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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 2nd Quarter of 2017.

The Markets
The 1st quarter saw a change in leadership in the markets, with foreign equities outperforming the U.S. equity markets. For the first time in many years the emerging markets had the highest returns at 11.2% for the quarter. The only negative returns were in the commodity and natural resource markets with losses of 4.0% and 5.2% respectively.

After a rise in interests late last year the bond markets settled down this quarter and all fixed income classes had low but positive returns. The standout was the strong 6.0% return in emerging markets local bonds.

Asset Class Returns- Ending 3/31/17

Asset Class	1st Qtr 2017
US Large Cap Stock	5.9
US Small Cap Stock	2.2
Foreign -Developed Mkts Stock	7.9
Emerging Mkts Stock	11.2
US Intermediate-Term Bond	0.8
Emerging Markets Local Bond	6.0
High Yield Bond	2.3
Inflation-Protected Bond (TIPS)	1.3
Cash	0.2
US Real Estate	0.8
Natural Resource Stocks	-5.2
Commodities	-4.0

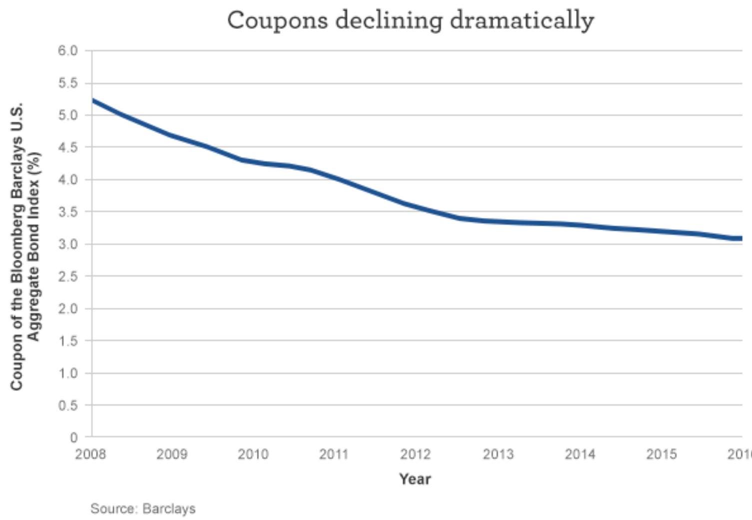
The Increasingly Passive Aggressive Bond Market
It is common knowledge that interest rates are near record lows for bond investors. What most investors don't realize is there are other significant changes in the nature of the market which are increasing risks for investors. Peter Chiappinelli, CFA with GMO (they manage one of our mutual funds) discusses these risks in detail in a recent blog.

"Our worry is that investors are feeling a false sense of security, particularly with passive bond portfolios-namely those funds and ETFs linked to a common benchmark, the Bloomberg Barclays U.S. Aggregate Bond Index (the AGG)." There are three main reasons for concern: the simple math of bond duration; the changing composition of the index; and the very logical financing behavior of corporate borrowers.

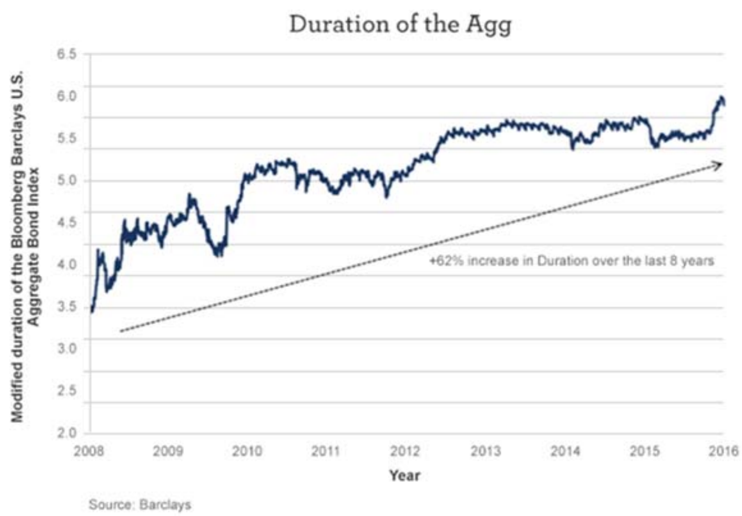
<u>Bond Math and Duration:</u> Without getting into the details which are sure to bore most of the readers, duration measures the sensitivity of a bond's price to a shift in yields (coupon). For example, a bond (or a bond fund) with a duration of five years will drop in value by 5% for every 1% increase in the yield. From the chart below bond yields for the AGG index have dropped from 5.2% to just above 3.0% over the last eight years. Over that same time period the duration of the AGG index has increased from 3.5% to 5.6%, for an increase of 62%.

