



APRIL 2015

## Market Commentary and Review

by Brad Bickham, CFA, CFP®

*“Even if you are on the right track, you’ll get run over if you just sit there.”*

*– Will Rogers*

### SUMMARY:

Foreign stocks and Mid Caps led the markets in the 1st quarter.

The Europeans are embarking on their version of Quantitative Easing – buying over one trillion Euros of bonds.

The dollar continued to climb, rising 9% against a basket of other currencies. This will continue to be one of the primary drivers of disparate returns of asset classes this year.

The economy continues to grow, albeit a little more slowly.

The Fed is continuing to debate the timing of raising interest rates. We believe this fall is the most likely lift off for rates.

Dear Clients and Friends,

Following are returns for the last one, five, and ten years ended March 31, 2015.

Returns as of March 31, 2015	1st Qtr 2015	Last 12 Months	Last 5 Yrs. Annual	Last 10 Yrs Annual
60/40 Balanced World Index	2.2	7.5	9.0	6.3
World Stock Index (ACWI)	2.6	5.6	9.3	6.7
Large Cap U.S. Stocks	0.8	12.5	14.5	8.0
Mid Cap U.S. Stocks	5.2	11.9	15.4	10.0
Small Cap U.S. Stocks	3.8	8.6	16.2	8.8
Nasdaq 100	2.5	21.8	18.4	12.1
Foreign Stocks – ACWI ex U.S.	3.9	-1.1	4.3	5.5
Foreign Stocks - Developed	5.4	-1.2	6.2	5.0
Foreign Stocks - Emerging	2.1	0.0	1.0	7.8
U.S. Bonds – Taxable	1.5	5.7	4.4	4.9
U.S. Bonds – Tax-Free Municipals	0.8	4.4	3.9	4.4
REITs	4.1	21.5	14.0	7.7
High Yield Bonds	2.5	0.5	7.4	6.9
Commodities	-7.3	-24.8	-3.3	-3.6
Hedge Fund Index	2.1	5.0	3.4	3.2
Gold	0.1	-8.1	0.9	10.3

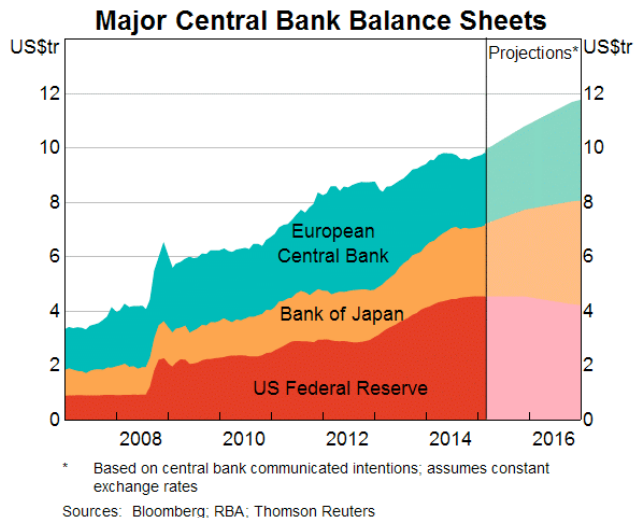
The Europeans have finally figured out that we Americans knew what to do all along. You can print money and all your problems will be solved. What took so long?

After suffering several years of economic stagnation, and watching the U.S. and Japan undergo monetary policy experiments on a massive scale, they decided to join the party. The European Central Bank recently announced they will buy over 1 trillion Euros worth of bonds. One result is historically low interest rates. Today, more countries have **negative yields** than ever before. Nine (9) countries have bond yields below zero.

This is so called “Quantitative Easing” and the ECB is just the latest central bank to jump on board. So what is QE and what are the implications?

