Investment Thoughts

This Issue:

Second Quarter 2016

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Dear Client,

Happy summer! Hope you are enjoying the sunshine and busy planning to make the most of the precious few weeks we have until the leaves turn.

My family was fortunate enough to celebrate the end of another school year with a family reunion in Gatlinburg, Tennessee (near my brother's college stomping grounds). Being up in the Smoky Mountains we were continually presented with warnings about the presence of bears and the precautions one should take. We dutifully glanced at them, but to be honest it was more of a skim than a thorough read. I had spent my fair share of time in the Wisconsin woods without an encounter – what were the odds…?

And with that mindset we set off into the park for a lovely morning hike. Of course, it didn't take long for the telltale signs to appear – piles of scat periodically littered the trail. Our awareness heightened, we stopped letting the kids run ahead of us and frequently scanned the trees, but continued on our way. Thankfully we did, because it allowed us to reach our destination - a beautiful waterfall that made the journey (and periodic shoulder rides for my youngest) worthwhile. But during the return trip, in that same section of the path, we encountered other hikers that were stopped in their tracks and delivered the news: "Bear ahead!" We noticed a number of cars stopped on the road below us with passengers taking pictures, but couldn't see the bear. It took a couple of minutes to locate him, but sure enough – there he was.

Caught in this surprise (and yet completely predictable) situation, the nerves instantly kicked in. The initial thought was to turn around, and yet we knew we ultimately needed to go on in order to arrive at our car and return home. But how to proceed? We took a moment to identify the danger (thankfully the bear was up the hill and not between the trail and road), assess our options (should we leave the path?), and remembered as much as we could from the notices (move slowly, make noise). Despite the sighting, the bear was never terribly interested in us and went peacefully about his business as we passed by. The advance preparations – and sticking to the plan in the heat of the moment – allowed it to be a completely harmless encounter (and great story!). Of course, my wife never did stop hitting trees with her walking stick or occasionally shouting until we safely reached the car – better safe than sorry…!

Of course, as investors we're always on the lookout for the bear (market), and the recent Brexit vote probably falls somewhere between noticing the telltale signs and an actual sighting off in the distance. But similar to our experience in the Smoky Mountains, a little bit of education, a little bit of vigilance and a little bit of discipline can go a long way towards a happy outcome. Our two featured articles and book recommendations can serve as the flyers posted in the Smoky Mountains – how much you skim over versus read thoroughly is entirely up to you!

While we like to use lighthearted stories to get our point across, we realize that navigating the markets is serious business. Please don't ever hesitate to reach out with any questions ("the only bad question is the one left unasked"), or to discuss any aspect of your financial plan. That is what we are here for!

Greg Rademacher, Chris Bugg, and Jodie McLellan

"How Much Stock Should You Have in Your Retirement Accounts?"

By: Jane Hodges

Date: April 3, 2016

It has been seven years since the start of this bull market for stocks in the U.S. Is it time for investors to adjust the equity allocations in their retirement portfolios?

Many financial advisers say yes. But that is where the consensus seems to end. Some believe that investors should start to reduce the amount of money they have in stocks. Others, however, argue for sustaining the stock allocation. What they do have in common is that they believe it is time to tinker with the models, while weighing different reasons to move the stock needle up or down.

There is no universal prescription for equity allocation, of course. Much depends on a portfolio's size, an investor's age and how soon he or she wishes to retire. Expectations for annual stock returns have ratcheted back since the stock market recovery began in 2009, with many financial planners modeling for annual returns in the 4% or 5% range, down from as much as twice that before the 2008-09 recession.

Meanwhile, the reduced outlook for equities still exceeds expected returns for other asset classes. But for many, all of the volatility of late makes the near-term risk/reward proposition for stocks less appealing.

"Returns expectations have ratcheted down, but the expectation of short-term volatility in the market continues," says Christine Benz, director of personal finance at fund researchers Morningstar Inc.

Other factors affect allocation decisions, too, such as whether an investor's portfolio has been rebalanced along the way, or whether it has passively wandered into an inappropriate asset mix for the person's risk tolerance or goals.

