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Asset Management • Retirement, Tax and Estate Planning • Fee Only • No Commissions • Independent Advisor

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Here is our newsletter for the 3rd Quarter of 2014.

The Markets
The 2nd quarter was another good one for investors with almost all asset classes having good gains in the equity and fixed income markets. Our portfolios continued to have consistent, modest gains reflective of our emphasis on limiting losses and staying diversified.

We discuss later in this letter why it is most important to protect your portfolio on the downside, especially for those close to or in retirement. Every good measure of stock market valuations tells us equities are expensive. The Shiller P/E ratio (CAPE) at 26 is at a level that has only been met 3 other times in 130 years, 1929, 2000, and 2007. Each peak preceded at least a 50% decline in the S&P 500. Except for the year 2000 the price/sales ratio, price/EBITDA and market cap/GDP ratios are all highest in history and at least double the historical average. Also, corporate earnings (after tax) as a percent of GDP has averaged 6% historically but are now above 10%, reflecting a level that if history is any guide will eventually revert back to the mean. Wall Street's estimates all assume corporate earnings will continue increasing indefinitely without interruption. This simply is not realistic.

Salt Lake Conference
As usual the annual conference of the fee-only financial planning organization (NAPFA) was a great success. There were many great sessions, many of them having to do with the emotional side of money. Most of the financial mistakes we make are emotional, not intellectual. Understanding how greed, fear, regret, even shame can affect our thinking about money and investing is a good first step in making sure you make good financial choices. Here is some detail on my favorite two sessions.

<u>Advanced Retirement Planning Strategies for Lifelong Income</u>
Jim Othr is a financial planner from Toronto, Canada who has written numerous books and over 100 articles in the financial press focused on how retirees can sustain an acceptable level of income and security in retirement. His research shows that the number one reason retirement portfolios do not last are poor returns in the first few years. Avoiding big losses close to the start and during the first few years of retirement is <u>the</u> best thing you can do to secure your retirement.

He shows 3 times over the last 100 years what happened to a $1,000,000 portfolio for a retiree who withdrawals $50,000 out every year, indexed for inflation. He assumes you put all your investments in large-cap US equities. If you retired at the beginning of 1929 your nest egg was gone in 12 years. If you retired at the beginning of 1966 your nest egg was gone in 15 years. If you retired at the beginning of 2000 your nest egg would be down to about $300,000 at the end of 2013 after 14 years, even though the stock market is well above 2000 levels.

The key is the timing or sequence of returns. If the returns are poor early in retirement the withdrawals become a much bigger load on the portfolio. This year for someone who retired in 2000 with their portfolio down to $300,000 the annual inflation adjusted withdrawal has increased to about $75,000. This withdrawal represents 25% of the portfolio value. It is very unlikely the retirees' nest egg will last more than 5 years for a total life of 19 years. The average couple both age 65 today have a 50% probability on one living for 25 years.

Shaping Investor Behavior

Craig Israelsen, PhD and professor of financial planning at Utah Valley University gave a great presentation explaining the benefits of having a truly diversified investment portfolio. His book "7Twelve, A Diversified Investment Portfolio with a Plan" is an easy read for anyone wanting to understand the magic of diversification. I see so many folks with the lion's share of their life savings in one or two asset classes. Here is what you should do.

The table below is an update of data from his website which describes the returns and volatility of seven single-asset class portfolios from 1970 thru 2013 starting with large US Equity and ending with Commodities. The data shown is representative of an index fund one can purchase for each asset class. The last portfolio is built using an equal-weighted mix (14.3% for each class) of the same 7 individual asset classes.

