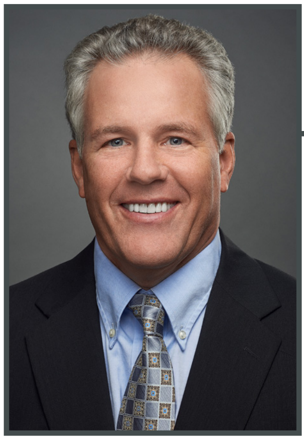
OCTOBER 2016

THE FIDUCIARY GROUP
INVESTMENT MANAGERS
A FOCUS FINANCIAL PARTNER

The INDEPENDENT ADVISOR

Quarterly Newsletter of The Fiduciary Group

An Asset Manager Embraces Financial Planning



Malcolm Butler, JD
President
malcolm@tfginvest.com

I have been investing other people's money for over 36 years. As most of my clients are either saving for retirement or living off of their retirement savings and/or trust accounts, my overriding goal has been to build durable, income-producing portfolios that will enable my clients to live off of the income from their investments during the entire "withdrawal phase" of their lives, and hopefully have something left to pass on to future generations. I have the same goals for my own investment portfolio.

Our investment philosophy has focused on investing in expanding businesses which are led by good management teams who maintain strong balance sheets. We have a preference for dividend payers and dividend growers. Despite periods of financial and economic turbulence, our investment portfolios have proved rather resilient and have served their purpose. For many of our clients, especially those whose withdrawals have been in line with the returns produced by their portfolios, the investment portfolios have supported them through their retirement or period of withdrawals, often leaving much of the remainder available for the next generation.

Given my personal experience of witnessing decent historical returns, I probably should have plenty of optimism as I peer into the future and plan to start living - at least in part - off of savings in the next 10 plus years. However, many industry experts believe that stock and bond returns may be lower over the next decade or two compared to historical averages. Volatility could increase as well. Lower expected returns and heightened volatility could have an adverse impact on people planning their retirements. I sense a greater level of concern from investors these days about planning for the future based on historical average return assumptions.

Investors have always had to endure economic and financial issues that adversely impact their returns and thus their standard of living. In the past, such issues have included periods of accelerated inflation which reduced the purchasing power of their investment income. At other times, these issues have involved the collapse of prices of housing and financial assets. Currently, we are witnessing bonds with negative interest rates, coupled with explosive growth in the cost of health care and education. We are also faced with local, state and federal government taxing authorities taking a bigger share of our wallets. Add to that a rise in violent crime, a breakdown of respect for "authority," and the spread of terrorism around the world. These factors, coupled with stock valuations currently trading above historical averages, all lead to investor anxiety and a concern that returns from our investment assets may vary widely from the mean, and not match the average returns we have enjoyed in the past.

CONTENTS

CONSERVE . PLAN . GROW. ®

If we assume that portfolio returns in the future might be lower on average and more volatile, what can a beleaguered investor do to have greater confidence that their retirement years will be free of financial stress? Rather than fly blindly into retirement, investors need to get the facts and have a plan that maps an achievable path to success, identifies the changes or strategies that may need to be implemented, and lets them monitor how they are doing.

When I am asked to look at household budgets of clients entering retirement, I sometimes see a level of expenses that can only be sustained if returns match the higher historical returns of the past 20 years. If we are not confident that we can rely on historical return assumptions to estimate our income as we contemplate retirement, it is important to perform a deep dive analysis on the expense side of the equation. Managing expenses is where the rubber meets the road for most households.

"Financial planning tools are now available to help investors answer the question of how much they need to save for retirement, and as they near retirement, how likely it is that the income from their retirement assets will allow them to maintain their lifestyle and household budget."

Ten years ago, risk-free money market funds yielded 5%. In those days, you could comfortably assume that your financial assets invested in a moderate to moderate-aggressive risk portfolio could generate 8-10% over extended periods of time. These days, risk-free money market funds are yielding barely above zero. It's no surprise that returns on risker assets are also correspondingly lower. With potentially reduced expected income, there is a greater need to be more precise with estimated expenses.

