Outlook

A Quarterly Newsletter from Roffman Miller Associates

09 July 2014

I read an interesting article in the Wall Street Journal last week. The headline read "Pension Funds Missed Stock Rally." The article went on to say that many corporate pension funds and university endowments have missed out on much of the stock market rally since 2009. "Institutions ranging from large corporations, such as General Motors Company, to big universities such as Harvard have been shifting to hedge funds, private equity and venture capital." These alternative asset classes have for the most part badly lagged behind the S&P 500 since the market plunge. To make matters worse hedge funds and private equity firms charge much higher annual fees than traditional investment managers and in addition take up to 20% of any profits.

The poor performance of alternative investments doesn't surprise me. What does surprise me is how such smart people can make such bad decisions. When the market was down over 50% these pension and endowment funds turned away from stocks. I guess they never heard of 'buy low and sell high.'

I would never imply that I am smarter than the managers of big pensions and endowments. Far from it! I learned about investing from my grandfather and father who were both in the investment business. In the past hundred years, as far as I'm concerned, the fundamentals of sound investing have not changed. Over the last 40 years of my own personal experience I have seen many examples of professional investors trying to reinvent the wheel. Some came up with strategies that were quite simple like the 'Nifty Fifty' in the 60s and 70s (a basket of stocks you could buy and hold without hesitation, but on average underperformed during the long bear market of the 1970s) or the 'Dogs of the Dow' where each year you would buy the ten highest dividend yielding DJIA stocks and hold them for 12 months. Others were complicated like Long-Term Capital Management, run by two Nobel Prize winners in economics, a firm which ultimately had to be liquidated after losing billions. Technical analysis may still be around today but they use computers where in the old days it was point and charts done by hand. Let's not forget the CMOs and other packaged products where no one knew what they were buying. And today we have high-frequency trading where computers predict the movement of the market or a stock for a fraction of a second.

For us at Roffman Miller investing is the opposite of a black box. At the end of the day we have people, not computers, who pick every investment and place every trade. I mentioned the Nifty Fifty which were all highly regarded companies that could be bought and held over long periods of time. But even a blue-chip company can become obsolete. Many of those companies are still solid performers today, but remember there were also names like Polaroid and Eastman Kodak. Over the years many individuals have had their 10 minutes of fame when they claimed to have a new system to predict the direction of the markets. But when it comes to picking stocks, that's one area where you can't simply say, "There's an app for that."

As always I welcome your thoughts and comments. Please feel free to give me a call at any time.

Sincerely,
Peter Miller
Chairman and Founder

Buybacks: Increasing Shareholder Value

"Effective capital allocators are managers who excel at deploying firms' resources to earn the best possible returns for shareholders. This is important because as investors, we think of shares as pieces of a business. We therefore buy shares in the hope that managers will use our money effectively to drive up profits and thereby cause share prices to rise. This is why we pay attention to firms' Return on Equity and Return on Capital Employed."
Warren Buffett

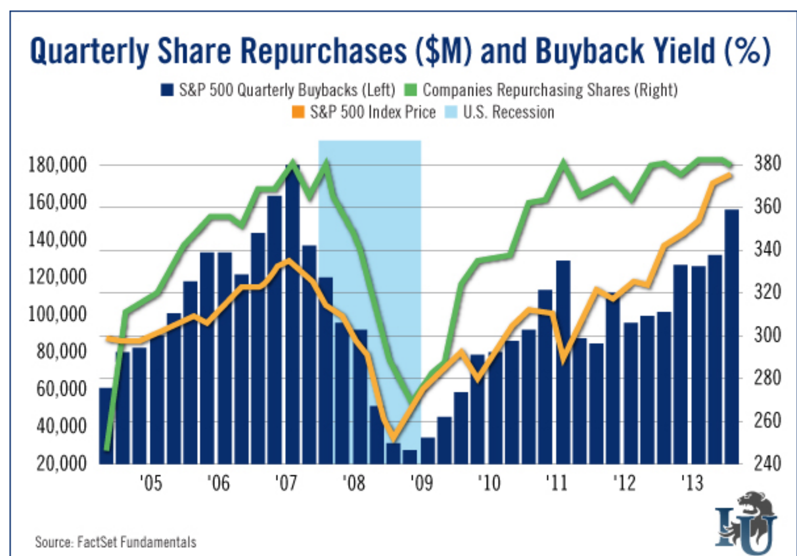
Warren Buffett believes that capital allocation is the most important job of a CEO. At Roffman Miller we share this view. There are many ways to allocate capital. Two of our favorite ways are dividend increases and share repurchases a.k.a. stock buybacks. I've written about the value of dividend increases in our October 2013 Newsletter so today I'll write about stock buybacks. When a company decides to buyback its own stock, it's reducing the number of shares outstanding in the marketplace. Doing so increases the percentage ownership for the remaining shareholders and increases the per share value of the stock. A good management team will aggressively purchase its stock when it believes the shares are undervalued in the marketplace. Even with the market currently trading at new highs there has been an enormous amount of buyback activity. In fact over the past 12 months there has been over $534 billion in S&P 500 share repurchases.

