THE FRANKLIN SOCIETY

The Alternative Investing Club

THE FIVE FUNDAMENTAL MARKET FLAWS

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The Five Fundamental Flaws That Could Sink Your Retirement

These retirement-killing flaws aren't widely reported or even talked about in the financial services industry.

Why?

There are a couple reasons. The first is that these flaws eat away at the very foundation of Wall Street. If these flaws are true, as you will soon discover they are, then the entire Wall Street system is flawed. And there are trillions of dollars at stake, so the industry has a vested interest in keeping you in the dark.

The second reason is more pragmatic: there simply hasn't been an alternative to the Wall Street Machine. With no options, we have all simply accepted their practices, no matter how corrupt, as a necessary evil.

In the following pages you will see the hard evidence that backs up these flaws. This paper is backed up by real data, culled from Forbes magazine, The Federal Reserve and other well respected financial resources.

Thank you for taking the time to read this resource.

Kriss Bergethon & Chaz Shively

Fed Report: Aging Baby Boomers Will Crush Stock Market Prices by 50%

As the Baby Boomers retire not only are they going to cash in on their investments to live, but they're going to be REQUIRED to draw from their IRA and retirement accounts. Its called 'Required Minimum Distributions' and they won't have a choice but to start pulling money from the markets.

What do you think will happen when 78,000,000 Americans start to withdraw their money from the already-disappointing markets?

A December 2014 study by the Federal Reserve Bank of San Francisco lays it out in stark terms.

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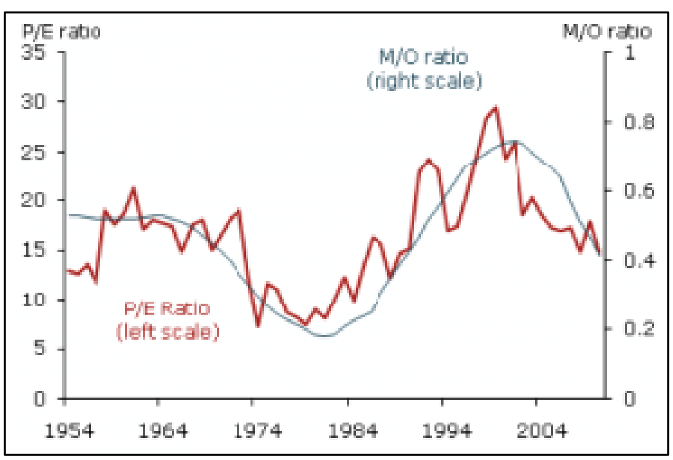
Global Aging: More Headwinds for U.S. Stocks?

Zheng Liu, Mark M. Spiegel, and Bing Wang

The retirement of the baby boomers is expected to severely cut U.S. stock values in the near future. Since population aging is widespread across the world's largest countries, this raises the question of whether global aging could adversely affect the U.S. equity market even further. However, the strong relationship between demographics and equity values in this country do not hold true in other industrial countries. This suggests that global aging is unlikely to create additional headwinds for U.S. equities.

Demographic patterns have a strong historical relationship with equity values in the United States (Liu and Spiegel 2011). In particular, the ratio of those people who are the prime age to invest in stocks to those who are the prime age to sell has historically served as a strong predictor of U.S. equity values as measured by price/earnings (P/E) ratios.

The Fed found a mathematical relationship between investor's ages and stock prices.

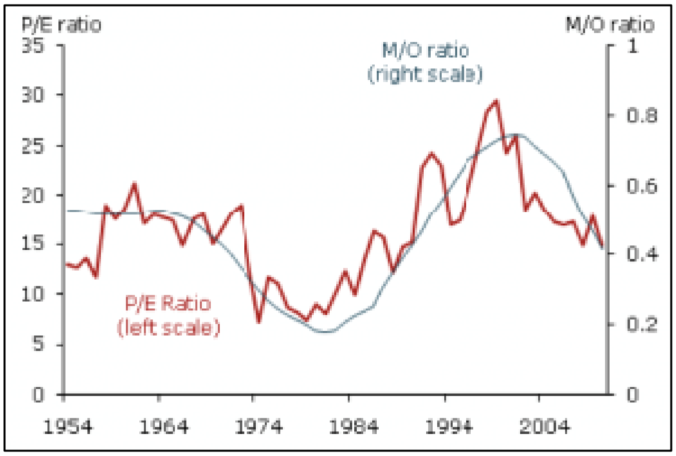


There are prime stock buying years (the population between the ages 40-49, or M in the chart) and stock selling years (the population between the ages 60-69, or O in the chart below). And if you put the two populations into a ratio, you get M/O.