For most of my career, my role as an investment advisor was that of an "asset manager," and my focus was on the underlying securities that comprised a portfolio. I strongly believed (and still do) that investing in the public markets over long periods of time is the best way to save and grow financial assets. Assuming client withdrawals are "reasonable," (4% of the portfolio value annually has long been considered a "safe" withdrawal rate), building portfolios with high quality securities was pretty much all that was necessary to achieve financial success in retirement. Basically, as an asset manager, my role has been to focus on the Balance Sheet of our clients. The household Balance Sheet is, in my view, primarily comprised of investment and retirement portfolios. I exclude residential real estate because even though it might be an asset, it is a personal-use asset with negative cash flow. Thanks to decent historical returns, investors nearing retirement could safely rely on their Balance Sheet to produce the funds necessary to finance retirement.

Recently, however, I have been giving greater attention to the Cash Flow statements of our clients. The household Cash Flow statement is a report that details the income (inflows) and expenses (outflows) that annually flow through a family budget. Perhaps due in part to interest rates being so low, and perhaps due in other part to household expenses rising at a greater rate than income, I am seeing a greater need to assist clients with their cash flow analysis than ever before. I have come to embrace that we asset managers need to understand the household budgets of our clients as we are crafting investment portfolios.

Financial planning tools are now available to help investors answer the question of how much they need to save for retirement, and as they near retirement, how likely it is that the income from their retirement assets will allow them to maintain their lifestyle and household budget. Our own financial planning software aggregates all of the financial assets, sources of income, and budgeted expenses into a report that sheds light on how long the assets will last based on current expenses and historical asset returns. We can modify all of these inputs to see how the plan might change as we change the assumed rates of returns and estimated withdrawals. We can even "stress test" the plan with a Monte Carlo analysis that calculates the likelihood of success based on thousands of different return environments.

By performing this in-depth analysis, we can make better decisions about the investment choices that fall within our clients' tolerance for risk, and recommend expense controls that will yield a higher chance of success in retirement within various return assumption environments. Because all the information is stored on-line and is accessible through a web browser, the plan can be reviewed and updated periodically to keep up with changes in asset returns and budget assumptions. I personally have my own Balance Sheet, Cash Flow, and projected household budget organized in such a dynamic "living" plan, and it gives me great comfort to monitor my progress and know the "levers" available to me to keep me on track.

When performing retirement planning analyses, we no longer concentrate exclusively on client portfolios. We now take into consideration client income and expenses since the household budget might influence not only how we build investment portfolios, but how clients manage their withdrawals. With the use of financial planning software, investors can now have a much better understanding of where they stand as they seek to define and fulfill their savings and spending goals.

Chasing Good Companies, Not Yield

Joel Goodman, CFA
Chief Investment Officer
joel@tfginvest.com

Scott McGhie, CFA, CPA
Director of Research &
Portfolio Management
scott@tfginvest.com

In the second quarter newsletter, we noted there were more than $10 trillion of negative-yielding bonds around the world. While U.S. Treasury bonds are not in that group, they are pretty close: the 10-year Treasury currently yields 1.6%, compared to an average of 6.5% over the past 50 years.

In addition to outperformance through the first nine months of 2016, equities that act as bond proxies have done well for some time: the S&P 500 Utilities index, for example, has reported nearly 14% annualized returns over the past three years, compared to 11% for the S&P 500 Index (9/30/16).

Chart 1: 10-Year Treasury Yield

Source: Federal Reserve

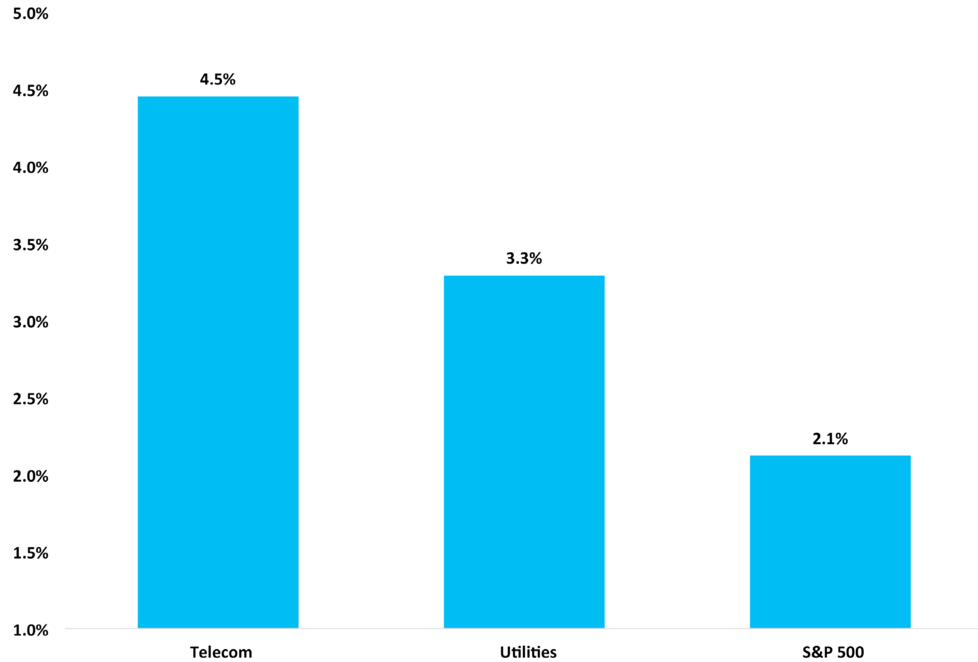
This period of low nominal interest rates has been particularly noticeable for retirees, who have spent decades saving money for retirement under the assumption that they could live off of the income generated by high-quality corporate and government bonds. Today, that math does not work. The current state of affairs has driven a search for yield outside of high-quality bonds.