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*The Economist* explains it this way: “Central banks are responsible for keeping inflation in check. Before the financial crisis of 2008-09 they managed that by adjusting the interest rate at which banks borrow overnight. If firms were growing nervous about the future and scaling back on investment, the central bank would reduce the overnight rate. That would reduce banks’ funding costs and encourage them to make more loans, keeping the economy from falling into recession. By contrast, if credit and spending were getting out of hand and inflation was rising then the central bank would raise the interest rate. When the crisis struck, big central banks like the Fed and the Bank of England slashed their overnight interest-rates to boost the economy.

But even cutting the rate as far as it could go, to almost zero, failed to spark recovery. Central banks therefore began experimenting with other tools to encourage banks to pump money into the economy. One of them was QE. To carry out QE central banks create money by buying securities, such as government bonds, from banks, with electronic cash that did not exist before. The new money swells the size of bank reserves in the economy by the quantity of assets purchased—hence “quantitative” easing. Like lowering interest rates, QE is supposed to stimulate the economy by encouraging banks to make more loans. The idea is that banks take the new money and buy assets to replace the ones they have sold to the central bank. That raises stock prices and lowers interest rates, which in turn boosts investment. Today, interest rates on everything from government bonds to mortgages to corporate debt are probably lower than they would have been without QE. If QE convinces markets that the central bank is serious about fighting deflation or high unemployment, then it can also boost economic activity by raising confidence.

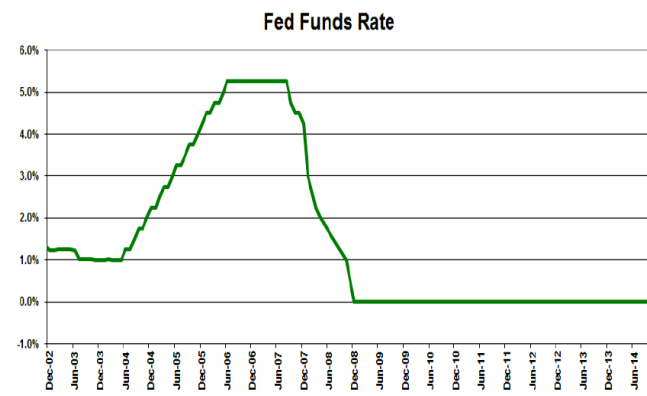
Several rounds of QE in America have increased the size of the Federal Reserve’s balance sheet—the value of the assets it holds—from less than \$1 trillion in 2007 to more than \$4 trillion now.

*The jury is still out on QE, however. Studies suggest that it did raise economic activity a bit. But some worry that the flood of cash has encouraged reckless financial behaviour and directed a firehose of money to emerging economies that cannot manage the cash. Others fear that when central banks sell the assets they have accumulated, interest rates will soar, choking off the recovery.”*

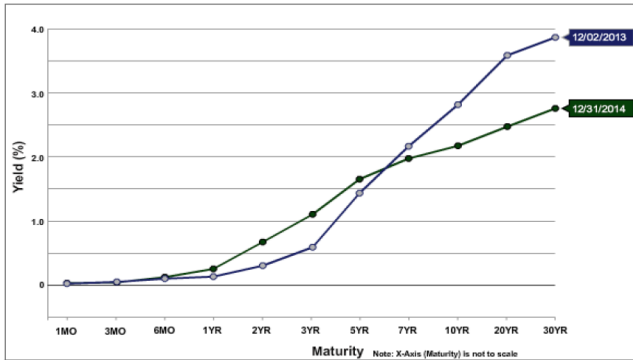
We really don’t know how this will play out, but we remain skeptical that it is this easy. That by waving their electronic wands, Central Bankers are able to change economic destiny without unintended consequences. In the meantime, the markets like European QE. The Euro has fallen 20% since last June and the international equity index EAFE is up 14% in local currency terms. Even in dollar terms, foreign stocks are the best performing asset class this year. This looks like it will be one of the main themes for 2015 – the dollar, European QE, and the corresponding effect on trade, earnings, and interest rates.

