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Here is our newsletter for the 4th Quarter of 2014.

The Fall of the Bond King

You may have heard about Bill Gross resigning from PIMCO last week. Bill has managed the PIMCO Total Return Fund since its inception in 1987, in addition to co-founding PIMCO. His fixed income fund was the biggest mutual fund on the planet until last year when it was overtaken in size (assets) by the Vanguard stock index funds. Bill has earned more rewards than anyone in the business due to his great long track in managing this one fund, one of them being fixed income manager of the decade (2000-2010) from Morningstar. We have had his fund in our portfolios since we opened the business in 2004. Bill and the management at PIMCO have had some differences lately and his resignation was not a total surprise. He has decided to move over to Janus and get a new start at the ripe age of 70.

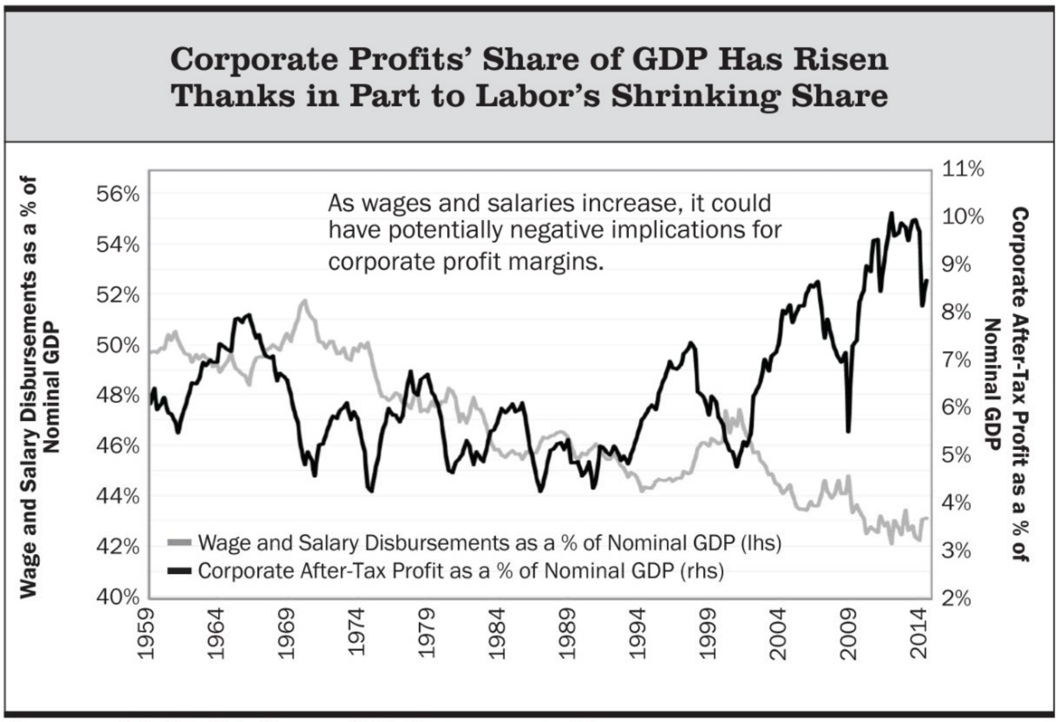
The last three years the fund has not done as well as in the past. In late 2011 we reduced our positions in his fund and added Doubleline Total Return to our taxable bond lineup. Our thinking was Bill's fund was just getting so big and Jeff Gundlach who broke away from TCW in 2009 to start his own fund has also had a great long-term track record. Going forward we do not plan on following Bill to Janus. We will be evaluating the new managers at PIMCO and other fund houses to see if changes are warranted in our lineup. PIMCO has a very deep bench and has grown into one of the best investment houses in the business and I'm sure we will continue to use them in our portfolios.

The Markets

The 3rd quarter was a down one for most asset classes. While U.S.large-cap stocks were up about 1%, small-caps were down 6%, developed foreign stocks were down 6% and emerging market stocks were down 2%. The U.S. total bond market was flat, the high-yield market was down 2% and world bonds were down 4%. The biggest losses were in the commodity markets with the GSCI index down 13%.

Our portfolios has low single digit losses for the quarter primarily due to the fact that over half of our equity holding are in the foreign markets. While the U.S. continues to do better in the short run values are much better overseas, particularly in the emerging markets where prices are 40% better than the U.S. based upon 10-year P/Es.

Last quarter we presented our case for caution due to the elevated level of PE ratios (price/earnings), particularly here in the U.S. The chart below illustrates the low level of wages and increasing level of corporate profits in the U.S. over the last many years. The former is one reason to explain the latter. There are signs that the job market is improving as the number of job openings is actually near an all-time high. While the job market has been weak for some time, it will not always be so. When the labor market changes and salaries rise this will reduce corporate profits and bring down the value of stocks.



