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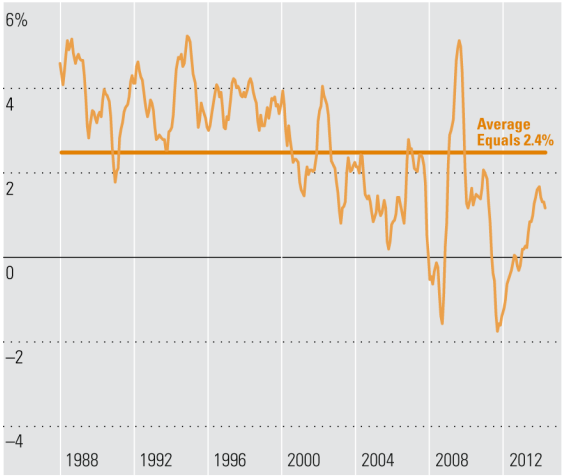
# Inflation Rate and Typical Spread Suggest Higher Interest Rates Ahead

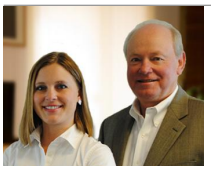
Given that the U.S. Federal Reserve is stepping back some its maneuvers to keep interest rates low, interest rates are expected to increase to more normal levels. Normal means that interest rates are generally dictated by the rate of inflation plus a spread. In the case of the U.S. 10-year Treasury bond, the spread has averaged about 2.4%, though that level has been quite volatile. If one puts that 2.4% spread on top of the current inflation rate of 1.5% (as of Apr. 2014), one could expect an interest rate of 3.9% (compared with 1.8% at the end of 2012 and 2.9% at the end of 2013). Yet, it might take some time to get there. Higher rates are generally bad news for the economy as they tend to slow both housing and auto activity.

10-Year Treasury and CPI Inflation Spread




Source: St. Louis Federal Reserve, updated June 2, 2014. Last data point is for April 2014.





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## Chambers Financial Group

Chambers Financial Group is a comprehensive financial services firm that was founded in 1984 with the goal of assisting our clientele with a holistic financial view in mind. We integrate many of the financial areas in your life, including investment planning, portfolio management, retirement planning, estate and tax planning.

We are an independent family practice dedicated to providing objective, responsible financial planning assistance to a broad range of clients. Our objective is to help our clients live the life they wish to, both now and in the future. Our clients' success is our success.

We believe in building long-term relationships with our clients. We believe in the value of building trust and confidence with long range plans to achieve your financial goals. We give unbiased, honest advice and believe patience along with discipline is crucial in the achievement of defined investment goals.

# A Simple Plan

Outlining an investment plan can be challenging: Today, individuals are responsible for building their own retirement accounts. This is a dramatic change from the past generation, who relied heavily on defined-benefit pension plans, which guaranteed income for life following retirement. Investors are faced with the challenge of making decisions on how much to save each month, how to allocate savings, and how to take disbursements in retirement. Fortunately, target-date funds offer a convenient solution to help simplify investing for the future.

Target-date funds, also known as lifecycle funds, have emerged as a popular investment option for individuals who may be unprepared or reluctant to make their own investing decisions. These funds provide a pre-built asset allocation strategy that automatically adjusts based on the participant's age.

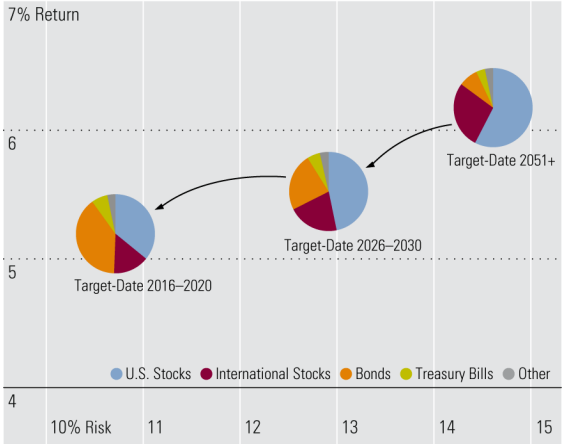
Target-date funds can make retirement planning easier: The image above illustrates three target-date fund categories with varying maturities. As time passes, each portfolio is adjusted to meet the needs and goals of investors. Target-date funds achieve this by continually adjusting the mix of stocks, bonds, cash, and other investments. These funds become more income oriented as they approach and pass a target date.

For example, an investor who plans to retire in 15 years might select a fund from the Target Date 2026–2030 category, which places a large amount of assets in domestic and international stocks. Similarly, an investor with a retirement horizon of three years may choose to invest in a fund from the Target Date 2016–2020 category, which offers a more conservative mix. Consult your financial advisor to learn about target-date funds that may be right for you based on your investment objectives and risk tolerance.

Diversification does not eliminate the risk of experiencing investment losses. Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index.