The second big topic of debate in the financial markets is whether and when the Fed will begin raising interest rates. We find the debate exaggerated. Does it really matter if the Fed raises interest rates by  $\frac{1}{4}$  -  $\frac{1}{2}$  % this year? It probably matters, but not nearly as much as the financial pundits seem to think. Hopefully, you do not follow this debate as much as we have to.

Short term interest rates have been at zero for over five years now. This is not a normal environment and we agree that they should begin the process of normalization. Raising rates should not be feared. In fact, it should be cheered because it will indicate we have moved beyond the crisis period.



Ironically, a small rise in short term rates does not mean there will be a rise in longer term rates. In fact, in 2014, we saw the opposite. Rates on bonds with maturities of 2 years increased by 0.35%, but rates on 10 year bonds fell by 0.75%. This year may see more of the same. As long as market participants believe there is little risk of rising inflation, longer term rates will change little. This seems the most likely outcome as inflation risks remain subdued.



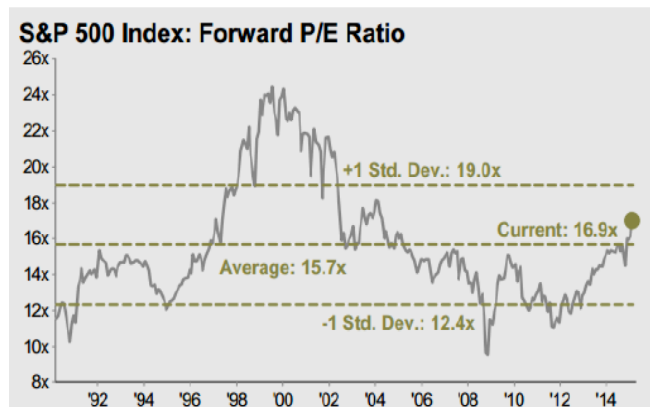
What are the risks of rising interest rates causing an economic slowdown or recession? Slim, in our view. Unemployment is low, the housing market is gradually improving, consumers will benefit from low gasoline prices, optimism appears to be increasing, and even our foreign trading partners might do a little better this year.

What are the greatest risks to investing now if they are not rising inflation and interest rates? Probably the greatest risk is the one that cannot be forecast – the geopolitical situation. Does the negotiated deal with Iran increase or decrease risks? That seems to be an open question at the moment. As usual, it is a shame politics enter into the debate. After ministers from Iran, France, Germany, the U.K., U.S., China, and Russia have come to an agreement, what do you think will happen if the U.S. Congress weighs in and objects? Also, what if Israel decides it cannot abide this deal and attacks Iran? These risks seem elevated at the current time. On the other hand, the *Wall Street Journal* led with an article recently about the potential business opportunities for the West in Iran. A true reduction in hostility could boost the global economy. Similarly, the Russian President Vladimir Putin is attempting to mend relations with Cyprus and is courting Greece in an effort to influence economic sanctions. How will Western countries deal with Russia? They have shown little resolve in confronting Putin up to this point (they did approve some sanctions).

What does all this mean to investors? History tells us not to spend much time worrying about geopolitical risks for two reasons. First, the geopolitical future is impossible to predict. Second, war (conflict) has generally had only a short term effect on the markets. Sure, the bigger the conflict, the bigger the effect; so one can draw any number of negative scenarios, but the past is littered with conflicts big and small and the economy and stock markets have survived them all and gone on to reach new heights.

A more pressing concern for us is that asset prices are no longer undervalued. Earnings growth is expected to be modest this year – now only 5% or so; and P/E ratios have risen to their historical average or higher. We still do not believe stock prices are too high, but there is also not the cushion that existed for the last few years.

