Investor Insights and Outlook

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"Just the facts, ma'am"

For those of you weaned on radio or black and white television, you no doubt remember the police drama "Dragnet" and it's by-the-book police officer, Sergeant Joe Friday.

Nothing seemed to phase him. Boredom, drudgery, danger and drama; to Joe Friday it was all the same. To succeed, Sergeant Friday focused on only one thing – the facts.

You would do well to emulate his "Just the facts" mantra as you develop, implement and monitor your wealth management plan.

When fearing recession, economist Brian Wesbury believes that investors face three different sets of information – forecasts, confidence and facts. Today, forecasts and confidence are decidedly negative. Recession fears are on the rise, convinced that the economy is contracting (and the world is ending).

But, the facts do not support these fears.

Many forecasters are predicting another recession. Nouriel Roubini (he of the Black Swan school of economics) is predicting a double-dip recession (he also predicted one in 2009, and in 2010). Many people, fueled by the media's relentless "crying wolf" mentality, are willing to believe these "forecasts" because confidence has declined. The well-known Consumer Confidence Index (an actual survey of real consumer's perceptions) drops; and other regional and national surveys have signaled weakness. Yet, many of these surveys are often moved by emotion and fear, not facts.

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Advisor Corner

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Thank you for the opportunity to serve as your advisor.

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The Labyrinth of Financial Statements: The Cash-Flow Statement

The Labyrinth of Financial Statements: The Cash-Flow Statement Public companies in the United States are required by law to disclose relevant business figures and other information. They do this in the form of financial statements: documents whose purpose is to offer detailed information on the company's financial situation: what the company owns (assets), what it borrowed and therefore has to pay back (liabilities), its stock, profit, cash going in and out, and other figures. All financial statements must follow official accounting rules and must be publicly available. There are three major financial statements: the balance sheet, the income statement, and the cash-flow statement. This article will focus on the cash-flow statement.

The cash-flow statement shows cash going in and out of the firm during a period of time. Based on activity type, it is organized into three sections: cash flow from operating activities, investing activities, and financing activities.

1. Cash flow from operating activities This section lists the sources and uses of cash that result from normal, day-to-day operations of the firm. The operating activities portion always starts with net income (the profit the company has made). Usually, there are four items that need to be added to or subtracted from net income in order to arrive at operating cash flow: depreciation, the change in accounts receivable, the change in accounts payable, and the change in inventories. The result is net cash flow from operations.

Depreciation represents the decrease in the value of physical resources resulting from wear and tear over time. For example, a piece of equipment is originally purchased for $50,000, but after being used for a year, its value decreases to $40,000. The $10,000 difference is depreciation. Accounts receivable designates the money the company is waiting to receive as payment for products sold or services rendered. Let's say the company sells a product for $5,000 on Oct. 3, but it does not expect payment until the end of the month. That $5,000 will go under accounts receivable until the actual payment is made. Accounts payable is just the opposite—the company has already received a product or service, but will not pay for it until later. Inventories represent the raw materials, work in progress and finished products the company has in stock at a certain point in time. Changes in all these items affect operational cash flow.

2. Cash flow from investing activities A company, just like an individual, can invest its money in order to increase the value of its assets. For example, if a construction company purchases new construction equipment, this will probably be considered an investment in property, plant, and equipment (PP&E), and the cash outflow will show up under investing activities on the cash flow statement. A company can also invest in the equity of other firms, subsidiaries, joint ventures, acquisitions, and others.

3. Cash flow from financing activities This section indicates how the company is raising capital to finance its operations. Cash inflow can be created by stock or bond issues, and cash outflow by debt payment or the repurchase of shares. Also, if the company pays a dividend to its stockholders, this will have to be recorded here (dividend payment is usually a significant financing cash outflow).

The sum (positive or negative) of cash flows from operating, investing, and financing activities represents the net increase (or decrease) in the firm's cash during a certain period of time (normally a year). Of the three numbers, the most important one is cash flow from operations; ideally, this would be the company's largest cash inflow. The cash flow statement is essential in determining a company's situation because it focuses on what's happening to the firm's cash. Even if net income looks great on the income statement, a company's position may be very weak if it doesn't have enough cash coming in.

