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THE BIG PICTURE ~ THE "SAFE RETURN" FALLACY

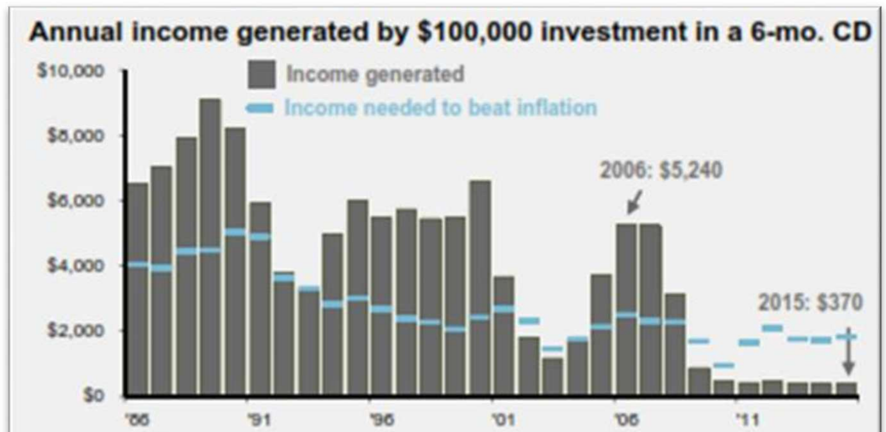
In early July, the current yield on the 30 year treasury bond hit an *all-time* low of 2.14% (Exhibit A). While this is a net positive for long-term borrowers purchasing homes and cars, historically low interest rates continue to punish conservative savers. Perhaps most negatively impacted by this situation are retirees and near retirees who, in many cases, rely on income from conservative investments like treasuries and other investment grade bonds.

Exhibit A

The hard reality in today`s world is that there is no "safe" return. While CDs, treasuries and fixed annuities offer various forms of principal protection (FDIC insurance, government guarantees, etc.), their low current yields provide a negative inflation adjusted return on your investment. Holding *only* these assets will almost ensure a slow deterioration of your wealth over time. Mattress money (cash) is even worse, as it erodes in value more rapidly due to lack of any current return. Henry Ford liked to say that as the cash piles higher, it begins to stink.

Exhibit B

Exhibit B highlights just how challenging the current environment is for conservative savers. $100k invested in a 6 month CD 10 years ago generated roughly $5,240 in annual income. Today, that same CD provides only $370 in annual income. Essentially, CDs have not provided an inflation beating return since 2008; and this is during a period of below average inflation!



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Investor Behavior

Perhaps even more troublesome than low yields, which are bad enough in their own right, is the effect these yields have on investor behavior. Retirees unable to generate enough portfolio income may be reaching for return in more dangerous and exotic places without fully comprehending the risks they are taking. For example, Master Limited Partnerships (MLPs) are yield oriented investments, typically involved with midstream and downstream oil operations. Following years of fairly steady returns, the MLP index declined more than 50% peak to trough with last year`s decline in oil. While these may recover longer term, retired investors who over-allocated to these securities for their seemingly safe yield were left with a sizeable decline to their principal. The problem here lies not in the investment, as MLPs may be appropriate for a portion of an investor`s portfolio, but in the misunderstanding of the risks associated with the investment, leading to a misallocation of capital. This is why Asset Allocation, the decision of how much to invest in stocks, bonds, cash and other diversifying assets, is our number one investment principal.

The alternative to investing solely in safe, low return assets is to balance your portfolio with more volatile yet carefully selected assets like stocks that provide higher return potential. The trade-off for this return potential is volatility and the uncertain timing of returns. As we often say, stock returns loosely follow Pareto`s 80/20 principle: *80% of the gains come 20% of the time.* For younger and/or more aggressive investors, this is a relatively easy trade off: take measured risks, accept volatility and be patient. Market history suggests that time is on your side, and that you will be rewarded for your patience. However, for retirees and near retirees, a more delicate portfolio balancing act is required. In a low interest rate environment, this means allocating a portion of the portfolio to more volatile dividend paying assets like stocks, while balancing this exposure with more conservative fixed-income assets. Since every investor is unique, a more comprehensive view, including outside sources of income, etc. is helpful in determining the appropriate asset allocation strategy.