Ms. Benz notes than an investor with $10,000 invested in a 50% stock, 50% bond-related portfolio in 2009 would have seen—if the portfolio were left unchecked—a transition to a 70% stock and 30% bond allocation by the end of 2015.

The good news? The investor's money would have grown substantially. The bad news? So would the risk exposure.

Here is a look at four percentages of stock allocation for an investor to consider, and the types of investors that might want to consider each of the levels.

0%: No Stocks, Thank You

Who is using this approach: The very rich, those with low required rates of return.

Rich, or "high net worth," investors have the luxury of turning to a cash-preservation approach earlier than their less-affluent peers, meaning they can afford to protect the assets they have accumulated rather than pursue potentially high returns at the cost of greater risk. These investors might avoid stocks altogether at any age, opting for fixed income or cash.

But the very rich aren't the only ones who might use a no-stock approach.

John Flavin, a certified financial planner and registered investment adviser with Synergy Financial in Seattle, makes the case that for the nonelite, a no-stock portfolio isn't inconceivable.

For each client, Mr. Flavin's firm determines a required rate of return—the return needed for the investor to accumulate the funds needed to live as planned in retirement. For some investors who have saved carefully or who are able to live frugally, the required return can be low, which means the assets used to achieve it don't have to deliver anything resembling stocklike returns.

"If you don't need to be in the market, by all means you can hold zero stocks in your portfolio," Mr. Flavin says.

He says that he works with an 80-year-old couple who have a low required rate of return, 1.5%, and that he has recommended an all-bond portfolio for them. Based on a rate-of-return approach, stocks aren't necessary for them, he says. Clients who need a 4% return, on the other hand, would likely use 30% to 40% stocks in their portfolio, Mr. Flavin says, and those who need 8% might need to deploy 60% stocks.

30%: Nearly Out Of the Market

Who is using it: Investors with short-term market concerns and those near retirement who want to reduce their risk.

Andrew Sloan, an adviser with Bluegrass Financial Planning in Louisville, Ky., says that for clients within five years of retirement he has been rebalancing portfolios toward a 30% stock and 70% fixed income/cash allocation, rolling back from a 40% stock and 60% cash allocation.

"You still need to take on some risk with equities to beat inflation," he says. Where clients are transitioning money out of stocks, they're not choosing cash, but rather shorter-duration bond funds.

Others are going down to 30% in the short term to protect bull-market gains.

"I've gone to 70% cash in my personal accounts," says Tim

Shanahan, a certified financial planner and president of Compass Capital in Braintree, Mass., a fee-only adviser. And it is an approach he has advised clients to consider, too.

Mr. Shanahan says that in the second half of 2015 he began advising many clients away from stocks. He says he decided cash was the wisest bet for the foreseeable future, based on his belief that equities are overvalued, that rising interest rates make rebalancing toward fixed-income riskier than before, and that rebalancing into "alternatives" isn't helpful given that they are ultimately correlated to the broader stock market.

Mr. Shanahan says he advised several clients—most within 15 years of retiring—to move from a typical mix of 60% stocks and 40% fixed income to a mix of 50% cash, 30% stocks, 20% fixed income.

The shift isn't one he would recommend for millennials, and even for his midlife investors it requires opportunity-cost analysis. Clients using individual retirement accounts can shift into cash without tax impacts. For those invested in non-IRA vehicles, Mr. Shanahan says, it is worth evaluating the impact of capital-gains taxes connected to selling stocks versus the impact of potential portfolio losses.

"The tax pain is typically much less than losing what could be 20% of their assets' value," Mr. Shanahan says. "I don't know when I'll personally get back into the market."

50%: The Middle Way

Who is using it: Middle-aged investors seeking to preserve some of their portfolio after the bull run.

Kris Garlewicz, a certified financial planner with Market Financial Group, a broker-dealer and registered investment adviser in Chicago, says his firm's views on the long bull run continuing began to turn last August.

