



Income Update

April 2009

Investment Income and Market Prices Delinked: Startling Bear Market Results, January 1, 2008 – March 31, 2009

We've long held that market price (which leads to account balance) is a secondary metric (method of measurement) when one is investing for income. We held that the flow of income should be the primary metric. We decided to investigate the matter during perhaps the most brutal period an investor will experience in their lifetime – the first part of 2008 to the first part of 2009.

Method

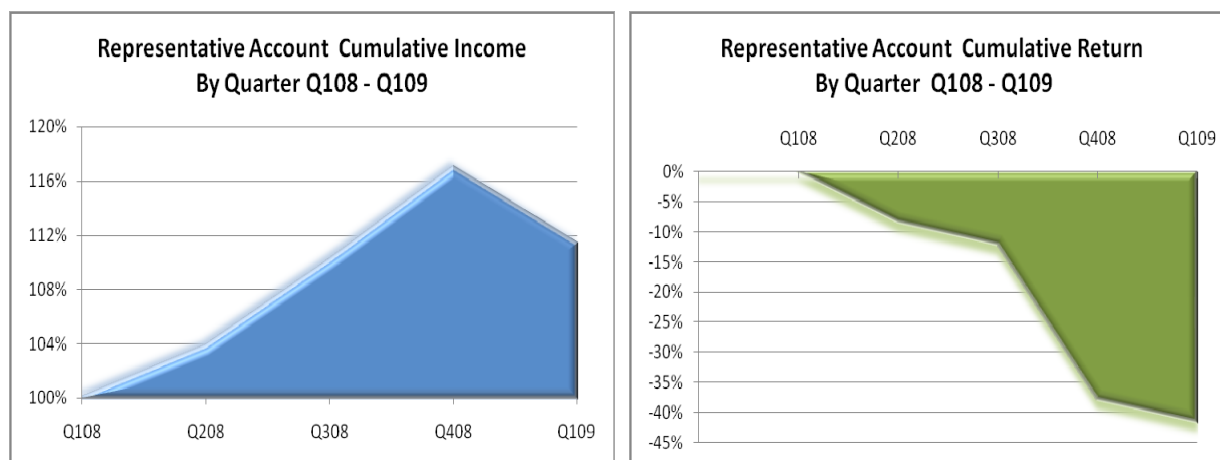
We recorded income by quarter from January 1, 2008 (Q108) through March 31, 2009 (Q109). We used our representative account. We also recorded the Total Return (price changes plus income) for each period, measured against the Total Return of the Standard & Poor's 500 Index, a widely used investing benchmark. Both quarter to quarter changes and the cumulative change using Q108 as a starting point were measured.

The Results

Not surprisingly, income grew from Q108 through Q408 and dipped a bit in Q109, rising from just under \$15,000 for Q108 to \$16,600 in Q109, a 10% gain for the 15 month measurement period. If we are right, Q209 will again see increased income over the prior quarter, as the income drop was due (we believe) to the repositioning of the portfolio in December and January. It often takes 3-4 months from the date of first purchase to the first dividend payment. At any rate, a 10% increase over the period was remarkable, given that the account suffered a 41% loss in the balance, or total market value of its holdings.

How can the account have increased income by 10% while seeing the balance drop 41% - isn't the balance required to support income? We need to examine the mechanisms which determine fluctuations and levels of income and total return.

Representative Account Income and Total Return - Q108-Q109							
Account						S&P 500	
Time Period	Total Income	Income Change	Cumulative Gain	Percent Return	Cumulative Loss	Percent Return	Cumulative Loss
Q108	14,960	0.00%	100.00%	-0.13%	0.00%	-9.92%	0.00%
Q208	15,529	3.80%	103.80%	-8.36%	-8.36%	-3.23%	-3.23%
Q308	16,508	6.30%	110.10%	-4.10%	-12.12%	-9.00%	-11.94%
Q408	17,638	6.85%	116.95%	-29.17%	-37.76%	-22.45%	-31.71%
Q109	16,648	-5.61%	111.34%	-6.01%	-41.50%	-11.67%	-39.68%



How the Income Grew

Income grew because of two things:

1. Reinvesting dividends (compounding)
2. Reinvesting at successively lower prices

The representative account generated far more income than the client withdrew, allowing us to use the cash dividend proceeds to buy shares of the issuer or another attractively priced company. Using income to buy more income-producing shares is called compounding. We were fortunate that during the study period we suffered very little income loss – our securities continued to pay their dividends.

During the year, securities prices fell, finally cascading to a crescendo in March of 2009. All of the time we were buying more shares, buying more of them near the end of the period than we did at the start of the period due to the much lower prices at period's end.

Dividends are quoted per share. Thus, the more shares one has the more income one receives – regardless of the share price. There is no connection between share price and income (see explanation in next section).

The final figure of a 10% income gain was reached by the combination of three forces:

1. The client made some income withdrawals
2. We made a few portfolio mistakes which lost income
3. Security prices got cheaper and cheaper, allowing us to buy more shares with the same amount of cash dividends

In summary, the 10% gain was to be expected, provided that we were able to maintain the income flow through our security selection process – and we did.

How the Balance Fell

The total of all portfolio market prices comprises the account balance. Market prices are set by an auction process of supply and demand. Are there more buyers than sellers? Prices go up and vice versa. The majority of the market price declines occurred after the Sept. 15th collapse of Lehman Brothers, a brokerage house with economic tentacles the world over. Following Lehman's collapse, world credit markets froze, commercial paper virtually stopped being issued (causing cash flow problems in many instances) and global trade, dependent on bank letters of credit, slowed to a trickle. Stock and bond markets reacted by engaging in a selling frenzy. In short, the culmination of the selling was not reached until mid-March 2009. In a word, sellers trounced nonexistent buyers on the way to the exits. Such levels of fear had not been seen since the 1930's. We remained invested much of the time, stopping only to trade out of some "names" whose dividend income was not secure and into those that were. The result was a short term fall in the account balance while income was maintained or increased over the old holdings.

In short, widespread market panic dropped prices almost across the board. Even our consistent income payers had their prices trounced. The astute among you will note that we made a choice to accept short term pain (market price) in exchange for the maintenance of our high income. We reasoned, probably correctly, that if income continued to be strong, the market panic-induced selling would subside and prices would recover. As of this writing, stocks are back to October-November levels, a vast improvement over even March 31, the end of our measurement period.

Summarizing, prices dropped because of a market panic, which dropped the good and the bad, the beautiful and the ugly, to levels not seen in 40 years. It is not surprising, then, that our portfolio balances dropped.

We decided to take the "long view", reasoning that exit and re-entry into markets to gain income is at best an inexact process and that we would be better off hunkered down in the shelter of our quality portfolio.

Conclusion

Market prices are supposed to reflect the future earnings power of an issuer. In this regard, market prices are most often fairly accurate. However, in periods of mass speculation and fear, market prices diverge widely from "true value." In panics, no one feels that they have a handle on valuations, so they err by selling until valuations become clearer. What is the rational act of one person (selling to avoid loss) becomes an irrational exercise if carried on by the entire market. And so it is that our carefully selected securities gained 10% while the market was spanking them to a 41% paper loss. No real loss was incurred because a) the securities did not go bankrupt and b) we did not sell anything whose income continued to flow well.

We will update this study quarterly.