The Three Pillars of Retirement Income

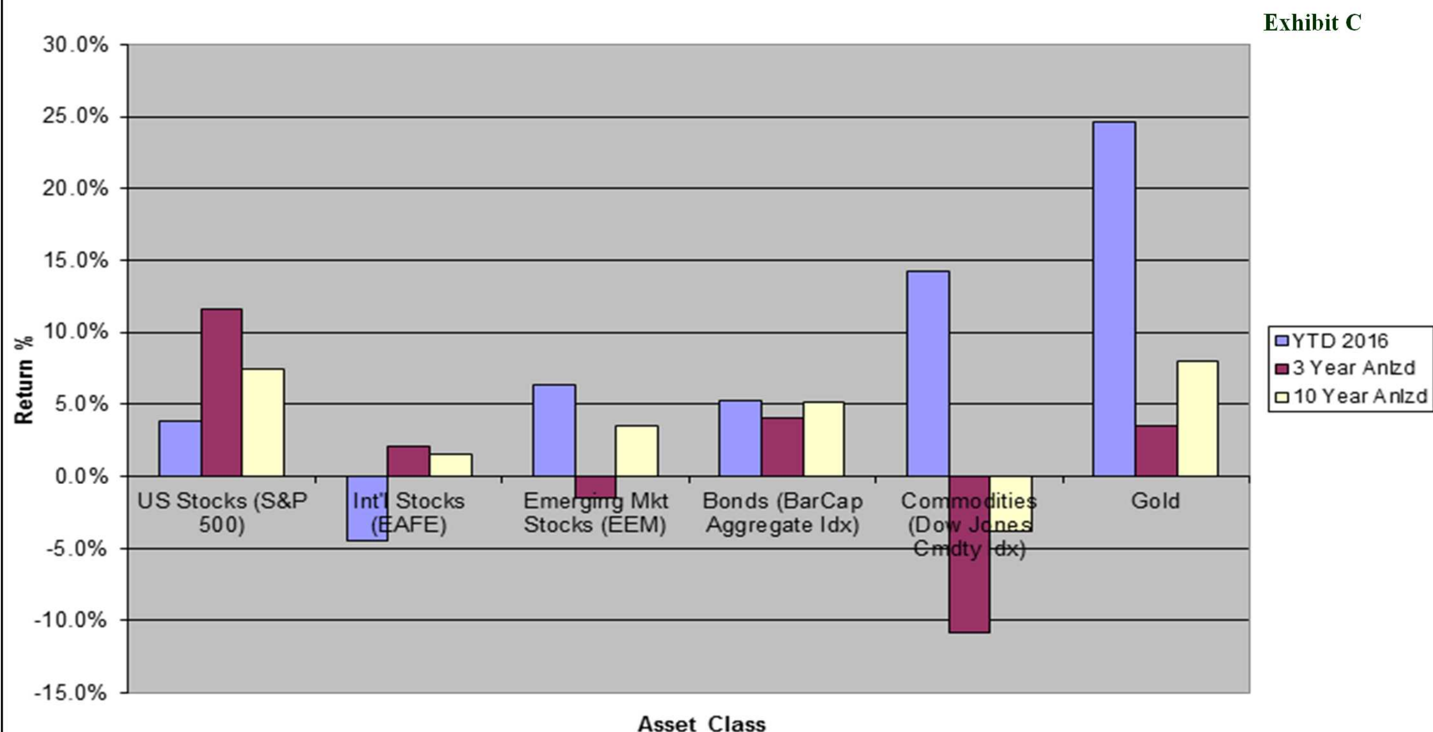
The backbone of a secure retirement is the ability to generate predictable income. This goes to figure, since by definition, retirement is replacing a salary with investment income for living expenses. We segregate retirement income sources into the following three "pillars" as each provide a distinct benefit to the retiree. Healthy exposure to all three pillars should improve the odds of a successful retirement.

