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RETIREMENT & WEALTH PLANNING • INVESTMENT MANAGEMENT & DESIGN

September 2017

Is Now the Right Time to Rebalance My Portfolio? & the Solar Eclipse and Investing

Questions from the Field:

During the course of teaching seminars, writing articles and newsletters, and meeting with clients we hear lots of questions. We will try to address some of the more timely and relevant questions that investors, executives, and retirees are asking us. Our questions for this month are:

Q: **Is now a good time to rebalance our portfolio?**

Q: And if it is, what should we rebalance to?

The US stock market keeps surging upwards and has bumped along to all-time highs during the normally stagnant for stock prices summer season. These records are being surpassed despite severe domestic political uncertainty, no economic reform passed by Congress, a national healthcare system that is in turmoil, a hurricane devastating the 4th largest city in the US, and an aggressive and irrational foreign nation that is threatening the US with nuclear missiles. There is lots of bad news to find in the media, but we can be thankful for the fact that the stock markets and our portfolios have grown nicely thus far in 2017. With the record highs and all the uncertainty, the questions that beg for answers: Is now a good time to rebalance our portfolio? And if it is, what should we rebalance to?

We can try and answer the first question by checking in with two of the very brightest minds in academics and investments, world renowned professors Robert Schiller and Jeremy Siegel. Schiller is a Nobel Prize winning economist, and Siegel is a famous finance professor at the Wharton School of Business. Their work is widely used by investment managers and professional investors, and everyone in the field of investment science has heard of them and probably used their research.

Schiller and Siegel recently had a friendly debate* and you couldn't have two more contrary views from these two leading luminaries of the investment markets.

"The US stock market hasn't been this overvalued except for a couple times in history—around 1929, around 2000." Robert Schiller Nobel Prize Economist

"I do not share Bob's high concern for this market, which, by the way, Bob has voiced for a long time." Jeremy Siegel Palmer Professor of Finance at the Wharton School of Business

According to Schiller, *"The US stock market hasn't been this overvalued except for a couple times in history—around 1929, around 2000."* And in a completely opposite perspective, Siegel who is optimistic and believes that stocks are in a Goldilocks scenario said that, *"…We are not in that world. We are in a low interest rate world. "I do not share Bob's high concern for this market," said Siegel, "which, by the way, Bob has voiced for a long time."*

If Schiller is right, the time to rebalance is now, and if Siegel is right, then it might be better to let our portfolio ride and continue the way they are for now.

(*You can read their debate here: https://www.cnbc.com/2017/04/29/robert-shiller-vs-jeremy-siegelon-stock-valuations.html)

If these two heavyweights of the financial world can't agree, then perhaps a more relevant way of determining if we need a rebalance has to do with our own personal financial goals and risk tolerance. According to Schiller, "*Right now is a good time to look at one's portfolio and ask if it's diversified enough, that's because the big rally in U.S. stocks compared with nearly every other asset class could have morphed a once-balanced portfolio into a big bet on the SP 500 continuing its run.*"

US Stocks vs. Bonds – January 2009 through August 2017

(Source: Stockcharts.com – vertical axis represents total return.)

For example, if an investor had a conventional balanced portfolio of 60% stock, 40% cash and bonds in 2009 and has not rebalanced during the last several years, his portfolio today may look completely different. Stocks have over performed bonds by a wide margin over the last eight years. A 60/40 mix might have changed to 70% or 80% stock or more, due to the rapid growth in the stock portion of the portfolio. That means this investor's non-rebalanced portfolio of today may have a much higher risk level than what they originally started out with.

Now that could be okay for the investor if his tolerance for risk and portfolio goals have changed. However, it is more likely and quite common for investors to ignore rebalancing, to not understand or overlook the fact that their portfolio has changed to a much higher risk level over time. It's important to review your portfolio's risk level and try to make sure your portfolio matches your goals.

Market history tells us that US stocks tend to drop 10% about once per year. A larger drop of 20% is fairly common and has happened every three years or so for the last century. So an accurate and careful self-evaluation of your risk tolerance is crucial in determining if you need to rebalance, regardless of what the experts may think about the future.