What happens if yields simply go back to the levels in 2008? The simple math is prices will drop by about 12%.

Changing Composition of the AGG: The AGG is primarily made up of three sectors: Treasury bonds, corporate bonds and asset-backed (mortgages) securities. A big shift has happened since the financial crisis, with Treasuries increasing their share from 22% to 37% today. Asset-backed bonds share of the index has dropped from 45% in 2008 to 30% today. This is one of the reasons why the duration of the AGG has increase so much as Treasuries are longer duration that asset-backed bonds.



Corporate Financing: Corporate bonds make up 26% of the AGG index, up from 20% eight years ago. A couple of years ago Apple issued its first ever 30-year bond; and it was **not** because Apple needed the cash! They were simply taking advantage of the record low borrowing costs by borrowing as much as they could for as long as they could. The interest rate on the bonds are 3.45% annually. The problem is many CFOs are doing the same thing and this in increasing the composition of the AGG to more corporates with longer-maturities (again higher duration).



Here is the bottom line. Those investors allocating most of their fixed income exposure to passive funds or ETFs that follow the AGG index are subjecting their portfolios to the possibility of double digit losses in their bond holdings in a rising interest rate environment. We have no idea when and how fast interest rates will rise: they could drop even further from these levels. However, we use five actively managed bond funds and one passive bond ETF, each with a different role in our portfolios, to manage the risks and limit the downside possibilities.
The duration in our bond holdings are about 1/3 less than the AGG index, primarily due to our fund manager's overweight to asset-backed mortgages and underweight long-dated Treasuries. We also use a floating-rate fund which reduces the interest rate risk by investing in bonds which the coupon rises with market rates. Also, the municipal bond fund we use (Thornburg Limited-term Municipal) uses a laddered approach where they maintain a range of maturities from about 10 to 1 years. Instead of investing all in the U.S., we also invest in bonds in the emerging markets where coupons are higher and durations are lower than the U.S. markets. Lastly, we use

a short-term bond ETF (Vanguard Short-term Bond) which has a duration on about 1.0 years (kind of like holding a one-year CD). This should minimize our passive aggressive behavior.

You might be asking yourself why we primarily use actively managed bond funds, as you believe most active funds do not beat their passive indexes. A paper by Maciej Knowar with Morningstar on 3/21/17 suggests there is a big difference between bond and stock fund performance. His works shows 66% of active bond fund managers beat their passive ETF counterparts, while only 18% of equity fund managers do so. We have seen other evidence that this is the case and our choice of active vs. passive funds (and EFTs) reflects this thinking.

Seven Common Mistakes Made on Beneficiary Designations

Most of your wealth can be passed on to your heirs by simply using beneficiary designations. However, many people make mistakes when doing so. Here are seven of the most common errors made.

1. Naming the estate as a personal life insurance policy beneficiary. This will made the proceeds subject to probate which may delay the funds availability. Also, this will subject the proceeds to federal estate taxes, not a good outcome. One should name an individual for a personally owned policy, or the trust for a trust-owned policy.
2. Failure to name a contingent beneficiary. If the primary beneficiary does not survive the owner of the asset this will result in an outcome similar to #1, having to probate the asset.
3. Naming a minor child as a life insurance policy beneficiary. The life insurance company will simply not pay benefits to a minor and again the asset will end up in probate. You should name a trust as the beneficiary which will benefit the child.
4. Failure to remove an ex-spouse as beneficiary. I discovered this with a client during a review and it was not intentional on his part.
5. Failure to regularly review beneficiary designations. People pass, move on from our lives and our goals change over time.
6. Failure to account for "special needs" children. Special needs children can be disqualified from receiving governmental and other assistance if they are beneficiaries of a financial product.
7. Failure to coordinate all beneficiary designations with the overall estate plan. Most people do not realize your wishes established in your last will are overridden by beneficiary designations on your financial products. Lack of coordination could lead to unintended consequences.

If it has been awhile since you have had a review give me a call to set up a time to meet.

Sincerely,

Stan Johnson, CFP(R)
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