During the first quarter of 2014 we've seen buybacks grow by 50% year-over-year - total buybacks from January through March equaled $154.5 billion. This astonishing repurchase activity was led by the largest of all companies: Apple. In fact, Apple purchased more than $18 billion in company stock during the first quarter of 2014. This was the largest quarterly share buyback for Apple since 2005. In the most recent earnings call CEO Tim Cook said that the "current stock price does not reflect the full value of the company."

Top S&P Company Buybacks	1st Quarter 2014 Buyback	1 Year Total Return	% Change in Shares (Quarter)
Apple	$18.55 billion	52.8%	(3.4%)
IBM	$8.32 billion	(8.3%)	(4.0%)
Exxon Mobil	$3.86 billion	15.0%	(0.9%)
FedEx Corporation	$2.79 billion	43.3%	0.0%
Boeing	$2.59 billion	31.1%	(2.2%)
S&P 500	**$154.5 billion**	**20.6%**	**0.1%**

Source: Factset

IBM also had a very large first quarter buyback totaling more than $8 billion. FedEx and Boeing spent more money on share repurchases during the first quarter than in any quarter in the last decade. These corporate executives obviously see value in their share prices. Above I've included a table which lists the five largest buybacks amongst S&P 500 companies for the first quarter of 2014.



During the great recession of 2008 companies were deleveraging. They were cutting costs, paying down debt and hoarding cash. Ever since the market bottomed in March of 2009, companies have been aggressively allocating capital to both dividend increases and share repurchases. At Roffman Miller we believe that these activities will greatly enhance shareholder value over time.

Bob Hofmann
President

A 'Backdoor' Roth IRA Contribution May Be Right For You

By Robert A. Gottschalk, Jr, CPA

A Roth IRA is an Individual Retirement Account that offers tax-free growth and tax-free withdrawals during retirement. It can be a powerful retirement tool and should be considered when planning your strategy for retirement savings. However, there are income limitations (described below) when contributing to a Roth IRA. These limitations often discourage and exclude high wage earners from making Roth IRA contributions. With a backdoor Roth IRA contribution there is now a way of getting around this limitation and still benefitting from tax-free growth and income.

Three reasons to consider implementing this strategy:

You already contribute to a workplace retirement plan and you are looking to save more for retirement
Typically, the workplace retirement plan is where you should start with your retirement savings. Most employers offer at least a partial match on your contributions making this option the best. A backdoor Roth IRA would be an additional strategy if you are already maxing out on the employer sponsored plan and are looking for a way to diversify your retirement tax portfolio (pre- vs. post-tax retirement savings).

Your current income level prevents you from contributing directly to a Roth IRA
The IRS has set income limitations on direct Roth IRA contributions. The 2014 limits are:

- For single filers – benefits are phased out between $114,000 - $129,000
- For married filers – benefits are phased out between $181,000 - $191,000

If your income is higher than the upper limits you cannot contribute directly to a Roth IRA and a backdoor Roth would be an option.

You do not anticipate needing the funds that will be contributed into the Roth IRA within the next five years
If you withdrawal the funds within five years of the conversion they will be subject to a 10% penalty, unless you are age 59 ½ or older. You should only consider this strategy if you are nearly certain you will not need to touch the funds being used for at least five years.