He cautions against reactionary portfolio rebalancing or "timing the market"—never a recommendation for long-term investors. But in recent months, he says, he has told a quarter of his clients to readjust their equity weightings.

He has helped some shift from a 70% stock and 30% bond split to portfolios containing 50% stocks, 30% bonds, and 15% to 20% in short-term bond funds or alternative investments, with a small remainder (under 5%) in cash.

"A lot of them see this as a time to take a breather from chasing returns," he says. "The market has been just one straight line up. Markets don't go up forever."

Clients aren't permanently ditching equities, but are using shorter-term investments they intend to revisit later.

"They want to take some chips off the table," Mr. Garlewicz says. "It is what I'd call a 'crash protection' approach."

Mr. Garlewicz says most of his clients are still in the prime of their working lives, ranging from their 30s to their 50s. Many are self-employed or operate small businesses and have lived through a variety of market cycles. Many say they have gained enough in the recent bull run that they'd rather protect their recent growth than continue betting with it, he says.

Doug Bellfy, a fee-only adviser with Synergy Financial Planning in South Gastonbury, Conn., says that for clients nearing retirement, rebalancing along the way should keep them protected from overexposure to stocks. He typically reduces near-retirees' stock exposure by 2% annually in the five years leading to retirement, moving from a 60% stock and 40% fixed-income mix to a 50% stock, 40% fixed income and 10% cash portfolio.

Within the stock portion of such a portfolio, he often rebalances the stock and fund picks away from small stocks to emerging markets, figuring that small-caps have had a strong run and emerging markets are now more affordable.

100%: All In

Who is using it: Some young investors, and the "undersaved."

All in with stock? There are always people who do it, including entrepreneurs with cash on hand. In theory, younger savers might place all (or nearly all) their retirement eggs in the equities basket, given their long time horizon before retirement, and thus the ability to ride out market cycles. Others may be close to retiring but short of their savings goals, and so hoping that a 100% allocation to stocks will make up for lost time. Few, if any, advisers would recommend such a move.

"You'd be hard-pressed to find anyone holding 100% equities" these days, Ms. Benz says. "Even portfolios for young accumulators should still have 5% cash or fixed income just for diversification."

Target-date funds for the young, such as those assuming a 2055 retirement, tend to max out at 90% stock allocation.

All the cautions aside, Compass's Mr. Shanahan and other advisers say stocks haven't lost their status as a valuable tool for investors. Even with downward-calibrated expectations, stocks are still likely to deliver the highest returns, experts say.

Says Mr. Bellfy, "There are a lot of market headwinds going forward, but I still expect equities to deliver the highest returns among asset categories."

"The Bear Market Playbook"

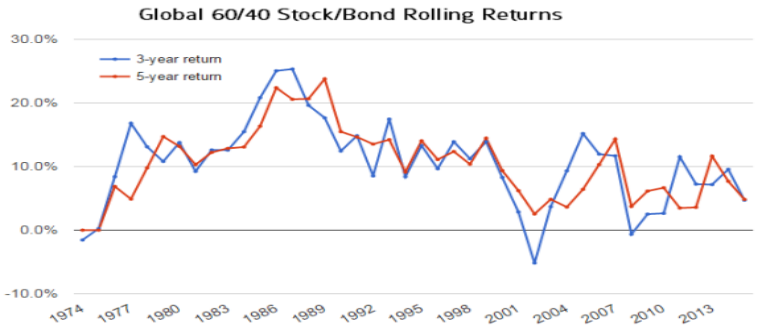
By: Cullen Roche

Date: January 15, 2016

As many markets enter bear market territory around the globe investors are inevitably getting skittish. Bear markets are a regular part of the financial markets, but that doesn't make them easy to handle. Here are some keys to handling a bear market:

1. Don't lose your perspective. In the last 45 years a globally allocated 60/40 stock/bond portfolio has never had a negative rolling 5 year return. Of course, it's not easy to maintain a 5 year time horizon, but if you have less than a 5 year time horizon you probably shouldn't be owning stocks and bonds in the first place. Resisting recency bias is the greatest struggle for most investors. And unfortunately, most people never overcome it….I've witnessed this for decades with clients. The financial markets are a revolving door of investor after investor dying one funeral at a time thanks to excessive short-termism.

