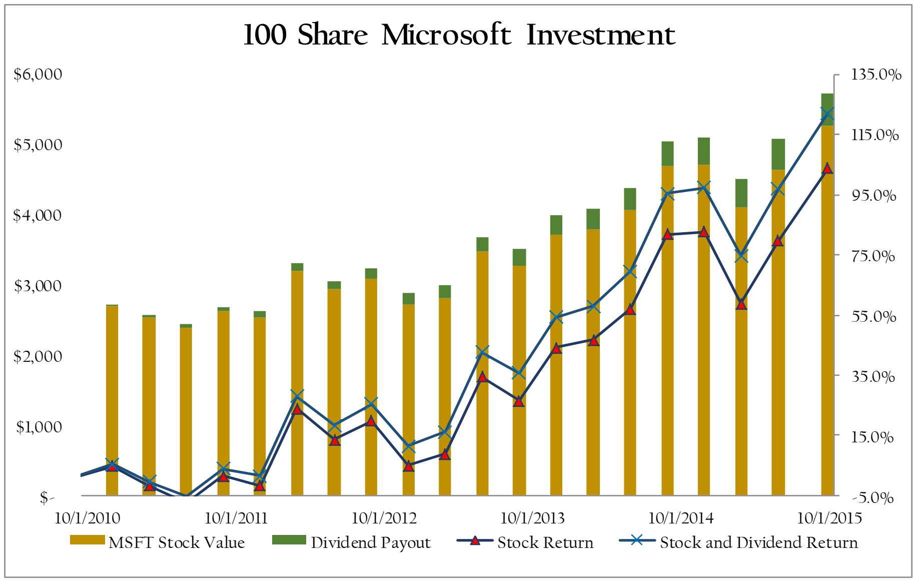
Trick or Treat?

By Deborah DeMatteo, Vice President & Chief Investment Officer

From the very first week of October we witnessed a spectacular rebound in the market after the dismal close for the month of September. The interesting thing is that the economic backdrop has not changed much at all. The Federal Reserve is still on hold and is leaving the door open for a rise in rates by year's end; essentially the same conditions that were present in September. The one catalyst that we can sight for a stronger market is central bank intervention from around the world.

The central banks of Europe and Asia announced additional accommodative monetary policies for their respectful economies in October. Mario Draghi, the European Central Bank Chief, strongly suggested that December would bring a further increase in its own quantitative easing (QE) program. *Remember QE is when a central bank purchases various assets, like government bonds, in order to* ***lower*** *rates and* ***increase*** *money supply to spur growth.* The ECB announcement was followed by news from the People's Bank of China cutting interest rates for the sixth time and further reducing bank reserve requirements. Not to be out done, Japan also indicated its willingness to further expand its already aggressive asset purchase program. This leaves our Federal Reserve as the only major central bank about to embark on a tightening policy. Following FED Chairwomen Yellen's statement of her willingness to move "sooner rather than later," caused the Dow Jones to rally almost 200 points.

With central bank policy driving the market, strong company earnings can often support and fuel further market participation. October is the start of the fourth quarter and the heart of third quarter reporting season. It is a time when we not only get guidance and financial results, but it is common for companies to make announcements regarding their dividend policy for the next twelve months. For conservative investors, especially in this zero interest rate environment, dividend payouts have become an important element to the overall portfolio performance and income generation. It is also important to note that a company's willingness to raise their dividend is viewed as a sign of financial strength and conviction in the economy. It can be an all-around win for investors when a company dividend payout is increased.



The impact of rising dividends can have a compounding effect on return over time. To illustrate this impact we can use Microsoft, a portfolio holding company, as an example. In September, Microsoft announced a 16 percent rise in their quarterly dividend effective in the next payment in December. This is on top of the 9.6 percent hike last year and the 21.7 percent increase the prior year. For every hundred shares owned in 2011, investors would have received $16 in dividends. Today, those same 100 shares would pay $36 in dividends. *Over the last five years the dividend from Microsoft has increased 125 percent.* It is important to note that dividends are not guaranteed and rate hikes are at the discretion of the board; they do not always go up. However, if you own businesses that have the financial capability to raise and pay dividends over the years, you are creating the ability to generate a growing stream of income while stock prices fluctuate from quarter to quarter. Companies such as Proctor and Gamble, Coca-Cola, and General Electric have 5-year dividend growth rates of 7.5, 8.3, and 11 percent respectively. Johnson and Johnson has increased its dividend every year for the last 53 years and has a 7.3 percent dividend growth rate for the last five →

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years that can help provide some peace of mind for conservative investors in these very volatile markets.

With the extraordinary amount of information that the market digests in any given period of time, which it uses to re-price the value of our securities, it is important to step back sometimes and think about all of the reasons you own these companies. Price appreciation is certainly one motivation for the long term investment in any company but if we can achieve a rising stream of cash flow while we wait, our long term goals have a better opportunity of be achieved. What the market does from month to month, such as the volatility in September and October, very rarely has direct correlation on long term shareholder value.

One component that we are seeing in this market that does drives long term shareholder value is shares repurchase programs. When a company announces its intent to buy back some of their existing shares this can also be viewed as a signal to shareholders about what management thinks about the current stock price. If a company elects to utilize some of the cash they have on hand or, even more aggressive, borrow to purchase shares, it is assumed that they believe the stock offers value at these levels. Statistically, it is not proven that management is any better at judging good value than investors. But, more importantly, over time it reduces the number of shares outstanding; this leaves the remaining shareholders with a larger percentage ownership in the company. In an environment where companies have either a significant amount of cash on hand or the ability to borrow very cheap, we continue to see increase in share repurchase announcements. This month Google, Johnson & Johnson, and United Technologies announced shares repurchase programs of $5.1, $10, and $12 billion respectfully. This does not have any meaningful influence on the price in the short term, but it can help increase shareholder value over the long term.

One more piece of bait for the bulls was at the end of the month with the election of Rep. Paul Ryan as the new Speaker of the House. The market did not want deal with the uncertainty of having no leadership in Congress at years end. In addition, in the 11th hour, Congress passed a bill extending our spending power, alleviating the fear of defaulting on our debt or shutting down the government. We have in no way solved any of the longer term structural issues, but only taken one card off the table that could have been very disruptive to the financial markets going into the end of the year.

With two months left of the year and reflecting on the last two months, who knows which way we will end. The economy continues to grind higher; earnings remain solid but not strong, interest rates relatively stable, energy prices accommodative to consumers, jobs on the mend, and investors looking for the next queue. Time will help us understand if the September decline was an early Halloween Trick or if it was an October Treat that sets us up for a strong finish.

Deborah DeMatteo, CFP® has more than 30 years of experience and is the Vice President and Chief Investment Officer of 10-15 Associates. She co-founded the S.E.C. registered investment advisory firm nearly 30 years ago.

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For More Information:
Please call (800) 225-1015
Or visit us at:
www.1015associates.com

10-15 Associates
168 Main Street
Goshen, NY 10924