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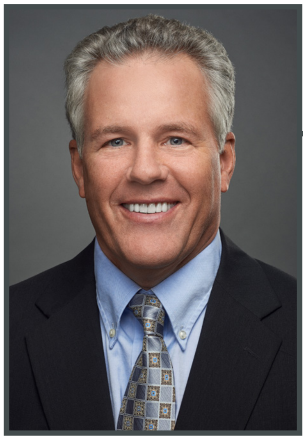
THE FIDUCIARY GROUP
INVESTMENT MANAGERS
A FOCUS FINANCIAL PARTNER

The INDEPENDENT ADVISOR

Quarterly Newsletter of The Fiduciary Group

It's a Mixed-up Investment World!



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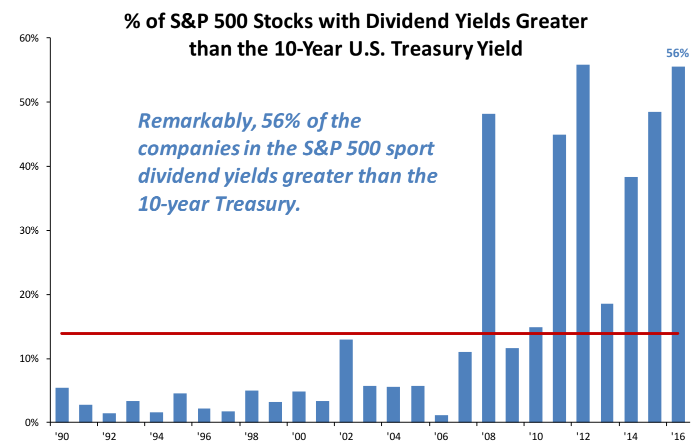
The most successful investment theme in 2015 centered on investing in high growth stocks like Alphabet (formerly Google), Amazon, Facebook and Netflix. In a slow growth economy, investors placed a premium on companies that could deliver high revenue growth. Thus far in 2016, by contrast, we have seen many slower growing—but good dividend-paying stocks—lead the market averages. This re-direction of investment capital within the stock market can likely trace its origins to activity in the bond market.

In mid-December 2015, the Federal Reserve raised interest rates and indicated that there would be multiple interest rate increases during the course of 2016. The Federal Reserve created an expectation that interest rates would rise throughout calendar year 2016. The US Treasury 10 year bond was yielding about 2.25% at the start of the year. In relatively short order, the yield declined to the 1.70% level. The bond market completely disregarded the commentary emanating from the Fed. Bond investors looking for a decent income return on their bond holdings have been challenged in this environment.

With expected future returns at such modest levels for bonds, investors have gravitated to more volatile investments like stocks in order to generate cash flow. There are plenty of stocks that yield 2-4% that have had a



Source: Strategas

long track record of consistently paying dividends. These companies are in stable businesses and should be able to maintain their payouts even in the face of a low-growth economy. Traditional dividend payers like utilities and telecom companies are up over 10% this year as a result of investor demand. Investors have accepted the higher price-volatility of stocks in order to receive better cash flow from their portfolio. In effect, investors have been searching for stocks that act somewhat like bonds.

Historically, investors have purchased bonds for income, and stocks for capital appreciation. With the decline in interest rates, the values of bonds have risen appreciably. We now find ourselves in a strange world in which bond investors have been reaping gains on the appreciation of their bond holdings, while stock investors are receiving higher income returns on their stock holdings than on their bond holdings. Surprisingly, more than half of the S&P 500 stocks have dividend yields higher than the 10 year US Treasury bond.

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S&P 500 Dividend Yield vs. 10-Year Treasury Yield

Source: Strategas

Part of the reason that dividend paying stocks have been in demand is that investors appear less confident that the Federal Reserve will be able to implement multiple rate increases during the course of the year. Investors are also witnessing negative interest rates around the world, including in major countries like Germany, Sweden and Japan. Negative rates are a rather unusual phenomenon in which the lender ends up paying the borrower. "What better value enhancer for dividend yielders than the threat of the fixed-income market going to negative yields?" said James Paulsen, chief investment officer at Wells Capital Management.

At the same time as we have seen investors gravitate towards income-oriented equities, we have also seen bond investors return to the high yield bond market. High yielding bonds offer higher yields than bonds issued by creditworthy borrowers because high-yield issuers have lower credit ratings and thus are more vulnerable to default in a struggling economic climate. This category of bonds behaves somewhat like stocks due to their volatility and higher risk/return profiles.