One way investors have tried to offset paltry bond yields in recent years has been dividend-paying stocks. Through the first nine months of 2016, the top performing sectors in the S&P 500 have been Telecommunications and Utilities – both of which have a materially higher dividend yield than the broader stock market.

As we will discuss in a moment, the gains in the Utilities index have largely been driven by valuation, not an improvement in underlying business fundamentals. Said differently, reaching for yield has been an effective strategy as of late (whether or not it will continue to work is to be seen).

Even when we look broadly, stocks hold promise for investors searching for yield: the current dividend yield for the S&P 500 Index, at 2.1%, is quite a bit higher than the yield on the 10-year Treasury bond. Importantly, unlike the static coupon from the bond, stock dividends are likely to increase over time (over the past decade, which includes a significant

Chart 2: Current Dividend Yield



Source: FactSet

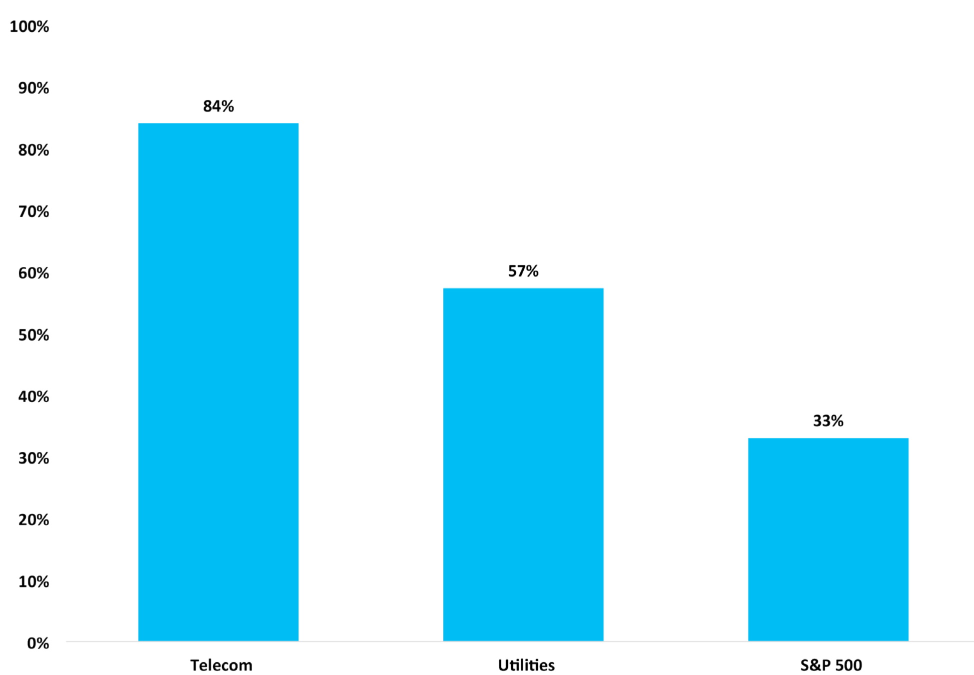
reduction during the financial crisis, the per share dividend for the S&P 500 Index increased 6% per year). On this cursory glance, equities appear to be a reasonably attractive substitute for fixed income securities (particularly for the long-term investor that is capable of dealing with periodic bouts of volatility).

