STRATEGIC
Wealth Advisors

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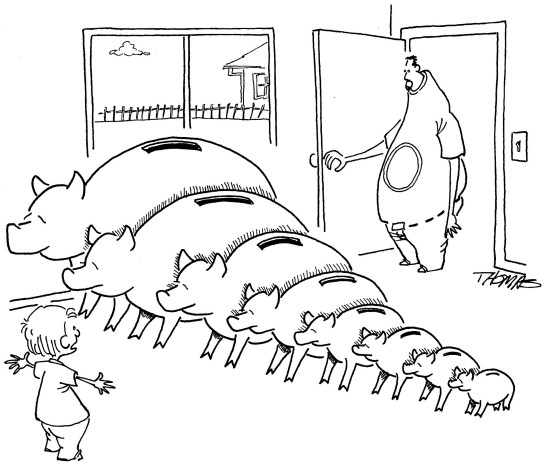
Two Types of Diversification



"I'm trying to diversify my portfolio."

Diversification works on the principle that not all asset classes react the same way to market events. For example, when stocks go down, bonds have a tendency to go up, and vice versa. This way, by combining various assets in a portfolio, investors may be able to protect themselves from extreme market fluctuations.

Classic diversification involves combining different asset classes: stocks, bonds, cash, gold, and so on. However, it is also possible to diversify within a certain asset class; by size, for example. Within the stock portion of a portfolio, an investor could combine large-, small-, and mid-cap stocks and obtain potential diversification benefits, because stocks may behave differently based on their market capitalization.

What's Happening at SWA

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You may have recently heard about the Heartbleed internet security vulnerability affecting websites using a certain brand of security software called OpenSSL. Going to www.heartbleed.com provides a considerable amount of information on this vulnerability, how to check for it on websites you use and what additional steps are recommended. Many websites do not use OpenSSL and those that did have already applied, or are in the process of applying, software patches to eliminate this vulnerability. At a minimum, it is recommended that you change your passwords for those sites previously affected by Heartbleed. These include, but are not limited to, Gmail, Yahoo!, Instagram, and Dropbox. By some estimates, nearly two-thirds of all websites may have had this Heartbleed vulnerability. If Two Factor Authentication is available at a website, such as at Gmail, you should consider using it for an extra layer of protection. To date SWA has determined that Schwab, Fidelity and our software vendors have not been impacted by Heartbleed.

Monthly Market Commentary

So far, it's been a chilly spring for the economy. Growth in most U.S. metrics has been slow for three months or longer. Some of that stagnation is weather-related, but certainly not all. Factors such as the government shutdown and budget settlement, major inventory build-ups, and higher interest rates have all been negatives for recent economic activity.

Federal Reserve News: The Federal Reserve policy statement, economic forecast, and press conference on March 18-19 didn't really tell markets much that they didn't already know. Much emphasis was placed on Fed Chairwoman Janet Yellen's comment that rates could begin to be raised as soon as six months after the bond-buying program was completely wrapped up. Irrespective of when, one thing's for certain: rates are going higher and investors will have to learn to live with it. However, unless the economy picks up a little steam soon, the Fed may not feel nearly as aggressive a month or two from now.

Housing: Existing-home sales fell from an annualized 4.62 million units in January to 4.6 million units in February. That is after a giant swoon between July 2013, when existing-home sales peaked at 5.38 million units, and the most recent 4.6 million level. A drop of 14% in unit sales in the middle of a recovery is more than a little disconcerting. In terms of total dollar values transacted, the market is down 20% from its July peak. Similar to the existing-home data, monthly housing starts changed little from January to February after several months of decline, perhaps indicating that the bottom is in, which would be a welcome relief. Data for housing permits looked better, but most of the improvement came from multifamily homes, which tend to be less expensive and add less to GDP growth.

Inflation: The headline inflation number for consumers looked great on a top-line basis. Month-to-month prices were up just 0.1%, and an amazingly low 1.1% when comparing February of this year with February of last year. However, the categories that were up are truly important to consumers. Grocery prices were up 0.5%, airline fares 1.3%, and drugs 0.9% after showing almost no growth in 2013. Holding back price increases was gasoline (down 1.7%). That was a bit of a mirage, though, as bad weather delayed normal refinery shutdowns from February to March.

GDP: The estimate of GDP growth in the fourth quarter of 2013 was bumped up modestly from 2.4% to 2.6% at an annualized quarter-over-quarter basis. The more representative full-year growth rate for 2013 was unchanged at 1.9%. Interestingly, both the annualized sequential growth rate and the fourth-quarter-to-fourth-quarter growth rate are now equal, at 2.6%. So it would appear that the economy's true GDP growth rate lies somewhere between the bounds of 1.9% and 2.6%. A meaningful shrinkage in the government sector just about cancelled an unusually large (and not sustainable) increase in exports. Business spending picked up some but not a lot, and residential investment was a net detractor from GDP growth for the first time since 2010.