Remember that stocks have a much higher return over history than bonds and cash, but is also true that stocks have far more risk and can drop significantly during bad years. If you think you can tolerate a higher level of risk, you have a plan to meet your income needs and can hold on to your portfolio during the inevitable bad years, then perhaps you don't need to rebalance. But if you are worried about risk and seek income or liquidity now, then it may make sense to rebalance back to your goal mix, regardless of what the future holds – whether it's Professor Schiller or Professor Siegel who is right about the direction of the stock markets.

Rebalancing Strategies

There are several steps to rebalancing a portfolio, but from a risk perspective the most important one is maintaining your ratio of stock to non-stock investments, like bonds, cash or an annuity. This first step is quite simple, the higher percentage you have in stocks the better return you're likely to have during good years, but the more your portfolio may decline during bad years. Let's examine three rebalancing options in more detail:

Rebalancing to Cash

One simple way to reduce risk and rebalance your portfolio is to simply increase the amount of cash you hold. This is very easy to do and to understand. Cash is generally considered risk free, however current returns for cash or money market investments are extremely low or even zero. Investors receive little return for holding cash and in fact they might even be going backwards because the return on their cash is less than the rate of inflation. In other words, that investor is losing purchasing power. If an investor rebalances and increases cash, he should also have a plan in place to reallocate cash back to the portfolio when the market conditions seem appropriate. A dollar cost average program to slowly trickle the cash back into the portfolio is a common strategy to accomplish this and creates a discipline to avoid sitting in too much cash for too long.

Rebalancing to Bonds

This is the conventional approach to rebalancing. An investor may take advantage of gains in their stock portfolio, rebalancing to reduce their stock weighting and add more money back to bonds. Bonds pay regular interest, they tend to behave differently than stocks do during downturns and they may have much lower risk. It is for all these reasons that investors have always used some bonds in their portfolio mix. However, there is a major problem with bonds today: Rates are very low now and have been for many years. And – bonds tend to LOSE value when rates start to rise, which could happen, perhaps even this year *(Caveat – there are different types of bonds, and some might perform well in a*

rising rate or rising inflation environment, so this is not a blanket statement). The point is that bonds might not be as attractive now as they were a decade ago, when an investor could have easily bought an investment grade bond with a 5%, 6% or even higher interest payment. Bonds, however, are still an important part of a portfolio and should still be considered a part of your overall allocation mix.

US Treasury Bond Yields: August 2017

Treasury Yields

NAME	COUPON	PRICE	YIELD
GB3:GOV **3 Month**	0.00	1.00	1.02%
GB6:GOV **6 Month**	0.00	1.09	1.11%
GB12:GOV **12 Month**	0.00	1.28	1.31%
GT2:GOV **2 Year**	1.38	100.11	1.33%
GT5:GOV **5 Year**	1.63	100.73	1.71%
GT10:GOV **10 Year**	2.25	101.08	2.13%
GT30:GOV **30 Year**	2.75	100.48	2.73%

(Source: Bloomberg.com)

Rebalancing to an Income Annuity

One strategy that bears considering, especially in the current low interest rate environment, is the use of an income annuity as an alternative for some of the bond/cash part of your portfolio. Now there are many different types of annuities and to be clear, this would be for an income annuity (*not a variable*

annuity) - in other words, an annuity that provides a lifetime guaranteed income stream. The payout rates on income annuities have started to rise over the last couple of years and although they are not necessarily an apples for oranges comparison with bond interest, they are becoming more attractive. For example, a 65 year old husband and wife might have a guaranteed payout rate of about $5400 per year on a $100,000 investment, which is 5.4% payout rate, and a 70 year old couple might have a guaranteed lifetime income of $6000 per year, which is a 6% payout rate. *(Payment guarantees are issued by the insurance company that issues the contract.)*

Here is an example of how this strategy might work. Let's suppose that a couple had a $1M portfolio they allocated to a 60/40 mix a number of years ago. Today the portfolio is far higher in value, especially the stock portion which has grown considerably, and thus the mix has now shifted to 75% stocks and only 25% bonds. The stock percentage has gone way up and the potential future risk level has also gone way up. These investors may feel a need to rebalance their portfolio to reduce their risk level, but they understand the dilemma of adding more money to bonds in a low interest rate environment and are not enthusiastic about parking money in cash investments, which earn basically nothing.