This is basically measuring the ratio of people in their prime wage earning years (people in their 40's) to people in their retirement years (people in their 60's).

When the M/O ratio goes up, there are more buyers in the market than sellers, because there are more people in their stock buying years. When the M/O ratio goes down, there are more people in those stock selling years.

And there is very strong historical relationship between M/O and the market's price earnings ratio, or P/E.



The market P/E is the ratio of overall market prices to their earnings. When prices go down, P/E goes down.

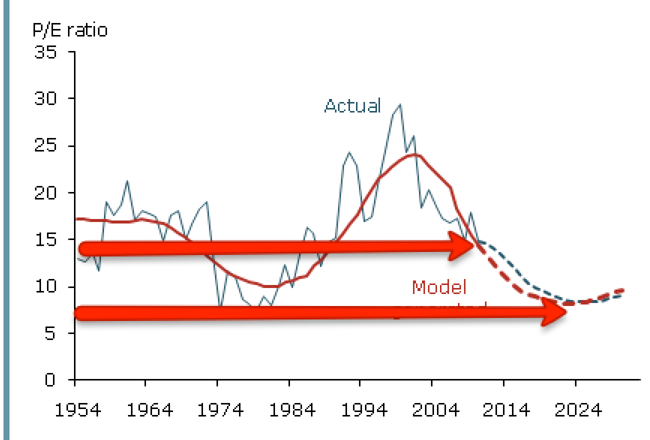
Here's the scary part: when M/O goes down, P/E goes down with it. Which means, as the majority of investors get older, prices go down. And, there's no question that the majority of investors - the majority of our country - is getting older. That's simply a demographic fact.

This makes sense if you think about it. When there are more overall sellers in the market (that is when investors are relatively older), prices are going to go down. The M/O ratio and the P/E ratio historically move in lock step, as this chart indicates.

Well the M/O ratio, because of the Great Baby Boomer Retirement, is going to hit all time lows. Which means that the market P/E ratios will too. In fact the Federal Reserve says in its own report:

"***Our current estimate suggests that the P/E ratio of the U.S. equity market could be halved by 2025 relative to its 2013 level.***"

Figure 2
Projected P/E ratio from demographic trends



<u>The Fed is predicting a 50% decline in stock values over the next 10 years.</u> Can you afford to lose 50% of your investments?

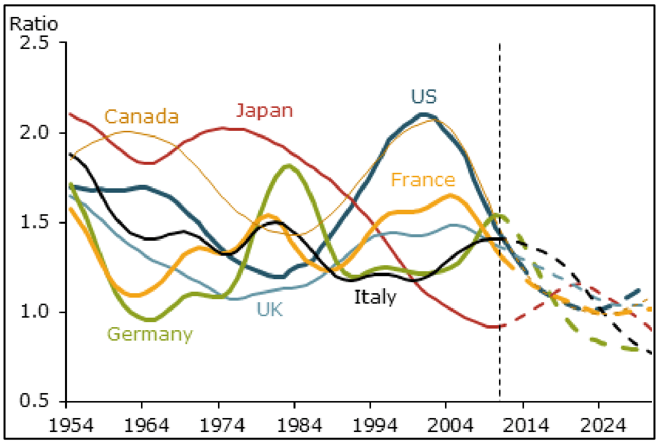
In the chart on the left you can where they are predicting market P/E ratios, and therefore market prices, to be in 2024.

Now some people will disagree with these estimates. They'll say that younger investors, or foreign investors, or even institutions will start to buy and keep the markets afloat.

I wish it were true.

They must be talking about the younger investors, in their 20's and 30's, that are carrying massive student loans, high unemployment, and are saving less than any generation before them?