As we dig deeper, we believe there's a pretty distinct separation among the different groups of dividend-paying stocks. In broad terms, we think it's appropriate to separate them into two buckets.

The first group of dividend-payers tend to be slowly growing, stable businesses that are primarily viewed as alternative sources of "safe" income. The Telecom and Utility sectors, cited above for their strong performance year to date in 2016, offer a useful example for us to look at. Companies in these sectors have historically returned 60% to 80% of their net income to investors as dividends, compared to a long-term average of 30% to 35% for S&P 500 companies as a whole.

Because of their ability to consistently generate excess cash, these companies can provide a steady source of income to

Chart 3: Trailing Ten-Year Average Dividend Payout Ratio

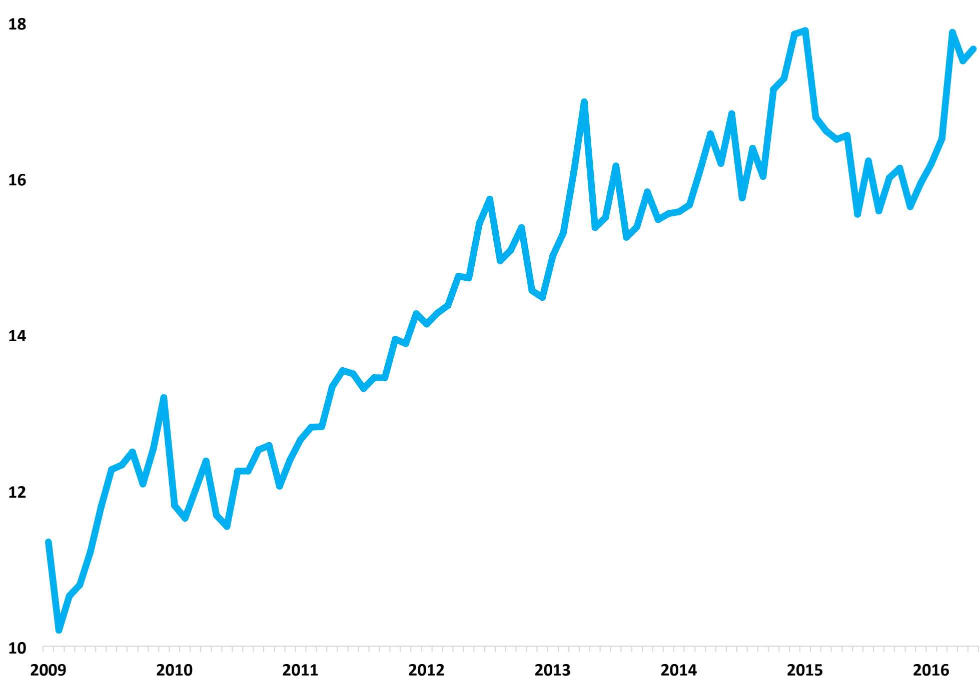


Source: Bloomberg

shareholders. This stability is highly sought after, particularly in the current interest rate environment. This has driven investor demand to the bond proxies in recent years. The Vanguard REIT Index, for example, has nearly $70 billion in total net assets – up from less than $10 billion in 2009. To put those numbers in context, listed equity REIT's currently have a total market capitalization of roughly $1 trillion (this number has increased meaningfully over the past seven years, reflecting the combination of higher valuations, an improvement in business results, and an increase in the number of listed REIT's). While the investment returns for the sector have been impressive, the majority of growth in the Vanguard REIT Index fund has been due to inflows (the same is largely true for other issuers). Outsized demand has helped drive prices higher.

Higher valuations pose a challenge as they result in lower starting dividend yields for investors. The current dividend on the Utilities index, at 3.3%, is well below the trailing 10-year average (3.8%). The index would need to decline nearly 15% to return to the long-term average yield. In addition to a below average dividend yield, Utilities are currently returning a much higher percentage of their earnings as dividends than they have over the past decade (75% of net income versus 57%, on average, over the past ten years). This is true for the S&P 500 as well (39% of net income versus 33%, on average, over the past ten years), meaning dividend growth rates have steadily outpaced earnings growth. While this can continue for some time, we may be approaching the upper limits.

