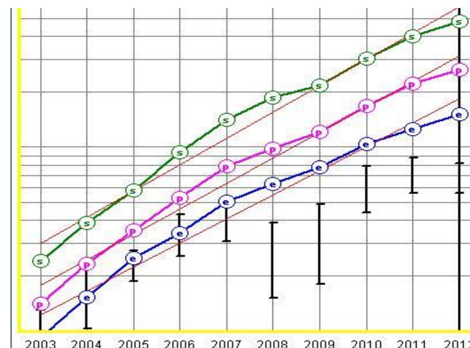


SECOND QUARTER (APRIL – JUNE) 2014 eNEWSLETTER

OVERVIEW OF UPCOMING EVENTS AND CLASSES:

- Fall 2014
  - Introduction to Investing, September 6, Christ Church United Methodist
  - Annual Meeting via Webinar, September 16
  - Introduction to the Stock Selection Guide (SSG), September 20, Christ Church United Methodist
  - Investor Forum, October 11, Colorado Christian University (CCU)
  - Beginning ToolKit and Lab, October 18, Colorado Christian University (CCU)
    - Lab Only, October 18 afternoon
  - Judgment on the SSG, November 8, Christ Church United Methodist
  - Advanced ToolKit and Research Tools, November 22, Colorado Christian University (CCU)
    - Research Tools Only, November 22 afternoon
- Spring 2015
  - Introduction to Investing, January 10, Christ Church United Methodist
  - Introduction to the Stock Selection Guide (SSG), January 24, Christ Church United Methodist
  - Beginning ToolKit and Lab, February 7, Colorado Christian University (CCU)
    - Lab Only, February 7 afternoon
  - Advanced ToolKit and Research Tools, March 14, Colorado Christian University (CCU)
    - Research Tools Only, March 14 afternoon
  - Portfolio Management, April 4

Class and Event Location Addresses

Christ Church United Methodist (CCUM) 690 Colorado Blvd, Denver Co	Colorado Christian University (CCU) 8787 W Alameda Lakewood, CO Computer Lab, Beckman Center

AMAZING FACT

"When we took over Berkshire, gold was at $20, and Berkshire was at $15. Gold is now at $1,349 and Berkshire is $185,149.40 as of March 29, 2014." – **Warren Buffett, CEO of Berkshire-Hathaway.**

WORKING TOGETHER

The Rocky Mountain Chapter board of directors see their main duties as 1) supporting clubs and individuals, and 2) providing quality education for everyone. All directors are unpaid volunteers who want to "give back" for the support they've received in the past. The board meets monthly over the internet using GoToMeeting. But the chapter has the special challenge of providing for a membership spread across Colorado, Utah, Wyoming, and the northern 2/3 of New Mexico. Do you live in Utah, Wyoming, or northern New Mexico? Then please become a volunteer to help provide support for those in your area.

GETTING TOGETHER AT BINC

The Better Investing National Convention (BINC) is in Chicago this year from May 15 through 18. The Rocky Mountain Chapter, of which you are automatically a member, is part of the Northwest Region and we have a special welcome table set aside for our members for the Friday morning breakfast. If you are attending BINC this year (and everyone should attend BINC at least every second or third year), please plan on joining us for Friday breakfast. Let's get to know each other better.

BRINGING MEMBERS AND CLUBS TOGETHER

The SEC prohibits the chapter from actively helping clubs and members to get together. So the following information is not a solicitation or recommendation.
Clubs looking for members: If your club has openings for new members, one good way to let others know is to list your club on the chapter's Find-A-Club roster. To list your club, just send an email to contact@rmchapter.org with the following information:

- Meeting location; dates, times
- Club composition (all male or female; mixed)
- Name of club
- Contact name and email address
- Alternate contact name and email address

Visit the chapter's Find-A-Club webpage for more advice on how to connect with members looking for a club.
Members looking for clubs: If you are a BI member and would like to consider a club, the chapter maintains a list of clubs open to visits. The decision to visit or join a club is strictly between you and the club. The Rocky Mountain chapter makes no recommendations one way or the other.

IS THE MARKET "RIGGED"?

