning positions that got hit least. Consumer staples worked well; no matter how bad the times, investors are not going to forsake toilet paper, toothpaste, or their prescription drugs from Walgreens or CVS.

Counterbalancing is a necessity for your portfolio. If you need assistance in creating a portfolio that is counterbalanced to protect your investments in good times and bad, please fill out the form below. You'll receive a call from a seasoned investment professional at Richard C. Young & Co., Ltd., my family run investment counsel firm, dedicated to helping retired and soon to be retired investors like you enjoy a successful retirement.

Don't Get Kicked Out of the Game

One of the biggest mistakes an investor can make is to imagine that the market will perform the same way year after year. Last year's winners are often this year's losers. I warned investors against this mistake in July 1992, writing:

> *How many investors—not you I hope—buy mutual funds keyed to recent performance ratings? These are usually the funds not to buy. Have you ever heard of Frank Russell Co.? These folk do a really good job of researching vital investment info. In a recent Pension & Investments article, the following item was of vital importance to you. A new study by the Frank Russell Co. has confirmed a long-held tenet of the investment industry: It's useless to select a money manager based on past performance. In fact, the study found, there is no satisfactorily significant relationship between past and future performance.*
>
> *Not only will you not find value in looking at past performance as a predictor of future results, you will not be able to deal with the high turnover, high taxes, anti-compounding issue. And just how important is compounding? Fortune magazine in its special investment strategy article "A Low-Risk Path to Profits" noted the views of Joe Rosenberg of Lowes Corp. "Joseph Rosenberg, who manages more than $1 billion for Lowes Corp., believes so fervently in the awesome power of compounding that he carries a compound interest table in his pocket at all times. His faith is simple and absolute." Says Joe, "It is the most important thing in investing. It's foolish to undermine the power of compounding by taking big risks that could kick you out of the game." Joe is dead on the money here.*

Joe was right. You don't want to get kicked out of the game by making a bad decision. Don't buy last year's winners hoping for a repeat. Work to mitigate risk in your portfolio and allow the awesome power of compounding to do the rest.

Here’s What You Need to Know about Dividends

In November 1999 tech stocks with no dividends seemed like a sure bet. Despite the hype, I was still doing my best to encourage my readers to stick the principles of dividends and compounding. Here’s what I wrote then:

> ### *Historically, Dividends Provide Much of Total Return*
>
> *What about the base for the economy and the stock market in general? As I’ve written often, the two are inexorably linked. After all, could stocks on average outrun the performance of all the companies that jointly contribute to our country’s gross domestic product? No. and, here’s why.*
>
> *Over seven decades, from 1926 to 1997, U.S. nominal gross domestic product (non-inflation adjusted) grew at a compounded 6.4% per year. Over the same period, the return on stocks due to price appreciation (dividends not considered) was a compounded 6% per year. The fit is almost exact. I know you’re thinking that the stock market must have done better than that, but it did not.*
>
> *Investors, however, did better due to the average annual compounded 4.6% return paid to shareholder from dividends. The total return from (1) price appreciation and (2) dividends was an average compounded 10.6%, but remember, over 43% of total return came from dividends. Sadly, today’s investors have almost completely forgotten about dividends. Perhaps with the average yield on stocks about 1.5%, instead of the historical 4.6%, there is some reason not to spend much time on dividends. Nonetheless, most investors are unlikely to see stock price appreciation that outruns nominal GDP growth over*

time.

You can read more about the benefits of dividends in your portfolio in, Dividend Investing: A Primer, a white paper on the subject produced by my family run investment counsel firm, Richard C. Young & Co., Ltd.

The 5 Rules of the Financial Armadillo

In the heart of a bull market in March 1997, I was urging investors to ignore the "TV media financial gibberish, most of which is sensationalized to keep you twitching to the max." I wanted to show readers how to insulate themselves from a bear market. To do so, I gave them my Financial Armadillo Strategy, an armor-plated long-term plan I use myself to this day. I wrote:

1. Take a pledge of allegiance each day to your most trusted investor ally, compound interest. Learning how to better harness the awesome power of compound interest assures you of long-term success. It is interest on interest that allows you to invest like the world's most successful capitalist, Warren Buffett.
2. Commit to memory the first two rules of investing. Rule #1: Do no lose your capital. Rule #2: Do not forget Rule #1.
3. Ruthlessly slash, hack and chop your investor costs. None of us knows the future for certain. Yet while you may not know the future, you sure as heck can know your costs today. Most mutual funds and annuities are high-cost

breeders. Get rid of these leeches. You win every day by keeping your costs low.

