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Money Matters

A monthly publication to keep our clients informed about current financial issues and trends

Quarterly Newsletter

Second Quarter 2017

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2017 Second Quarter

The U.S. stock market has more than tripled in value during the run-up that started in March 2009, and the most recent quarter somehow managed to accelerate the upward trend. We have just experienced the third-best first half, in terms of U.S. market returns, of the 2000s.

The Russell 3000 Index, a broad measure of U.S. stocks, rose 3.02% for the quarter, finishing the first half of the year up 8.93%. Looking at large cap stocks, the Russell 1000 large cap index finished the first half of the year with a similar 9.27% gain, while the widely-quoted S&P 500 index of large company stocks gained 3.09% for the quarter and is up 9.34% in the first half of 2017. The technology focused Nasdaq Composite Index broke the 6,000 barrier in April, rising 4.16% for the quarter and is up 14.71% in the first half of the year.

Meanwhile, the Russell Midcap Index gained 7.99% in the first two quarters of the year. Small companies as measured by the Russell 2000 Small-Cap Index finished the first half of the year up 4.99%.

International investments are finally delivering returns to our portfolios. The broad-based EAFE index of companies in developed foreign economies gained 6.12% in the recent quarter, and is now up 13.81% for the first half of calendar 2017. In aggregate, European stocks have gone up 15.36% so far this year. Emerging market stocks of less developed countries, as represented by the EAFE EM index, rose 6.27% in the second quarter, giving these very small components of most investment portfolios a remarkable 18.43% gain for the year so far.

Looking at other investment categories, a different picture emerges. Real estate, as measured by the Wilshire U.S. REIT index, gained 1.78% during the year's second quarter, posting a meager 1.82% rise for the year so far. The S&P GSCI index, which measures commodities returns, lost 4.90% for the quarter and is now down 9.10% for the year, in part due to a 14.30% drop in the price of oil. Gold prices are up 7.87% for the year, and silver has gained 3.99%.

In the bond markets, longer term Treasury rates haven't budged, despite what you might have heard about the Fed's tightening efforts. Coupon rates on 10-year Treasury bond rates have dropped a bit to stand at 2.30%, while 30-year government bond yields have dropped in the last three months from 3.01% to 2.83%.

By any measure, this represents a strong first half of the year, driven (as you can see by the graph on the next page) by the S&P 500 tech sector, biotech firms and information technology companies generally. What is interesting is that investors appear to be flooding into these business categories because they are the ones most likely to grow their sales even if the economic environment was to turn sour, which suggests a growing pessimism about future economic growth among seasoned investors.

Is that justified? Economic growth was admittedly meager in the first quarter, U.S. GDP grew just 1.4% from the beginning of January to the end of March, a figure that was actually revised upwards from initial estimates of 0.7%. That represents a slowdown from the 2.1% growth in the fourth quarter of last year, when the country was being managed by a different Presidential Administration. It might be helpful to note that the budget proposals floating around Washington, D.C. make the optimistic assumption of an economic growth rate of 3.0%. If the economy fails to achieve that rate, then watch out for a significant rise in the federal deficit.

There is room for hope. The Atlanta Federal Reserve recently forecasted that the U.S. economy will grow at a 2.9% rate for this year's third quarter. We won't have definitive evidence of that until sometime in October. More good news: the unemployment rate is at a near-record low of 4.7%, and wages grew at a 2.9% rate in December, the best increase since 2009. The underemployment rate, which combines the unemployment rate with part-time workers who would like to work full-time, has fallen to 9.2% representing the lowest recorded rate since 2008.

Meanwhile, the energy sector, which was a big winner last year, has dragged down returns in 2017. This proves once again the value of diversification; just when you start to question the value of holding a certain investment, or wonder why the entire portfolio isn't crowded into one that is outperforming, the tide turns.

There are many uncertainties to watch in the days ahead. The U.S. Congress is still debating a health care package and has promised to revise our corporate and individual tax codes later this year. There's an infrastructure package somewhere on the horizon and perhaps a round or two of tariffs on imported goods. Inflation often follows when the Fed raises rates, but we don't know if or when the Fed will do that or by how much.

Meanwhile, the current the bull market is aging, and as you can see from the accompanying chart, the run up has lasted for longer than anybody would have expected when we came out of the gloomy period after the 2008 crisis.