As an alternative, they might consider taking some gains from the stock side of their portfolio and moving it to an income annuity. If for example, they had $400k in gains from their original $1M starting point and they moved $100,000 to an income annuity, they could get a lifetime payout today of a little over five percent ($5400 per year for life based on the rates as I am writing this.). By doing so they've accomplished several important financial goals: First, they've increased their annual lifetime income. Second, they've taken advantage of gains on the stock side of their portfolio. Third, they've reduced the risk in their portfolio. And they've done so using a vehicle that has potentially a much higher payout than the bonds or cash alternatives.

Income Annuities and IRA accounts – the QLAC

There is a new tax wrinkle that makes this income strategy even more appealing for older investors with IRA accounts. Remember that once you reach age 70, the IRS requires you take annual mandatory withdrawals from your IRA account. This is disappointing as you will now have to start paying taxes on all the deferred contributions and gains you've enjoyed through the years. However, recent tax law changes may allow an IRA owner to purchase a special type of income annuity (*Called a QLAC in the tax code lingo*), which may be exempt from the mandatory withdrawal requirement.

Here's an example of how it might work. Let's go back and revisit our investor from the last example. Let's suppose they decide to rebalance their portfolio using an income annuity, but felt they might need more income in the future instead of today. If they allocated a portion of their IRA to this special type of income annuity, the balance in that annuity would be exempt from the mandatory distribution

rules when they turn 70 and would thus provide them some additional tax deferral and tax savings. The annuity could be structured to start income at age 75 (or even later, if they chose).

An additional benefit of structuring the income annuity with a later start date is that the income payout rate could be substantially higher. For example, if this 65 year old couple moved $100k of their IRA to a QLAC annuity and selected guaranteed income starting at their ages 75, that $100k balance would not be subject to the mandatory distribution requirement and could keep deferring until their age 75, and the payout rate at current levels might be over eight percent. Again, these payouts compare favorably to the extremely low bond rates and money market rates we're seeing today.

One common and valid objection to the income annuities is that if both the husband and wife are gone, the value of the account will also be gone. Fortunately, there is an easy way to solve that problem. The income annuity might be structured to include a return of principal provision, which allows for any unused dollar amount allocated to the annuity to be returned to the children or other beneficiaries if both the husband and wife pass before they have used all the income from the annuity.

The income annuity may make a lot of sense for investors that need income now, and for IRA investors that are approaching or are over age 70. As interest rates move up, the payout rates on income annuities also rise, making them even more attractive.

Rebalancing is a crucial part of investment management and successful portfolio planning. We can review rebalancing and rebalancing options like using cash, bonds or an income annuity in more detail at our next scheduled review meeting. Of course, as always, please feel free to call us if you have any questions or would like to discuss this before our next meeting. *(Note: Rates are hypothetical and are for illustrative purposes only, and are subject to change.)*

Solar Eclipse and Investing

Like most of you, I was caught up in the excitement surrounding the solar eclipse. We had made plans to visit our family in Boise who were in the path of totality, but ended up ditching our plans because of the hysteria about massive traffic jams. In retrospect, I'm sorry that we didn't go. My brother in law reported that it was an incredible event to see in person and there weren't an overly large amount of people in their area.

It reminded me of the stock market - oftentimes some future economic or political event creates a storm of hype, news and hysteria, and we can all easily get caught up in the anxiety that results from that. And often, just like the eclipse, the actual event is only a shadow of what the media built it up to be (*pun intended*☺). The eclipse was a good reminder to me to not get too overwhelmed or caught up by what we read in the media – especially as it relates to our investments.

Instead of going to Boise, I rode my mountain bike to the top of Tiger Mountain early Monday morning and watched the eclipse with a few other hardy mountain bikers and hikers at the East Tiger summit.

Here is what the eclipse looked like from the summit of Tiger Mountain. Even at 92% coverage the sun is still very bright!

...and the trail back down. The temperature dropped dramatically even though the sun was still shining.

I hope you and your family have enjoyed a wonderful summer and this amazing abundance of sunshine and fantastic weather. I look forward to seeing you at our next appointment and wish you blessings, prosperity and our whole team here remains committed to your financial well-being.