Recently, I was working on a financial plan for one of our clients. The sophisticated financial planning software that we utilize is one of the most widely used platforms in the industry. The platform relies on investment return assumptions based on data going back to 1970. For purposes of retirement planning, the software default setting assumes that cash will earn 3%, short-term bonds will yield 3.5%, and large cap value stocks will generate 8% annually.

While these are probably reliable metrics for planning for 10-15 years into the future, the current yields on fixed income investments are well short of these assumptions. With cash currently earning not much more than 0% and short-term bonds yielding substantially less than 2%, it is presently hard to imagine that these are indeed realistic assumptions for these asset classes over the coming 10 years. At some point, we will probably see assets yield closer to their long-term averages, but in the meantime, investors are faced with accepting lower cash yields from their fixed income investments.

Investors appear to be substituting high quality dividend paying stocks for a portion of their fixed income allocation, and layering in more high-yield exposure to their bond allocation. Investors have to take on more stock price-volatility in exchange for this enhanced income from dividend payers, and more credit and price volatility risk with high-yield bonds. If the Federal Reserve does end up increasing rates over the next year or so, bonds may again provide reasonable cash flow for income oriented investors. In the meantime, looking to equities for income and to bonds for capital appreciation has become a familiar—albeit historically uncommon—characteristic of today's investment portfolios.

Long-Term Thinking

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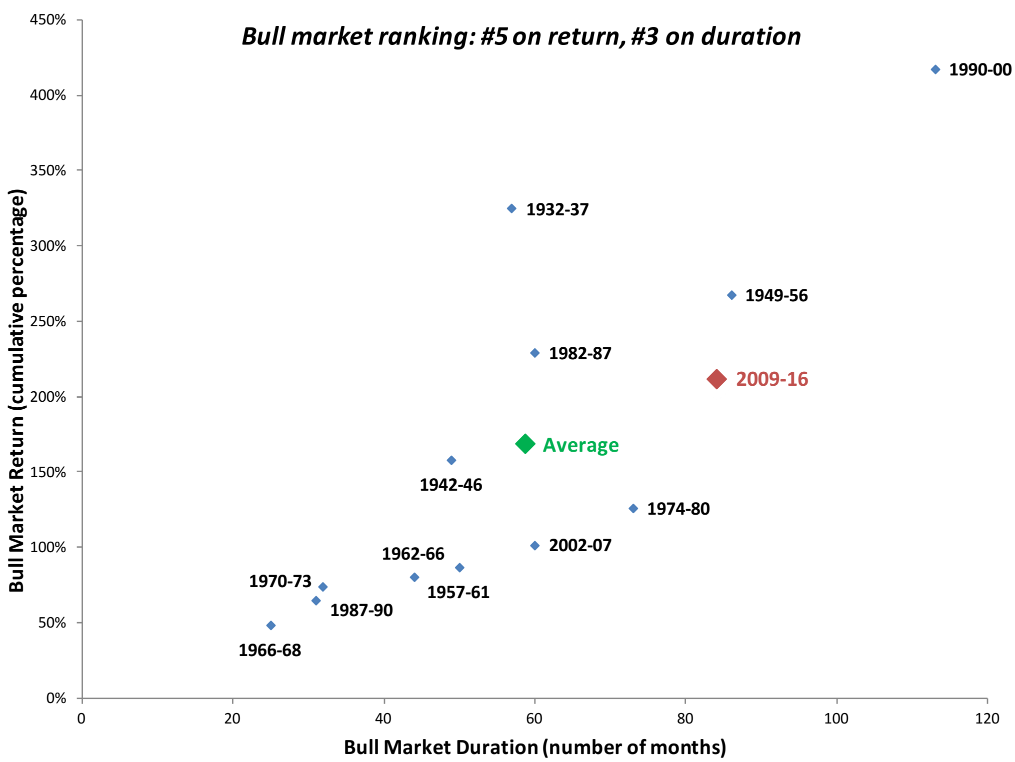
The sideways market of 2015 became even more indecisive in the first quarter of 2016. The S&P 500 Index stumbled out of the gates, and was down more than 10% by early February. In the ensuing weeks, the Index made a strong turn higher, ending the first quarter up marginally. At quarter end, the Index traded a few percentage points below its all-time high. Despite the volatility, the current bull market just reached its seven year anniversary in early March, making it the third longest and fifth highest returning run since the Great Depression.