Year End	Operating EPS	% y-y
2007	\$82.54	-5.91%
2008	\$49.51	-40.02%
2009	\$56.86	14.85%
2010	\$83.77	47.33%
2011	\$96.44	15.12%
2012	\$96.82	0.39%
2013	\$107.30	10.82%
2014	\$113.90	5.36%
2015e	\$119.76	5.04%



## Strategy

Where does all this leave us? Continue to stay the course, but raise the ‘wary flag’ a little higher. We believe the economy will grow, stocks will outperform cash and bonds, and investors should stick close to their long term asset allocation targets. On the margin, we are a little more concerned about valuation and will not stretch for growth stocks at the expense of good value. We are concerned about volatility when the Fed begins removing some of the liquidity in the system. This might have outsized effects on unexpected sectors. Emerging markets, REITs, or certain bonds might be vulnerable. If you are afraid of volatility, talk to your Advisor and make sure we have your portfolio allocated properly. But some volatility is to be expected and must be accepted. Volatility is not a loss unless you sell and lock in your losses at the bottom.

## Performance

So far 2015 is better for active management than 2014 was. Our core equity (individual stocks) strategy is about 2% ahead of the S&P 500 through the first quarter; and our mutual funds are also faring better. As we reported about 2014, it was an unusual period where a small number of companies led to outperformance by the indexes. We are cautiously optimistic that this year will be better for active managers. This year some of those stocks, such as Microsoft and Intel, have gone the other way and hurt rather than helped indexes. But we also hold significant positions in index funds in all areas of client portfolios in order to get broad diversification and low fees.

## Financial Planning

*By Gary Powell*

### Are Roth IRAs the Best Asset for Your Heirs?

There is momentum in the financial planning community to extol the virtues of Roth IRAs as the best asset to leave to one’s heirs. After all, inheriting a Roth IRA and being the beneficiary of a discretionary tax-free source of income is a wonderful income tax planning result for the heirs. Compared to receiving mandatory taxable distributions from a traditional inherited IRA over one’s life, the Roth IRA appears to win hands down.

However, more intrigue lies beneath the surface.

First, there has been income tax paid with a Roth IRA either through systematic after-tax Roth contributions

spanning many years or through taxable Roth conversions. If the original IRA owner has paid too much in taxes from other inheritable assets to create the Roth, the beneficiaries might have been better off inheriting a traditional IRA and paying the taxes themselves.

The logical next step is to check whether the original owner of the IRA or the heirs is in a lower tax bracket to minimize the tax cost between the two generations.

At this point, we believe making the correct assessment merely based on a tax bracket analysis understates the complexity of the analysis. It is simply unreliable to make assumptions about heirs’ future tax brackets given the uncertainty of economies, tax laws, interest rates, earnings power of heirs, and other variables too numerous to predict accurately.

So let’s stay with what we know today. The first goal is to minimize the tax impact of after-tax contributions or a Roth conversion. For those who retire in their 50s or early 60s, there may be an opportunity to make multiple annual partial Roth conversions while tax rates are especially low, before Social Security benefits begin – because the phase-in of taxation of Social Security benefits can skyrocket the marginal tax rate – and to mitigate the tax impact of higher income in their 70s once required minimum distributions (RMDs) from retirement accounts begin.

If the IRA owner has charitable intent, it may be even more appealing to avoid converting to a Roth IRA. Just leave the IRA to charity and use other taxable assets to satisfy beneficiary bequests – especially if both the IRA owner and the beneficiaries are in high tax brackets.

Additionally, to minimize the tax cost of a Roth conversion (if appropriate), one should check options to pair charitable contributions and other ordinary losses with the ordinary income from a Roth conversion.

A traditional IRA also has its own tax deferral benefits. Beneficiaries can stretch distributions over their lifetimes to lessen the tax effects. However, the beneficiary may override all the careful tax planning by electing to take the distributions in a lump sum or over a smaller number of years. Communication with your heirs on your intent is crucial.

Other factors influence the analysis of a Roth conversion affecting at least two generations:



- State of residency of IRA owner and beneficiary. Moving from a high state tax rate (e.g. California) to a lower rate (e.g. Colorado) and then making the Roth conversion can save tax conversion costs.
- The number of beneficiaries for an IRA. This can spread the income tax cost over multiple parties.
- Extra income from other inherited assets to the beneficiaries.