And if you're counting on foreign investors to save our bacon, think again. China is slowly entering a massive recession that even its meddling government can't avoid.



Europe and Japan have similar aging patterns to ours, which means they are going to be experiencing a massive retirement and stock drawdowns too. You can see in the chart at the left their M/O ratios are in massive decline as well.

And what about institutional investors? Well the majority of what they are holding is baby boomer wealth. They are investing on behalf of the soon-to-be retired, and they'll be selling securities at a rate we've never seen before too.

Now you might be saying 'Why should I believe the Fed, aren't they responsible for this mess?' I agree with you, the $85 Billion that the Fed is printing every month certainly isn't going to help things. But if you believe the Fed is responsible for this mess, and they're telling you what is going to happen here very soon, shouldn't we pay attention?

The Fed tries to make everything look 'rosy' - what if this is their 'rosy' picture of things?

What if they're wrong though? And what if the decline is only 13%? Or 5%. I don't know about you, but I was really hoping for a GAIN over the next decade. Think about it, can you afford to lose ANY of your investments over the next 10 years?

Your financial advisor probably doesn't want to talk about this. In fact Wall Street and the entire financial industry would like to pretend this market force just doesn't exist. That's why you don't see it being talked about in the Wall Street Journal.

There's actually a pretty good reason for this: there's never been a solution. There simply hasn't been an alternative for investors.

Why yell 'The Emperor Has No Clothes!" when we're all just standing around naked too?

But what if there was an alternative? What if there was a solution to this impending financial crisis? For more on this check out our special report The New Investing Revolution.

Real Returns are Lower Than Anyone Is Willing to Admit

Stock returns are much lower than Wall Street and the financial services industry are willing to admit. Wall Street loves to point to historical return numbers like 8, 9, and 10%, but are those numbers accurate? What happens when we adjust for inflation?

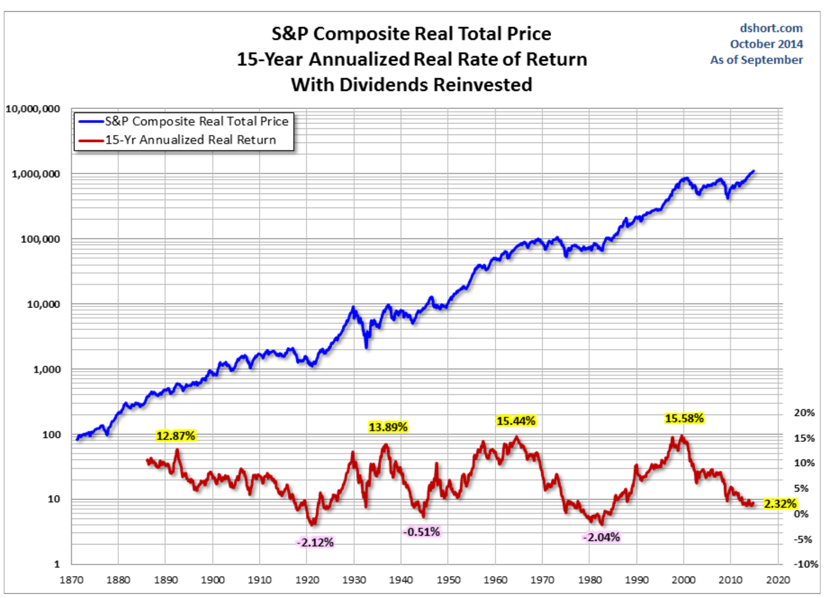
Let's look at some returns over the last few years after adjusting inflation. Although, as you'll soon see, Wall Street is not very good at accounting for ACTUAL inflation.

If you invested $10,000 in the S&P 500 in 2004, you would have $17,700. This is equivalent to an inflation adjusted **yearly return of just 5.74%** over the last 10 years. But lets face it, most of us have been investing for longer than 10 years.

What if you invested $10,000 in the S&P 500 15 years ago? You would have $14,100 today for an inflation-adjusted **yearly return of just 2.32%**.