Quarter-End Insights: The U.S. economic data has shown signs of weakening for the past three months running, despite some real optimism that developed in the fourth quarter of 2013. That optimism was based on the end to the fiscal stalemate in Washington in October, a 4.1% GDP growth rate in the third quarter, and a 3.2% estimated growth rate in the fourth quarter (later revised down to only 2.4%). Sky-high retail sales data that was subsequently revised sharply downward also contributed to economists' bright mood at the end of 2013. However, poor weather seems to have interrupted the upward trajectory. The effects of abnormally cold and snowy weather seem real, but the weather is not the only cause for the recent weakness. Parts of the economy, including the housing sector, were already showing some slowing even before the cold weather arrived.

The Great Yield Chase

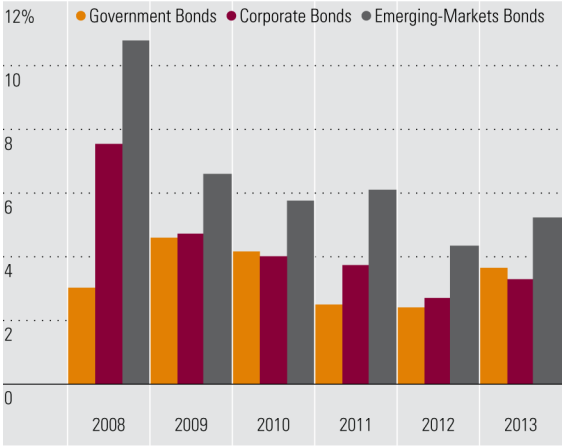
With Treasury yields still relatively low and worry about the eventuality of rising rates ever present, many investors have been moving away from Treasuries and into other fixed-income sectors in their quest for income. Two fixed-income segments seeing activity from this migration are corporate and emerging-markets bonds.

Corporate bonds: Many investors have bumped up their allocations to corporate bonds for reasons that are pretty straightforward. Company balance sheets are about as healthy as they've been for many years, with cash holdings high and default rates at multiyear lows. In addition to these attractive fundamentals, buying has been strongly encouraged by central bank policies, including the Federal Reserve's quantitative-easing programs. They have played a major role in suppressing agency mortgage and Treasury yields, which in turn has pushed investors to take on more credit risk in search of more yield.

Emerging-markets bonds: The trend of holding emerging-markets bonds has gained popularity in recent years. Again, investors have been given incentive to hold higher-risk assets because developed-markets central bank policies have pushed Treasury yields down. A byproduct of these central-bank policies is that assets have not only poured into U.S.-based investments but also into emerging-markets bonds of all kinds, including both sovereign and corporate sectors. Further boosting their attractiveness, emerging-markets credit ratings have been rising based on a number of factors, including economic structural reforms and growth rates that are meaningfully higher than in developed markets. To top it off, the underlying balance sheets of many emerging economies look increasingly appealing when compared with the debt-laden, major economies of the West.

With greater return potential comes greater risk. The ultimate questions for investors moving out of Treasuries are whether their investment alternatives will stand up to potential trouble down the road and whether their portfolios still line up with their risk and return expectations. There's a tension between trying to provide the best possible returns when things are going well and maintaining the kind of portfolio that should provide better diversification in the case of volatile equity markets. In recent years, investor demand has significantly pushed prices up and yields down. Those new lower yield levels suggest that, even under the best circumstances, the prospect for future returns is muted. While currently attractive, there's reason to be wary of how these sectors will perform under stress scenarios. Most investors aren't expecting a repeat of 2008, when Treasuries rallied and risky assets sold off, but it's nearly certain that bumps in the road will appear at some point. It is important to be aware that a dearth of yield may be causing some investors to take on more risk than they realize.

Yields for Government, Corporate and Emerging-Markets Bonds



Diversification does not eliminate the risk of experiencing investment losses. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest. With corporate bonds, an investor is a creditor of the corporation and the bond is subject to default risk. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, and differences in accounting and financial standards. Emerging-markets debt carries unique risks and may not be suitable for certain investors. Emerging-markets investments are more risky than developed-markets investments.

Data: Government bonds—20-year U.S. government bond; Corporate bonds—Barclays U.S. Corporate Investment-Grade Index; Emerging-markets bonds—Barclays Emerging Markets Aggregate Index.

Find the Right IRA in Three Easy Steps

Even if you're already convinced that saving in an IRA is a sensible thing to do, there's still a little bit of research to conduct. There are two main types of IRA accounts, and selecting the one that's best for you can be a daunting process. You can figure this out in relatively short order by following these three steps.