Destination Correlation

Please note:

There are times when a negative can turn investments positive.

"Correlation" and "correlated assets" are mainstay expressions in the jargon of investors and financial professionals, and while the concept of correlation can be confusing to novice investors, a quick explanation can clarify why correlation is a key factor in portfolio construction.

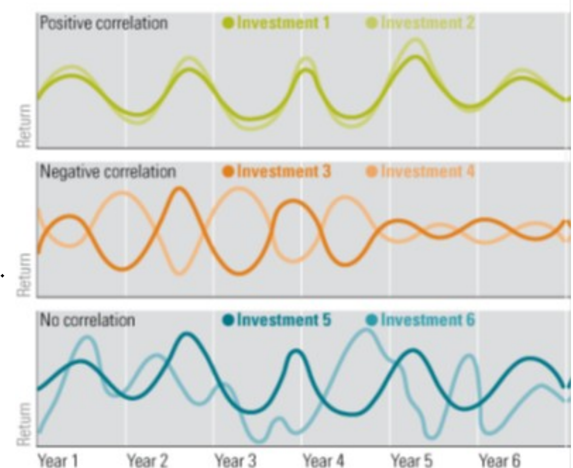
Let's say you or your financial advisor are trying to choose two investments in the construction of a portfolio. Would you prefer investments that are similar (move in the same direction) or investments that are dissimilar? Think about it this way: If you are going on vacation to an unknown island, what type of clothes will you put in your suitcase? If you only take summer clothes and the island nights turn out to be cold, or if you only bring winter clothes and the climate is tropical, your vacation will probably end in tears. It's the same with investing: You're better off diversifying than putting all your money in similar investments.

In order to create a truly diversified portfolio, the investments in the portfolio have to compensate for each other's shortcomings. If investment A declines in value, ideally you would want investment B to increase in value, or at least decline less than investment A. In order to achieve this, you need two investments that behave differently, meaning they have a low correlation.

Correlation is a statistical measure designed to quantify the interrelationship of two investments (again, investment A and investment B). By taking into account the characteristics of the two investments, a mathematical formula calculates a number between –1.00 and +1.00. This number is called the correlation coefficient. If this coefficient is negative (for example, –0.81), we say the two asset classes are negatively correlated. This simply means they tend to move in different directions: if asset class A declines in value, asset class B is likely to increase in value, and vice versa. If the correlation coefficient is positive (for example, +0.34), the two asset classes tend to move in the same direction: they are positively correlated. A correlation coefficient of zero means the asset classes are completely uncorrelated; their movements in relation to one another are random.

Adding investments with low correlation to a portfolio can soften the impact of market swings because the investments do not all react to economic and market conditions in the same manner. For example, building a portfolio with large, small and international stocks would probably not be such a good idea because stocks are generally highly correlated to one another—if large stocks go down, the other stock categories will probably go down, too. The same logic applies to a portfolio with only bonds. However, combining stocks and bonds in a portfolio could provide a significant diversification benefit because these two types of investments do not tend to move together (they have a low correlation).

Various Levels of Correlation



Past performance is no guarantee of future results. Diversification does not eliminate the risk of investment losses. Investment returns shown and correlation numbers mentioned in the text are based on hypothetical data. Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds.

“Just the facts, ma’am” - continued

Although of no consolation to those still unemployed, initial jobless claims dropped to their lowest level since May 2008.

Same-store chain store sales are consistently above 2010 levels. Rail traffic (movement of goods) is up almost 4% from a year ago as is hotel occupancy (business & vacation). Car and truck sales are also headed higher.

To top it all off, the Federal Reserve (the Fed) remains extraordinarily accommodating, money supply remains high and interest rates low. Recessions just do not happen when the Fed is easy, unless there is a panic.

Today, the U.S. is not experiencing a panic. The facts support this.

Of course, fear overlooks these facts. Fear continues to wreak havoc on the financial markets. Fear can lead people to make unwise financial decisions, oftentimes with serious consequences.

Someone once said golf is an incredibly easy game (you, a club and a ball); it’s just hard to play.

The successful wealth management plan focuses on what it can control and ignores everything else. Easy to say, hard to do? Well, maybe. But if we took Sergeant Friday’s approach and considered “just the facts”, perhaps we would all be better off.

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