COLORADO
FINANCIAL
MANAGEMENT®

Summer 2018

SUMMARY:

The economy continues to grow and is even picking up speed.

Corporate earnings could be 20% higher this year than last.

Interest rates are likely to keep rising. We try and explain what the effect is on bonds and what we're doing about them.

Political noise is having some impact on the markets, and possibly on the economy.

We remain "nervously neutral" on our long-term strategy.

Our tactical strategy favors stocks over bonds, has recently reduced international, and increased small/mid-caps.

We've included an update on cyber-security.

Dear Clients and Friends,

As Of 5/31/18	YTD 2018	Last 12 Months	Last 5 Years (Ann'l)
60/40 Balanced World Index	-0.4%	7.3%	6.5%
World Equity Index (ACWI)	0.4%	12.5%	9.1%
U.S. Equities (Wilshire 5000)	2.4%	14.9%	12.9%
Foreign Equities (ACWI-ex U.S.)	-1.9%	9.7%	5.5%
U.S. Bonds	-1.5%	-0.4%	2.0%
HFRI Fund of Funds Composite	1.0%	5.4%	3.2%

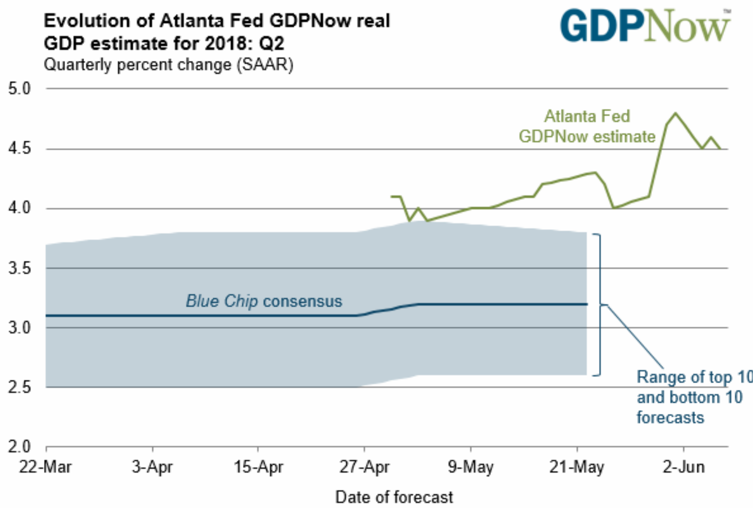
Predicting the future is a dangerous business. A recent *WSJ* article profiled Meredith Whitney, who was one of the few analysts who predicted the financial crisis 10 years ago – more specifically she penned a report on Citigroup anticipating their problems. She was catapulted to fame, was on the cover of *Fortune* magazine, and named one of the most powerful women on Wall Street. She started her own consulting and research firm and then a hedge fund. A few years later, however, she predicted a meltdown in municipal bonds that never happened. Her reputation collapsed, her hedge fund and her consulting firm closed. In fact, most if not all of the handful of prognosticators and investors that predicted the real estate and financial crisis of 2008 have had sub-par results since.

We don't believe it's possible to predict the future reliably; and when we're dealing with something as important as investing our life's savings we need a process that is reliable and replicable. We start by analyzing the same five or six "pillars" that we have learned will help guide us.

From those we make asset allocation decisions within pre-defined ranges – accepting the fact we will be wrong at times, but not being satisfied with being average. And then we spend a lot of time studying companies, securities, and managers. Following are our current thoughts:

Economy, Inflation, & Interest Rates. The U.S. economy has been growing at an average rate of 2.2% since this recovery began in 2009. Despite what some politicians are saying about it being too slow, it has been a goldilocks growth rate – not too hot and not too cold. How can you argue with unemployment below 5% and inflation below 2%?

Partly due to tax reform, but also because of a number of other factors, the economy has accelerated to a 3% (or better) pace.



As good as it sounds, it may be too much of a good thing. With unemployment so low, wage pressures are slowly building. The Fed will keep raising rates to cool off inflationary pressures. They will raise rates either two or three more times this year, with the next move coming in June.

