

Changing the DOW

The Dow Jones Industrial Average is a price weighted average of the 30 largest companies from various sectors of our economy. The companies that comprise this average change from time to time and they've just recently made changes to 10% of this index. Here are the 30 Dow member firms as of mid-October 2013:

<u>Name of Company</u>	<u>Trading Symbol</u>
3M	MMM
American Express	AXP
AT&T	T
Boeing	BA
Caterpillar	CAT
Chevron	CVX
Cisco Systems	CSCO
DuPont	DD
Exxon Mobil	XOM
General Electric	GE
Goldman Sachs	GS
Home Depot	HD
Intel	INTC
IBM	IBM
Johnson & Johnson	JNJ
JP Morgan Chase	JPM
McDonalds	MCD
Merck	MRK
Microsoft	MSFT
Nike	NKE
Pfizer	PFE
Procter & Gamble	PG
Coca Cola	KO
Travelers	TRV
United Technologies	UTX
United Health Group	UNH
Verizon	VZ
Visa	V
Wal-Mart	WMT
Walt Disney	DIS

The recent changes to the DOW are 3 new companies kicked out 3 old stalwarts. The people at McGraw Hill (who own the DOW) have decided these firms are more representative of how our economy operates today.

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Psychological, Societal & Emotional

These are the things we deal with on one corner of the decision making tree, with logic and common sense on another, far away corner. I am more comfortable than average on the logical side of this process as I'm a numbers guy and need mathematical proofs on most things I see. I also prefer models and statistics, tests and results. I do not relate well to emotional and societal pressures unlike many people in this world who are very creative, artistic and imaginative. We all have certain skills and gifts and need to play to those strengths as we push through life. We need all types of people and their associated skills to make the world go around and around. We face these pressures in almost every aspect of our lives and money is no exception. The rule of balance calls this dilemma the logical mind vs. the emotional heart. Humans are very emotional creatures and must recognize the issues we will battle with internally as we process and make decisions. I find many, if not most people make an emotional decision and then find a mountain of reasons to justify this decision from a logical perspective.

Dale Carnegie may have put it best when he said "when dealing with people remember you are not dealing with creatures of logic, but with creatures of emotion, creatures bristling with prejudice and motivated by pride and vanity."

Most of the population works more from the emotional realm and as soon as we recognize this, we can begin to find ways around this and tools to deal with it, if we so choose. This is true in all aspects of life and we all manage to get through it. Think about life as a child, we want to do what every other child wants to do if left to our own devices. Without proper parents, mentors, teachers and coaches we normally don't become all we can be. Children push the envelope as far as they can until an adult makes them realize there are consequences to the bad behavior. The child would of course prefer to play, eat and hang out and never go to bed, never do any work, never learn and just remain where they are in life, it's all fun! Why would they work, learn, go to school or otherwise do things they believe to be unpleasant at the time if not pressed to do so by an adult?

As adults we have developed mechanisms to help deal with these innate characteristics that had we not mastered, would hold us back as people and eventually as a society. (I don't think the political class has even acknowledged these issues) We know when it is time to play, time to go to work, time to be serious, etc. We can clearly do what we need to do when we need to do it and then do the things we want to do after the business, work and other hard decisions have been taken care of. Some of us can better handle and process these decisions than others. Some of us were never given the opportunities or tools as kids to handle this.

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I think it's a fair assessment and here are the changes:

Goldman Sachs replaces **Bank of America**

Visa replaces **Hewlett Packard**

Nike replaces **Alcoa**

These all seem very reasonable and as our world economy changes, we should have the companies that represent our indices. One could argue the old companies are still relevant and they are, but it's a moot point as it is a done deal.

With a price weighted index such as the DOW, we take the share price of all of the components and add them to determine how much of an impact any one stock has on the whole index. If we look at all of the stock prices today they add up to around 2400. Before the changes were made around 2000 was the total of all stocks. A more expensive stock has a much larger impact on such an index than a lower priced stock. Let's look at the stock prices of the old components vs the new and see how big of an impact it has.