1970-2013	44-Year Average Annualized % Return	Number of Years with Negative Returns	Worst Three-Year Cumulative % Return
Large US Equity	**10.4**	**9**	**(37.6)**
Small US Equity	**11.3**	**13**	**(42.2)**
Non-US Equity	**9.4**	**12**	**(43.3)**
US Bonds	**7.9**	**3**	**6.2**
Cash	**5.2**	**0**	**0.2**
Real Estate	**11.3**	**9**	**(35.6)**
Commodities	**9.2**	**12**	**(39.7)**
7-Asset Portfolio	**10.3**	**5**	**(13.4)**

Notice the 7-Asset Portfolio average returns are almost identical to large US Equities but with much less volatility. Twice over the last 14 years the equity markets have actually had a 50% loss over periods of less than 3 years. Why is this important? More on that later. If you do the math the average return for all seven asset classes is only 9.2% or 1.1% per year lower than the 7-Asset Portfolio. How this can be is two-fold. First, the asset classes don't always move in the same direction. When some classes are rising in value, others are falling and visa-versa. Second, once a year the portfolio is rebalanced by selling the classes that have done the best and buying the classes that have done the poorest. This sets up a process of selling high and buying low which increases returns over the long run.

Craig uses an analogy of making salsa to building a portfolio. You wouldn't make a salsa by using 500 different varieties of tomatoes (buy the S&P500 index). You need other ingredients which, combined in the proper portion add the variety of flavors required to make a great salsa (onions, salt, garlic, peppers). Some of the ingredients you would not eat by themselves: the magic is how they work together to make the whole more valuable than the parts.

So why is it important to avoid large losses? It's really just simple math which is shown in the table below. When you compare the 37.6% maximum 3-year loss for Large US Equity with the 13.4% maximum 3-year loss for the 7-Asset Portfolio, the return required to get back to breakeven is about 4 times higher than for the Large US Equity Portfolio.

How to much gain do you need just to breakeven?

Amount of Loss	Return Required to Breakeven	# of Years to Breakeven with Annual Return of 10%
10%	11.1%	1.1
15%	17.7%	1.7
20%	25.0%	2.3
25%	33.3%	3.0
30%	42.9%	3.7
35%	53.9%	4.5
40%	66.7%	5.4
45%	81.8%	6.3
50%	100.0%	7.3

More recently Craig has shown that with the additional asset classes that have become available to fund investors more recently one can get returns that exceed equity-only returns with much less risk. These additional asset classes are midcap US stock, emerging non-US stocks, natural resources, Inflation Protected bonds or TIPS, and non-US bonds. In more recent years returns for all the investible asset classes have been much lower than the 44 year average. Over the last 15 years Large-cap US Equities have only returned 4.6% annually on average compared to the 8.4% return for the 12 asset class portfolio. Cash is earning less than 1% compared to the 5.2% 44 year average. We're simply in a low return environment and in this low return environment the diversified 12 asset class portfolio has had an even higher edge over the single asset classes or even the traditional 60% stock/40% US bond portfolio. For our clients we apply these same principals and even use additional asset classes which have become available in the last few years.

Taxes on your Portfolio

In my October 2012 newsletter we detailed the tax increases coming into effect. Capital gains and other income tax rates on your portfolio went up significantly. In light of this we thought we should let you know how we minimize the taxes you owe to increase your after tax return on your investments. We do this by:

- Placing less-tax-efficient investments, such as those that generate much of their return in the form of ordinary income, in tax-deferred accounts when possible (i.e., IRAs, Roth IRAs, and other retirement accounts)

- Examining the tax efficiency of each new investment with a focus on its potential after-tax return relative to competing investment options. For example, index funds are much more tax efficient than actively managed funds, so we will use more index funds in our client's taxable accounts.

- Avoiding the sale of investments with large built-in gains, unless the sale is justified by the higher expected return from an alternative investment, or is necessary to maintain the portfolio's asset allocation objective

- Selecting securities to sell that have the largest tax losses (or least taxable gain) when raising cash in the portfolio

- Offsetting realized gains by selling positions with built-in capital losses

- Holding an investment until it qualifies for preferential long-term capital gain rates (when appropriate)

- Last but most important, understanding your specific tax situation and performing some tax planning in the last few months of the year to make sure you take advantage of all the tax breaks available to you.

Last but not least we just moved our office last month. I was 10 years in the office at Durango Office Suites, probably 8 years longer than I have ever been anywhere in my 40 year career. The new office is at the northeast corner of 9th and Main on the 2nd floor above the Irish Embassy. The new address and our new logo are at the top of the first page of this letter. My other contact information has not changed so give me a call to schedule a time to check out the new office and discuss any issues you may have.

Sincerely,

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