Managing Income Risk

When I first started in this business in 1991, I remember one-year CD rates were 6%, ten-year government bonds paid 7.5%, stocks offered a yield of 3% (S&P 500 average dividend yield) and retirement planning was fairly simple. We just allocated money to stocks, bonds and cash (or cash equivalents like CD's) and rebalanced the portfolio annually.

Today interest rates are 1% for one-year CD's, 1.5% ten-year treasury bonds, and 2% for the S&P 500. This begs the question; how do you earn a reasonable rate of return in retirement without taking substantial risk?

CD's by definition will never get you a better return than the current interest rate. Although the return on government bonds has been exceptional over the past 30 years (as rates have come down on these bonds, prices have gone up), it is unlikely that rates will decline substantially from here. That leaves us with stocks. According to Dr. Jeremy Siegel, the long term (he's looked at over 200 years of historical data so I mean really long term) the return on stocks is roughly 8% compounded. That'll do you say. Well, unfortunately that return is not consistent. There have been periods (even periods as long as ten years or more) where stocks have substantially underperformed cash and bonds. Additionally, if you need income in retirement and you have to sell some of your stocks to get it, it doesn't matter that the stock market ultimately recovers. You had to sell your shares to live. Bummer.

Additionally, retirees are living longer today than they have in the past. So not only do you have uncertain investment returns to contend with, you also have a longer lifetime to fund. We are dealing with this new normal a few different ways.

Declining Expenses: We have found that most people reduce their spending habits later in life. The Employee Benefit Research Institute found that household spending is 19% less for 75 year-olds than it is for 65 year olds, and 34% less than 85 year olds. Additionally, according to David Blanchett with Morningstar's retirement research "higher income retirees saw a more notable decline than other's because so much of their spending is discretionary. So you may be able to take more income now, because you won't need as much in the future.

Lifetime Income planning: This is a fancy term for your heirs don't get as much. Trading market and mortality risk for guaranteed lifetime income options makes more sense when rates are low. Using this tool may allow the remaining portfolio to grow with less income stress than it otherwise would have.

Managing volatility: Re-balancing the portfolio when there is a substantial difference in the performance of assets that are not positively correlated can add some return while reducing your overall risk.

Managing retirement income in a 0% interest rate environment is tough. Let's just hope for your sake and mine, we don't have to figure out how to do it in a negative interest environment like they have in parts of Europe and Japan. Now that's a depressing thought.

Doug Lagerstrom

Arizona or California?

I would like to share where I spend a lot of my time when I am not at work or home. Not only do I have 2 adult daughters living in Arizona, I was born and raised in Tempe, Arizona. Although Arizona is known for the summer heat there is a fair trade off when they usually get 12 inches of rain or less and have over 250 days of sun per year.

The months of September thru May are my favorite times to visit and there are so many things to do outdoors. There are more than enough hiking trails that will take you to tops of mountains to view the valley below, along with the beauty of the cacti and desert plants. In March, MLB Spring training games were always a favorite of our family while I was growing up. Many MLB baseball teams come to train and play games. You are able to enjoy the weather and watch the games in a smaller venue.

Lakes are plentiful (120+) in Arizona. Some are within an hour of the Phoenix area. Many of my hot summers were spent boating and waterskiing at Canyon and Saguaro Lake to keep cool.

December and January are good months to go to Flagstaff, AZ which is 2 hours away from Phoenix, to play in the snow or ski. The season is usually short, but just long enough to get a couple trips to the cold weather areas. I also enjoy our family time at my brother's place in Prescott, located between Phoenix and Flagstaff which also gets some light snow and cool summers.

I feel very fortunate to enjoy the best of both Arizona and California, and lucky to call them both Home.

Lynn Hillyard

Pitfalls of Hedge Funds

Google defines a Hedge Fund as "a limited partnership of investors that uses high risk methods, such as investing with borrowed money, in hopes of realizing large capital gains." According to Fortune Magazine, some of this year's most volatile stocks have a key factor in common: Hedge Funds own a high percentage of their shares. According to Hedge Fund Research, they as a group lost money in 2015 and the first quarter of 2016-their worst performance in years. To make matters worse, $15.1 Billion has marched out of Hedge Funds during the first quarter of 2016, the industry's biggest withdrawal since the recession of 2009.

Hedge Funds tend to favor investments with high earnings growth and a proclivity for acquisitions, as well as "momentum" stocks-companies on an upward tear ahead of the market. According to Bob Olstein, a value manager and the founder of the Olstein mutual fund family, "hedge funds love buying companies that are sexy but aren't producing any cash". Concentrating on only this type of investing can sting shareholders when sentiment about the economy sours like it did in the first quarter of this year when bear market fears spurred by China and tepid global growth took center stage. To make matters worse, Hedge Funds have a tendency towards the herd mentality. They often crowd into the same stocks which leaves a shortage of prospective buyers when they try to flood out at the same time. This worsens the drop of the stock price they are all trying to get out of at the same time because by this point, some Mutual Fund managers and individual investors are also trying to head for the same exit.

Fortune ran an analysis of US companies with a market capitalization of $1 Billion or more and a clear pattern emerged. Companies with lower hedge fund ownership performed better. These companies also had other characteristics in common. These companies had less debt, were larger in size, and their earnings grew at a much slower and consistent basis. They did not have the scent of instability that normally attracts the hedge funds.