Chart 4: Forward P/E Ratio, S&P 500 Utilities Index



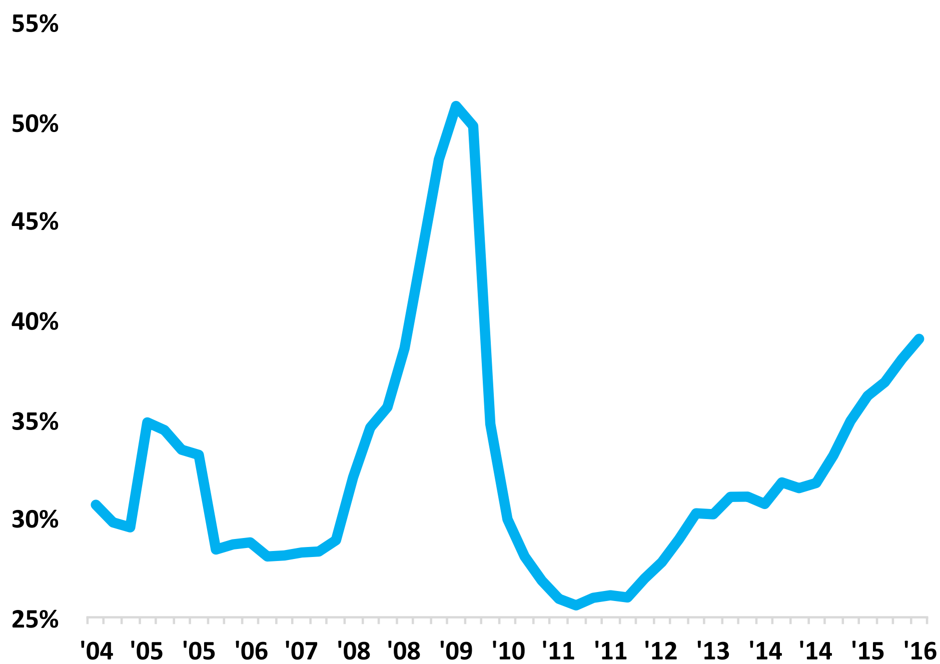
Source: FactSet

We see another example in the Utility sector. A look at the historical data shows that the higher price-to-earnings (P/E) multiple applied by the market has accounted for nearly half of the cumulative gains for the Utilities index over the past five years. The multiple paid for a dollar of earnings has consistently climbed since 2009. While this is directionally correct for the equity markets as a whole, it has been particularly helpful for bond proxies like the Utility sector.

As a result of these factors, we're generally less attracted to companies in the first group (while we've used Utilities, Telecoms, and REIT's for illustrative purposes, other sectors fit here as well).

Companies in the second group of dividend-paying stocks, on the other hand, are not solely viewed as yield plays.

Chart 5: S&P 500 Dividend Payout Ratio



Source: FactSet

These companies are viewed and valued in the market relative to their business prospects; factors like earnings growth and financial strength are primary considerations.

These companies tend to return a lower percentage of their net income to shareholders as dividends, with the expectation that they can grow profits – and ultimately, capital returns to shareholders – at higher rates long-term. As opposed to an overwhelming focus on the current dividend yield, where the first bucket holds a clear advantage, these companies are reinvesting to fuel future growth.

The appeal of income leads some investors to disproportionately focus on current yields, an approach that fails to appreciate the full picture. Thorough analysis requires an understanding of the dynamics that enable a company to consistently return a large percentage of its profits to investors while simultaneously defending or improving its competitive position. While the numbers cannot always be taken at face value, growing dividends over a period of many years often provides meaningful insight into the competitive dynamics of the business. It's a useful signal for investors.

But dividend yield is not where we start our work. Our first filters when evaluating potential investments are business quality and financial strength. We are not interested in securities with above average yields that are attached to dated business models, stretched balance sheets, or both. In addition, dividends are not the holy grail of investing. If a company has attractive investment opportunities, dividends are ill-advised. In this scenario, long-term shareholders would be better served if management retained excess cash for reinvestment back into the business. It's worthwhile to forgo the bird in the hand when you're quite certain that there will ultimately be two or more birds in the bush (and that's before considering the material benefit to taxable investors when they're able to delay payments to Uncle Sam for years – or even decades).