How does a backdoor Roth IRA strategy work?

Essentially, you contribute funds to a non-deductible (i.e. after-tax), traditional IRA then quickly convert those funds to a Roth IRA. A non-deductible traditional IRA does *not* have any limitations on income; the contribution/conversion allows individuals that would not otherwise be eligible for a Roth IRA to contribute to one.

What's the catch?

In its most efficient form, the backdoor Roth contribution should not trigger any current income tax. However, one of the major drawbacks of the backdoor Roth IRA strategy is the *Pro Rata Rule*. The Pro Rata Rule states that if you already have funds in existing IRAs, then a portion of the backdoor Roth IRA conversion becomes taxable. Without going into too much detail, the more money you have in existing IRAs (SEPs and SIMPLEs included, but not 401ks) the more of your backdoor contribution is taxable and the less sense it makes.

Roth IRAs are not ideal for everyone but they should be considered when planning your retirement strategy. If you are over the age of 70 ½ you're ineligible to contribute to a traditional IRA and therefore you cannot utilize the backdoor Roth contribution. Also, the process cannot be automated so you would review this every year with your tax professional and implement accordingly.

Rob Gottschalk is a partner with the accounting firm Lynn, Gottschalk & Company in Bala Cynwyd, PA. The firm's expertise ranges from basic tax preparation and accounting services to more in-depth services such as audits, financial statements, and high-level tax planning and strategies.

Call (215) 687-4444 to schedule a consultation, or visit them at www.lynngott.com

Inflation, not Rising Rates, Biggest Bond Threat in the Long Term

Intermediate-Term Government Bonds
January 1926–March 2014

Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Government bonds are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest.

Data: Nominal performance of intermediate-term government bonds—Ibbotson SBBI U.S. Intermediate-Term Government-Bond Index, total return. Inflation-adjusted performance of intermediate-term government bonds—Ibbotson SBBI U.S. Intermediate-Term Government-Bond Index, inflation-adjusted return. Inflation—Consumer Price Index. The data assumes reinvestment of all income and does not account for taxes or transaction costs.

Given that the U.S. Federal Reserve is stepping back some of its maneuvers to keep interest rates low, interest rates are expected to increase to more normal levels. Normal means that interest rates are generally dictated by the rate of inflation plus a spread. In the case of the U.S. 10-year Treasury bond, the spread has averaged about 2.4%, though that level has been quite volatile. If one puts that 2.4% spread on top of the current inflation rate of 1.5% (as of Apr. 2014), one could expect an interest rate of 3.9% (compared with 1.8% at the end of 2012 and 2.9% at the end of 2013). Yet, it might take some time to get there. Higher rates are generally bad news for the economy as they tend to slow both housing and auto activity.

Since the beginning of 2013 when rates started to rise, investors have been concerned about a potential decline in bond performance. In general, bonds tend to perform poorly in times of rising interest rates, but by worrying about rates investors may lose sight of an even bigger long-term threat: inflation.

Over the long term (since 1926) investors have lost 3.2% (the difference between 5.3% nominal and 2.1% inflation-adjusted) in return every year to inflation. Compounded over almost 89 years, the difference in ending wealth values is astounding: A $94 nominal value becomes only $7 when adjusted for inflation. Investors may be well advised not to neglect inflation risk while focusing on interest-rate risk.

Source: Morningstar

U.S. Supreme Court Rules Inherited IRAs Not Protected in Bankruptcy

In a unanimous opinion, the nation's highest court said inherited individual retirement accounts are not protected from creditors in bankruptcy.

The court held that IRAs inherited by someone other than a spouse cannot be considered 'retirement funds,' because beneficiaries cannot invest additional money or delay distributions until retirement.

The court said the bankruptcy code is designed to strike a balance between ensuring creditor recoveries while protecting a debtor's "essential needs." Justices determined that an inherited IRA did not fall within the scope of an essential need.

Traditional IRAs and company retirement plans normally enjoy a protected status of varying degrees under state and federal code. This may be something to discuss with your estate planning attorney.

Source: Reuters

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