Did you see the recent *"60 Minutes"* featuring Michael Lewis, author of "*Flash Boys*", and his expose of the high frequency trading peril? Lewis says the market is "rigged" because the high frequency traders (HFT) can see your buy/sell order flows before they are finally executed and "front run" your trade to their advantage. There are a myriad of shady practices a trader can pursue if their computer is fast enough… and we're talking about making trade moves on the order of milliseconds (one thousandth of a second; there are 1,000 milliseconds in one second). Front running is just one of many methods the HFT pursues. This is certainly a practice that should be investigated and regulated

but is it something small, long term, retail investors should be concerned about? Not in the least.

One way HFTs are able to skim a few mils per share is by front running the stock. What is a mil? A mil is kind of like a millisecond. It is a thousandth of a dollar or a tenth of a cent. Now if you or your club decide to trade (buy or sell) 1000 shares of a $30 stock at Charles Schwab, you will pay $8.95 for the trade which works out to about 9 mils per share. The HFTs can front run your trade and skim off an additional 2 mils per share or $2 for the trade. If you follow the BI guidelines and plan to hold your stock for five years or so, the HFTs will cost you less than $1 per year as they will skim you on the sale as well as the buy (i.e., a total of $4 over five years). Meanwhile, your $30,000 investment may well grow to $50,000 or more. Would you turn down a $20,000 gain to avoid paying an HFT a $4 skim? Are you kidding? High frequency trading is unethical, immoral, and even illegal. Action should be taken by the SEC to rein in this practice. But it shouldn't keep you out of the stock market. Furthermore, the HFT profit margin per share is so small, they aren't really interested in a trade involving a 100 shares or even 1,000 shares. They are watching for the 1,000,000 share trade volumes. So the chances are that small investors aren't affected at all except indirectly through pension plans or mutual funds where the big trades are made.

The HFT phenomenon isn't particularly new to the market. In the 1880's, inventors made millions inventing new and faster ways to get market news to traders. That is when the "ticker tape" machine was invented and it was used by traders to keep up with the market to the nearest half hour or so. Wow! We've come a long way from a half hour to get a quote to a millisecond to get the quote and then front running it.

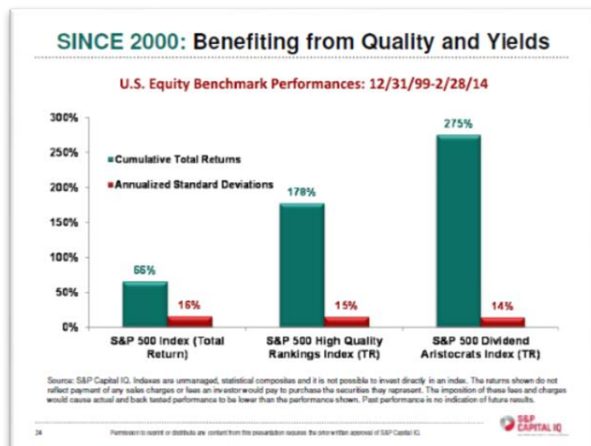
Before the computer, the New York stock exchange floor was a bedlam of activity with traders madly signaling buys and sells and running bits of paper here and there as buyers tried to find sellers and sellers looked for buyers. The exchange had "specialists" or "market makers", who worked for exchange approved firms. They were on the floor to try to bring some order to the mayhem by facilitating trades and in so doing they accomplished three things: 1) reduced market volatility, 2) facilitated liquidity, and 3) skimmed a dime or two off each share traded by taking advantage of the "bid-ask spread" and the fractional quoting system (A stock price used to be quoted in eighths of a dollar, or 12.5 cents. We now quote in decimals which narrows the spread considerably). Today, the "specialist" function is computerized.

That was also before the advent of the "discount broker". Then a "full service broker" could charge you a brokerage fee of over $100 for a single trade up to 1,000 shares and then a per-share "add on" cost after that!! For a trade of 1,000 shares, that works out to be 10 cents a share, so a dime or two over several years wasn't a big deal. At least to the longer term investors. Day traders and hedge funds are a different story.

To find out more about the HFT issue, read this article by John Rekenthaler, VP of Research at Morningstar. Another article of particular interest is by Felix Salmon at Reuters.

S&P CAPITAL'S "RULE OF 20"

Many saw Sam Stovall's BetterInvesting sponsored March 19th webinar titled "Don't Dump Those Dividends". If you missed it, you can watch it online and even download the displays. Sam is S&P Capital's Chief Equity Strategist and he made the case for the outperformance of dividend paying stocks over time as shown in the display to the left. From December 1999 to February 2014, the S&P index was up a strong 56% while the S&P 500 Dividend Aristocrats were up an astounding 275%. The Dividend Aristocrats are S&P 500 companies who've raised their dividend every year for the last 25 consecutive years. The Dividend Aristocrats index is equally weighted. As interesting and informative as his remarks on the importance of dividends, Sam also showed a way to put a value on the overall market.

