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

Part 2 CPI Baloney or is it SPAM?

By W. Michael McBride, J.D.

In Part 1 I illustrated that since 1999 the major indices have not been keeping pace with inflation as measured by the Consumer Price Index (CPI). A question arises as to whether the CPI adequately represents a true change in the cost of living.

I think it appropriate to include in this analysis a figure that includes a modified version of the CPI to at least, at some level, account for the changes that were made in the late 1990s in the way the CPI is calculated. In 1995 the United States Senate appointed a commission formally called the "Advisory Commission to Study the Consumer Price Index" chaired by Michael Boskin who was President George H. W. Bush's chief economist. Its mission was to study the possible bias in the computation of the CPI, a laudable goal on the surface. The final report was published on December 4, 1996 and was titled "Toward A More Accurate Measure Of The Cost Of Living." The report concluded that the then existing methodology of calculation the CPI overstated inflation between 1% and 2%. What is less often discussed is that the prevailing government opinion at the time, was that the CPI overstated inflation prior to the formation of the Boskin Commission. In true government form, a conclusion was reached and a study commissioned to rationalize the conclusion. The report to support such a conclusion was critical because the CPI as calculated by the Bureau of Labor Statistics is used to adjust the annual payment increases in Social Security as well as a host of programs. This is a good deal for the government as it reduces those payouts. It's a bad deal for recipients, particularly if the rationale for the reductions isn't grounded in reality. While the Boskin report warrants its own study, let's look at just a couple of the core rationales behind the assumption of their proposition.

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The Boskin folks made the argument that the old method of calculating CPI did not account for the “substitution bias” that occurs when prices rise. The traditional measure of CPI used a fixed basket of goods measured year over year. Simply stated; what was the price of a 12oz T-bone steak this year versus last year? Boskin advocated that the CPI should instead reflect the change in behavior consumers make when specific prices rise. According to Boskin, if steak rises in price, some consumers will switch to hamburger which is lower in price thus there was no increase in the price of “meat.” Taking this thought process to the next level does the new CPI calculation assume that as hamburger becomes too expensive that people will switch to SPAM or perhaps premium pet food? The interjection of a substitution adjustment in the CPI calculation is the equivalent of converting the index from a cost of living to a cost of survival.

The other main argument Boskin advanced for overstatement of the traditional CPI measure revolves around quality changes. The rationale here is that price changes in products need to be adjusted for quality enhancements in the product and netted out accordingly. Boskin states the price of gasoline didn’t increase as much as you think because it contains new additives that burn cleaner. The television you bought has an improved remote control so it didn’t really go up that much in price. That new car you bought wasn’t really that much more expensive because it has more features on it. According to the Boskin rationale, if enough new features and imputed quality changes are incorporated, the price of the product actually went down in price even though you are paying more for it! While we are on the subject of assumed quality changes in products, each of us has our own anecdotal experience that challenges the assumption that products are always increasing in value. For example major appliances that used to last 10 to 15 years for our parents, now seem to need replacement or expensive repair within 5 to 10 years. The CPI calculation doesn’t include the fact that a consumer may now have to buy 2 items in the same time frame that one purchase used to satisfy.

I would make the argument that the CPI has become a political statistic and is no longer a true economic statistic reflecting changes in the true cost of living for the average American. Yet we need some benchmark to guide us in determining if our investment returns are real in purchasing power terms or just nominal. If we use the CPI as that benchmark, we should at least look at a pre-Boskin version to provide perspective. Ultimately you can decide for yourself if you believe the government stated CPI accurately reflects your personal changes in cost of living.

As was illustrated in Part 1, the following table shows 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), modified by adding two percentage points to adjust for the Boskin report to show what the average would need to be **just to maintain purchasing power with the 1999 closing average**.

	FED CPI <i>FRB Minneapolis</i> <i>Web Site</i> Plus 2%	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	5.40%	12,118	1,548	531	4,289
2001	4.80%	12,699	1,623	557	4,495
2002	3.60%	13,157	1,681	577	4,656
2003	4.30%	13,722	1,753	602	4,857
2004	4.70%	14,367	1,836	630	5,085
2005	5.40%	15,143	1,935	664	5,359
2006	5.20%	15,931	2,035	698	5,638
2007	4.75%	16,687	2,132	732	5,906
2008*	6.00%	17,689	2,260	775	6,260

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

Again, 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.

So what does the achievement of a Dow 15,000 really mean? Under this illustration a better question would be what does Dow 17,000 really mean? If you accept the premise that the CPI understates the true cost of living, the answer is, not much.

Savings and investment of those savings represent future consumption. It is imperative that those investments not only maintain purchasing power, but provide gains to compensate for the risk assumed. A portfolio or a portion of your portfolio investing in those sectors that stay ahead of inflation (your personal inflation not just the government's idea 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.

W. Michael McBride, J.D.

W. Michael McBride is President of Mason McBride Capital Advisors, LLC.

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Next,
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trouble



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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®.

We're here for you.

Contact:

Mason-McBride Capital Advisors, LLC

2301 West Big Beaver Road, Suite 400

P.O. Box 7028

Troy, Michigan 48007

248-822-7170 phone

248-822-7150 fax

www.Mason-McBrideCapitalAdvisors.com