

## SHOULD WE RETHINK CONVENTIONAL WISDOM?

*“When you’re young you can afford to take a lot of risk because you have time to recover. But when you are older you don’t have as much time to recover so you should take less risk.”* I am sure everyone is familiar with this line of reasoning, and most likely has put it into practice sometime during their lives. But is it correct? Does it make sense? Does it work? After lots of research, thinking, and reflecting I believe this line of reasoning is flawed, so allow me to explain.

Many investors make investment decisions based on *time*, or how long they intend to have their money invested until it is used at a future date. Let’s use retirement for illustration. If someone intends on retiring at 65 and is currently 30 years old, they might make investment decisions with the expectation of a 35 year horizon. Based on this logic they believe they can afford to take risk because “time is on their side.” Compare this to someone who is 60 years old and plans on retiring in 5 years. They don’t believe they can afford to take risk because they have a short amount of *time* until they retire. The problem with this logic is investors are focusing on *time* instead of *value*.

When an investor focuses on value, it is more likely they will make better and more rewarding investment decisions. If they buy something when the price is low, they will most likely make a profit in the future when they sell it higher. On the contrary, if they buy something when its price is high (think real estate over the past few years or internet stocks back in 2000) they will most likely suffer a loss in the future when they sell it lower. So when it comes to the stock market, how does an investor determine value? How about dividend yields? Unlike company earnings, dividends can’t be manipulated. Either a company has the cash to pay and increase their

dividends over time or they don’t. Many prominent analysts are currently promoting how “cheap” the stock market is today based on earnings. But what earnings? Future **projected** earnings! As for me, I don’t buy it. I value dividend yields which are tried and true, rather than projected earnings that are little more than an educated guess.

So looking at current dividend yields, what does it tell us about value in today’s stock market? As an investor you should be familiar with the concept that over long periods of time the annualized return from the stock market is about 10%. But that return is comprised of two items – dividends and capital gains. In the past, the dividend yield on the stock market was typically in the neighborhood of 4%+. So to earn an annual 10% return in the stock market would require your stocks to appreciate by 6% or less. Now the more return you earn in the form of dividends the less return is **required** from stock appreciation. Herein lies the rub. The more return required from capital appreciation the greater the risk in your investment. So how does this concept apply today? At the time of this writing and according to Barron’s, the dividend yield on the Dow Jones Industrial Average is 2.54%. So if an investor is buying into the stock market at today’s level, the market must appreciate by 7.46% each year for them to earn their expected 10% return. The dividend yield on the S&P 500 Index is even worse, currently standing at 1.96%. So an investor has to earn over 8% in price appreciation. How confident are you that this will happen from today’s price levels?

Now let me tie this information into the purpose of this article. *If values are expensive, then should you invest aggressively if you are a 30 year old with a long time to invest? Not necessarily. If you are a 60 year old and*

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*values are cheap, does it mean you should invest defensively?* **Not necessarily.** Investors, all investors, need to pay attention to *values* and make their investment decisions accordingly.

Now with that being said, does this mean the stock market can't go higher in the short-term? Not at all. It simply means the higher the stock market rises, the lower the return that will be realized by investors over the coming years. In my past few articles I feel I may have come across as too negative on my expectations for the future. That was not my intention. While I believe volatility and losses will be likely for many investors, it doesn't have to be for those who are prepared.

If as a reader of this article you happen to be one of my clients, don't fret! Today we are able to use investment vehicles to hedge, and/or profit whether markets are rising or falling. As your advisor I am indifferent to the direction of the trend as long as it can be identified and your investments can be positioned accordingly. And if you are one of my clients nearing retirement, keep the following in mind. Should lower prices result sometime in the future, imagine being able to invest in blue chip, dividend paying stocks ***when you are going into retirement*** that pay 5-6%+ dividend yields with price appreciation to boot! So not only could you receive great cash flow from dividends but rising prices to offset inflation during your retirement years!

The only requirement here and now is think twice before buying into conventional wisdom. Instead apply rational decision making to your investment decisions and do your best to check your emotions at the door!



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