

EPIC CAPITAL WEALTH MANAGEMENT



WEEKLY MARKET COMMENTARY

August 27th, 2012

The Markets

Close, but not quite.

Last week, the U.S stock market hit an intra-day four-year high, but it couldn't hold the gain and closed slightly lower for the week, according to MarketWatch. As usual, news flow from Europe and the Federal Reserve helped move prices.

While we often look at the broad market indexes to gauge progress in the stock market, those indexes sometimes send misleading signals. One cause of the misleading signals is the way the indexes are calculated. For example, some indexes, like the Dow Jones Industrial Average, are calculated using the *price* of each stock. This means a stock with a high price (e.g., IBM) will have a larger influence on the index than a lower priced stock. By contrast, the S&P 500 index is a capitalization-weighted index. This means stocks with a large market value (like Apple) will have a larger influence on the calculated price of the index.

Let's take a closer look at Apple and see how its massive size influences a sub-index within the S&P 500. Standard and Poor's subdivides the capitalization-weighted S&P 500 index into 10 major industry groups. Information Technology is one of the 10 industry groups and its biggest component is Apple – the world's largest company as measured by market capitalization. MarketWatch pointed out that between the all-time stock market high on October 9, 2007 and August 20, 2012, the Information Technology sub-index of the S&P 500 was up an impressive 16.6 percent. However, if you remove Apple from the equation, the index would be *down* 4.1 percent. That's a huge change just due to one stock.

Yes, it is important to monitor the broad stock market indexes to gauge the overall health of the stock market. However, it's also necessary to look under the hood and understand what's driving the performance. Sometimes the headline performance numbers are misleadingly driven by a relatively small number of stocks that, by quirk of a high stock price or large market cap, have an outsize influence – good or bad – on the headline number.

| Data as of 8/24/12 | 1-Week | Y-T-D | 1-Year | 3-Year | 5-Year | 10-Year |
|---|--------|-------|--------|--------|--------|---------|
| Standard & Poor's 500 (Domestic Stocks) | -0.5% | 12.2% | 19.8% | 11.2% | -0.9% | 4.1% |
| DJ Global ex US (Foreign Stocks) | -0.2 | 5.2 | -0.5 | 1.6 | -5.4 | 5.9 |
| 10-year Treasury Note (Yield Only) | 1.7 | N/A | 2.3 | 3.5 | 4.6 | 4.2 |
| Gold (per ounce) | 3.2 | 5.9 | -5.8 | 20.6 | 20.3 | 18.3 |
| DJ-UBS Commodity Index | 1.6 | 3.3 | -8.2 | 4.1 | -2.4 | 3.5 |
| DJ Equity All REIT TR Index | -0.3 | 16.6 | 24.6 | 23.8 | 3.4 | 11.1 |

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Notes: S&P 500, DJ Global ex US, Gold, DJ-UBS Commodity Index returns exclude reinvested dividends (gold does not pay a dividend) and the three-, five-, and 10-year returns are annualized; the DJ Equity All REIT TR Index does include reinvested dividends and the three-, five-, and 10-year returns are annualized; and the 10-year Treasury Note is simply the yield at the close of the day on each of the historical time periods. Sources: Yahoo! Finance, Barron's, djindexes.com, London Bullion Market Association. Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. N/A means not applicable.

WHAT ADDS MORE VALUE TO YOUR PORTFOLIO, CAPITAL GAINS OR DIVIDEND INCOME?

When folks invest in the stock market, they hope to get back more money than they put in. This return on their investment can come from either a capital gain, meaning the stock price rises, or it can come from the company paying a dividend, or both. So, historically, has the return from common stocks come mostly from capital gains or from reinvesting dividend payments?

Researchers Elroy Dimson, Paul Marsh, and Roy Staunton of the London Business School crunched the numbers and came to a startling conclusion. Here's what they discovered:

- Counting capital gains only, \$1 invested in the U.S stock market in 1900 grew to \$217 by the end of 2010. This is an annualized return of 5.0 percent.
- Counting capital gains *and* reinvesting your dividends, \$1 invested in 1900 grew to \$21,766 by the end of 2010. This is an annualized return of 9.4 percent.
- Similar results were found for other markets around the world.

Source: *Financial Times* article, March 4, 2011

No doubt, capital gains are sexy. Who doesn't love to go to a cocktail party and talk about the stock you bought which doubled or tripled in value? Yet, as the research shows, the rather boring dividends account for a substantial part of investors' stock market returns.

A report from ING Investment Management added, "Research shows that companies paying high dividends are likely to become the most profitable, that dividends bring the largest contribution to equity portfolios over the long-term, and, finally, that companies paying high dividends outperform those paying low or no dividends."

So, yes, dividends matter.

There are times, though, when investors get carried away and bid up the price of dividend-paying stocks such that they're no longer attractive. Accordingly, ING said, "While companies paying high dividends outperform the market over the long run, they can underperform it over a shorter period."

Based on the research, it's clear that over the long term, dividends are an important consideration in building a portfolio.

Weekly Focus – Our Crazy English Language...

The English language contains autoantonyms, which are words that have two meanings—which are *opposite each other*! For example, one meaning of the word "rock" is "solid, unchanging, providing firm foundation." However, it can also mean, "to move from side to side, especially gently and soothingly." Same word, but two different meanings! Can you think of any other autoantonyms?

Financial Factoid: The S&P 500 has produced a positive total return for the final 4 months of the year (September-October-November-December) during 8 of the last 9 years (i.e., 2003-11) (Source BTN Research).

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Irish Wit & Wisdom: Parentage is a very important profession, but no test of fitness for it is ever imposed in the interest of the children.

-- George Bernard Shaw, *Everybody's Political What's What?*, 1944

Have a great week!

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* The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.

* The DJ Global ex US is an unmanaged group of non-U.S. securities designed to reflect the performance of the global equity securities that have readily available prices.

* The 10-year Treasury note represents debt owed by the United States Treasury to the public. Since the U.S. Government is seen as a risk-free borrower, investors use the 10-year Treasury Note as a benchmark for the long-term bond market

* Gold represents the London afternoon gold price fix as reported by the London Bullion Market Association.

* The DJ Commodity Index is designed to be a highly liquid and diversified benchmark for the commodity futures market. The Index is composed of futures contracts on 19 physical commodities and was launched on July 14, 1998.

* The DJ Equity All REIT TR Index measures the total return performance of the equity subcategory of the Real Estate Investment Trust (REIT) industry as calculated by Dow Jones.

* Yahoo! Finance is the source for any reference to the performance of an index between two specific periods

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