Focusing on the current dividend yield in a vacuum misses the forest for the trees. Total shareholder return (dividends plus capital appreciation) is the metric that matters most. When measured over long periods of time, outsized returns are likely to accrue to high-quality businesses with sustainable competitive advantages. As long as management makes intelligent capital allocation decisions – which may or may not include dividends – long-term investors will be happy with the result.

Primer on Individual Taxes

Julia Butler, JD, MBA
Chief Operating & Compliance Officer
Director of 401(k) Advisory Services
julia@tfginvest.com

Tax planning to minimize tax liability and maximize after-tax returns starts with an understanding of Form 1040, the tax return filed annually by individual taxpayers. My goal in this article is to give the reader a "primer" on Form 1040 and the key considerations that will impact your tax liability.

Status: The first thing you as a taxpayer have to decide is the status under which you're going to file, because different schedules apply to different statuses.

- To file as a Single, you must be unmarried, divorced, or legally separated on the last day of the tax year.
- To file as Head of Household (which has higher standard deductions and more favorable tax brackets than Single taxpayers) you must be single or separated from a spouse for the last six months of the tax year and pay half the cost of providing a household that is the principal place of abode for a child or dependent for at least half a year.
- To file as Married Filing Jointly, you must be legally married on the last day of the tax year. A widow or widower may file Jointly in the year of the spouse's death, and for 2 years afterward if he/she continues to provide a household for a dependent child and remains unmarried (the filing would be as a "qualified widow(er)"). When a couple files jointly, the spouses are treated as one person and each is jointly and severally liable for the taxes owed.
- If you are married on the last day of the tax year but you want to avoid being jointly and severally liable for the tax liability, you can choose Married Filing Separately.

If you are married, you do not have the option to file as a Single. Your only choices are Married Filing Jointly and Married Filing Separately. Same-sex couples who now are legally married may find themselves disadvantaged being prohibited from filing as Single (which in general is more advantageous than Married Filing Separately).

Gross Income: Unless specifically excluded, all income is subject to tax and must be reported. This includes all forms of compensation, investment income, alimony, income from business, taxable Social Security, annuities, pensions, unemployment income, rents, royalties, and trust income, to name a few. Moreover, income does not have to be in cash. You can also receive income in the discharge of an indebtedness, from services provided, or the transfer of property.

The following exclusions are some of the most common classes or items that are excluded from income: property received as an inheritance or gift; employer contributions for health or accident benefits (in a properly designed plan); workers' compensation; child support; damages for personal injury; municipal bond interest; employer-provided child care services; payments from insurance (accident, health, long-term care); proceeds of life insurance; certain non-cash fringe benefits; educational assistance provided by the employer up to $5,250; employer-paid group life insurance up to $50,000; distributions from 529 accounts for qualified educational expenses; return of original investment (cost basis); and meals and lodging provided to an employee for the convenience of the employer.

There are several examples of imputed income to note: if you lend more than $10,000 to someone and do not charge at least the applicable federal rate of interest (AFR), the difference between the actual rate and the AFR will be imputed to you, the lender (so you pay taxes on interest you did not receive); if you purchase a bond for less than the amount the issuer will pay at maturity—for example a zero-coupon bond—a portion of the difference between the amount paid and the maturity value will be included in your income each year even though you will not receive the income until maturity; and if you sell property for installment payments and do not charge the AFR, the AFR will be used to discount the planned payments to present value and the difference between the present and future values will be imputed as interest income, taxed at ordinary rates (instead of the more favorable capital gains rates).

Adjusting Gross Income: After you've totaled all non-excluded income, you may subtract certain items to arrive at the Adjusted Gross Income (AGI). These subtractions are called "Above the Line Deductions." Some of the more common ones are: contributions to an IRA up to $5,500 ($6,500 for those over 50), though this is phased out for active participants in a company 401(k) plan who earn more than the threshold compensation (phase out starts at $61,000 for Single filers and $98,000 for Married Filing Jointly); alimony that is paid by the taxpayer (the receiver includes the alimony in his/her income); certain payments by self-employed persons (retirement savings, one-half of the self-employment tax, and medical insurance); penalties on early withdrawals of savings such as CDs; moving-related expenses to start work in a new location; interest on qualified educational loans (this is phased out for higher-income taxpayers, starting at $65,000 for singles and $130,000 for married couples); up to $4000 of qualified educational expenses (again, phased out at higher income levels); and contributions to a Health Savings Account up to the allowable amount.