Next year, they will continue to raise until they get to 2.5% - 3%, at which time the economy is likely to slow and they may be forced to begin cutting rates again. The speed that this process takes will depend on those inflationary pressures and the tax cut may accelerate the process. It also adds a trillion dollars to our national debt. Taken together, we should expect another year of rising rates.

Earnings and Valuation.
Corporate earnings are going to have one of their best years in memory – growing 20% to 25%. This rapid growth is largely driven by the drop in corporate tax rate. Some analysts would call this 'low quality' growth, meaning it isn't driven by fundamentals.

The problem is not this year's earnings, but next year. In all likelihood, 2018 will mark the peak in earnings growth for this cycle. We may have increased earnings, but it won't be at 20% like this year. The following table shows estimated earnings according to Standard & Poors:

	12 Month Earnings	Yr over Yr change
Dec 2017	$125	+17%
Dec 2018	$157	+26%
Dec 2019	$175	+11%

Take the 2019 estimates with a large grain of salt, and even the 2018 numbers are likely to be lower. As we've pointed out before, analysts are typically over-optimistic.

Valuation. With the market trading at 2,754 (S&P 500), the P/E on 2018 earnings is 17.5 and on one-year forward estimated earnings is 16.7. These are average valuation levels.

Financial Stress & Politics. Those of you who have read our newsletters will remember we added this to try and anticipate the next banking crisis. They tend to recur every decade or so. When we last wrote there were no indications of stress, but that has changed over the last few months. Italy has formed the strangest government – even for them. It's a combination of right wing anti-immigration populists and left-wing socialists. They are anti-Euro but have no real alternative solutions. There was chaos in the bond market for a few days and there has been an impact on U.S. markets – a flight to quality that lowered yields on U.S. Treasury bonds.

Politics generally is a lot less important than people think, but the Trump administration's threats about tariffs is likely to have some impact on business activity. The noise from Washington could make business leaders think twice about long-term capital plans. And, with mid-term elections coming later this year, uncertainty will continue to grow.

Based on the history of mid-terms favoring the minority party, odds are the Democrats will take control of the House. That's certainly not guaranteed, but if true, then we can expect little to be accomplished over the next two years. Some would argue that's a good thing.

Strategy[1]. Last year, concerns about valuation and the political environment led us to be slightly conservative. We were never under-weight equities, but we did not over-weight them either. This year, the economy and earnings are even better than last, valuation is better due to the windfall from a lower tax rate, but the political stress level is rising. This leads us to stick with our "nervously neutral" position.

Investors got a little carried away in January pushing the market up over 7% only to see it give it all back in February and March. Since then, stocks have meandered mostly sideways – some weeks up 1% - 2% and some weeks down.

Bonds, on the other hand have had negative returns for most of the year. This has some of our clients confused, or worried, because bonds are supposed to be where we invest our 'safe' money. How can we explain this? And, what if anything should we do about it?

Bond prices decline when interest rates rise. This happens so that bonds already issued and outstanding have the same yield as newly issued bonds. For example, imagine a bond issued on 1/1/18 that yields 1% per year for 5 years. Then assume on the following day interest rates increased by 1% so that a new bond being issued would yield 2% per year. What price would a buyer of the 1% bond pay so that he would have an equivalent yield as the 2% bond? The price would have to be 5% lower as follows: the new bond pays 2% x 5 = 10%. The old bond pays 1% x 5 = 5%, but the buyer would get the 5% discount. 5% yield plus 5% discount = 10%.

What happens to the holder of the 1% bond if he never sells? If we assume rates stay at 2% going forward, then in year one the bond holder will receive his 1% but will have a value below par of -4% or -5%. As time goes on, the bond will increase in value because at maturity it pays off at full price. So, in years 2 – 5, the bond holder gets his 1% yield, plus about 1% appreciation per year.

Therefore, the answer to the question "What should we do about it" is… nothing. Whether you own individual bonds or a bond fund, you should just hold your bonds. There may be a few months, or even a year or two when we have price declines on bonds, but they are still paying income and providing stability to your portfolio. In the last 50 years, the worst year in bonds was a return of -4%. We don't need to remind you that the worst year in stocks was a lot worse.