If we increase the time frame to **20 years the adjusted annual return is 7.4%,** and for **30 years its 8.2%.** So the only way to get anywhere near Wall Street's 'rule of thumb' returns is to increase the time frame to back when returns were decent.

Chances are you've been investing throughout the last 20-30 years, so your portfolio has seen a mix of all these returns.



Thank you to dshort.com for the data presented here.
http://www.advisorperspectives.com/dshort/updates/Total-Return-Roller-Coaster.php

Mutual Fund Fees Are Killing Your Profits

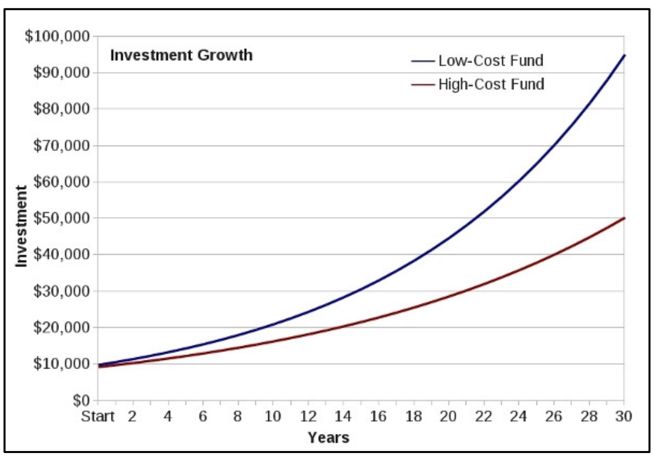
You probably have a couple mutual funds in your portfolio, nearly every investor does. And what comes with mutual funds? Mutual fund fees. Most people try to target fees of less than 3%, thinking that the fund managers will more than make up for those fees with sound investing. That idea is questionable in itself, but the real question is: Do you know what the real cost of those fees are?

A recent study by Vanguard revealed that even a 2% management fee can reduce your overall profits by 40-70%.

How can that be? Let's do some quick math. A $10,000 investment with 7% returns annually would be worth about $76,100 after 30 years. But if the fund manager takes 2% of that every year, you're really only seeing a 5% return. So you're $100,000 with a 5% return is worth only $43,200 after 30 years.

So your profit was just $33,200 instead of $66,100 – all because of a 2% fee.

So you just gave away 50% of your profits to the fund manager. That's due to the power of compounding interest. You're not earning a return on the profits that the fund took as fees.



If we raise the fund fees to 3%, the numbers are even more depressing. In the same scenario your profit would be just $22,433 with a 3% management fee.

So the fund manager took $43,667 of YOUR PROFIT, or 66% of the total profits, even though the management fee of 3% is less than half of the 7% annual return.

And that doesn't even account for the hidden fees that are lurking in the fine print of your investment prospectus. This CNBC article lays it out in stark terms: there are myriad 'account maintenance fees', 'shareholder servicing fees', and 'revenue sharing fees' that can add up to as much a full percentage point.

After doing the math above, do you think you can afford to give away ANOTHER percentage point to the fund manager?

Real Inflation is Actually 226% Higher Than What is Reported

In America businesses, consumers, and government rely on a key economic metric produced by the US Federal Government for making financial decisions. In fact this number is used worldwide for many economic measures. Its called the Consumer Price Index (CPI) and it is supposed to measure what we commonly call inflation.

Now the creators of the CPI might argue with that. What they set out to actually measure was consumer spending, and how it changed from year to year. But over the years it became the default measure of inflation.

This number is so widely used and reported that there is an entire class of inflation-adjusted securities (called Treasury Inflation-Protected Securities) that peg their performance to CPI. Every discounted cash flow or financial pro forma used by big business and banks uses CPI in some fashion to predict the true value of future investments. The CPI is one of the most commonly reported metrics at every financial media organization in the country.

And it's complete bullsh*t.

At least as a measure of true inflation, which is how it's being used.

The number that we commonly know as CPI might as well be called the Made-up Government Inflation because its conjured using shoddy math and manipulated for political reasons. And we're about to show you exactly how that is done and what the true number should be.

The Bureau of Labor Statistics states on its own website:

"The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services."