Many market participants found great discomfort in the declines of January and early February. The idea that markets could swing so violently without explanation was insufficient, as investors have become accustomed to ready and plausible answers from market pundits. Of course, the easy answers are seldom meaningful and instructive. Amid the uncertainty of early February, an article from the Wall Street Journal titled "What's Going On in the Markets?" (WSJ, 02/10/2016) captures the inherent difficulty of explaining short-term market movements:

> "As investors and analysts search for reasons for the global volatility, what seems plausible one day is quickly disqualified when the market veers in the other direction… Finding a widely accepted, overarching thesis has proved elusive, leading to the rise of multiple, competing, largely unsatisfactory explanations. Yet analysts and traders keep searching, hoping to devise a road map for the peaks and valleys that lie ahead."

The reality is that a road map for the peaks and valleys that lie ahead does not exist. Importantly, focusing on the short-term peaks and valleys diverts one's attention from making intelligent long-term decisions. It's difficult to remain attuned to your investment goals when you're constantly inundated with noise. We believe that the analysts and traders attempting to bridge this divide will ultimately be unsuccessful. In the long run, market timing is a fool's errand.

The corollary of that argument is that the near future is unknowable. The only way we know to intelligently account for this factor is to think long term. Benjamin Graham, the father of value investing, put it best: "In the short-run, the market is a voting machine - reflecting a voter-registration test that requires only money, not intelligence or emotional stability - but in the long-run, the market is a weighing machine."



Source: TFG, Strategas

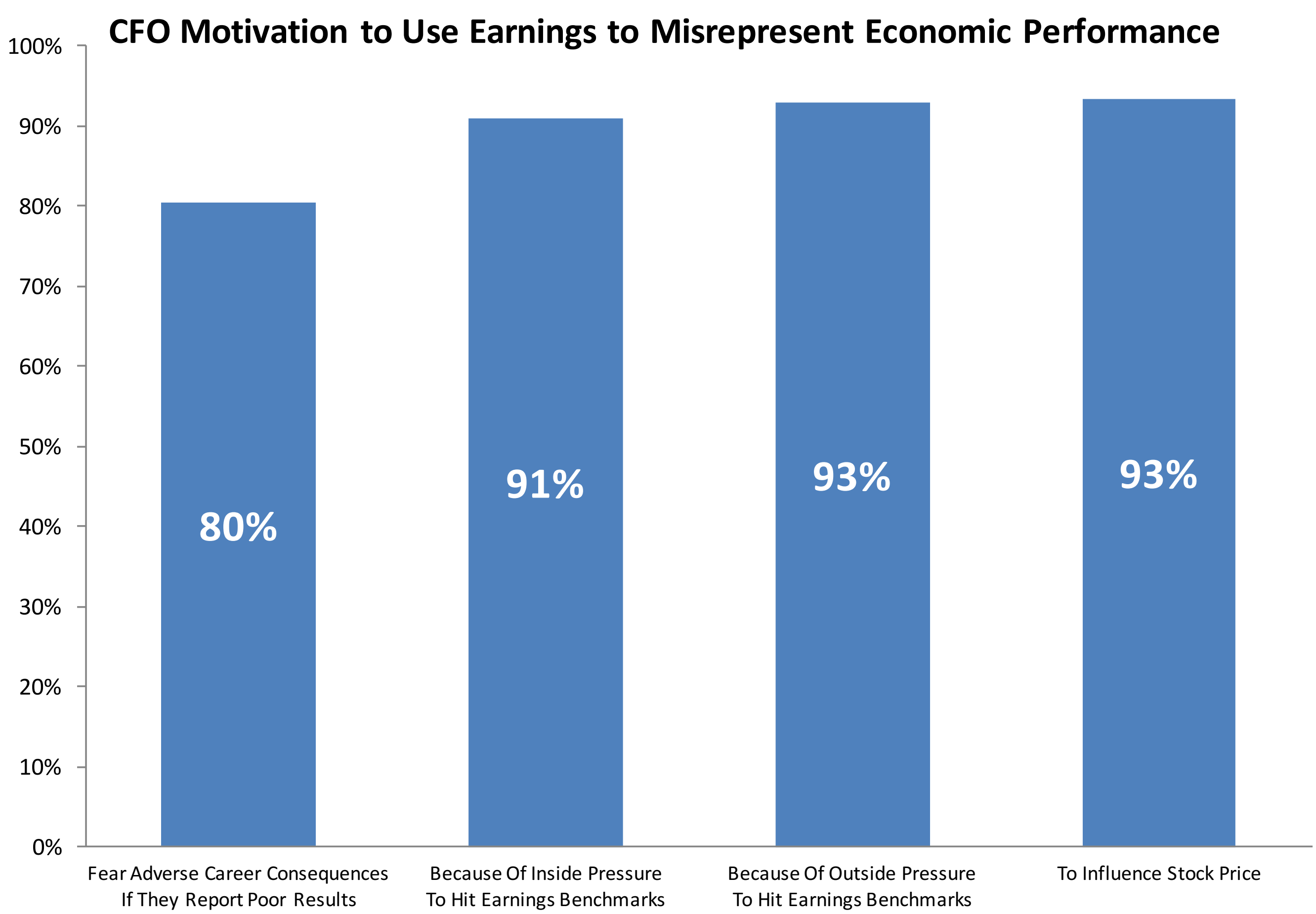
In a declining market, it's easy to lose your bearings and get caught up in the short-term commotion. Staying level-headed in the short-run, during bouts of market volatility, is easier said than done. We would argue this has become tougher as market participants have become increasingly short-sighted.

