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Dow 15,000!!! So What, Who Cares, Big Deal

Part 1 Accepting CPI

By W. Michael McBride, J.D.

On July 17, 2007 the Dow Jones Industrial Average (DJIA) closed fractionally above 14,000 for the first time in its history. Whenever a nominal threshold is achieved, the pundits, prognosticators and talking heads can't resist speculating on when the next nominal threshold, in this case DJIA 15,000, will be reached. Such was the case last summer. However, absent from the emotional euphoria was the critical question:

What does DJIA 15,000 really mean?

To properly answer this question, I first need to select a starting point to create a proper frame of reference. The inherent problem with retrospective analysis of investments is that you can select a point in time that will support virtually any conclusion desired. In an attempt to be reasonably objective in addressing this potential bias issue, I have selected closing values of 12/31/99 as starting points for the following reasons:

- It represents the conclusion of a month, quarter, year, decade and century.
- A full eight years have passed. Conventional Wall Street wisdom says the "long term" must include a five to ten year time horizon minimum.
- While stocks were in a heated bull market, virtually every publication and pundit advocated investing new money at these levels for the "long term." It was after all a "new economy" remember?

So let's look at the closing values of the major indices at 12/31/99.

DJIA 30	11,497
S&P 500	1,469
Russell 2,000	504
NASDAQ	4,069

It seems appropriate to pause and allow some readers, after looking at the NASDAQ figure, to regain their composure either from pain or laughter. The benefit of hindsight shows the absurdity of a NASDAQ valued at 4,000 at the end of 1999. However people were encouraged to invest in the "new economy" or be left behind. It was all about clicks not bricks. Traditional valuation ratios no longer mattered. The internet changed all that old way of thinking and "dot com" was going to rule the world. So while some may think it is inappropriate to include the NASDAQ in this type of analysis, significant money was being invested at these levels and higher.

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Fast forward to 12/31/07 and we find the closing values of the major indices as follows:

DJIA 30	13,265
S&P 500	1,468
Russell 2,000	766
NASDAQ	2,652

The eight year nominal gain/loss sorts out accordingly:

	<u>12/31/1999</u>	<u>12/31/2007</u>	<u>Point Gain/Loss</u>	<u>Gross Return</u>	<u>Annualized Return</u>
DJIA 30	11,497	13,625	2,128	18.5%	2.6%
S&P 500	1,469	1,468	-1	-0.1%	0.0%
Russell 2000	504	766	262	52.0%	7.4%
NASDAQ	4,069	2,652	-1,417	-34.8%	-5.0%

These results are uninspiring by themselves and while it is considered poor sportsmanship to pile on, I'm going to do so anyway to illustrate a point. As noted above these returns are nominal and not adjusted for inflation. Nobody invests to achieve a nominal return. Investments are funded by savings and savings are delayed consumption. Eventually we intend to spend those dollars or give them to someone who may spend them at some point in the future. We make value decisions about the costs and benefits of immediate consumption and delayed or forgone consumption through savings. The investment return received for savings should compensate an investor for the time delay and the risk assumed through those investments. There is another element that creeps into our decision process and that is loss of purchasing power of those dollars held for delayed consumption.

So nominal figures are meaningless to us in terms of what our savings can buy in the future. To fix this problem I need to target our expected returns in real terms. That is, adjusted for inflation, what can our future dollars really do for us in purchasing power terms? This real dollar perspective is necessary to guide our investment strategy.

This brings us to our next problem. What proxy do I use for inflation to properly represent the loss of purchasing power of our currency? The Consumer Price Index (CPI)? Let's be clear, that the CPI is now more of a political statistic than an economic one (a subject for future articles). Since the public and investment community has been convinced the CPI is a proxy for inflation I will use it for purposes of this article as published by the Federal Reserve Bank – Minneapolis web site.

In the following illustrations, I show the 12/31/99 closing index average for the DJIA, S&P 500, Russell 2000 and NASDAQ. These closing averages are then adjusted for inflation (using CPI as published by the FRB Minneapolis) to show what the average would need to be **just to maintain purchasing power with the 1999 closing average**.

	FED CPI <i>FRB Minneapolis Web Site</i>	Inflation Adjusted Dow 30	Inflation Adjusted S&P 500	Inflation Adjusted Russell 2000	Inflation Adjusted NASDAQ
12/31/1999		11,497	1,469	504	4,069
2000	3.40%	11,888	1,519	521	4,207
2001	2.80%	12,221	1,561	536	4,325
2002	1.60%	12,416	1,586	544	4,394
2003	2.30%	12,702	1,623	557	4,495
2004	2.70%	13,045	1,667	572	4,617
2005	3.40%	13,488	1,723	591	4,774
2006	3.20%	13,920	1,779	610	4,927
2007	2.75%	14,303	1,827	627	5,062
2008	4.00%	14,875	1,901	652	5,264

* An estimate for 2008 is based on the change in the CPI from fourth quarter 2006 to fourth quarter 2007.

While this illustration does not include an average dividend yield for the DJIA and S&P 500 which have roughly been 2% for the time period in question, the only index that was positive from an inflation adjusted point of view was the Russell 2000. This would be consistent with the conventional wisdom that over longer periods of time, smaller capitalization companies, represented by the Russell 2000, tend to perform better than larger capitalization companies. On average, all other indices have been lagging in terms of purchasing power for the last eight years.

So what does the achievement of a Dow 15,000 really mean?

In real purchasing terms it means absolutely nothing.

If you accept the integrity of the stated CPI by the government, a Dow 15,000 would represent the rough equivalent of the Dow 11,497 on 12/31/99. Stated another way, if all that index investing does is break even in terms of purchasing power (which has not happened for the last eight years) then if you are going to need \$50,000 per year in retirement, then you will need to save \$50,000 now for each year you plan to be in retirement.

If savings and the subsequent investment of those savings represent future consumption, then it is imperative that those investments not only maintain purchasing power, but provide gains to compensate for the risk assumed. Clearly the indices are not satisfying even the first requirement.

A portfolio or a portion of your portfolio investing in those sectors that stay ahead of inflation is an essential portion of an asset allocation strategy. If you or your current advisor is not integrating these elements into your strategy, perhaps it's a good time for a second opinion.

In Part Two I'll explore the effect of these returns with a slightly different view of CPI.

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Securities offered through LPL Financial Member FINRA/SIPC.*

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WHO WE ARE

W. Michael McBride, J.D., Financial Consultant

Mike builds on nearly 25 years of financial services expertise, offering a unique perspective and insight on the economy and financial markets for individuals as well as clients who own and operate businesses. Serving as Director on several local and state boards in the Insurance and Finance industry, Mike has positively influenced policies and legislation that impact companies and individuals.

Scott P. McBride, CIC, LIC, Insurance Consultant

Scott has more than 20 years of risk management knowledge, focusing on strategies designed to help protect client assets as part of the Total Return Process®. Serving as Director on several charitable and non-profit organizations, Scott provided valuable insight to these organizations and the communities they serve.

Michael Einheuser, J.D., Financial Consultant & Branch Manager

With 20 plus years of Estate Planning experience as an Attorney, Financial Advisor and Lecturer, Michael is proficient in assisting families with strategies that help identify and achieve their goals throughout and beyond their lifetime. Michael is a former member of the Board of Governors of Wayne State University and teaches Business Ethics in the Master of Business Administration at Wayne.

Carrie Hillock, Client Services

Carrie brings over 10 years of diverse experiences in banking, securities and insurance underwriting to the Mason-McBride Financial team. This unique background enables a holistic support of our clients to help achieve the Total Return Process®.

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