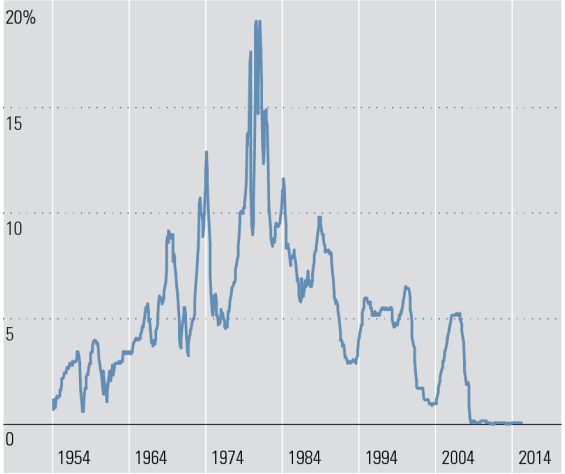
October 2015 | Vol. No. 10 | Investment Updates

The Fed Kicks the Can Down the Road

The Federal Reserve decided not to raise rates at its September meeting. While admitting that employment and inflation levels were approaching its goals, the Fed worried that slower international economic activity would potentially depress U.S. growth rates (and employment), while a strong dollar was likely to keep inflation lower for longer. Given the uncertainty, it didn't feel an imminent need to raise rates. On the other hand, their longer-range forecasts show rate increases over the next year, albeit at a pace well below normal cyclical patterns. Current Fed governor forecasts have the Fed Funds rate moving up from 0.12% currently to just 1.4% by the end of 2016, slowly working its way to 3.4% by the end of 2018. In total, that is just barely over a 3% increase in more than three years. The relatively slow pace and small size of the total increase are all well below history.

Effective Federal Funds Rate



Source: Federal Reserve. This article contains certain forward-looking statements which involve known and unknown risks, uncertainties, and other factors that may cause the actual results to differ materially from any future results expressed or implied by those projected statements. Past performance does not guarantee future results.

Advisor Corner

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2015 Market Performance
01-01-2015 to 9-30-2015
DJIA ^DJI Down -8.63%
S&P 500 ^GSPC Down -6.74%
NASDAQ ^IXIC Down -2.45%
Russell 2000 ^RUT Down -8.75%

* Index performance does NOT include any fees (Gross of fees)
Source: http//finance.yahoo.com

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How Will Bond Funds React to Rising Rates?

It is difficult to predict how the markets will move once the Fed decides to raise rates. That said, this article explores some ideas about how different types of fixed-income mutual funds are likely to react to an increase in interest rates.

Debt securities and funds that invest in them have varying levels of sensitivity to changes in interest rates. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities tend to be more sensitive to interest rate changes. Funds holding short-term debt securities are the least sensitive to changes in interest rates, while funds investing in longer-term bonds are the most interest-rate sensitive.

That being said, markets have responded very differently in past rounds of rate hikes. For example, during the rate hikes from March 2004 to June 2006, yields on the 30-year bond actually fell as the yield curve flattened; during the September 1993 to December 1994 hikes, yields rose across the yield curve. If the yield curve steepens (the long-end rises faster than the short-end) or shifts upward in a more or less parallel fashion, long-term bond funds could take a significant hit. But if the yield curve flattens, which is not out of the question given the troubles abroad that may continue to push investors toward the safe haven of U.S. Treasury bonds of all maturities, longer-term funds may fare better. For example, during the 2004–06 rate hikes, the 10-year Treasury bond lost 1.7% while the 30-year bond gained 2.2%.

Globally, it's expected that the eurozone and Japan (the two main non-U.S. developed markets for bond investors) will be relying on quantitative easing much longer than the United States, thus delaying their own rate hikes. But the market for high-quality non-U.S. government bonds, including German bunds and Japanese government bonds, can track U.S. Treasuries when investors seek safe-haven assets. If the Fed continues to delay the rate hike, it could be seen as a signal that it's concerned about economic growth and may stoke fears of slowing global growth, and German and Japanese government bonds could strengthen. Under the same scenario, the dollar is likely to weaken, which would boost issues denominated in euros or yen.

What does this mean for an investor's portfolio? Predicting the timing and magnitude of interest-rate movements is difficult, and many bond portfolio managers believe it's folly to significantly change a fund's position based on interest-rate predictions. Investors may be better off sticking with an allocation that suits their long-term investment goals, and understanding how different bond funds might perform during various rate environments can help.

The investment return and principal value of mutual funds will fluctuate and shares, when sold, may be worth more or less than their original cost. Mutual funds are sold by prospectus, which can be obtained from your financial professional or the company and which contains complete information, including investment objectives, risks, charges and expenses. Investors should read the prospectus and consider this information carefully before investing or sending money.

Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest. With government bonds, the investor is a creditor of the government. With corporate bonds, an investor is a creditor of the corporation and the bond is subject to default risk. Corporate bonds are not guaranteed.

With international bonds, the investor is a creditor of a foreign government or corporation. International bonds are not guaranteed. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards.

Investors Are Driving Expense Ratios Down

Morningstar's 2015 fee study examined expense-ratio trends in the asset-management industry. The main takeaway was that expense ratios are falling, and investors are paying less for fund management.

The asset-weighted expense ratio across all funds analyzed (which include mutual funds and exchange-traded funds, or ETFs) was 0.64% in 2014, down from 0.65% in 2013 and 0.76% five years ago. The trend is being driven more by investors seeking low-cost funds than it is by fund companies cutting fees. Fund investors are increasingly buying passive funds and investing in lower-cost actively managed funds.

During the past decade, low-cost funds have been attracting far more inflows than their more-expensive peers. This has helped to reduce the industry's average asset-weighted expense ratio over time. Mutual funds and ETFs with expense ratios ranking in the least-expensive quintile of all funds attracted an aggregate $3.03 trillion of estimated net inflows during the past 10 years, compared with just $160 billion for funds in the remaining four quintiles. That is to say that 95% of all flows have gone into funds in the lowest-cost quintile. Passive funds (mutual funds and ETFs) have been prominent recipients of the capital flowing into low-cost funds. Compared with funds falling in cost quintiles 2 through 5, funds in the lowest-cost quintile are more likely to be passive/index funds.

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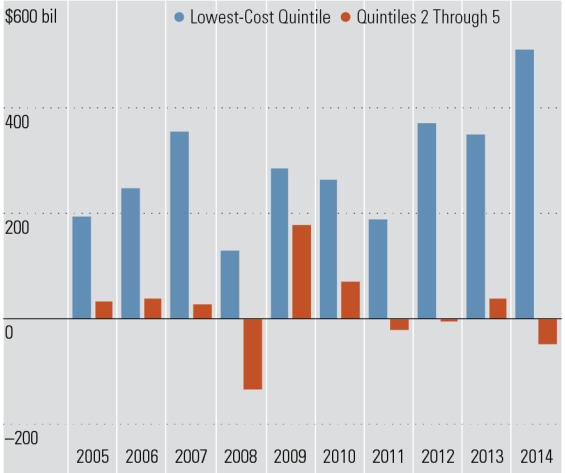
Holding an exchange-traded fund (ETF) does not ensure a profitable outcome and all investing involves risk, including the loss of the entire principal. Since each ETF is different, investors should read the prospectus and consider this information carefully before investing. The prospectus can be obtained from your financial professional or the ETF provider and contains complete information, including investment objectives, risks, charges and expenses. ETF risks include, but are not limited to, market risk, market trading risk, liquidity risk, imperfect benchmark correlation, leverage, and any other risk associated with the underlying securities. There is no guarantee that any fund will achieve its investment objective. In addition to ETF expenses, brokerage costs apply. Fees are charged regardless of profitability and may result in depletion of assets.

Estimated Net Flows by Expense Ratio Quintile



Source: "2015 Fee Study: Investors Are Driving Expense Ratios Down," Morningstar, Inc.

A Few Simple Tips for Fund Investing

A few ideas/tips/reminders investors might want to consider when reviewing their existing mutual fund line-up or choosing new funds:

Focus on your plan, not the news. Market-timing is very difficult to do well, so stick to your plan and keep investing.

Look for lower-risk funds. After a long-running bull market, this is probably more important than ever. Lower-risk funds may appear rather unappealing, but you may well hold on to these funds through the next downturn.

Find the right funds for you. If you have made a lot of fund trades over the years, maybe you need to dial down the volatility. Diversified or balanced funds may appear dull, but that may be a good thing. Dullness keeps emotions out of the equation, and it is emotional investing that wrecks a good plan.

Look for fund companies that close funds before they get too big. You can do this by finding funds that have closed in the past but have reopened. In addition, some funds will name a closing target well in advance so you can have some confidence that the fund won't suffer asset bloat going in.

Low-cost funds should be a key part of your strategy.

The investment return and principal value of mutual funds will fluctuate and shares, when sold, may be worth more or less than their original cost. Mutual funds are sold by prospectus, which can be obtained from your financial professional or the company and which contains complete information, including investment objectives, risks, charges and expenses. Investors should read the prospectus and consider this information carefully before investing or sending money.

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