In our view, financial markets have been influenced over the past two decades by a proliferation of products and investment vehicles that, in combination with financial incentives, have reinforced an increasingly myopic focus for many industry participants, including executives at publicly-traded companies, Wall Street analysts, and fund managers.

Publicly-traded companies face intense pressure to meet short-term financial targets. For corporate executives, beating or missing consensus earnings estimates can be the difference between a multi-million dollar bonus and looking for a new job. This pressure has a meaningful impact on behavior: in a study of 400 financial executives, researchers found that a majority of managers would avoid starting a project that would generate meaningful long-term value for owners if it meant falling short of the consensus earnings estimate for the current quarter ("The Economic Implications of Corporate Financial Reporting," National Bureau of Economic Research, June 2004).

A recent CFO survey ("The Misrepresentation of Earnings," Financial Analysts Journal, February 2016) suggests forgone investments are not the only path to beating earnings estimates: the participants estimated that in a given year, one in five companies intentionally misrepresent earnings by using the discretion available within generally accepted accounting principles. They estimated that the average magnitude of misrepresentation was ten cents for every dollar of earnings. To put that number in perspective, stock prices can move materially based on financial results (earnings per share or EPS) that miss or beat consensus estimates by a small percentage. For the long-term investor, the reality is that quarterly earnings have a limited impact on the intrinsic value of a business. Much like market commentary and volatility, reported earnings in any given quarter are essentially noise. The headline figures are less important than what truly matters – sound capital allocation, building and sustaining competitive advantages, and maintaining balance sheet strength. As Albert Einstein once said, "Not everything that can be counted counts and not everything that counts can be counted."

Recent innovation in exchange traded funds, or ETF's, highlights how product development has encouraged the short-term investor mindset. Early on, ETF's were primarily index funds, which provided broad market exposure in a cost-effective structure. It's important to recognize that indexing can be a useful tool in meeting long-term financial goals, but it's not a panacea. As many individuals found out during the financial crisis of 2008, it's not any easier to stick with an index ETF strategy after the market has fallen 50% than it is to stick with an individual company after a similar decline. While ETF's can be used to construct portfolios and meet client needs, it's important to recognize that these "solutions" are not a magic bullet.