You don't have to be irrationally long-term, but focusing on the short-term is just as irrational. *Of course, if you don't have a proper allocation in the first place then you need to ensure that your risk profile is aligned with your asset allocation.*



2. Turn off the news. *Most* of the financial media isn't there to help you. They're there to get your attention so they can earn a profit selling ad placements. Unfortunately, there is no emotion more powerful than fear. This is why financial TV ratings surge during bear markets. You tune in, get scared out of your wits, churn up a bunch of taxes and fees in your account, sell into panics, rinse wash repeat. I turned off financial TV almost a decade ago. It was one of the best financial decisions I ever made.

3. Stop looking at your account. Fidelity once found that investors who don't log-in to their accounts perform better than investors who log-in regularly. The best thing most investors could do is lose their password to their account about once every five years. Logging in and incessantly focusing on your portfolio is just about the best way to ensure that you become a victim of recency bias. If you have a reasonable plan in place you just need to let time do the heavy lifting for you.

4. Focus on something else. Get your mind off the short-term swings in the market. There is nothing you can do to control the markets. Excessive activity is the illusion of control during the course of creating inefficient portfolio frictions. Get your mind off your portfolio by focusing on hobbies or work. Sitting around worrying about your portfolio isn't going to help you or your portfolio.

Professor Bugg's Lecture Notes

Due in part to all of the Brexit uproar, I want to emphasize that when we send you articles each quarter, we are hopeful that you will view them with a critical eye rather than as edicts from your all-knowing advisors. Nevertheless, I wish I could insist that you take to heart the reasonable and straightforward, if difficult to follow, advice in the second article (Bear Market Playbook).

The first piece (How Much Stock?), however, is more problematic. Each of the 4 strategies suggested has merit for a narrow set of circumstances, but a closer examination shows the writer hedging in all 4 cases. Please read them carefully. We want to provoke your thoughts. Even when the rationale is sound, the correlation to a suggested portfolio should be viewed on more of a sliding scale than as a given fixed point. My critical eye really took issue with the 30% stock "for investors with short-term market concerns." A cut from 60% to 30% is market timing – making a bet on what will happen within a few weeks rather than several years. It doesn't work (at this time I'll refer you to the cover's opening quote).

Finally, a thought on the 50% stock allocation recommended "to preserve your portfolio after a significant bull run." Greg wrote last month about the "17.5 Club" for those who can no longer tolerate the ongoing volatility. The implications of Brexit aren't fully known, but continued (increased?) volatility seems among the safer bets. Until the asteroid hits us, the world won't end. But there will likely be days when it feels like it in the financial markets. The offer remains on the table. Call or write to us with your questions. Class dismissed…

Greg's Summer Reading List:

- The Essays of Warren Buffett: Lessons for Corporate America, arranged by Lawrence A. Cunningham
- The World is Flat by Thomas L Friedman
- The Big Short by Michael Lewis
- The Way We Live Now by Anthony Trollope
- How Not to be Wrong by Jordan Ellenberg
- Behavioral Finance and Investor Types by Michael M. Pompian
- Nudge by Cass R. Sunstein and Richard H. Thaler
- Thinking Fast and Slow by Daniel Kahneman
- Little Book of Common Sense Investing by John C. Bogle
- The Intelligent Investor by Benjamin Graham
- A Random Walk Down Wall Street by Burton G. Malkiel

Make a Statement

Haven't received the latest Social Security Statement by mail? They are now available online at:

SSA.gov/myaccount

Please send us a copy when you have a chance to check it out online.

State Employees:

Please remember to send us your retirement plan statement when you receive it.

If you would prefer to receive our newsletter electronically, just let us know and we will send it via email each quarter.

Email linda@btnwd.com

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Please also contact us if you would like information about online account access and/or receiving your statements electronically.

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2016 Q2 Newsletter

"More money has been lost trying to anticipate and protect from corrections than actually in them."
- Peter Lynch

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