Just as individuals have unique personality traits, families should consider their unique financial characteristics when evaluating the appropriateness of an IRA versus a Roth IRA for future beneficiaries. Please give us a call if you would like to discuss this topic in more detail.

## Operations and Company News

*By Patty Meneley, COO*

It won't be news to some of you that scammers use email to attempt to commit wire fraud. SBL has had a few of these attempts come to us (none has been successful).

Typically, email-based wire fraud occurs when an unauthorized individual gains access to a client's email. Once the account has been compromised, the fraudster finds the advisor's contact information and starts a conversation, ultimately requesting third party wired funds.

These fraud attempts typically have clues in them that tip us off that they are not coming from you. For example, they may want to rush something through very quickly due to some sort of emergency. They might state in the email that they are not available by phone, hoping that we'll skip the verbal confirmation. Or the emails might have odd wording, uncommon phrases, grammatical errors, or incorrect punctuation. However they are becoming more and more sophisticated and Schwab and other custodians rely on us to know our clients and that any wire request we make on our clients' behalf is authorized. This is why we will verbally confirm any request that we receive via email. We will contact you

by phone or in person to verify that the request actually came from you.

Please know that safety and cybersecurity are always on our radar and be patient with us if we insist on confirming any transfer requests you may have in progress. Give us some time to make sure that all checks and balances are made to ensure that no fraudulent attempts are successful.

Are you using mobile apps yet? One of the best ways to ensure that you are up to date on your investments and that you are in control is to use Schwab and other custodians' mobile apps. They are available for Apple, Android, and Kindle devices. Simply download the app, then log in with your credentials. There are many functions such as cashing, bill pay, and research available to you 24/7 through the use of these apps. If you'd like more information on these tools, call your client service manager for the Mobile Set-up Guide.

## The Last Word

*By Rick Lawrence, CEO*

Comparing the first quarter of this year to last year, it is easy to see that the higher returns are coming from different kinds of investments this year. Foreign country stocks are up almost 4.0% in the first quarter of this year and were up only 0.5% in Q1 of 2014. Small company U.S. stocks are also performing better this year than last. Will this healthy activity take a hit when the Fed starts raising interest rates? It makes for an interesting discussion in Brad's commentary about monetary policy and quantitative easing in Europe and Japan. There will be a quiz in your next account statement.

Now that most of us are done with our taxes, it is a good time for some strategic thinking about future tax liabilities. Gary has put together some thoughts about Roth IRAs in this newsletter. The idea of being able to put assets in the so-called "tax free" bucket is appealing, especially if you think tax rates are going up in the future. It is easy to make a mistake converting to a Roth though, both in the course of analyzing the decision as well as in the execution of the changes, so don't forget about us. We are here to help you.

Patty mentioned mobile apps in her comments. Today's

apps are a convenient tool for on-the-go thinking or a quick check on how the market is doing. We are spending more and more time here discussing the kinds of data and other support material our clients would find most valuable on their smart phones, tablets, and watches – just testing you, we haven't gone there yet! If you have a wish list of functionality, or something about investing or information about your account that you wish were available to you more conveniently, send me a note. Direct input from clients is very helpful.

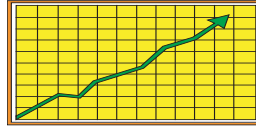
Finally, the biggest company news of the quarter came last month with the announcement that SBL has added two partners, Meagan D'Angelo and Luke Daniel. Meagan and Luke have both been with the firm for a number of years, and most clients know one or both of them. Here is a link to the press announcement:

<http://prn.to/1Dg42HT>. This is an important step for our company and we are excited that the future of SBL can come from the talent that is already in place.

Have a great springtime.

- Rick

*Many happy returns,*



*Sargent Bickham Lagudis*

[www.sblfinancial.com](http://www.sblfinancial.com)

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