<u>Old Member Name & Price</u>		<u>New Member name & Price</u>	
Bank of America	14.80	Goldman Sachs	158.80
Hewlett Packard	23.40	Visa	200.40
Alcoa	8.63	Nike	75.79
Total =	46.83	Total =	434.99

Total as a % of the index

Old stocks = $46.83/2100 = 2.25\%$ New stocks = $434.99/2400 = 18.1\%$

Just changing these three stocks, which is 10% of a 30 stock index has made a dramatic impact on how the index will calculate each day. The three old stocks only had a 2.25% impact on the index calculation each day as they moved around in price. The three new stocks have an 18.1% impact on prices as they move around in price. This is how a price weighted index operates, the higher the price of any component, the larger of an impact on the total. Many thought Google should have been added to the index, but a 1000 stock would have an outsized impact on that index. Big priced stocks such as Google, Priceline, Apple, etc. never appear on indices because of that reason. Even on the NASDAQ, those names have a huge impact because of their size. The NASDAQ is a capitalization weighted index and it had a time earlier in the year when Apple was accounting for 15% + of the NASDAQ movements every day just because it's market capitalization was so large.

Other big price stocks such as Berkshire Hathaway with a stock price of \$175,000 per share will never show up on an index as they'd dominate it. At that point the index would lose its value as a barometer for the particular market or sector it is attempting to track and would instead become an index that mostly tracks a single stock with some satellite holdings around that dominant position. ☺

We're very happy to announce a new team member has joined the firm. Larry Hsu (Pronounced Shoe). Larry will be working out of the New York City office and he comes to us from Deutsche Bank where he managed a proprietary institutional trading book of about \$10 billion for 12 years. The trading strategy focused on the spread between derivatives and indices. Larry is from central New York and has lived in Manhattan since 1997.

Larry ironically has a very similar background to me; he started his education in Electrical Engineering and then moved into finance. Larry earned his Bachelor of Science degree from Rensselaer Polytechnic Institute. Larry holds the FINRA series 7, 24 and 63 licenses. He's also licensed for life accident and health in NY, CT, PA, FL & NJ. He is currently pursuing the Certified Financial Planner (CFP) degree from the American college and expects to have it completed within the year.

Larry is an avid runner and continues to participate in sports. He loves to run, play kickball and dodge ball. He grew up playing lacrosse and soccer in high school and lacrosse in college.

Although many consider this to be an odd educational path going from engineering to finance, I see it as a natural progression if you're mathematically minded (some may say dorks, that's okay) and love to interact with people too. This business is the perfect combination for people with those two skillsets unlike any other occupation I know of.

Many think I'm good at math and although I may be better than most, Larry takes math skills to a whole new level. In middle school he was taking high school math classes like my Hannah does, he was so advanced in math in high school not only was he taking classes many years ahead of his grade level, but exhausted what the school had to offer. He was ahead of the teachers in his capacity and at that point the teachers just gave him books to read on the subject. Everyone has a gift and this clearly is his. We see many advantages to having such a dynamite math mind on board. In the investment world many mathematical models, commonly known as Quantitative or Quant techniques are employed. The ability to follow, understand and create such calculations is invaluable in this world.

He's really looking forward to a new career within another corner of the financial world. Financial planning for individuals and helping others improve their financial outcomes has been a long term goal and passion of his. He feels he's been put on the planet to help people improve their financial outcomes so his purpose is now being fulfilled. Making the transition from the institutional side to the individual retail environment is a very exciting one so now Larry can touch a lot of lives and help people. Making profits for Deutsche Bank is fine, but they have plenty of money. Those who really need the help are the many; all of us who do most of the living and breathing and paying and dying in this society. We continue to work towards educating and guiding the public on finances.

Noteworthy News!!!

- Congratulations to Anita Santa Maria on her new job with the Plainville Board of Education! ☺
- Congratulations to Fran Berling on her recent retirement! ☺
- Congratulations to Blaine Rogozinski on his new job with the New Britain Police Department! ☺
- Congratulations to Jon & Michele Maghini on the purchase of their new home! ☺

Question & Answer

Ask any financial question you have and we'll address it here.

Q: What is multiple expansion in the financial markets?

Multiple expansions are another hot topic in the investment arena today that everyone seems to be talking about. Before we get into the expansion concept, let's first define exactly what multiples are expanding. The most popular way to gauge price of an investment is the price to earnings ratio. There are many prices to earnings ratios we measure but for this comparison let's look at the current year's earnings ratio. This ratio takes the price of a stock today and divides the earnings of the company over the current year to determine the ratio. The average P/E for the stock market in general from the beginning of time has been 15.

