Monthly Commentary

August 5, 2016

Watching Paint Dry

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Writing our monthly commentary often revolves around current events affecting investing, the financial markets, and/or wealth management. Developing a "catchy" relevant title can sometimes prove challenging. How about "Death by Papercuts", or "Watching Paint Dry?" I like them both. What thoughts enter your mind when you consider either of these titles? Both were considered for this commentary.

Economic growth is slow and uninspiringly boring – like watching paint dry. It is difficult to see paint drying. Paint dries slowly in the summer, particularly in areas with higher humidity. Like the summer, housing activity is hot, but many parts of the domestic and global economy are slow, and appear barely growing. Developed markets are shrouded in uncertainty with weak growth expectations. Yet, economic growth is critical for the stock market to advance. Markets are forward looking; usually they look forward 6 to 9 months on anything that could affect market values, like what future economic and other conditions may be like. Often, current events create short term distractions and/or volatility to longer-term expectations. For most of the last two years, markets struggled to "see" much opportunity for accelerating economic growth, especially as monetary acceleration strategies seem to be losing their effectiveness.

Finally, after 280 trading days (that's almost one year on the calendar) the stock market made a new closing high. For almost two years, the stock market was caught in a "go no-where" trading range that was boring, maybe even painful – like a "death by papercuts" or akin to "watching paint dry." The pain of 2 meaningful stock market drawdowns was also experienced in that time – down 13% in 3Q2015 and -15% in 1Q2016. And with all asset types generating "mushed-down", low returns, investors struggle with confidence about remaining invested for the long term. During July, domestic stock markets achieved new highs following the surprising Brexit vote, each major US party officially nominating their 2016 presidential candidate, a military coup in Turkey, and continuing terror attacks in France, Germany and violence in the US. Also, low bond yields exist globally, with many countries seeing their sovereign debt yields move deeper into negative territory. Arguably, the domestic and global market backdrop seems less than positive to achieve new highs. Yet July generated strong stock market performance and boosted YTD returns in client portfolios.

Style	July	YTD
Small-Cap Stocks	+5.0%	+8.2%
Mid-Cap Stocks	+4.3%	+8.2%
Foreign Stocks	+4.3%	+1.5%
Avg US Stock Fund	+4.1%	+5.7%
S&P 500	*+3.7%*	*+7.7%*
Large-Cap Stocks	+3.6%	+5.9%
Barclays Bond Idx	+0.6%	+6.0%

Client Objectives (Stocks/Bonds)	July	YTD
20/80	+1.2%	+3.7%
35/65	+1.7%	+3.8%
50/50	+2.3%	+4.2%
65/35	+2.6%	+3.8%
80/20	+2.9%	+4.3%
95/5	+3.6%	+4.9%

Why are investors not happier? Aren't bull markets and all-time highs supposed to be more enjoyable? Investing when the market was 1000 points lower (than now) was certainly more fun in retrospect. That is always the case. We can always see 20/20 in the past, while the future is too unknown. Generally, one does not want to invest when uncertainty is high or too many bad past events scare our perspective about future prospects. We must be continually reminded that growing portfolio values only accrue to those who maintain long-term in-the-market discipline. We manage client portfolios by incorporating many factors into the equation – age of the bull market (currently older than average), economic outlook (currently soft and slow, with low inflation and interest rates), government activities (monetary and fiscal policy, including regulatory environment and taxes). At this time our perspective, like that of many clients, is guarded or cautious. We hold some cash; and want to get cash more invested, while also managing portfolios to a more conservative, risk-reduced structure.

The next couple of months - August and September - are often the weakest performing of a calendar year. Add too that the 2016 Presidential election is 3 months away, and it seems reasonable to expect the markets may show some increased volatility. Studying past open-election years (wherein the current president cannot be re-elected), the market often predicts who will win. When the stock market advanced in the 3 months leading to the election, most often the *(continued..)*

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incumbent party retained the White House (this "rule" was successful in every open election since 1984, and 19 of the 22 since 1928); if the market declined during that 3 month period, the challenger party typically won the election. Also, incumbent candidates struggle if the economic conditions are soft or deteriorating. Clinton, from the incumbent party, wants an improving economy and rising stock market as we move toward November. Trump represents a populist electorate that is frustrated with very slow economic improvement since the Great Recession of 2007-2008. America's political "theater of the absurd" raises into question the character misses of both candidates and creates the "wish" that there might be another choice (are these two, the best presidential candidates we can find?).