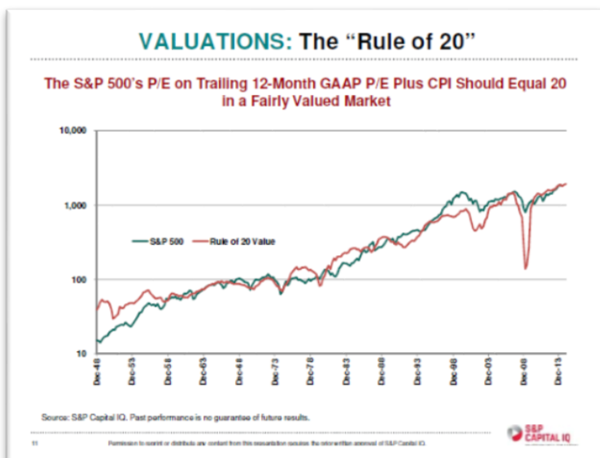


It turns out there is a simple relationship linking the rate of inflation with the S&P 500 index EPS and share price. So why should we be interested in the overall market as represented by the S&P 500 index? After all, we invest primarily in individual stocks. Yet it is well known that up to 30% of the current price of an individual stock reflects the enthusiasm/pessimism of the overall market. The rule can also teach us a lot about the effect of EPS growth rates and the rate of inflation on the stock market.

It turns out that the S&P500 index price can be pretty accurately calculated for a fully valued market (i.e., the long term average P/E). The rule equation is

(20-Inflation Rate)*EPS=Index Price

How well does this simple relation track actual index performance? The graph to the left shows the actual price of the S&P 500 index over time along with the Rule of 20's price prediction. The actual price is in green and the Rule of 20 projection is in red. Although it isn't perfect, the Rule mirrors the actual index price quite well. So let's calculate some examples using the Rule and see what we can learn.



The EPS for the S&P500 index is currently $110. The top half of the table below shows how the inflation rate affects market prices. As inflation goes up, the

market price comes down. Right now the S&P500 index price sits at $1865 and the inflation rate is 2%, so the market is only slightly below fully valued right now. That's the reason it is getting harder to find good stock buys these days.

Inflation Rate	S&P500 EPS	S&P500 Index Price
1.5	$110	$2,035
2	$110	$1,980
2.5	$110	$1,925
3	$110	$1,870
3.5	$110	$1,815
4	$110	$1,760
4.5	$110	$1,705
2	$110	$1,980
2	$119	$2,138
2	$128	$2,309
2	$139	$2,494
2	$150	$2,694
2	$162	$2,909

TABLE: Rule of 20

The bottom half of the table shows an EPS growing 8% per year and inflation holding at 2%. In five years the index could be around $2909 for a fully priced market. That would be an increase of 47% in five years.

You can also re-arrange the equation to calculate the inflation rate that is currently built into the market which may be telling us something about inflation expectations going forward:

20-(Index Price/EPS) = Inflation Rate

For the current Index Price of $1865 we get a priced-in Inflation Rate of 3.04%. Again, indicative of a fully priced market anticipating a slight increase in inflation next year. If the market is right and the inflation rate will rise to 3% and assuming it holds there, then the projected Index Price in five years drops to only $2748. Inflation and EPS growth play a huge role in a fully valued market.

WORDS OF WISDOM

"Some academics, citing the Modigliani-Miller theorem, argue that it doesn't matter whether a company pays a dividend. A company that holds back earnings, they claim, clearly has good investment opportunities to further grow profits. However, a 2003 paper by Robert Arnott and Clifford Asness showed that, contrary to common wisdom, higher dividend payouts predicted increased earnings growth for the aggregate U.S. stock market. A 2006 study on 11 countries also showed the same relationship, though it was weaker. Ping Zhou and William Ruland found in a 2006 study that high dividend payouts predicted strong future earnings growth among individual firms. The broad sweep of evidence strongly supports the idea that dividends enforce discipline on managers who may otherwise binge on empire-building. Further poking holes in efficient-market thinking is the fact that dividend-paying stocks have outperformed non-paying stocks in almost every market studied, with lower volatility." - **Samuel Lee, Morningstar**