October 2011 – Are Stocks a Good Investment?

You can probably guess that what follows will say that stocks are, indeed, still a good investment despite these dismal results, and I will be trying my best to say this in a not so self-serving way.

When Callahan Advisors started twelve years ago, I simplistically thought that over the long-run stocks would go up about ten percent a year. Apparently, my twelve year period is not a good sample as we have been through two severe market corrections with the dot-com and housing/mortgage bubbles bursting. This quarter has also been terrible with the S&P down over fourteen percent at one point. Why did this happen? Earnings have been good, dividends are increasing, corporate cash is at high levels, stock buybacks are high (Jason Zweig and Jonathan Cheng reported that "U.S. companies overall bought back $475.2 billion more of their own shares than they issued" in the last quarter), and interest rates are extremely low. We should truly be singing: Happy Days Are Here Again.

But we aren't. We perceive that our political system is in shambles with party loyalty trumping everything else. Unemployment is very high. People that saved in their 401k plans have not seen any return or growth. Retirees are being forced to make higher allocations to riskier securities in order to get enough money to live. (Recently I did a calculation for a client that showed at the current rate of interest a short-term CD was paying she would need $14 million more in savings to take out $1,000 more a month)!

When I think of our unemployment rate I think about all that money being used to buy back stock or being invested in capital projects outside our borders. Clearly our politicians must consider meaningful ways to change this. Less regulation and more logical fiscal and tax policies would go a long way. Hopefully, we will all be involved in the political process. My own opinion is that the incumbents have not solved the problems, and that maybe it would be best to let someone else have a go at it. I want to emphasize that I am not against all incumbents, but you have to ask yourself if they are the problem or the solution.

In a recent newsletter, I wrote that about 35% of your return comes from dividends. Lately I believe it is much higher simply because dividends keep increasing and while stock prices have been volatile, they are essentially where they were twelve years ago. There is no shortage of companies with comfortable dividend payouts, yields and an excellent history of dividend increases. I have said many times lately, it really doesn't matter what the stock price does if the stock you own pays its expected dividend and continues to increase it at a rate in excess of inflation.

This brings me to another point that I want to make about stocks. With our very high national debt, which is owed mostly to our own citizens and to foreign investors, and with trillion dollar current deficits adding annually to this debt for the foreseeable future, it is hard to imagine any way around our financial problems without weakening the value of the dollar. What has saved us thus far is that most other countries of economic significance are democracies and their politicians are more corrupt or incompetent than ours. We cannot count on that to last. China, Japan, India and several European and other countries may get it done before we do. If so, we will be worried about a lot more than Medicare and Social Security entitlements. When this devaluation/inflation comes, hard assets such as land, gold and investments in companies with capital assets will protect us. Cash won't and bonds won't.

Just think of those entitlements. We believe in life, liberty and the pursuit of happiness. That is what we are "entitled" to. The pursuit of happiness must mean that we have to plan to provide for ourselves. Even the sick and elderly will find more comfort and satisfaction if they have provided for their own needs rather than relying on the government or someone else. To be sure, other countries are not going to take care of us although they are currently providing a great deal of financing for us.

To be able to provide for ourselves we must work when we are able. We are entitled to pursue work; no one is responsible for hiring us. Companies won't invest here in the United States unless they believe they can get an adequate return on such investments. The United States competes with the rest of the world for those investments (and jobs). Taxation policies, regulation, and a trained, motivated and efficient work force all become factors in these capital allocation decisions. In the end only companies can create jobs. As we have seen over the past three years, governments can't create sustainable jobs; they create deficits which destroy jobs.

In another letter I quoted Dean Witter in saying we will have recovery over chaos because chaos is impossible. However, we came close to chaos with the banking crisis of 2008 and the potential for another more serious upheaval (if possible) exists if we have another recession soon. It is hard to imagine our politicians doing anything with 2012 being the election year. It is critical to be diversified and invested for wealth preservation. Our stock selections and allocations will be following this theme. We realize that you will be experiencing valuation fluctuations, more than you would like, but know that we expect to grow your cash flow, and, accordingly, your assets.

As always we are grateful for your support, comments, ideas, and questions.

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