1) Know the Basics: Understanding the difference between the two types of IRAs—Roth IRAs and traditional IRAs—is the key first step in determining which is suitable for you.

Both vehicles let you sock away money and enjoy a tax benefit. With a traditional IRA, you won't have to pay taxes on your IRA's investment earnings until you begin taking distributions from it during retirement; thus, your money enjoys the benefit of tax-deferred compounding. (That means you'll have to pay taxes on your earnings when you begin withdrawing money, but not as you go along.) The Roth, however, has a couple of huge advantages over a traditional IRA. Whereas traditional IRAs carry restrictions governing when you have to begin taking distributions, the Roth carries no such restrictions; you won't be forced to take distributions at any age. And perhaps even more significantly, qualified distributions from a Roth will be tax-free, not tax-deferred as is the case with a traditional IRA.

With that information, the choice might seem clear: Roth IRA all the way. But there are a few other issues to consider. For those who qualify (consult a tax professional or the IRS' site to determine if that's you), a traditional IRA provides up-front tax savings. All of your contribution to a traditional IRA plan could be tax-deductible. Contributions are not tax-deductible with a Roth IRA.

2) Determine Your Eligibility: Okay, you've now identified the account type that suits you, but there are eligibility hurdles you'll have to clear in order to use a traditional IRA or a Roth IRA.

Let's start with the most sweeping limits first. For 2014, according to IRS Publication 590, if you are covered by a retirement plan at work, your deduction for contributions to a traditional IRA is reduced (phased out) if your modified adjusted gross income (AGI) is: more than $96,000 but less than $116,000 for a married couple filing a joint return or a qualifying widow(er); more than $60,000 but less than $70,000 for a single individual or head of household; or less than $10,000 for a married individual filing a separate return.

For 2014, according to Publication 590, you cannot make a Roth IRA contribution if your modified AGI is $191,000 or more if your filing status is married filing jointly; $129,000 or more filing single, head of household, or married filing separately, and you did not live with your spouse at any time in 2014; or $10,000 or more if your filing status is married filing separately and you lived with your spouse at any time during the year.

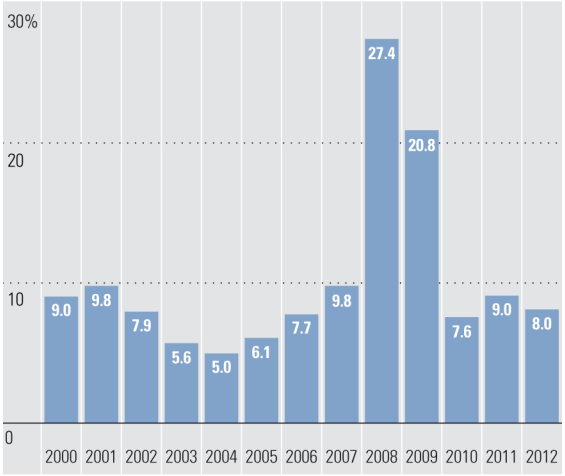
3) Weigh Your Options: You may find that certain IRA types are automatically off limits to you because of your income level. But what if you establish that you're eligible to make more than one type of IRA contribution—for example, you can contribute to a Roth and make a deductible contribution to a traditional IRA? You may decide to do both if you have the money to do so, but if you have a limited sum of money to invest, the decision becomes a bit tougher. For a situation like this, as well as to keep abreast of the latest rules and regulations pertaining to IRAs, it would be in your best interest to consult with your financial advisor/tax professional.

Funds in a traditional IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free, and can be withdrawn tax free if assets are held for five years. A 10% federal tax penalty may apply for withdrawals prior to age 59 1/2.

Dividend Income: Not So Fixed

Since interest rates are still relatively low right now, many investors looking for income and yield have begun to assess switching a portion of their investment allocation from bonds into dividend-paying stocks. However, it is important to remember that the interest payment of a bond is a contractual obligation of the company, whereas dividend payments are not. If a bond issuer does not pay either interest or principal on time, the company will be in default, and likely will be placed into bankruptcy. However, dividend payments are not a contractual obligation of a company and can be either cut or raised by its board of directors at will. When times are tough, companies may cut dividends to conserve cash, such as during the 2008 credit crisis. Conversely, when times are good, companies may increase their dividend payments, providing investors with additional upside.

Percentage of Companies That Cut Dividends



Source: Morningstar analysis. This is for illustrative purposes only and not indicative of any investment. Past performance is no guarantee of future results. Returns and principal invested in stocks are not guaranteed, and stocks have been more volatile than bonds. Dividends are not guaranteed and are paid solely at a company's discretion. Percentage of companies that cut dividends is calculated for listed companies on NYSE, NASDAQ, and NYSE AMEX.

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