But what they don't tell you is that those numbers are manipulated from the outset to account for what is ambiguously called 'quality'. The BLS believes that as the quality of goods increases the 'true cost' should be revised down to account for this.

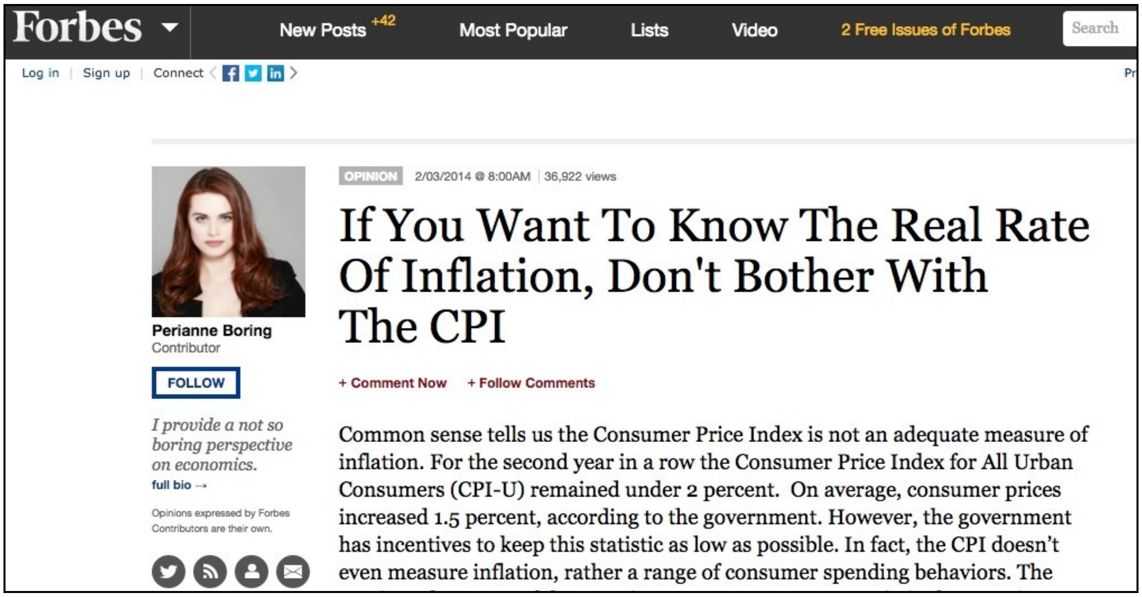
So if you purchased an smart phone last year and it cost $250, but the one you bought this year cost $450, they would revise that price inflation number down because the $450 smart phone had a significant increase in quality.

Can you see a problem with that?

Do you see any room for manipulation in that method?

To be sure, the government has a vested interested in keeping the inflation numbers low. Reporting true inflation of 4-5%, which is probably much closer to the real number, would set off economic alarm bells. Economists and policy makers have decided that 1-2% inflation is acceptable to the masses, so the number is revised to reflect that.

Did you know that according to a this [Forbes article], the Consumer Price Index, (CPI, the standard government measurement for inflation) doesn't even meet the government's OWN criteria for measuring TRUE inflation?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OPINION 2/03/2014 @ 8:00AM | 36,922 views