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, while stocks are not guaranteed and have been more volatile than bonds. 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.

## Target-Date Funds Alter Allocations Over Time January 2002–May 2014




Source: Target Date 2016–2020, Target Date 2026–2030, and Target Date 2051+ are target-date fund categories from Morningstar's open-end database.

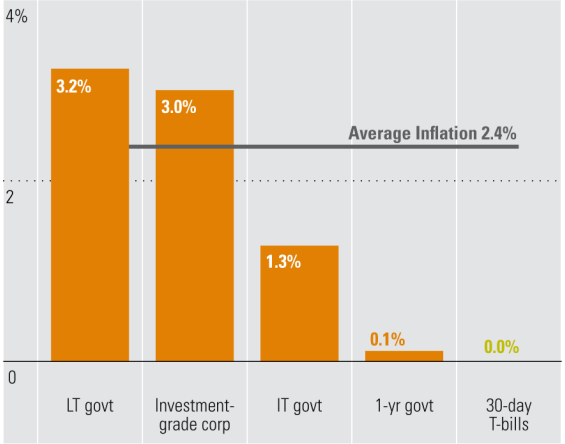
# Fight or Flight?

The market turmoil of 2008 has caused panicked investors to flee to safety, from stocks and mutual funds to risk-free investments like Treasuries and savings accounts. However, a risk-free portfolio might carry a high price. With their low returns and limited growth potential, some fixed-income investments may leave investors with little return after inflation. Further, by dumping stocks and investing solely in fixed income, investors are not only losing out to inflation, but they are also missing out on an eventual market recovery and growth. Although Treasuries at times provided investors with a safe haven from market volatility, they didn't provide much protection against inflation over the time period analyzed. The image illustrates the current rates for fixed-income instruments with varying maturities, as well as the average inflation rate over the last 10 years. The yields for intermediate- and short-term instruments examined are currently below the average inflation.

Locking investments in Treasuries' current yields might not provide a long-term real return, especially with expectations of a high inflationary environment on the horizon. Too much allocation to conservative investments can cause investors to forfeit long-term growth. An allocation to equity and longer-term bonds could position portfolios to capitalize on an eventual rebound.

Average inflation is annual, from 2004 to 2013. Current yields are for the month of April 2014. Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Diversification does not eliminate the risk of experiencing investment losses. 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.

## Current Yields of Fixed-Income Instruments Versus Trailing 10-Year Inflation



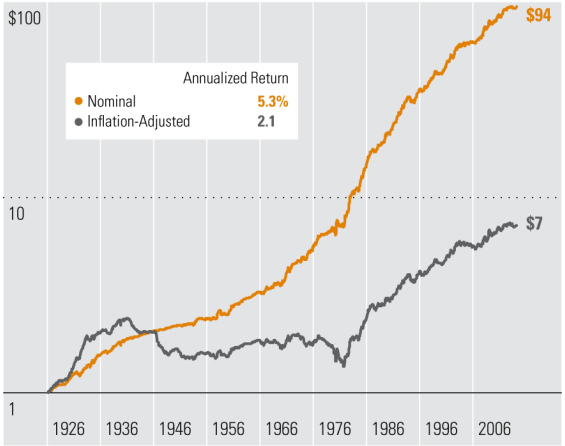

Investment-grade corporate bonds are represented by the Barclays U.S. investment-grade corporate bond index, long-term government bonds by the 20-year U.S. government bond, intermediate government bonds by the 5-year U.S. government bond, 1-year government bonds by the 1-year constant maturity U.S. government bond, Treasury bills by the 30-day U.S. Treasury bill, and inflation by the Consumer Price Index.

# Inflation, not Rising Rates, Biggest Bond Threat in the Long Term

Since the beginning of 2013 when rates started to rise, investors have been concerned about a potential decline in bond performance. In general, bonds tend to perform poorly in times of rising interest rates, but by worrying about rates investors may lose sight of an even bigger long-term threat: inflation.

Over the long term (since 1926) investors have lost 3.2% (the difference between 5.3% nominal and 2.1% inflation-adjusted) in return every year to inflation. Compounded over almost 89 years, the difference in ending wealth values is astounding: A $94 nominal value becomes only $7 when adjusted for inflation. Investors may be well advised not to neglect inflation risk while focusing on interest-rate risk.

Intermediate-Term Government Bonds
January 1926–March 2014




**Past performance is no guarantee of future results.** This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Government bonds are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest.

**Data:** Nominal performance of intermediate-term government bonds—Ibbotson SBBI U.S. Intermediate-Term Government-Bond Index, total return. Inflation-adjusted performance of intermediate-term government bonds—Ibbotson SBBI U.S. Intermediate-Term Government-Bond Index, inflation-adjusted return. Inflation—Consumer Price Index. The data assumes reinvestment of all income and does not account for taxes or transaction costs.

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