What's next for investors?

November 3, 2008. The U.S. Commerce Department reported on October 30 that the U.S. economy contracted at an annualized rate of 0.3% in the third quarter — the largest drop since the end of 2001 — as consumer spending declined at the fastest rate in 28 years. Most observers concede that a recession is under way. The report came just when the Federal Reserve lowered the federal funds rate by one-half of a percentage point — down to 1% — in its attempts to boost economic growth and increase the availability of credit. That's the lowest rate since the 12-month period between June 2003 and June 2004. Before that the rate had not been that low in 45 years, back when Dwight Eisenhower was in the White House.

The markets responded positively to the Fed's move, but whether it will have a long-term positive impact on the credit and economic crisis won't be known for some time.

Is now the time to buy stocks?

Right now, stock prices remain unusually volatile, influenced by daily events and investor emotion. As stock prices fall, the dividend yield goes up for those companies that pay dividends. Falling stock prices have pushed dividend yields on the Dow and S&P over 3%, a level not seen since the early 1990s. What's more, dividends have the potential to grow in the eventual economic recovery.

Should you consider a company's price earnings ratio (P/E) in making your decision? The P/E is the price paid for one share divided by the company's annual earnings per share. Although the long-term average P/E for companies in the S&P has been 15.5, it's dropped to a bit over 13 during the past 12 months, based upon the market's close on October 24. That low figure suggests that, on the whole, stocks currently are undervalued.

But many investors worry that if corporate earnings fall, we could see P/Es fall as low as 7, as we did in 1975 and 1980. In a recession, companies have the option of reducing or omitting their dividends. Stocks purchased now, dividend paying or not, could prove to be a poor bargain if the company suffers reversals during the downturn.

There are good companies selling at bargain basement rates; the trick is to select the ones that will survive.

Is it better with bonds?

Investors with a conservative leaning, especially those in retirement territory, usually are looking for safety and a reliable source of income. They often place greater emphasis in their portfolios on bonds, issued by governments and corporations. Bonds provide a degree of certainty in the uncertain world of investing because (1) the amount of income that the bond will generate each year is fixed until maturity, and (2) when the bondholder holds the bond until maturity, he or she will receive the bond's par (face) value.

Bond prices fluctuate as interest rates change, so a bond can trade above or below the par value based on what interest rates are when the bond is sold. If a bondholder sells a bond before it matures, when interest rates are higher than the rate that the bond is paying, he or she will receive less than par value for the bond and take a loss.

The latest rate cut by the Fed., although, potentially good news for economic growth, isn't good news for investors and retirees who are seeking a stream, rather than a trickle, of income, from their bond portfolios. Shorter-term Treasuries offer the most protection against a loss when there might be a need for money within a relatively brief time span. An investor must be willing to accept today's very low interest rates (yields of Treasuries with a three-year maturity or less were under 2% at the month's end).

Some investors are turning to TIPs (Treasury inflation protected securities) which adjust principal and income payments with the Consumer Price Index. Corporate bonds are offering substantially higher rates but are a significantly riskier investment, with the chance of default or bankruptcy during the recession.

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Municipal bonds typically offer lower interest rates than Treasuries because the federal government generally doesn't tax income from bonds issued by state and local governments. So investors in high tax brackets may do better with munis because their after-tax return may be higher than with taxable bonds. But some investors have been reluctant to lend money to cities and states that are facing their own financial crises, which has driven yields up and prices down. During October some yields topped 6% on long-term issues.

Microscope and telescope

Short-term market fluctuations will continue in response to the daily economic news, domestically and globally. But we believe that we can best serve our clients by a view not just through the microscope of daily events but through a telescope as well, to catch a glimpse of the far horizons.

We also believe that the core principles still apply: setting your long-term and short-term goals for your money and reducing your risk to the extent possible by using asset allocation and diversification strategies.

The safety of our clients' assets and the future financial security of their families are paramount to us. These are two of the key reasons why so many people are turning to us for guidance in these difficult times.

The challenges are great, but we are here to help you meet them. Call on us for an appointment at your earliest convenience.

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