Warm Regards,

Willy

William R. Gevers
Financial Advisor/President

PS: *We have been repeatedly asked by clients if they could share these e-mail notes with their friends or neighbors. Please feel free to forward this with the stipulation that it may only be forwarded if done so in its entirety with no portions omitted. We would be delighted to share our comments and opinions with your friends, and welcome your comments and feedback. If you received this and would like to be included on our newsletter list, please email us at info@geverswealth.com.*

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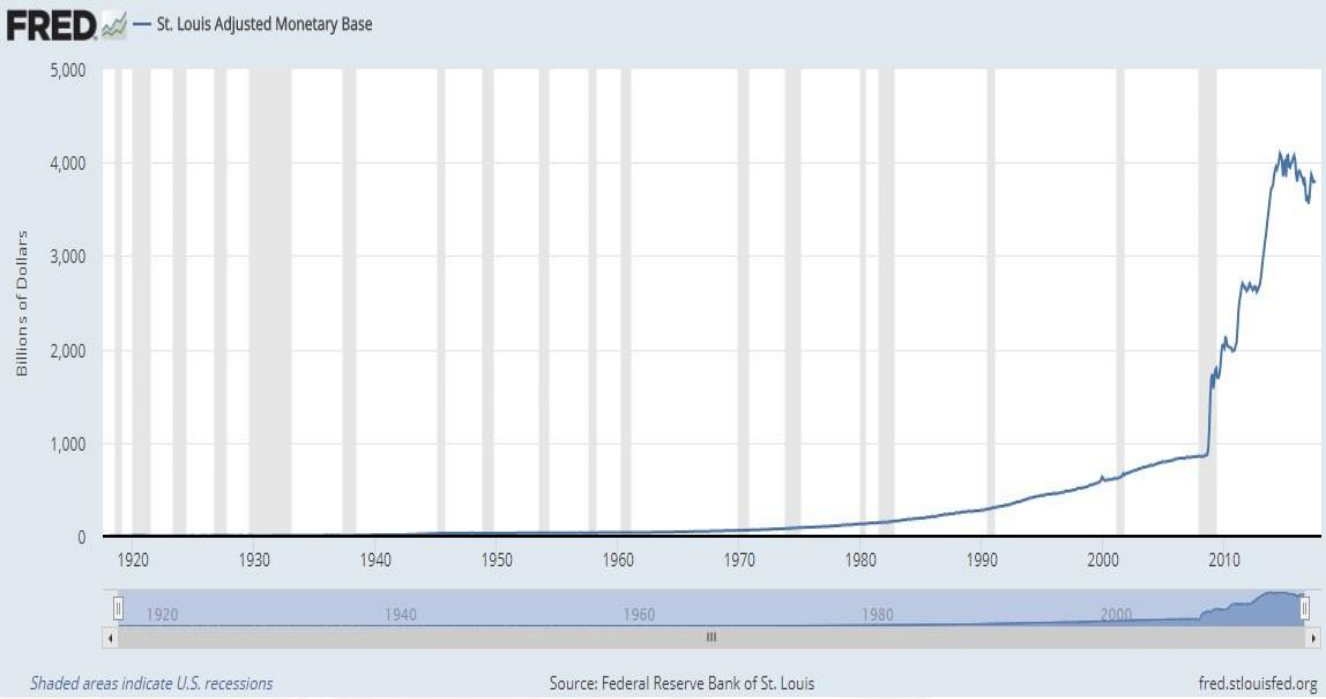
US Money Supply, US Dollar, and Inflation/Deflation Watch

"Neither a wise man nor a brave man lies down on the tracks of history to wait for the train of the future to run over him." - Dwight D. Eisenhower