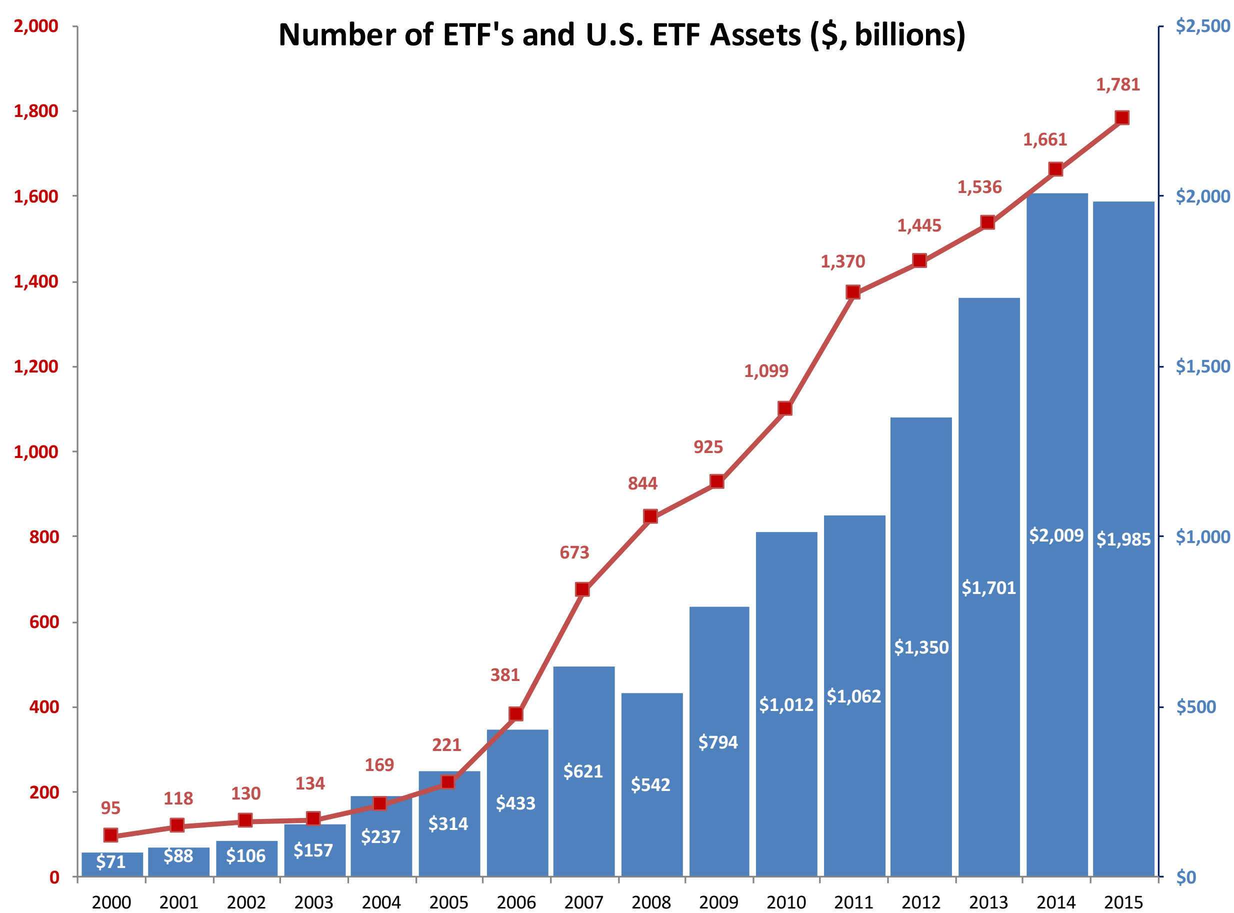
Source: Financial Analysts Journal

Over time, the industry has expanded beyond traditional index funds, and this is where we find fault. In the past 15 years, the ETF business has grown rapidly, from 100 ETF's with $70 billion in total assets to 1,800 ETF's with $2 trillion in assets. The rapid expansion of new alternatives reflects an industry capitalizing on the marketability of ETF's in general. It's not clear whether many of the new variations, like leveraged ETF's, have the best interest of investors in mind. As opposed to offering long-term market exposure in a cost-effective structure, recently introduced products offer an avenue for participants to easily speculate on short-term market movements. They may serve a purpose for the people selling them, but it's less clear that they add value for the individuals using them. When we read about these exotic ETF's, we're reminded of a story Charlie Munger tells about a friend who sells fishing tackle: "*I asked him, 'My God, they're purple and green. Do fish really take these lures?' And he said, 'Mister, I don't sell to fish.'*"

Similar to ETF's, hedge funds have reported sizable asset growth over time. The industry has been the beneficiary of incessant investor interest, appealing to their desire to mitigate downside risk while generating absolute returns. In the early days, there were relatively few hedge funds managing fairly modest sums and returns were outsized. Their success resulted in more investors seeking out star managers. The compensation structure, referred to in hedge fund speak as "2 and 20," which consists of an annual management fee equal to 2% of assets under management (AUM) and a performance fee equal to 20% of the fund's profits, encouraged the proliferation of new hedge funds, an expansion in the number of strategies, and unbridled growth in assets. In addition, the rapid expansion resulted in intense competition between managers and an acute focus on generating short-term results.