Of course having said all this doesn't mean that simply owning companies with the lowest hedge fund ownership is a promising long-term strategy. Stocks that hedge funds traditionally buy are expected to perform well again once; the U.S. and global economies show clear signs of growth, China's slowdown stops threatening the rest of the world, and investors stop worrying so much about the potential market crash. (Good luck figuring out when all of that is going to happen.) All in all, between the illiquidity and the high risk nature of hedge funds, we prefer to use Mutual Funds with proven long term track records.

Allen Minassian

Summer Loving

Yes, we are full speed ahead into Summer, as the weather here in California will not let us forget. Be sure to take precautions on unbearably hot days, stay indoors, go for a swim in a nice cold pool, or, as I do, head to the beach!

My home away from home is in Malibu. I leave the heat of the Valley to enjoy the beautiful ocean air and a much cooler climate. Point Dume in Malibu has a gorgeous stretch of beach were one can walk, play volleyball, surf and even cliff climb. The community also has weekly festivals, swap meets and delicious restaurant choices. One of my favorite health food sandwich shops is Johns Garden. You can find weekly events at www.allthingsmalibu.com.

Of course if you are a California local you already know that we have many coastline spots to choose from. I would love to hear about your favorite beach or vacation areas.

Enjoy your Summer.

Andrea Baird

Brexit

Whoa! That election result certainly came out of the blue. If you ever needed proof that markets hate uncertainty, consider that the S&P 500 dropped nearly 6% in two days and then rallied 6% over the next three. We ended June at just about the same level we entered Brexit. What gives?

Brief EU history

The European Union was created by the signing of the Maastricht Treaty in 1992. The underlying thought was that countries that trade with each other are less likely to go to war against each other. After the devastation of two world wars last century, this idea had plenty of support. Because countries would share a common currency (except for UK ironically who chose to keep the pound), rules were put into place to ensure economic prudence. Member countries would maintain "sound fiscal policies, with debt limited to 60% of GDP and annual deficits no greater than 3% of GDP."

Nobel Prize winning economist Milton Friedman said a common currency with individual country's budgets couldn't last. He may finally be proven right. Nearly all member countries have cheated on these agreed upon standards. The so called PIIGS (Portugal, Italy, Ireland, Greece and Spain) countries were in such bad economic shape after the great recession that the ECB had to repeatedly bail them out. Austerity demands by the ECB led to riots in Greece and fears of a complete collapse of their financial system.

The Bad

Free and fair trade is good for global economic growth. This basic tenant of economics helps explain the concern investors realized when the UK voted to leave the European Union. All other things being equal, less trade should lead to less economic activity, lower incomes and less demand for goods and services. Furthermore, the lower economic activity results in lower tax revenues, which results in larger deficits and.. well you get the picture. After the Brexit vote, former Fed chief Alan Greenspan claimed we entered "the worst period I recall since I've been in public service". A prominent London trader claimed, "this is as big as 2008 and has the potential to be even bigger."

The Good

How can Brexit be good for the global economy. A group in Brussels currently negotiates all trade between countries in the EU. The Committee for International Trade passes rules that apply to all member nations. **IF** the Brexit vote leads to new, and better trade agreements with an independent Great Britain, other countries may respond in kind. Success could embolden the EU to take a similar tack to remain competitive. The resulting economic activity could be just the tonic the global economy has been waiting for ever since the economic crisis of 2008. Pollyannaish? Perhaps, but this result is certainly possible and interesting to consider.

Conclusion

Markets hate uncertainty and we have that in spades today. With an election on the horizon, uncertainty will likely continue. Buckle your seat belts.

Doug Lagerstrom

PRIVATE WEALTH SOLUTIONS

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Woodland Hills, CA 91367

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Generational Wealth Management

What will our economy look like in the wake of Brexit and the Presidential election season? Well, the economy doesn't look particularly good or bad. I guess it all depends on your perspective. On the positive side, consumer prices (as measured by CPI) remain low, unemployment is low (4.7%), and consumer confidence (98 in June up from 92 in May) is high. At the same time, economic growth is low (2.1%), US debt is large ($19 trillion), and the labor participation rate is the lowest since 1978 (62.7%).

...odds of a *rate decrease* is greater than a hike.

These mixed signals have made the difficult job of our central bankers more challenging as they decide whether or not our economy can handle higher interest rates. In fact, recently the Fed warned the market that they may raise rates as many as four times in 2016. After Brexit, the odds of any rate hikes this year have diminished. The futures market now believes the odds of a ***rate decrease*** is greater than a hike at their next meeting in July.

Expect to hear arguments about how well the economy is doing from Democrats who want to see Hillary Clinton elected as President. At the same time expect to hear arguments about how bad things are from the Republican nominee Donald Trump. The truth is, of course, somewhere in between. In my opinion our economy is currently the best house in a bad neighborhood. While there is certainly much to fret about, our economic engine is the healthiest in the world.

The remedy for our biggest economic problems (slow growth, debt, labor participation), unfortunately lies with fiscal policy. According to political polls, most voters don't like our odds when our economic future is tied to leadership from Hillary Clinton or Donald Trump.

Stranger things have happened and if it's one thing the history of our country has taught us it is that the US economy is resilient and can survive anything thrown at it... so far.

Financial Quotes

"It's easier to run a revolution than a government."- *Ferdinand Marcos*

"Every once in a while, the market does something so stupid it takes your breath away."
Jim Cramer

"When choosing between two evils, I always like to try the one I've never tried before."
-Mae West

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