1. **Current Income:** Current income includes yield oriented investment income like rental income from real estate, private income-producing debt instruments, higher yielding bonds, etc. The primary goal of the current income pillar is to provide a reasonably stable degree of income with a modest degree of risk and principal fluctuation.
2. **Growing Income:** Different from current income, growing income is generally represented by investments in dividend growth stocks. Because the timing of stock appreciation is very difficult to predict, a focus on underlying dividend payout and growth should be the primary focus of the retired investor. The primary goal of the growing income pillar is to provide a "pay raise" each year via the growth of dividend income.
3. **Safe Income:** This category includes non-investment income like social security and pension payments, which are generally guaranteed, as well as part-time work. Additionally, income from conservative bonds, CDs and fixed annuities are included in this category. The primary goal of the safe income pillar is to provide stable income with solid principal guarantees and/or very limited principal risk.

The structure of the retirees investment portfolio will vary depending on their individual circumstances. Retirees with sizeable guaranteed pensions that are indexed to inflation may not need as much invested in the current income or growing income categories. Alternatively, an investor with limited pension or social security income and a high cost of living will need to allocate more to the first two pillars. **If you are at or nearing retirement, and want to discuss the development and implementation of a retirement income plan for your portfolio, please contact us so that we can do a comprehensive review.**

2016 Mid-Year Review

Through 06/30/16, domestic stocks (S&P 500) increased 3.8%, developed international stocks (EAFE) decreased -4.4%, and emerging market stocks (EM) increased 6.4%. Bonds (Bar Cap Agg Idx) increased 5.3%, commodities (DJ Commodity Idx) increased 14.2%, and gold was up 24.6%. We have updated our asset class return chart (Exhibit C) to reflect YTD 2016 along with three and ten year annual returns for the aforementioned asset classes.



The low 10 year returns for Int`l and Emerging Market stocks remind us of both the cyclical nature of asset price returns and the importance of prudent diversification and rebalancing. At the end of 2010, US markets had annualized returns of around 1% per year over the preceding 10 years, while Emerging Markets had annualized at 16% per year over the same time frame. Fast forward to 2016 and Emerging Markets have now underperformed the US by almost 4% per year over a ten year time horizon.

As a great investor/philosopher once said, "shift happens". Today`s underperforming asset classes will more than likely be tomorrow`s leaders, and vice versa. In statistics, this is called reversion to the mean, the idea that assets over time will revert back to their long-term average return. This is why selling after a market crash is generally a bad idea, while taking profits after an exceptionally strong run is reasonable. Eventually, returns will reverse course.

Rather than try to predict what the market will do next, we tend to focus our trade timing on what the market has already done via periodic rebalancing: essentially, buying more of an asset after it declines and is underweighted in the portfolio and selling an asset after a period of above average returns where it is now overweighted. It`s not sexy, but, over time, we believe this prudent approach to "timing" should improve portfolio returns. Rather than try to predict the exact timing of asset price moves, often referred to as a "fool`s errand," it is far better to establish an appropriate asset allocation for your unique circumstances, stick with it, then rebalance periodically to take advantage of the market`s moves.

**Individual accounts will vary based on a client's stated objectives, risk tolerance and time frame. We manage several different portfolio strategies, so not every client has exposure to the securities, asset classes or trading strategies discussed above. In addition to growth and/or income oriented asset allocation strategies, we also manage more concentrated equity portfolios that generally carry a higher degree of risk and volatility. Please contact us if you want to discuss your portfolio strategy in greater detail.*

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Should you have any questions regarding your investment account(s) or, if there have been any recent changes to your investment and/or retirement objectives, please do not hesitate to contact our office. We can also provide you with a current copy of our SEC Form ADV Part II, at your request.

As always, we thank you for entrusting AMM to help you achieve your investment and retirement objectives.

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