4. Armor-plate yourself against the taxman. Your best strategy is to hold trading to an absolute minimum. The mutual fund arena is fraught with trading excess. The average turnover rate is 80%, or more than 10 times what I target in my own account and advise for you. In every mutual fund's annual and semiannual reports is a statistical display of portfolio turnover. Aim for 40% or less for your CORE funds. Don't forget, each time a mutual fund manager sells a stock at a profit, you get a tax bill. These guys invest with no regard for your tax bill or your devotion to compound interest. You simply cannot pay enough attention to mutual fund portfolio turnover.
5. Diversify, diversify, diversify. Proper diversification will help you sleep well during bear stock markets. We have not seen a bear market in years, and we are all, quite honestly, spoiled. Today is a dangerous time in the annals of the stock market and the least safe time in the last 16 years to be inadequately diversified. Sooner or later the music will stop, and you do not want to be the one left without a chair. You want to properly diversify yourself before it's too late. You will never regret your diligence.

Times are never too good to ignore these basic tenets of investment philosophy. When you take off your investment armor, that's when you become vulnerable to the swings of the market. If you aren't already following this plan, start today.

You’re in Charge: Act—Don’t React

Thirty years ago this month, I was working hard to explain to investors like you the simple power of having a plan. An investment plan is the reliable engine that keeps your investment train on its track. I told readers they shouldn’t make investments without consulting their plan, writing:

> *Am I clear on this? Sit back, take a deep breath and repeat after me, “I will have a plan; I will not be a reactionary investor; I will practice diversification.”*
>
> *Still with me? You see, I want you to lower your financial blood pressure. If an idea is sound today, it must be sound tomorrow. I learned decades ago never to make an investment move on the day I think it is time to move. I always sleep on an idea; rarely am I sorry I’ve waited. Do not be an emotional investor, do not be sold investments by salespeople, and do not make investments that do not fit into your predesigned master plan.*

Later I explained how a vital part of my investment plan, diversification, reduces risk, and how important that is to your investment future.

> *When you own only one stock, your stock portfolio comes with about 72% more risk than the minimum risk, or systematic risk, in owning a portfolio of hundreds of stocks. By simply adding one stock and building a two-stock portfolio, you cut your associated risk to about 36%. By the time you add eight more stocks and reach the 10-position portfolio level, you will have assembled a portfolio that has only about 7% more risk than owning hundreds of stocks. [Editor’s note: For various technical reasons that number is higher today.]*

If you are reacting in the investment markets, you're already too late. You must create a plan ahead of time to deal with market volatility. If you need help building an investment plan, sign up in the form below to be contacted by a seasoned member of the investment team at Richard C. Young & Co., Ltd. They will discuss your financial goals and provide feedback under no obligation.

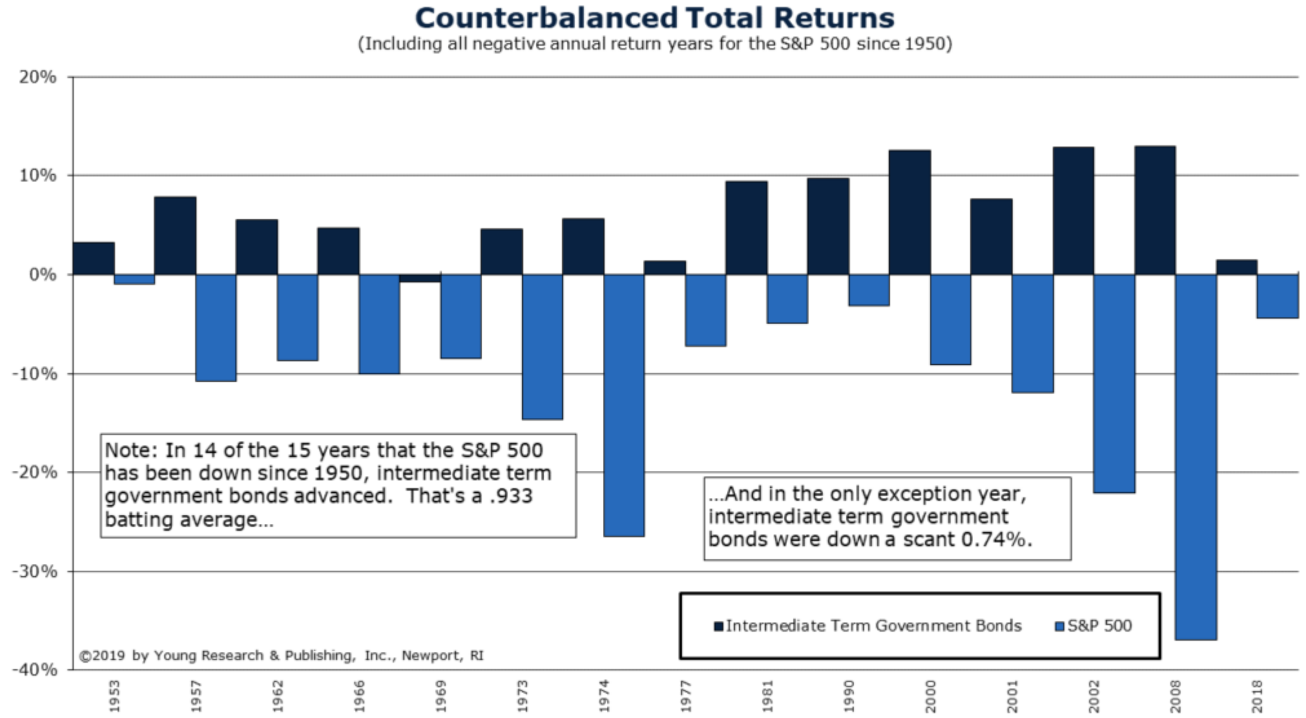
Act—don't react.