If You Want To Know The Real Rate Of Inflation, Don't Bother With The CPI

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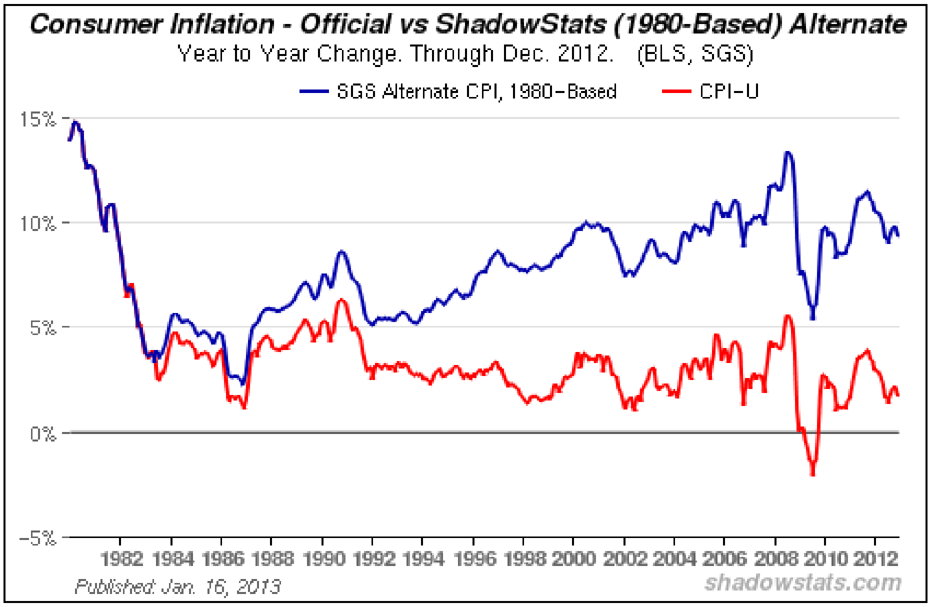
Common sense tells us the Consumer Price Index is not an adequate measure of inflation. For the second year in a row the Consumer Price Index for All Urban Consumers (CPI-U) remained under 2 percent. On average, consumer prices increased 1.5 percent, according to the government. However, the government has incentives to keep this statistic as low as possible. In fact, the CPI doesn't even measure inflation, rather a range of consumer spending behaviors. The

That's right, the government-produced number that we all base inflation estimates on isn't even accurate enough for the most government agencies to use! <u>Most of them use monetary inflation, which measures how much money was put into the system by the Federal Reserve.</u>

Care to guess what that monetary inflation rate was in 2013 alone? It was 4.9%.

THIS IS MORE THAN THREE TIMES THE REPORTED CONSUMER PRICE INDEX INCREASE OF 1.5% IN 2013.



Source: http://www.shadowstats.com/alternate_data/inflation-charts

This article on Investopedia lays out the flaws in CPI and how the government manipulates the numbers – always with the aim of lowering their reported inflation numbers.

Ask yourself, do your grocery bills, fuel costs, and energy bills look like they only went up 1.5% in the last year? Let's not kid ourselves. Ultimately our retirement lifestyle depends on knowing the TRUE inflation.

So what is the true inflation? It turns out there is an easy answer and a complex answer. Not surprisingly, the government doesn't reveal the formula for CPI.

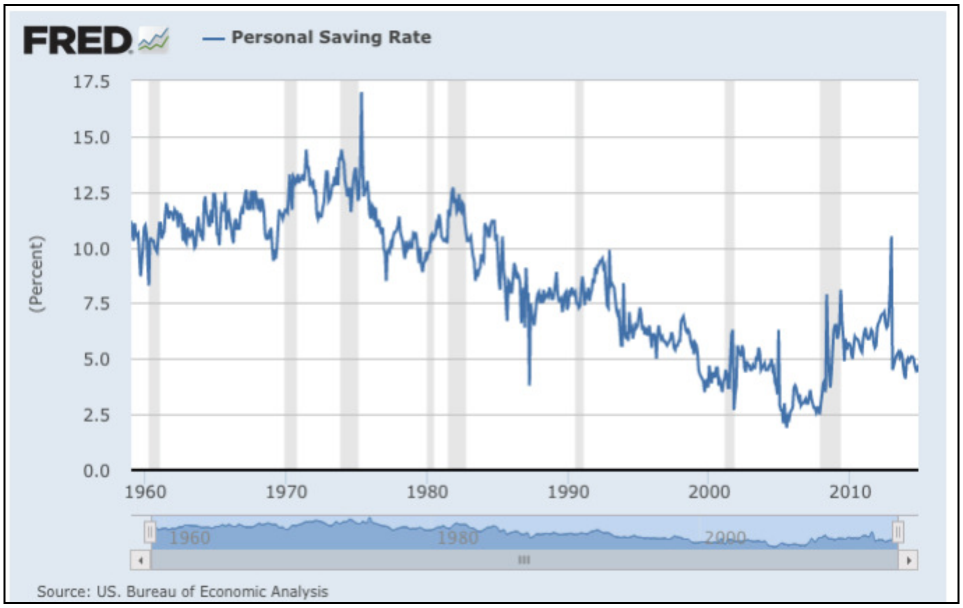
The easy answer is to use monetary inflation. Monetary inflation measures how much extra money was put into the economy (this is the 'money printing' we hear so much about). This number has been close to 4.5% for the last few years.