Inevitably, we are moving ever closer to a period when stock prices will go down. That day cannot be predicted in advance, but it is always good to spend a moment and ponder how much of a downturn you would be comfortable with when markets finally turn against us. On the other hand, as Warren Buffett astutely remarked, "Be fearful when others are greedy and greedy when others are fearful."

What Does It Mean When Your Portfolio Is Up 10%

You receive portfolio performance reports every three months—a form of transparency that financial planning professionals introduced at a time when the typical brokerage statement was impossible to decipher. But it might surprise you to know that most professionals think there is actually little value to any quarterly performance information, other than to reassure you that you actually do own a diversified portfolio of investments. It's very difficult to know if you're staying abreast of the market, and for most of us, that's not really relevant anyway.

Why?

The only way to know if your investments are "beating the market" is to compare their performance to "the market," which is not easy. You can compare your return to the Dow Jones Industrial Average, but that index represents only 30 stocks, all of them large companies. Most peoples' investment portfolios include a much larger variety of assets: U.S. stocks and bonds, foreign stocks and bonds, both including stocks of large companies (large cap), companies that are medium-sized (mid cap) and smaller firms (small cap). There may be stocks from companies in emerging market countries like Sri Lanka and Mexico. There may be real estate investments in the form of REITs and investment exposure to shifting commodities prices, like wheat, gold, oil and pork bellies.

In order to know for sure that your particular batch of investments outperformed or underperformed "the market," you would need to assemble a "benchmark" portfolio made up of index funds in each of these asset categories, in the exact mix that is in your own portfolio. Even if you could do that precisely, daily, weekly and monthly market movements would distort the original portfolio mix by causing some of your investments to gain value (and become larger pieces of the overall mix) and others to lose value (and become smaller pieces), and those movements could be different from the movements inside the benchmark. After a month, your portfolio would be less comparable to the benchmark you so painstakingly created.

Many professionals believe that there are several keys to evaluating portfolio performance in a meaningful way—and the result is very different from comparing your returns with the Dow's.

1) Take a long view. What your investments did last month or last quarter is purely the result of random movements in the market, what professionals call "white noise." But you might be surprised to know that even one-year returns fall into the "white noise" category. It's better to look at your performance over five years or more; better still to evaluate through a full market cycle, from, say, the start of a bull market to the start of a new bull market. However, you should remember that there are no clear markers on the roadside that say: *"This line marks the start of a new bull market."*

2) Compare your performance to your goals. Your financial plan indicated that your investments needed to generate (let's suppose) 4% returns above inflation in order for you to have a great chance of affording a long, comfortable retirement. If that's your goal, then chances are, your portfolio is not designed to beat the market; it represents a best guess as to what investments have the best chance of achieving that target return, through all the inevitable market ups and downs between now and your retirement date. If your returns are negative over three to five years, that means you're probably falling behind on your goals—and you might be taking too much risk in your portfolio.

3) Recognize that some of your investments will go down even in strong bull markets. The concept of diversification means that some of your holdings will inevitably move in opposite directions, return-wise, from others. Ideally, the overall trend will be upward—the investments are participating in the growth of the global economy, but not at the same rate and with a variety of setbacks along the way. If you see some negative returns, understand that those are the investments you're counting on to give you positive returns if/when other parts of your investment mix are suddenly, probably unexpectedly, turning downward.

That doesn't mean you shouldn't look at your portfolio statement when it comes out. Make sure the investments listed are what you expected them to be, and let your eye drift toward the longer time periods. Notice which investments rose the most and which were down and you'll have an indication of the overall economic climate. And if your overall portfolio beat the Dow this quarter, or over longer periods of time, well, that probably only represents "white noise".

Statehood or Bust?

You've probably read about the troubled finances of Puerto Rico, the U.S. territory in the Caribbean that has issued more than $70 billion in municipal bonds, with no visible way to pay out the interest, much less the principal. Now Puerto Rican have overwhelmingly voted that they want their island territory to become the 51st U.S. state.

Puerto Rico has been an autonomous territory since 1898, when the U.S. forcibly acquired it from Spain. The territory was granted self-rule in 1952. Last year, in response to the mounting fiscal crisis, Congress revoked some of the local government's autonomy, creating a control board that has the power to veto any item in Puerto Rico's budget. In light of this forced change in autonomy, on June 11th the territory asked voters to weigh in on the territory's status. In 2012, the last time islanders voted on the issue, 61% of voters who made a selection picked statehood as their preferred alternative. In this vote, nearly half a million voters chose statehood on the ballot, compared with just 7,800 votes for independence from the U.S. and 6,800 votes for the status quo territorial status.