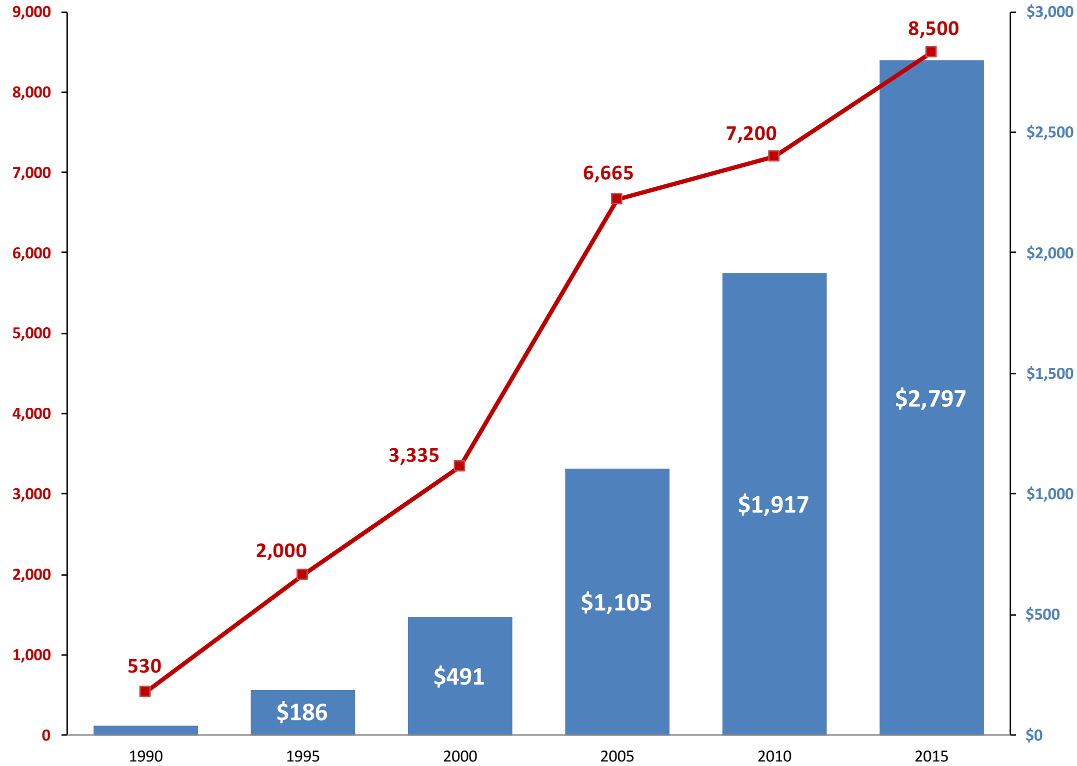
The focus on short-term results, in combination with greater influence from the hedge fund community, has exacerbated the market's volatility and added additional pressure on corporate executives to meet short-term earnings targets. By way of example, activist hedge funds (similar to corporate raiders of yore) that agitate for rapid changes and instant gratification have tripled their AUM in the past five years. As one might have predicted, relative performance by hedge funds as a group has begun to lag. Over the past three, five, and ten year periods, a simple blend of index funds (60% stocks / 40% bonds) has outperformed the Barclay Hedge Fund Index ("As Hedge Funds Returns Falter, Money Continues to Flow In," NYT, 02/26/2015). As a result of poor relative performance, large investors like pension funds and university endowments are questioning their allocations and fees paid to hedge funds.

As other market participants shorten their time horizon, we believe opportunities arise for long-term investors. For us, that means it's more important to focus on the long-term growth of the business, not fluctuating stock prices or short-term results. Based on the data, it's safe to say most market participants are not long-term investors: fifty years ago, the average holding period for a stock in the United States was seven years; in 2015, it was nineteen months (with the average for the 100 largest stocks under one year). With the help of technology, individuals



Source: BlackRock

Number of Hedge Funds and Hedge Fund Assets ($, billions)