The BLS would argue that this doesn't actually measure what consumers spend (we'll show you why the consumer spending numbers are nonsense soon too). But lets do a simple thought experiment.

Lets say for simplicity that the sum total of American wealth, the Gross Domestic Product) is $100 Trillion. The Federal Reserve then 'prints' its share of $4.5 Trillion.

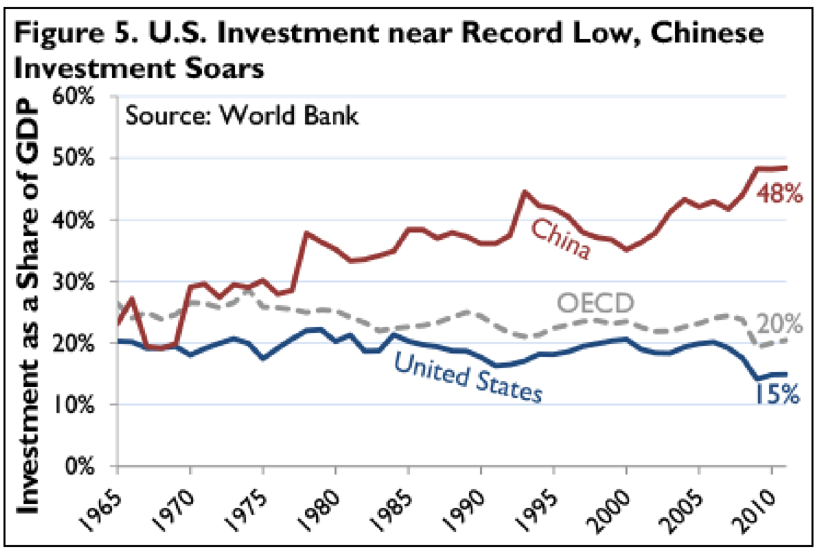
Where does that extra money go?

Well it doesn't go into savings accounts. American savings rates have been falling for decades.



http://research.stlouisfed.org/fred2/series/PSAVERT/

And its not going into investments either, US investment is near a record low.



http://taxfoundation.org/article/how-tax-reform-can-address-america-s-diminishing-investment-and-economic-growth

So where does that money go? You can probably guess. The money is 'consumed' by buying goods and services. And this extra influx of money drives inflation of the prices for those goods and services.

Admittedly, it's more complex that I am making it sound. But shouldn't true inflation numbers account for the vast amount of money that is simply being created by the Federal Reserve?

But lets take a look at the complex answer. How much are goods and services REALLY rising?

Food

Food accounts for 17% of the index, and it should surprise no one that food costs are skyrocketing.

Meat prices alone have soared this year. Beef is up 10.4%. Pork is up 12.7%. If you look at the spreadsheet here:

http://www.ers.usda.gov/data-products/food-price-outlook.aspx

Look at 'Changes in Food Price Indexes 2012 through 2015', and look at the Year over Year increase for food prices from Nov-13 to Nov-14 were 3.4% for food at home and 2.9% for restaurants.

The index predicts similar growth next year.

Housing

So what about housing? This is a major part of American spending of course. This is one of the more difficult aspects of CPI to track down, so the BLS uses rents to account for housing costs. But the CPI uses quite a bit of voodoo and shadowy math in their numbers. So it's hard to know what exactly they are tracking.

But if we look outside the government for numbers, the trend is stunning. Research firm Capital Economics said rents rose 4% this year. The Wall Street Journal says rents are rising about a percent a quarter.


THE WALL STREET JOURNAL. U.S.

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2 of 12 Oil Prices to Play Into BP Fine

U.S. NEWS

U.S. Rents Rise Again as Market Tightens

Landlords raised rents by an average of 0.8% to $1,083 a month in the quarter.