Political uncertainty aside, there is little on the economic landscape that provides much encouragement to support taking more risk. Yet it would be challenging to acknowledge, without the benefit of hindsight, a period of time where big worries did not exist. If growth were to meaningfully accelerate because businesses and consumers confidence improves, following years of unprecedented global monetary accommodation and/or because governments "get out of the way" (via a slowdown or removal of new regulatory burdens), the flat market experience since mid-2014 could turn out to be viewed as a pause that refreshes, setting up the next leg of the bull market. The recent fresh all-time market high might suggest that an improved economic growth trajectory is on the horizon. If so, volatility during the upcoming weeks/months, could provide opportunity to buy (add) to current investment holdings at cheaper values than present. We are searching for future returns - seeking value for long-term investors; trying to find higher returns for the least amount of risk.

In the short run, the investing process may require more "watching the paint dry."

ALERT – Insurance Product Strategy Involving Roth Conversions

Be aware! We are hearing that insurance agents and other financial advisors who sell insurance and annuity products are boosting their efforts to sell product, promoting the strategy of Roth Conversions. A Roth Conversion involves converting part or all of your IRA (and/or former employer 401K or other retirement accounts) into a Roth IRA. At conversion, the IRA owner pays income taxes on the converted amount; paying taxes based upon one's applicable marginal income tax rate. If one converted $100,000 of IRA into a Roth IRA, this amount would be added to current wage and other income, possibly pushing them into a higher tax rate than without the conversion. From our perspective, these insurance product-pushers are touting fear – higher tax rates in the future due to the probability that the US government will increase taxes to support new and increased social programs. They claim taxes will only be higher in the future. In essence, pay your taxes now, and avoid them down the road when you ultimately redeem from the Roth IRA (managing taxes and paying the least amount is a true and worthy consideration in saving for retirement).

Be aware however! Many CPAs and non-commissioned wealth advisors are not saying a Roth Conversion is inappropriate; on occasion it may be a worthy strategy. For everyone, the biggest consideration on the topic of Roth Conversion is whether you believe your effective tax rate will be higher in retirement than it is today. For that reason alone, converting an IRA into a Roth IRA is often inappropriate; because most clients we work with will not be in a higher income tax bracket during retirement. Rather, most pay lower tax rates because of lower earned income than during working years. Second, and in addition to that key reason, conversion at this time also seems wrong as the financial markets are near all-time highs, not near bear market bottoms. At present, future return expectations are low compared to when markets are recovering after a recession. If it were appropriate based on personal circumstances, one would rather consider a Roth Conversion at low market valuations (resulting in lower tax implications) and when future return expectations are high. That's because paying taxes reduces retirement savings, and it takes several years (often at least 5) to earn returns sufficient to bring retirement savings back to prior levels (before paying the tax for the IRA conversion). With current low investment returns, the return-recovery timeline is even longer to breakeven value. It does not make economic or financial sense. Why pay taxes before you need to? Third, annuity or insurance structures holding a Roth IRA are often operationally expensive and poor investment performers. Operational expenses erode investment returns needed to recoup the taxes paid. They also lock-up your money for 7 to 10 years, wherein you pay a penalty to move the money, if desired. Our perspective is that an investment should never control you; rather you should be in control of your investment.

Why are Roth Conversions starting to be heavily pushed at is time? We suspect it is because the US Department of Labor's new fiduciary rules go into effect in 2017, affecting retirement accounts. No longer will advisors selling insurance related products be able to use their suitability standard to apply to retirement accounts; instead they will be required to follow the fiduciary standard which requires that decisions be made in the best interest of clients (a standard we have always lived by). Since insurance related investment products cost more than regular brokerage or custodial accounts, these insurance products are less productive, and less flexible. It is very difficult to argue that they are the best vehicle for retirement savings to accumulate. Commissions and other expenses are much higher than most current IRA account structures. An insurance product used to hold a Roth may be suitable, but it certainly is not fiduciary appropriate. Retirement account holders: beware of fear-touting insurance and commissioned financial advisors pushing Roth Conversions; their motives may not be yours.

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