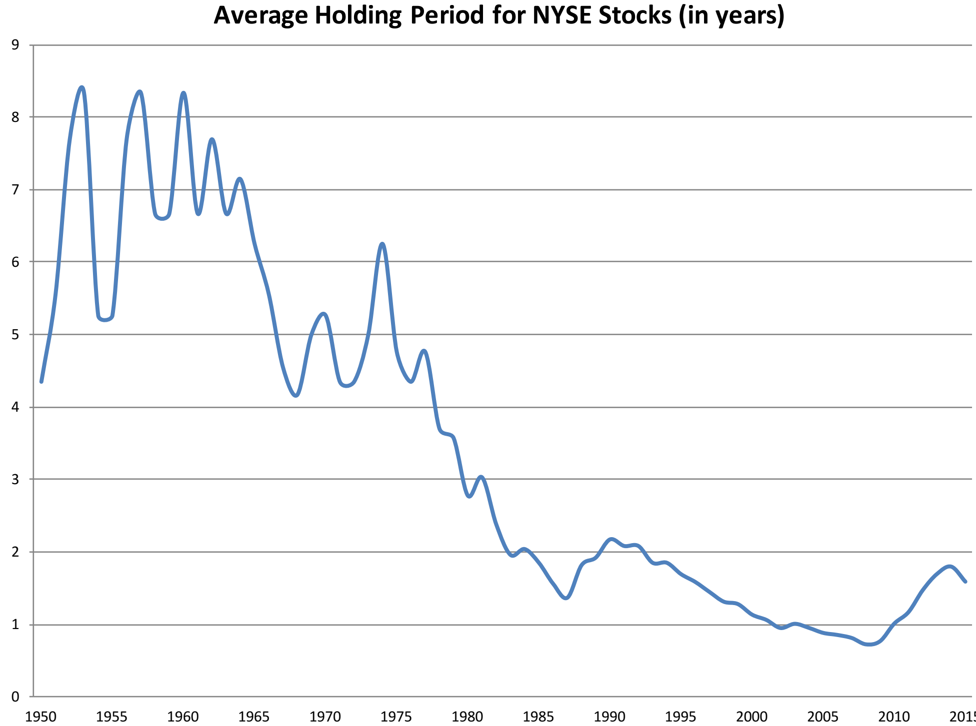
Source: CAIA Association

who have a casino mentality can speculate cheaply and quickly. In the long run, the odds of success are not in their favor.

A willingness to accept market swings with equanimity is critical to long-term investment success. Volatility tests conviction, but this is ultimately a good thing as it helps investors focus on properly aligning their investment objectives with their time horizon and risk tolerance. Importantly, lower prices present us with opportunity. Expected future returns increase as current market prices decline.

The primary issue investors struggle with – maintaining a long-term focus during tough market environments – remains. No matter how products and investment vehicles evolve, this will not change.

Average Holding Period for NYSE Stocks (in years)



Source: TFG, NYSE

How Much Life Insurance Do You Need?

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Life insurance is a risk management tool for both personal and business risks. Life insurance can provide cash and income to a family to pay estate taxes and settlement costs and meet the financial needs of dependents in the event of the premature death of an income earner or parent/ guardian. Businesses can use life insurance to mitigate the risks of business continuation and succession in the event of the death of a key employee or owner.

For purposes of this discussion, we'll focus on the financial needs of families in the event of a breadwinners' death, and talk about how much "term" life insurance is needed when the financial risks to be covered are for a fixed period of time. "Permanent" insurance such as whole or universal life, which provides a cash value on a tax-deferred basis as well as a guaranteed death benefit for a period of time intended to be longer than the lifetime of the insured, is beyond the scope of this article.

Term insurance is useful when the need for insurance is temporary. It provides a stated benefit for a stated period of time, typically from one year to 45 years or until a specified age such as 65. It is especially relevant to mitigate the financial risks to a family when an income earner on whom the family depends, dies prematurely. For relatively small premiums, term life insurance can provide significant guaranteed cash funds on a tax-free basis to a surviving spouse and dependent children.

What are some of the cash needs that may need to be covered?

- Final expenses (medical costs, burial expenses, estate settlement costs)
- College and wedding expenses
- Emergency fund for dependents
- Payment of outstanding debts (mortgages, credit card, auto loans)

Income needs may include:

- Income needed to replace the lost earned income of the deceased
- Income needed to pay for care providers of dependents

How much life insurance you need depends on your unique circumstances and your answers to questions such as:

- Who is dependent on your income, and for what period of time? The financial risks of a single person with no dependents are materially different than those of a primary income earner, married with dependent minor children.

- What are the financial resources available to your family upon your death to meet your family's cash and income needs? Those whose resources are limited to public assistance such as Social Security Survivor Benefits or Worker's Compensation are in an entirely different position than those with employer-sponsored death benefits, business assets, surviving spouse income, and/or significant financial assets.