Having said all that, we do try to improve upon a passive approach to holding bonds. We reduce the average maturity of our bond holdings – either through individual bonds or by our choices of bond funds. This reduces the price risk. We ladder maturities of individual bonds, so we can re-invest at higher rates. We also diversify into alternative strategies. This includes high yield bonds, foreign bonds, and even some low volatility equity strategies. This has helped provide higher returns this year and in most prior years.

In our equity strategies, we benefited last year by increasing our international allocation to about half of equities. Just recently we have backed off that a little. The strong dollar has hurt the returns of foreign investments – especially emerging markets. Some of those proceeds have gone into small and

[1] Discussion is about our general strategy for our "models". Individual accounts will vary based on taxes, personal preferences and many other factors.

mid-cap investments, and a small amount has been targeted into energy and commodities.

Our managed stock portfolio had a great 2017 – returning 24% and beating the S&P (by 2.3%). This year we're holding a slim lead with a 3.2% return vs. 2% for the market. Once again Amazon is a top performer, up 39% year to date. The worst performing sector has been consumer staples with Newell Rubbermaid being our biggest loser. This stock has since been sold as we continue the search for outperforming companies.

The same is true for mutual funds both in equities and fixed income. We're making changes in our emerging markets funds and our large cap funds. Earlier this year we made a change to our core bond fund manager. Each quarter we have a dozen or so meetings and conference calls with mutual fund representatives either in our office or sometimes at theirs. So far this year we've visited California, Massachusetts, Illinois, New York; and we have several more trips already planned.

Brad Bickham, CFA, CFP®
Chief Investment Officer

Cybersecurity Update

Not a week seems to go by without an announcement of a major data privacy breach at a corporate or government office. Cybersecurity has become part of our daily vocabulary and our worry list. Therefore, we thought it timely to reach out with an update about the work Colorado Financial Management is doing to protect the data you have entrusted to us and describe some of the steps we are taking to ensure that everything we do for you really is for you, and that your information stays private.

Cybersecurity refers to the processes and techniques used to protect the integrity of networks, programs, and data from attack, damage, unauthorized access, or theft. In the course of establishing accounts and developing information for financial plans, we gather significant private information about our clients. We take our obligation to protect this information very seriously.

CFM has implemented systems and programs that require fully encrypted and secure connections when we access or share data with our business partners. We encrypt our data whenever we share it with anyone, including our clients. It is our standard practice to back up everything daily and save the backup data in a remote location.

We have adopted policies that require annual reviews of the controls and protocols followed by the vendors and custodians with whom we work and share data, to ensure that they have appropriate safeguards and controls in place

Our two primary custodians, Schwab and Fidelity have both invested heavily to develop and implement sophisticated protection and cybersecurity tools, and both provide explicit guarantees that they will cover 100% of losses resulting from unauthorized account activity. Read more here: Schwab & Fidelity

Finally, we have adopted and tested a Business Continuity Plan which describes the processes to recover our data and operate our business from a different location in the event of an unforeseen event that compromises our systems or damages the physical facility in which our data is maintained. You can help us in the effort to keep your data safe by

- frequently changing and securing your passwords to financial websites
- avoiding granting access to sensitive information to outside parties

- promptly notifying us of any changes in your address, phone numbers, emails and other contact information
- avoiding the use of public Wi-Fi connections when conducting private business including financial transactions
- notifying us as soon as you suspect any unauthorized transaction or fraud attempt has occurred
- notifying your Advisor or Client Service Manager if you will be traveling and may need a distribution when gone

We must work together to protect our systems and data from outside parties looking to take advantage of us. If you have questions or wish to discuss this important topic or if you suspect that there might be a problem of any kind with your accounts or data you have shared with us, do not hesitate to contact your advisor or myself. We are eager to help you and committed to working together with you to ensure that your assets and private information are safe.

Thank you,

Rick Lawrence
President and CEO

PS – Keep your calendar open for the evening of August 8. CFM is bringing in a cybersecurity expert, Gary Rossi, and sponsoring a reception and presentation. Mr. Rossi was a special agent in the FBI for 14 years, specializing in a wide variety of white collar crime investigations including sophisticated financial frauds, cybercrimes and public corruption matters. Several of us have heard Gary speak before and found him to be very well informed, and entertaining.

This will be an interesting evening, and of course you are invited! More to come.