Outlook

A Quarterly Newsletter from Roffman Miller Associates

"It was a very good year."

as sung by Frank Sinatra

It was more than a very good year. The best part was it validated our disciplines of long-term investing. Companies that we have owned for many years had great success not just in their stock price but more importantly in executing their long-term business plans. To paraphrase The Wall Street Journal, "In the best year for US stocks since 1995, the smart way to play the markets involved buying and holding a plain-vanilla portfolio of US stocks that did much better than the more complex approaches employed by hedge funds and other professional investors. Many hedge funds were left in the dust alongside investors who used tactical timing of the markets' ups and downs and those who spread their bets among a wide variety of assets such as commodities, emerging markets and exchange traded funds. The more colorful your pie chart, the worse you did."

Before I take any credit, I want to remind you that I'm not a genius. Not even close. The Journal called it "dumb-money" strategies which is okay with me. I've always said that if you need a PhD to explain a company or an investment strategy then I'll let that PhD buy that company or strategy. The real credit for our success goes to our team of professionals. They work well together and enjoy each other's input. They are what I am most proud of.

Now many of you would like to know what is going to happen in 2014. The answer is: So would I. My advice is the same as other years. First, do what's best for you. That means staying with your long-term plan. Asset allocation, planning for your needs, and patience are the important ingredients. When things are going well don't get too greedy, and when we have corrections don't become too fearful. Seems simple but it works in the long-run.

I want to wish all of you a healthy, safe, happy and successful new year. As always we are here to review your goals, needs and any concerns.

Sincerely,
Peter Miller
Chairman and Founder

08 January 2014

INCOME TAX – LOOKING BACK AND FORWARD

As we are now in year 2014 and the financial markets for 2013 are closed, investors should evaluate the 2013 tax ramifications of the Affordable Care Act (AKA Obama Care) and how they affect their tax bracket and investment decisions.

The maximum income tax rate increased January 1, 2013 to 39.6% from 35.0%. Coupled with the new (effective January 1, 2013) net investment income tax of 3.80% on the lower of modified gross income or net investment income, this brings the highest combined top marginal tax rate to 43.4%. This increase can be significant to certain taxpayers and you should be aware of the tax consequences prior to tax filing.

While I try not to thoroughly confuse you with rates and tax increases, there was an additional Medicare tax of .9% levied on wages and self-employment income over $200,000. In addition, starting in tax year 2013 and based upon your adjusted gross income, itemized deductions may be phased out and the personal and dependent exemptions can be reduced or even eliminated. The adjustments for itemized deductions and personal exemptions will increase your taxable income and could potentially put you in a higher tax bracket.

The Net Investment Income Tax of 3.8% mentioned above relates to passive income. Items included in net investment income computation include:

ADD: Income

1) Taxable interest
2) Dividends
3) Capital gains - sale of securities and capital gain distributions
4) Rental and royalty
5) Non-qualified annuities
6) Business income from passive activities - **Very Important** that business income is properly classified

LESS: Expenses

1) Investment interest expense
2) Investment advisory and brokerage fees
3) Expenses related to rent and royalty income
4) Tax preparation fees
5) State and local income taxes - as related to Investment Income

The information provided above will not affect all taxpayers. I decided to discuss the changes that may increase your federal tax for 2013 and future years. On the investment side the above tax increases should be discussed with your advisor and may affect decisions such as buying taxable or tax-exempt bonds. I suggest consulting your tax advisor as to the applicability of the various changes to your 2013 tax return.

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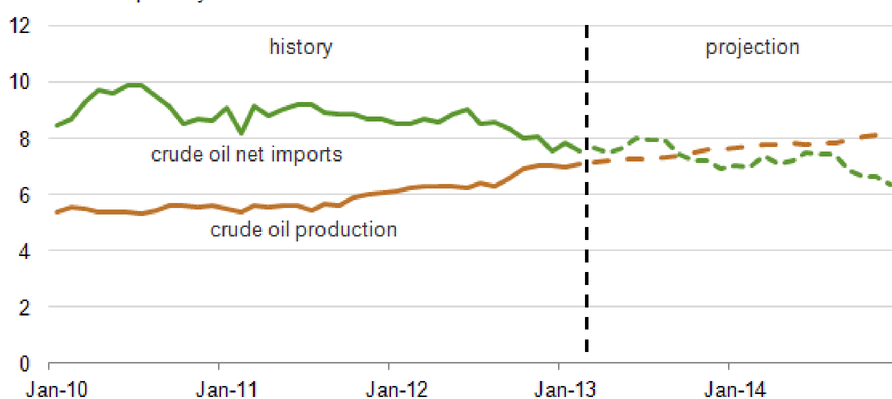
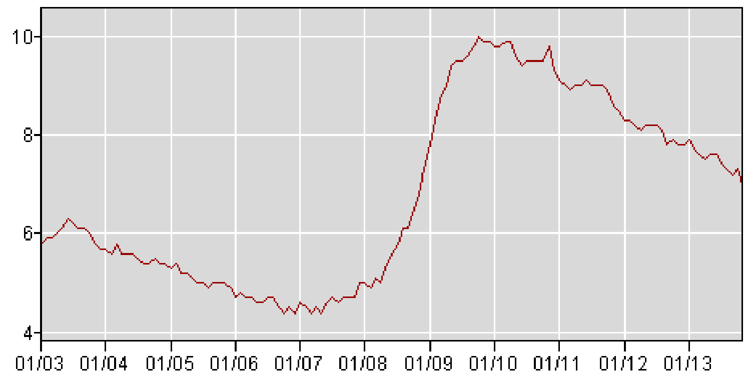
Chart:
The US Energy Information Agency predicts that more oil will be produced in the US than imported by the US in 2014