Let's look at an example today of a company's price to earnings ratio. Company X is currently trading at around \$80.00 per share and the company's earnings are \$4.00 per share. This company makes a lot of things we need every day from razor blades to diapers and we all use them even if we don't realize it. If we divide the earnings into the price we get a ratio of 20. This is about 33% higher than historical averages, but is often justified if the company is growing quickly. This is high for a company who expects a 1% revenue growth next year, clearly not a quick grower as many small firms are. Last year the P/E ratio of this stock was 15, exactly the long term average. No sales growth and a higher stock price give us multiple expansions.

Many times a company will have a much higher P/E ratio if they're growing very quickly and earnings are moving up much faster than normal. In this case share prices eventually catch up with earnings when the growth in earnings slows many years later. Today we're seeing a lot of companies that have no real growth whose earnings and sales are flat and many that are actually shrinking sales and earnings where the company is actually shrinking a bit.

In these situations if earnings are flat to shrinking and share price is going up, we call that earnings expansion as the ratio of price to earnings is going up even though earnings are not. This isn't something we see very much and we usually see it when the economy is growing very fast and people are euphoric. We're seeing a lot of these today, multiples are expanding at record rates so that is why everyone is talking about it.

Psychological, Emotional & Societal (cont'd from page 1)

As adults we still have these innate characteristics inside of us. Think about many of the things we're drawn to that are emotional. We love entertainment, music, drama, comedy and art. None of these things are logically based, but we as humans need and desire them. Sadly our world doesn't have a great mechanism to allow people to turn these loves into careers, but many try. The old saying "starving artist" didn't just appear; it's so very true. Those on the very top of the profession do incredibly well while the masses are struggling to survive. Many use their artistic ability to get a job such as art or music teacher, where they can use their gifts and their love but still have the stability and safety of a regular 9 to 5 job with benefits for a predictable life.

There is a portion of the population that loves the logical side and that fires us up like nothing else in the world. It's so exciting just like the art show attracts the most artistic of people and the opera the most musically gifted. Many call it dorky or geeky to be so excited about these things but think about the wonderful and amazing things that logic and science bring to our world. The love of these things has a great following of occupations such as us financial folks, engineers, architects, physicians, computer people, etc. Inventions such as airplanes, banking, computers, electronics, lights, cars, satellites, TV, radio, medicines, skyscrapers, genetics, etc. wouldn't exist if someone hadn't been consumed with a need to figure out or invent something that was a burning desire deep within them.

I wouldn't be comfortable flying on the airplane that didn't have 3-4 layers of redundant hydraulic and mechanical systems that dozens of engineers didn't think through and test in every possible situation they could imagine. The surgeon isn't naturally open to cutting open a person and repairing or replacing parts of the human anatomy, but the proper training has the surgeon operating in a machine like fashion when in the OR, they don't get disgusted or grossed out, they react to what they see and do what is necessary to improve the patients outcome and accomplish their objective. The soldier isn't naturally able to work through war, but again training makes the process automatic and reactive, emotional thought is overridden, and the mission is taken on and hopefully accomplished. This process is so tough, many of our heroes of the armed forces successfully accomplish their missions but after the fact, when the adrenaline wears off, they are in a tough mental place as they wrestle with trying to justify what they did, even though they were trained and ordered to do it. This is just another example of the mind and how it works; the war hero has nothing to be guilty or ashamed of, as they were in an unimaginable place performing an unimaginable task.

When it comes to financial decision making, we're sitting on the logical mathematical end of the spectrum and we'll try to help you see the logical answers. Most of the population is on the emotional and societal end of that decision making tree, our job is to get you to move closer to the logical end without violating your comfort zone. The closer you get the better your outcomes will be. ☺

Money Quiz

This month's challenge is to tell us what the total credit card debt in our country is today as of August 2013. It was \$1.020 trillion on 8/31/08. Do we have more or less credit card debt than we did during the 2008 year? Last month's quiz wasn't won! ☹️ 47.8% of tax returns filed in 2011 reported AGI of less than \$30,000.00. ☺️ Winner goes to Ruby Tuesday on us! 10/14/13:06

Market Cycles

The economy is a very diverse, complicated and interesting animal. It has a rhythm to it just like our hearts do, but not quite as consistent. Economic cycles can be long and strong, short and weak, consistent or very erratic or any combination thereof.

Many factors play into how the economy acts and reacts to various stimuli in the world in general. Unfortunately government has been the big influencer of late and not in a positive way. The drivel coming out of Washington today is downright embarrassing. They will get it all worked out in time, but in the interim, we're left hanging on their every word and promise to see where things may be going next.