However, some are questioning the validity of the vote, since just 23% of eligible voters chose to go to the polls—the lowest participation in any election since 1967. Part of the low turnout was attributed to the fact that three of Puerto Rico's political parties urged their supporters to boycott the vote—which, of course, means that the parties claimed that "boycott" soundly defeated the statehood results.

The vote does nothing toward solving Puerto Rico's fiscal crisis, which has been compared unfavorably to the Greek debt problems. And even a resounding victory for statehood would have been mostly symbolic. For Puerto Rico to enter the union, Congress would have to pass a law admitting it. Even though the Republican platform of 2016 officially supported Puerto Rican statehood, the Republican leadership would not rush to add two senators and five representatives who would probably, based on Puerto Rican political history, lean Democratic.

Vanishing Equities

A recent Wall Street Journal article, citing a study by the Center for Research in Security Prices, tells us something remarkable about the times we are investing in: the number of stocks on the U.S. market has quietly diminished by more than half over the last 20 years. In November 1997, investors could choose from 7,355 U.S. stocks. Today, there are fewer than 3,600.

Why haven't you noticed this? Most of the decline has come from vanishing companies ranging from small to microcap—the sort of names you probably haven't heard of. Small stocks have diminished from more than 2,500 in 1997 to fewer than 1,200 today. Microcap companies that are even smaller numbered nearly 4,000 in 1997, compared to 1,900 today. Some went out of business, while others were gobbled up by private equity firms. Meanwhile, the ecology has changed; instead of new companies going public to replace those that have retired from the market, venture capital firms are allowing younger ventures to stay private for longer.

The article talks about several possible consequences. Since the surviving companies tend to be larger and better known, it becomes harder for professional asset managers to get an information edge or find small undiscovered gems that are undervalued. The declining roster of stocks may also mean that a long era of higher returns from small cap stocks compared to larger firms could be coming to an end. But the truth is that nobody knows what the investment consequences will be from the quiet shrinkage of investment options.

Have and Have Nots

The U.S. unemployment rate has dropped below 5%, as recovery of jobs that nobody could have expected when we were in the teeth of the Great Recession. But the wealth of jobs is spread unevenly among U.S. states.

The Bureau of Labor Statistics publishes the unemployment rate for each state, ranging from the most highly-employed (Colorado, at 2.3% unemployment rate) to Alaska on the bottom end (a 6.7% unemployment rate). It is perhaps encouraging to see that none of the U.S. states has anything close to 11% of workers out of jobs, which was the national unemployment rate back in 2009.

Among the most highly-employed states are North Dakota (2.5%), Hawaii (2.7%), Nebraska, New Hampshire and South Dakota (2.9%) and Iowa, Vermont and Wisconsin (3.1%). States near the bottom of the ranking include New Mexico (6.6% unemployed), the District of Columbia (6.0%) and Louisiana (5.7%). You can find the full list here: https://www.bls.gov/web/laus/laumstrk.htm

Exercise For Life

By now, you've probably read about surprising new scientific research that has shown that physical exercise is not—despite what we've heard for generations—a very effective weight loss technique. So is there any good reason to hit the gym, or might you as well hang out on the couch?

While the weight loss effect has been debunked, a host of other studies are uncovering more significant benefits of regular exercise. When people work out regularly, their bodies tend to have fewer proteins linked to cellular inflammation. The effect is a boosted immune system against cardiovascular disease, diabetes, certain cancers and neurodegenerative conditions. Their bodies also secrete fewer stress hormones, and their heart muscles and blood vessels tend to be healthier and stronger.

Meanwhile, aging researchers have been investigating the mysterious caps at the ends of your body's chromosomes—called telomeres—which are associated with accurate reproduction of your body's cellular structure. They are finding that people who exercise are physically younger, at the cellular level, than their couch potato counterparts. The telomeres shorten as we age, but they shorten far less rapidly in people who stay in shape than in those who seldom hit the gym. In addition, regular exercise is associated with the growth of new brain cells, and it has been shown to reduce depression in adults. This may be some of the reasons why people who exercise are at a significantly reduced risk of developing dementia or Alzheimer's disease.