Good Signs on the Home Front

2013 can be summarized as a year of highs and lows. Stocks advanced with gains not seen since the mid-1990s, but those who held on to gold and silver lost 28% and 36%, respectively. Boeing's new 787 Dreamliner, a 'miracle of modern engineering' built from composite materials and 20% more fuel efficient than the plane it replaces, was grounded several times early in the year for electrical and mechanical issues. Despite this low point for the company, Boeing's stock at the end of the year was the biggest gainer of the 30 stocks in the Dow Jones Industrial Average. And remember the 'fiscal cliff' and 'sequester;' both were major concerns in the first quarter of 2013. Ignoring these and a two-week government shutdown in October, the nation's GDP is estimated to have advanced by 3.5% in the second half of the year. This is significant because our economy has not seen 3% annual growth since 2005.

While 2014 is still an unknown, the stage is set for a decent year of economic news. Consider that the Great Recession ended 4 ½ years ago. Unemployment peaked in October 2009 at 10% and people have been getting back to work since (unemployment currently hovers around 7%). 5 million existing homes changed hands in 2013, average prices rose 10%, and new housing starts were strong.



US Unemployment Rate 2003 - 2013

One of the benefactors of the rebounding economy is The Home Depot. With 2,200 stores across North America, Home Depot is positioned to take advantage of the turnaround in home construction as well as the aging of existing homes and the 'wealth effect,' with record levels in the stock market making people feel comfortable spending once again. In December, Home Depot management met with institutional investors to announce updates to their Strategic Priorities and to provide 2015 Financial Targets. CEO Frank Blake detailed his focus on sales, productivity, and capital allocation.

Home Depot's founders were passionate about customer service. That idea got pushed aside briefly during the early 2000s, but is again a major focus since Frank Blake came to the company five years ago. At today's Home Depot, employees (referred to as 'Associates') are better trained, empowered, and incentivized. When Blake arrived in 2007, store associates spent 40% of their time with customers and 60% doing tasks. Now that situation has been reversed and Associates spend 60% of their time 'customer-facing.' By saving time and doing the tasks more efficiently, Home Depot realized a 50% increase in customer interactions without increasing payroll. That translates to more satisfied shoppers and higher revenues for the company.

About 5% of Home Depot's customers are Pros – professional builders and contractors. Although small in number, this segment makes up 35% of Home Depot's sales and so deserves some special treatment. Pros get everything from reserved parking and dedicated checkout to account reps, job-site delivery, rebates, discounts, and online tools. As most of us are aware, a loyal customer is a valuable repeat buyer.

Improving productivity is a challenge for every large organization. Home Depot is using 'big data' to analyze buying trends and help control inventory costs. Sorting through the data, the company realized that online shoppers are not a new group of buyers, they are the loyal store customers just looking for an easier shopping experience – fully 30% of online sales are 'BOPIS' (Buy Online Pickup In Store). In a new phenomenon, 10% of online orders are *placed from within a Home Depot store*. If a customer doesn't find, for example, the ceiling fan they want among the 250 that are normally stocked in-store, an associate helps guide them through almost 10,000 options that can be found online. Several Rapid Deployment Centers are under construction to support customer demand as required delivery times fall to nearly zero.

Home improvement and building supply sales are a factor of GDP growth, housing, and employment – three metrics that seem to be swinging in Home Depot's favor. The company does not believe it has to grow square footage significantly to achieve its 5% long-term revenue growth rate, and plans to open only 8 stores in 2014. At that pace, it would have taken them 275 years to build all their current stores, so this is a departure from the days when several hundred new stores would open in a single year. Now, as company revenues grow and profit margins increase through greater productivity, fewer dollars spent on new stores means an ever-increasing amount of cash to return back to shareholders.

Home Depot today pays about a 2% dividend. Management plans to increase the payout each year as well as buy back stock (reducing the amount of outstanding stock will increase the earnings per share and dividends per share of the remaining shareholders). Although the business is mature, the Home Depot brand seems to be intact with a strong management team behind it. The stock is no longer cheap, but could again be a rewarding growth and income investment in 2014.

- Mark Frombach, Chief Investment Officer

FEDERAL RESERVE press release

Release Date: December 18, 2013

Information received since the Federal Open Market Committee met in October indicates that economic activity is expanding at a moderate pace. Labor market conditions have shown further improvement; the unemployment rate has declined but remains elevated. Household spending and business fixed investment advanced, while the recovery in the housing sector slowed somewhat in recent months. Fiscal policy is restraining economic growth, although the extent of restraint may be diminishing.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects that, with appropriate policy accommodation, economic growth will pick up from its recent pace and the unemployment rate will gradually decline toward levels the Committee judges consistent with its dual mandate. The Committee sees the risks to the outlook for the economy and the labor market as having become more nearly balanced.

Taking into account the extent of federal fiscal retrenchment since the inception of its current asset purchase program, the Committee sees the improvement in economic activity and labor market conditions over that period as consistent with growing underlying strength in the broader economy. In light of the cumulative progress toward maximum employment and the improvement in the outlook for labor market conditions, the Committee decided to modestly reduce the pace of its asset purchases. Beginning in January, the Committee will add to its holdings of agency mortgage-backed securities at a pace of $35 billion per month rather than $40 billion per month, and will add to its holdings of longer-term Treasury securities at a pace of $40 billion per month rather than $45 billion per month. The Committee's sizable and still-increasing holdings of longer-term securities should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative, which in turn should promote a stronger economic recovery and help to ensure that inflation, over time, is at the rate most consistent with the Committee's dual mandate.

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