Here's How to Build Yourself a Barricade Against Volatility

Back in October of 2006, as the crest of the Housing Bubble was forming, I remained doggedly attached to my principled investment strategy of diversification and compound interest. That month I encouraged readers to build a "volatility barricade." Here's what I wrote (with updated numbers to reflect the intervening years):

> ***Your Volatility Barricade***
>
> *Your portfolio's fixed-income position does two things for you. (1) It either throws off cash for you to spend at Ace or True Value (not Wal-Mart or Home Depot) in retirement or, instead, allows your interest to compound in an IRA. (2) Your fixed income holdings (short and medium term) will most often zig when stocks zag. You benefit with a counterbalancing teeter-totter. Please [refer to the chart below]. Here you will see that since 1950, in 14 of the 15 years that the S&P 500 has been down, intermediate-term government bonds*

advanced. That's a .933 batting average. And in the only exception year, intermediate-term government bonds were down a scant 0.74%. Nice counterbalancing, wouldn't you say?



If you had built yourself a volatility barricade in 2006, it is likely you managed the bursting of the housing bubble with fewer gut-wrenching swings in your portfolio's value. I encourage every reader to incorporate fixed income into his portfolio, today.

High Barriers to Entry Make for Safer Investments

I have written many times through the years about the benefits of businesses with high barriers to entry. Those barriers often include protection by government regulations, including rights of way, monopoly power, and intellectual property. In November of 1996 I explained the value of intellectual property and how difficult it is to generate. I wrote:

> *Have Mercy!…*
>
> *Back in the spring of 1964, XERF was the most powerful commercial radio station on earth. With a thunderous quarter-million watts of energy pumping from its massive transistor deep in the Mexican Coahuila Desert south of the Texas border of Del Rio, the XERF signal could bounce off the ionosphere on a clear cold night all the way from the Rio Grande to Cleveland, Ohio.*
>
> *A nighttime spin on an AM radio dial to XERF 1570 brought in the tortured wail of Wolfman Jack. With his patented intro of "Aaaoooooooooo…all right, baby, have mercy," the Wolfman influenced thousands of rhythm-and-blues fans of the sixties, including the creator of Star Wars and American Graffiti—George Lucas.*
>
> ***George Lucas Preceded Star Wars Fame With American Graffiti***
>
> *Needing a link between the teenagers and music for his groundbreaking movie, American Graffiti, Lucas cast the Wolfman playing himself as that central link. Lucas' genius of tying together great rock 'n' roll music from the fifties and sixties with then-unknown actors (Richard Dreyfuss, Ron Howard, Cindy Williams, Harrison Ford) and their trusted nighttime ally, disc jockey Wolfman Jack, made American Graffiti one of the biggest selling pictures of all time. It stands today as a true American icon.*
>
> *Intellectual property, like that created by George Lucas and certainly Bob Smith for his long-running "Wolfman Jack" syndicated radio shows, is the stuff that can make for great investing. Intellectual property is not created on an assembly*

> *line. Rather, it is crafted one story or image at a time by unique individuals. A company that epitomizes America's ability to create intellectual property in a seemingly never-ending flow is Disney (NYSE: DIS).*

Working in an industry with high barriers to entry allows companies to limit gains of competitors attempting to take market share with identical or only slightly improved products. Many of investors' favorite companies today are working in industries with very low barriers to entry. If you are investing in companies operating in low-barrier-to-entry industries be sure to account for the additional risk.