Email

By DAWN WOTAPKA CONNECT

Jan. 6, 2014 11:31 p.m. ET

Apartment landlords continued to push through higher rents in many cities in the fourth quarter, offering little relief for renters who have seen increases over the past few years.

http://www.wsj.com/articles/SB10001424052702304887104579304830053269994

Home prices rose 4.5% (there's that number again) this quarter according to Case-Shiller. Construction material costs rose 3.2% this year. Electricity prices increased 3.9% last year.

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Electricity Price Index Soars to New Record at Start of 2014; U.S. Electricity Production Declining

February 21, 2014 - 2:24 PM

By Terence P. Jeffrey
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http://cnsnews.com/news/article/terence-p-jeffrey/electricity-price-index-soars-new-record-start-2014-us-electricity

Anyone noticing a pattern here?

Medical

The Millman Medical Cost Index rose 5.4% this year. If there is one thing we can count on in America, it's that our already-ridiculous medical costs will keep rising. In fact the 5.4% increase last year was the LOWEST annual change since 2002.

Milliman | Our Company | Solutions | Careers | Insight | Find

2014 Milliman Medical Index

By Christopher S. Girod, Lorraine W. Mayne, Scott A. Weltz, Susan K. Hart | 20 May 2014

$23,215. That's how much is spent in 2014 on healthcare for a typical American family of four covered by an average employer-sponsored health plan according to the 2014 Milliman Medical Index (MMI).[1] And yet while the amount has more than doubled over the past 10 years, growing from $11,192 to $23,215, the 5.4% growth rate from 2013 to 2014 is the lowest annual change since the MMI was first calculated in 2002.

Download the report »

Employers pay the largest

FIGURE 1

http://www.milliman.com/mmi/

Other

There are a lot of other numbers that go into the CPI, but they have a relatively low weighting. Apparel and 'Other' account for about 13% of the index. But as you can see above, the writing is on the wall.

Nearly every index we can find found price inflation last year was AT LEAST 2% and much closer to 5%. This is nearly 2.5x what the government is reporting.

Also, for those that don't live in a city the fine print in the CPI language might make you a bit angry:

"the rural population may or may not be included; "

According the Census, 60,000,000 Americans live in rural areas. Why are they excluded?

What Does This Mean For You

You need to recalibrate your investments. The low interest-bearing accounts and bonds just aren't going to cut it anymore. It's time for Americans to seek out higher return alternative investments that offer low risk and capital preservation at the same time.

The Diversification Myth

Financial experts love to talk about diversification. This is the go-to argument for anyone questioning the almighty Wall Street machine. But the benefit of diversification, at least in the way we've learned about it, is a myth.

Question: what good is diversifying your money within a market that is slowly sinking. Every market segment, every industry, every public company will feel the drain of billions of dollars leaving the market.

What's the point of moving your money from the back of the Titanic to the front of the Titanic?

And the kicker is that 'modern portfolio theory', and the government's financial policy, actually demands that fund managers diversify and slow down their fund's growth to reduce risk.

The best fund managers are REQUIRED to invest in dead weight stocks to conform to industry practices.

Think of this way: you are a fund manager. You purchase 20 stocks that you love. 5 of those stocks absolutely take off, just as you had hoped. But what has happened to your portfolio? Now your portfolio is weighted with 5 high-performing stocks.

Now normally you would be fine with this, you would 'let the winners run' as they say. But according the industry ratings agencies, the SEC, and companies like Morningstar, you are now the owner of a HIGH RISK portfolio. Fund managers want to avoid this so that they can attract the large institutional investors like pension funds and public retirement accounts.

Modern portfolio theory, the basis for our financial policy and practices, COMMANDS you to sell some of your winners, purchase low-risk (and low-performing) stocks and bonds to balance out your risk. And it works of course; it kills your overall return. It brings your profits right back in line with the rest of the market.

<u>Its like telling the champion thoroughbred horse that keeps winning all the races that they have to start carrying extra weight.</u>

Diversification, both on a personal level and a market level will invariably bring your returns right back in line with everyone else.

For TRUE DIVERSIFICATION, you must diversify your investing strategy to include hard assets and off-Wall Street vehicles that will not be susceptible to these overwhelming market forces.