A popular method for calculating the amount of term life insurance that you need is the Capital Needs Analysis. This approach evaluates the family's cash and income needs, assuming the death of the insured at the time of the analysis. Available assets (cash, investments, retirement plans, other life insurance) as well as public and private resources (survivor and retirement benefits, deferred compensation, stock options) that will offset cash and income needs are then identified. The shortfall between available resources and the cash and income needs is then translated into the capital that is required to make up the difference. That is the amount of term life insurance needed.

The best way to demonstrate the analysis is by walking through the questions to be considered, followed by an example.

1. **What are the financial objectives you seek to cover in the event of your death?**

   Your financial objectives need to be quantified, and might include among others:

   a. Provide an an inflation-adjusted annual income of $xxx to maintain your family's standard of living;
   b. Pay off all debts, both short-term (credit card balances, auto loans) and long-term (mortgages);
   c. Pay off all final expenses associated with your death;
   d. Establish an emergency fund of $xxx;
   e. Provide cash to fund the college educations of your children in the amount of $xxx;
   f. Provide cash to fund the weddings of your children in the amount of $xxx.

2. **What are your current assets and liabilities?**

   You need to prepare a balance sheet which reflects all assets (cash and cash equivalents, personal property and real estate, financial assets, life insurance) and liabilities (current and long-term). This will show what capital is available upon your death to meet the objectives you have identified, as well as the liabilities you may want to pay off.

3. **What are your net cash needs?**

   Add up the amounts you identified as needed to pay off debts and final expenses and to fund your emergency, education, and wedding funds. Then identify all the cash that is available to meet those needs, most notably the cash balances from your balance sheet and the proceeds of any life insurance policy or policies which you may own. The net cash shortfall is the difference between the two. As an example, suppose you determined your cash need for all the above was $665,000 ($350,000 to pay off mortgage, $200,000 to fund education, $50,000 emergency fund, $25,000 for wedding, and $40,000 for all other debts and expenses). Suppose your current assets (cash, employer-provided life insurance proceeds) are $125,000. You would have a net cash need of $540,000 ($665,000 - $125,000).

4. **What resources are available for income?**

   This is determined using your balance sheet. Personal use assets (personal property and real estate) are usually excluded. The primary sources for income are your financial and income-producing assets (taxable investment accounts, IRAs, income-producing assets, business interests). Collectively this is the capital available to your family for income. In our example, let's assume the available capital is $250,000.

5. **How much capital is needed to fund the income shortfall?**

   You have already determined how much income your family will need on an inflation-adjusted basis to maintain their standard of living (you want the income to be adjusted every year to keep pace with inflation). After taking into account any other sources of income such as income of the surviving spouse, annuitized death benefits, or Social Security Survivor benefits, suppose you have determined that the net income shortfall (Annual Net Income Need) is $100,000. The net capital needed to generate that income is determined by the following formula:

(Annual Net Income Need ÷ Inflation-Adjusted Interest Rate) + (First Year's Payment – Existing Capital) = Net Income Capital Needed

In our example, we'll assume annualized returns of 5% and inflation of 2%, which gives us an Inflation-Adjusted Interest Rate of 2.94%. Filling in the numbers from our example, we conclude that the Net Income Capital Needed for this example is just over $3.2 million:

($100,000 ÷ 2.94%) + ($100,000 - $250,000) = $3,251,361

As a final step, add back the net cash that is needed to the net capital and you'll have the total amount of insurance your capital needs analysis suggests is appropriate:

Net Cash Needed + Net Capital Needed = Amount of Insurance

In our example, the insured might want to buy a life insurance policy with a face value of about $3.75 million.

$540,000 + $3,251,361 = $3,791,361

A couple of important things to note: First, this is a mathematical example. It needs to be tempered by other factors such as the likelihood that the surviving spouse will be remarried or return to work. Also, this is not a one-time analysis. Rather, it should be undertaken periodically, and always prior to any renewals. The more you build up your own capital to fund cash and income needs, the less insurance you need to buy.

Last, there are other methods to calculate these needs that would result in a lower target face value such as an analysis that assumes the depletion of capital over time (ie., that the capital needed to provide income has gone to 0 by the end of the survivor's life) or the human value approach, which is a straight-forward present value calculation of the insured's future earnings. It may be interesting to evaluate your life insurance needs from several different perspectives and decide what amount meets your objectives and risk profile.

We hope you found this edition of The Independent Advisor to be informative and relevant. Please feel free to send your comments or requests to Julia Butler, Editor: Julia@tfginvest.com

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