US Money Supply – Adjusted Monetary Base

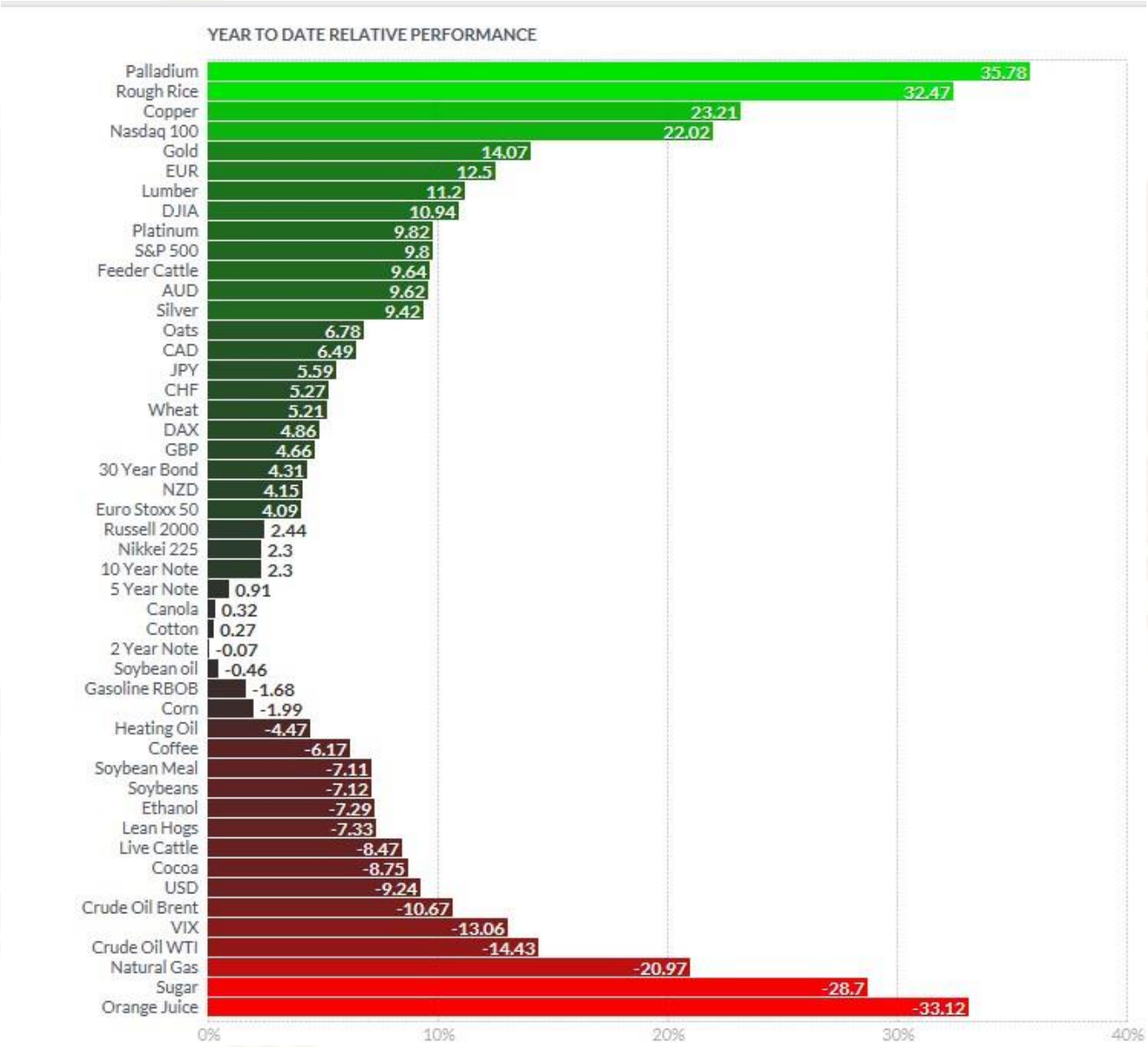


(http://research.stlouisfed.org/fred2/graph/?s%5B1%5D%5Bid%5D=AMBNS#)

US Dollar Price – (DXY) USD Index measured against other currencies

(http://www.barchart.com/chart.php?sym=DXY00&style=technical&template=&p=MC&d=X&sd=&ed=06%2F11%2F2015&size=M&log=0&t=LINE&v=0&g=1&evnt=1&late=1&o1=&o2=&o3=&sh=100&indicators=&addindicator=&submitted=1&fpage=&txtDate=06%2F11%2F2015#jump)

Inflation/Deflation -Year to Date price increase in commodities and basics as measured by futures



(http://www.finviz.com/futures_performance.ashx?v=17)

Velocity of Money – Velocity is a measure of how quickly money is spent. High velocity is typically a precondition for inflation.

(http://research.stlouisfed.org/fred2/series/MZMV)