Deductions: After calculating the AGI, you apply your deductions. These are "Below the Line" deductions. You can choose to use the standard deduction ($6,300 Single, $9,300 Head of Household, $12,600 for Married Filing Jointly, with an additional amount for those who are over 65 and/or blind), or you can itemize, whichever results in the highest deduction. If you choose to itemize, here are the major categories and their limitations:

- Medical expenses: Although this is a significant cost for most households, you can only deduct medical expenses (insurance premiums, out-of-pocket, dental work, travel for medical care) to the extent they exceed 10% of your AGI. Thus for a married couple earning $175,000 per year combined, only medical expenses in excess of $17,500 are deductible.
- Taxes paid: You can deduct the taxes you paid for personal property (auto), real estate, and state and local taxes.
- Mortgage interest: Mortgage interest is deductible on both a principal and second residence up to a maximum acquisition cost of $1,000,000. Interest on home equity loans is deductible up to $100,000. Points paid on the acquisition of a principal residence are deductible in the year paid.
- Qualified charitable contributions: Contributions of cash or property are deductible from AGI. You can deduct cash contributions up to 50% of your AGI, and appreciated capital gain property up to 20 or 30% of your AGI (depends on the type of entity receiving the contribution).
- Casualty and Theft Losses: Damage or destruction of property losses due to sudden unexpected causes (hurricane, fire, etc.) are deductible for amounts in excess of 10% AGI, less $100 per loss.
- Investment interest: Interest on loans attributable to property held for investment such as interest on a margin account is deductible to the extent of net investment income. Net investment income is the excess of investment income over investment expenses. However, investment expenses are deducted only to the extent they exceed 2% of AGI. Thus a taxpayer with an AGI of $75,000 who pays $2,000 for investment fees can only deduct $500 from his investment income (2% of $75,000 is $1,500, so he can only deduct the $500 excess).

Phase out of itemized deductions: For high income households, itemized deductions are phased out up to 80% of the allowable deductions. Single taxpayers with AGI over $259,400 and Married Filing Jointly with household income over $311,300 will lose deductions equal to 3% of the value to which their AGI exceeds these thresholds.

Personal exemptions: The final deductions are personal exemptions. A personal exemption of $4,050 can be claimed on the taxpayer, the spouse, and dependents. Once again, personal exemptions for high-income taxpayers are phased out beginning at $259,400 for Single filers and $311,300 for Married Filing Jointly. The total amount of exemptions is reduced by 2% for every $2,500 by which AGI exceeds the applicable threshold. A married couple with 3 children would thus lose all personal exemptions when their AGI reaches $436,300.

Calculate Tax Liability: The tax tables provide the progressively higher rates at which income brackets are taxed. The lowest tax bracket is 10% (for Married Filing Jointly income up to $13,250), and the highest marginal tax rate is 39.6% (for Married Filing Jointly income over $441,000). However, there is an additional 0.9% "Medicare" tax charged on all taxable income of Singles over $200,000 and on the income of Married Filing Jointly taxpayers over $250,000. In addition, the Net Investment Income of those high-income households is taxed an additional 3.8% tax on the lesser of net investment income or the excess of modified AGI over those threshold amounts ($200,000 Single, $250 Married Filing Jointly). Long-term capital gains and qualified dividends are taxed at either 0% (taxpayers in the 10% or 15% brackets), 15% (taxpayers in the 25%, 28%, 33%, or 35% brackets), or at 20% for those in the 39.6% bracket.

Credits: Once the liability is determined, certain payments can be claimed as credits to offset dollar-for-dollar the tax liability. Many of these credits are phased out for (and thus unavailable to) higher-income households. Some of the more popular credits include: American Opportunity Tax Credit (up to $2500 per student) for college tuition (subject to phase-out at $80,000 for Single filers, $160,000 for Joint); Child Tax Credit ($1,000 per child, subject to phase-out at $75,000 for Single, $110,000 for Joint); Child and Dependent Care Credit (phase-outs apply); Adoption Credit (phase out for all taxpayers at $201,920); and Premium Tax Credit for those who purchase health insurance through the Marketplace.

Taxes must be paid by the filing date for their returns, whether or not an extension is filed. Payments are typically made throughout the tax year, either through employer withholding or estimated payments. Estimated payments may be based on either 100% of the prior year (110% for Joint filers with AGI over $150,000) or 90% of the estimated current year.