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WISDOM OF INVESTING WITH THE CROWDS

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McCarthy Asset Management, Inc. is an independent, fee-only investment advisory firm that has been helping people invest wisely for over fifteen years. Our mission is to help you better understand and improve your financial situation. We specialize in Retirement Planning, Portfolio management and Tax Planning.

Gold or Real Estate? I have often written about the dismal track record of investors' performance resulting from the ill timing of their purchase and sale decisions. This pertains to not only the stock market, but also to bonds, commodities and real estate. A common tendency is for an investor to "chase performance" and purchase an investment after it has had very strong performance. Much of this can be explained by human nature. From an emotional standpoint, after an investment has performed well for an extended period of time investors either get greedy for returns (e.g. buying technology stocks in the late 1990's) or become complacent about risk (e.g. investing in real estate in the mid-2000's because "real estate prices never fall"). I recently read an interesting comment from Richard E. Band's Profitable Investing. Band wrote that with gold trading at over $1300 an ounce, it now costs 138 ounces of gold to purchase a typical existing home in the United States. Ten years ago, the same house cost 498 ounces of gold. In other words, during the last ten years home prices have dropped 72% relative to the price of gold. Which is the better buy now? While many may now be looking to invest in gold as an inflation hedge, it is clear to me that real estate currently offers better long-term value.

Bonds or Stocks?: During the last year I have had a few clients ask why I don't sell off the equities in their portfolios and load up on bonds. After all, they can see that the best performance came from their bond funds. It is easy to see why investors can be so negative in their outlook on stocks. During the last ten years the return on the S & P 500 Index has been slightly negative. This dismal 10-year track record was accompanied by two periods when stocks plunged by 50%. Meanwhile bond investors enjoyed strong returns during this time. Therefore, they figure bonds must be a better investment than stocks. Investors appear to think so based on mutual fund inflows and outflows.

According to the Investment Company Institute (ICI), from January 2008 through June 2010, outflows from equity funds total totaled $232 billion, while bond funds saw a massive $559 billion of inflows. This trend has not abated this year. For the first seven months of 2010, $185.3 billion was invested in bond funds, the most for the first seven months of any year since 1984, when ICI started compiling the data. This shift out of equities and into bonds is the exact opposite of what investors were doing in 1999 and 2000. During those two years ICI reports that investors added $496.9 billion into equity funds when stocks traded at 40 times earnings. During that same time, investors were liquidating bond funds with 10-year Treasuries yielding around 6%. We know how this move played out as the stock market tanked from 2000 through 2002 while bonds started a 10-year period of very strong performance. With interest rates now at a near all-time low, one has to wonder about the wisdom of those investors who have been exiting stocks and piling into bonds.

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Appeal of Dividend-Paying Stocks: Although I don't feel bonds are currently at risk of suffering significant losses because I expect the Fed to keep interest rates very low for at least another year, I do think dividend-paying stocks are now a very compelling alternative to bonds. As of August 31, according to data compiled by Bloomberg and Bank of America, 68 stocks in the S & P 500 paid dividends that exceeded the average corporate bond yield of 3.8%, more than at any time in at least 15 years. Today the 10 largest dividend payers in the U.S. are AT & T, Exxon Mobil, Chevron, Procter & Gamble, Johnson & Johnson, Verizon Communications, Phillip Morris, Pfizer, General Electric and Merck. These ten companies sport an average dividend yield of 4%, approximately 1.5% ahead of the yield on standard 10-year Treasury bonds. The average price-earnings ratio, based on 2010 estimated earnings, is 11.7 for these ten companies (versus a price-earnings ratio of 40 for the S & P 500 when investors were pouring into equities back in 1999 and 2000). Furthermore, these 10 companies are paying out only approximately 50% of their earnings as dividends (or said another way, their earnings this year are projected to cover their dividend by more than 2 to 1).

Even more importantly, stock dividends have historically grown faster than the rate of inflation. This is in contrast to the fixed coupons paid by bonds. In fact, the average dividend income from a portfolio of S & P 500 companies grew at a rate of 5% per year since the index's inception in 1957, fully 1% ahead of inflation over this period. That growth rate includes the disastrous dividend reductions that occurred in 2009, the worst year for dividend cuts by far since the Great Depression.

Dividend-paying stocks is a theme that I have emphasized since last fall. In the portfolio repositioning done in November, I added to most portfolios Vanguard Dividend Appreciation, an ETF that focuses on stocks which pay an increasing dividend. This spring I added Thornburg Investment Income, a mutual fund which focuses on global stocks and bonds, and sports a yield of 6%. This fall I am considering adding a mutual fund that focuses on Asian-dividend-paying stocks and pays a yield of over 3%.