The economy generally expands for a while and then contracts a bit. This contraction is known as recession and is a normal and healthy part of the economic cycle. Historically the cycle has been 4-5 years total. There is generally 3-4 years of expansion, then things get out of balance in certain areas and the contraction or recession has a way of bringing equilibrium back into the system. This is also the great equalizer, when things get out of whack they cannot go on forever, so the contraction is what keeps the system stable over the long run.

The national Bureau of Economic research has a great historical tool you or anyone else can use to see how this data has played out historically. They break it down by various time lines so I'll share with you how they parse the data.

Year Range	Contraction	Expansion	Total length
1854-2009	17.5	38.7	56.3
1854-1919	21.6	26.6	48.5
1919-1945	18.2	35	53.1
1945-2009	11.1	58.4	69.0

The current expansion cycle is old and long at 67 months, in fact one of the longest on record ironically during the weakest economic recovery in history. This is an example of a divergence – typically when a recovery is weak so is the cycle, but here we're in a new era today where governments across the globe are desperately trying to borrow their way to growth. It's not mathematically possible to do this, but for the time being we're still mid cycle.

Insiders are defined as people who know what is going on within a company that the general public doesn't know. Common insiders are the executive team, attorneys, accountants and other such consultants that help steer a business through the world who have information not available to anyone else. We follow what insiders are doing with their money very closely to see if what they're saying is consistent with what they're doing with their own money.

This portion of our investment strategy has worked very well for us, normally when a stock has a bright future the insiders will be aggressively buying that stock because they know in the future good things are coming to this company. We don't know how long it'll take, it could be a few months a few years, but the future is bright for the firm in general when the company executives and key advisors are pouring a large percentage of their net worth into the companies they run and control. This is in addition to any stock they receive through grants and stock options, which generally account for the majority of an executive's compensation package.

Our theory says that if insiders are buying stock aggressively, the company looks fundamentally solid and meets our criteria; good things will come for this company. We prefer to see aggressive buying when things in the world or a particular industry of this company seem bad, that is when prices are most attractive. This portion of our trading system also allows us to avoid pitfall areas where executives are telling people one thing and doing another. This doesn't happen often but it happened big time with Enron. Executives were telling the employees to buy shares aggressively while they were simultaneously selling all of their shares while prices were high; the executives knew the house of cards was imploding. Most executives are great people, but sometimes when something fishy is going on inside a business this double-check system will help us find winners and avoid nightmares. It's not bulletproof, we've had one company where executives were actually buying shares and the company was financially very attractive but the accountants were cooking the books. Perhaps even the executives didn't know?

On a one to one basis this system, just like any other isn't perfect. On a global perspective when prices are low and we see a ton of buying we know good things are to come for the industry, sector or economy in general. Conversely if we see prices are high and a ton of selling, we know tough times are ahead. This is exactly where we are today. We watch form 4 filings with the SEC each day to see who is buying and selling what in each company listed in America. Here is a summary of the report from Sept 23rd, 2013.

17 buyers of shares for a total purchase price of \$574,124.00

50 sellers of shares for total sales proceeds of \$192,583,518.00

What do the executives know the general market doesn't seem to? Executives have been saying for months now the environment isn't conducive to business, growth or expansion and share prices are high, much higher than they deserve to be. I'm listening very closely.

Inspirational Quotes

- Do not regret growing older, it's a privilege denied to many.
- Live your life and forget your age.
- Spending time with children is more important than spending money on children. Anthony Douglas Williams
- If you are depressed, you are living in the past. If you are anxious, you are living in the future. If you are at peace, you are living in the present.
- Everybody is a genius. But if you judge a fish by its ability to climb a tree, it will live its whole life believing that it is stupid. Albert Einstein
- Whoever said diamonds are a girl's best friend never owned a dog.



We can piece the puzzle together and make your money work for you!

Don't make excuses; make things happen; make changes; make history!

Kids Korner

Watering down the standards is a scary and common occurrence in our educational world today. This is something that has been happening in the past few decades as our public schools are forced to try to be all things to all people, which is impossible. More and more time and energy is spent making things equal today for everyone rather than grouping people within their skill or talent groups. As a result, the best and brightest are not being challenged like they once were. Those who have a disability or other challenge are no longer in separate groups with kids like themselves, they're mainstreamed. This has slowed down the process for the rest so the responsibility becomes ours as parents, coaches and mentors to make sure we're pushing the kids so they can hit their true potential. All within reason of course, but we cannot expect the same level of instruction that we had as children as the laws are dragging everyone down.

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