Data as of 6/30/14. Source: U.S. Department of Commerce.

What's the Best Strategy for Managing Your Debt?

In past newsletters I have discussed the Great Leveraging or increase in debt in the public and private sectors over the last 30 years in the U.S. and other developed countries(April 2009 newsletter) and the challenges we will face in paying it off (April 2011 newsletter). What's the best strategy for managing your own debt? The answer is determined by your specific situation and doing a detailed analysis, but here are a few concepts that I often present to clients as they go thru the stages of their life.

For college students I generally advise avoiding going into debt if at all possible. Unless you know you are going to get a 6 figure job out of school you will saddle yourself for many years. There are many things one can do to avoid or at least reduce the debt including college savings plans, scholarships, grants and other ways to reduce the cost of college.

In your early and mid-life years using debt appropriately to buy real estate, a business or other appreciating assets is a powerful tool. You just have to be cognizant of making an appropriate down payment and your ability to pay thru the life of the loan. The single biggest problem borrows had in the housing meltdown was not putting enough down upfront (if I were writing the rules I would require everyone put at least 10% down).

As you go thru mid-life you should put a plan in place to reduce your debt over time. The goal should be to have your debt almost eliminated at retirement. According to studies done by Wes Moss, the author of "You Can Retire Sooner than You Think", happy retirees were nearly four times more likely than unhappy retirees to be close to paying off their mortgage. While you are working the loan interest deduction can be your biggest tax break. However, in retirement the tax break for many diminishes as your income drops.

So now you are over 62 and retired (whatever that means for you) and you have your home paid off. What do you do now? Enjoy. Want to enjoy more? One option that has become more attractive for the right situation recently is a Reverse Mortgage. I know this may sound like a contradiction. You advised me to pay down my debts now you want me to go back into debt? Well not really. These products are hard to understand so I will try to keep it simple. Let's say you own your home and you are healthy and plan on staying in the home thru your retirement. Now say you are concerned about having enough income as you have no pension and you are living on your Social Security and supplementing with withdrawals from your investment portfolio. You can take out a Reverse Mortgage and either take a monthly paycheck or a line-of-credit you can use when needed for extra expenses. Every time you take a payment you are selling some of your home equity back to the lender. All that happens when you move out or pass is you share the equity in the house with the bank. No matter how much you take, you or your heirs will never owe the bank more than the home is worth. If there is a shortfall in equity the FHA guarantees any shortfall and makes up the difference.

There are upfront and other costs associated with these and many options that need to be evaluated. I looked at one of these for a client. Estimated monthly income for a $400,000 home was $1,244 or almost $15,000 per year. Another benefit is all this income is <u>tax free</u>. So if you are making withdrawals from your IRAs or other tax-deferred assets which create fully taxable income, taking out a Reverse Mortgage can cut your taxes. Let me know if you would like more information.

Investment Books of Interest
It has been awhile since I have written about financial books of interest. Michael Lewis, the best-selling author of several great books (Money Ball, The Blind Side, The Big Short) made a big splash with his new book "Flash Boys, A Wall Street Revolt" earlier this year. Even if you are not into finance this is a great read. I expect it will be made into a movie before long. The book details the rise of high-frequency traders and their impacts on the markets. A few years ago there were only a few exchanges where stocks and other investments were traded and they were all run and regulated pretty much like public utilities. Over the last few years the market has been opened up to competition. There have been many benefits to this competition, most reflected in the large decrease in trading costs. However, in many aspects trading has gone back to the days of the wild-west where anything goes. Here is a quick excerpt.

"By the summer of 2013, the world's financial markets were designed to maximize the number of collisions between ordinary investors and high-frequency traders at the expense

of ordinary investors and for the benefit of high-frequency traders, exchanges, Wall street banks, and online brokerage firms."

Here is another quote from another great book I read 10 years ago, Pioneering Portfolio Management. David Swensen's book originally written in 2000 is about his investment process used at the Yale University endowment fund. Although written for portfolio managers and probably not an interesting read for you, it struck me as describing very well what I try to implement for my clients.

"Investment success requires sticking with positions made uncomfortable by their variance with popular opinion. Casual commitments invite casual reversal, exposing portfolio managers to the damaging whipsaw of buying high and selling low. Only with the confidence created by a strong decision-making process can investors sell mania-induced excess and buy despair-driven value." —David F. Swensen, Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment (Free Press; Rev Upd edition, January 6, 2009)

Reviewing Your Life and Long Term Care Insurance Coverage

We have used John Ryan's firm in Denver to help our clients with their life, disability and long term care insurance for many years. Recently he added capability on his website exclusively for fee-only advisors like myself to get policy pricing very quickly to get a "ballpark" idea of options available and costs of coverage. If you would like to get a review of your existing coverage or look at new coverage give me a call.

Hope we can meet to discuss any planning opportunities with you before year end.

Sincerely,

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