One problem, however, is that it is not yet clear how much exercise you need to commit to in order to get these benefits. The usual recommendation is 150 minutes a week of moderate activity, but scientists are looking deeper into whether more or less is more or less beneficial. Meanwhile, the best advice is to figure out how to make exercise a weekly habit, with an eye to increasing the levels as more research is published.

Who's On Your Side?

Friday, June 9 quietly marked/will mark an historic day in the financial services world. On that date, all financial advisors will be required to forego any sales agenda and give advice that would benefit their clients or customers—or, if they decide otherwise, to explain how and why they intend to give advice that instead primarily benefits themselves and their brokerage company. This rule only pertains to rollovers from a qualified plan like a 401(k) into an IRA, and to the investment recommendations for that IRA account. But it may be a first step toward something larger.

The polls consistently show that most Americans believe they already receive objective advice—called "fiduciary" advice by the profession and regulators. But the overwhelming odds are that they don't. There are half a million brokers who earn commissions if they can convince you to buy an expensive alternative to the thriftier, better-performing investment options on the market. That's more than ten times the number of advisors who adhere to a fiduciary standard. Government research estimates that consumers lost $17 billion a year to conflicted advice in the recommendations made by brokers and sales agents posing as advisors related to retirement plans. This, to put it bluntly, helps explain why so many Wall Street brokers are insulted if their annual bonus is in the low seven figures.

The actual number of real fiduciary advisors may actually be lower than this discouraging figure. A mystery shopper study in the Boston area found that only 2.4% of the "advisors" (most were almost certainly brokers) it surveyed made what most would consider to be fiduciary recommendations. On the other side, 85% advocated switching out of a thrifty portfolio with excellent funds into something a bit more self-serving.

An article in the most broker-friendly publication imaginable—Bloomberg—recently outlined some of the ways that you can be taken in by a sales pitch and never know it. (The full article can be found here: https://www.bloomberg.com/news/features/2017-06-07/fiduciary-rule-fight-brews-while-bad-financial-advisers-multiply). It notes that the brokerage industry—that is, the larger Wall Street firms, independent broker-dealer organizations and life insurance organizations—repeatedly fought the fiduciary rule in court, arguing, in some cases, that their brokers and insurance agents shouldn't be held to this standard because, despite what they said or what the companies' marketing materials proclaimed, they were nothing more than salespeople trying to effect a sale. The courts refused to block the rule.

It gets worse. Even though brokers are held to a sales standard—they are required to "know their customer" and to make investment recommendations that would be "suitable" to somebody in your circumstances (a very low standard that is appropriately known as "compliance"), a new study found that 8% of all brokers have a record of serious misconduct, and nearly half of those were kept on at their firms even after getting caught.

We don't know how long this regulation will be in effect. New Labor Secretary Alexander Acosta has announced that he's studying whether the rule that requires brokers to act in the best interests of their customers is good or bad for customers, and his comments hint that he thinks you would be harmed if suddenly you were able to trust the advice you receive. But there is one simple way to determine whether you're working with somebody you can trust.

First, ask your advisor directly to provide written documentation that he or she will act in your best interests. This should be no longer than a page and might be no longer than a sentence or two. There's even a "Fiduciary Oath" that many financial advisors are giving to their clients—without any prompting. If the broker hems and haws, then hold onto your wallet or purse, because chances are any recommendations you receive are going to cost you money that will be disclosed in the fine print of whatever agreement you sign, somewhere after page 79.

Quarterly Benchmarks

	2Q	YTD	1 Year	3 Year	5 Year
Fixed Income					
3-Month T-Bill	0.22%	0.37%	0.55%	0.25%	0.17%
Citigroup World Government Bond Index	2.89%	4.49%	-4.14%	-1.00%	-0.20%
Barclays 7 Yr. Muni Bond Index	1.93%	3.92%	0.17%	2.81%	2.80%
Vanguard Total Bond Market Index Fund	1.48%	2.40%	-0.44%	2.43%	2.13%
Large Cap					
Vanguard 500 Index Fund	3.07%	9.31%	17.85%	9.58%	14.59%
Mid Cap					
Russell Mid Cap Index	2.70%	7.99%	16.48%	7.69%	14.72%
Small Cap					
Russell 2000 Index	2.46%	4.99%	24.60%	7.36%	13.70%
International Equity					
Vanguard Developed Markets Index	6.39%	14.71%	20.30%	1.85%	9.10%
Vanguard Emerging Market Stock Index Fund	3.47%	14.69%	18.86%	0.64%	3.36%

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