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SENIORS/BOOMERS NEWSLETTER

'the retirement experts'

November 2016

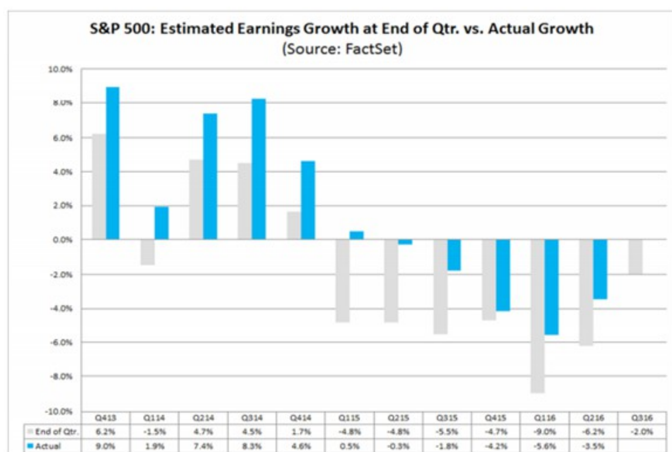
IS NOW THE TIME TO GET DEFENSIVE?

Over the past several months I have had great difficulty finding value securities to purchase. The reason is that everything available is either fully priced or over-priced. So the question now is...should we begin to move towards a more defensive portfolio?

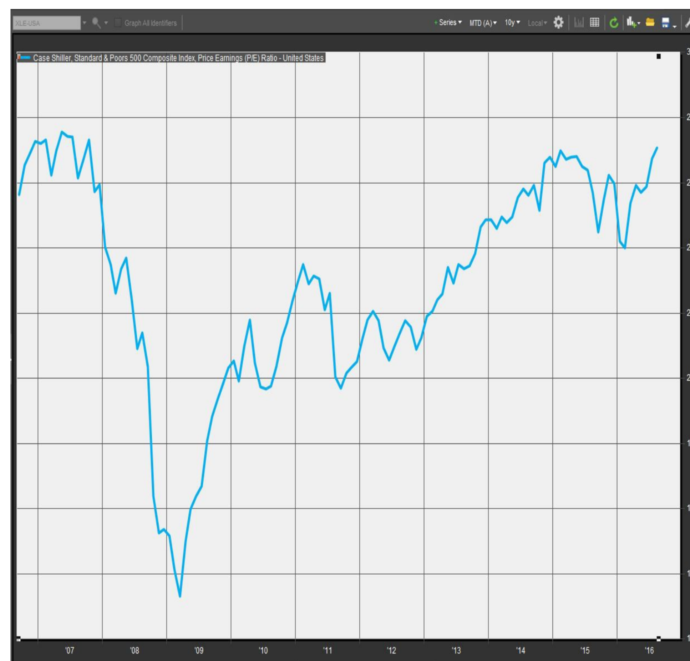
I think we can all agree that the current bull market (which began in March 2009) is closer to the end than the beginning. I'm not proposing that we pull the Abandon Ship alarm, but we probably want to put on our life vests.

As you know I am very definitely a value guy when it comes to buying stocks and bonds. I also believe in fundamental evaluations and analysis. Over the years I've consistently stated that earnings drive companies which drive stock prices.

So, where are we with the earnings picture? The chart below, courtesy of FactSet, is clear that earnings have not been growing for the past year and a half.



Next is a chart prepared by Case-Shiller. These gentlemen use slightly different measurements for calculating P/E ratios, however what we do see here is a straight comparison of ratios over the past 10 years. It shows that stocks are at their priciest since about 2007, with a P/E of 27.07



As we enter the 3rd quarter earnings season. I continue to see earnings & profit warnings from many industry stalwarts...Honeywell, PPG, Ford, General Mills, Kroger, Fastenal...who literally sell the nuts & bolts to industrial America, etc. Additionally, because of the controversial November elections, many, many companies are putting off investment decisions until after the results are known. This means that the 4th quarter basically has 6 weeks to put in a strong showing!

Some of the top equity firms have expressed caution going forward because the values just aren't there. Firm like Blackstone who manage $356B; Blackrock with $4.9T of assets under management, has issued warnings on bonds, Treasuries and have even stated investors should get out of mutual funds.

Morgan Stanley's chief economist, Ruchir Sharma recently wrote a piece in the Wall Street Journal saying that 60% of the gains in the stock market have come courtesy of Central Bank support and their artificially low rates.

Larry Fink, the head of the world's largest asset manager sounded the alarm about potential dangers in the bond market as pensions, insurance companies and individual investors across the U.S. wrestle with how much risk to take chasing dividends, as they look to fulfill mounting retirement obligations.

Many of the world's most successful investors have also been expressing deep concern. People like, Bill Gross, Jeffrey Gundlach, Carl Icahn, George Soros, Ray Dalio, Stan Druckenmiller, Paul Singer, Julian Robertson just to name a few. We currently have $12.3 trillion of money printing - $10T of which is in negative-yielding global bonds. . The feeling is that this will end badly.

So far in 2016 investors have pulled $80B out of equity mutual funds, and foreigners have pulled $67B out of Treasuries. Stocks simply cannot keep moving higher when the money needed to support them is pouring out the door.

With such a search for yield paramount among investors, I'd like to touch on one investment I have espoused for many years: Preferred Shares.

As you know we have done **extremely** well with the preferreds we have purchased since coming out of the Great Recession. They were always going to be great investments in a low interest rate environment. Six percent yields are a no-brainer when looking at 1.5% Treasuries. Low interest rates, however, may be slowly grinding to an end.

Just to give you some definition about preferreds and how they work:

*they are a hybrid of stocks & bonds
*they combine features of debt by paying dividends
*like stocks they can also return capital gains
*the dividend however is not guaranteed
*when interest rates rise, they are frequently called
*a 1% rise in interest rates = roughly 1% drop in price
*when called, new issues usually have a lower rate
*a credit rating downgrade = usually lower prices
*there is limited upside growth potential
*although we were early adopters with preferreds, they are now attracting big crowds and lots of money
*therefore many are trading at a premium to par and would be vulnerable to losses if called
*80% are issued by banks meaning we may end up with an over concentration of financial institutions in the portfolio. If banks go down there is a risk of the preferreds dropping in value

Because of the massive inflows of cash going into dividend paying stocks , companies such as Vanguard have actually closed their flagship dividend funds to new investors. I believe they basically have nowhere to put new money. Their head of investment strategy said, "My main concern is, and what we're trying to make sure investors recognize, is that just given where we've been over the last several years, there's been this tendency to take more and more risk". Translation: The time has come to take on less and less risk.

I mentioned in an earlier newsletter this past year that BARRON'S has described this market as the Twilight Zone. The S&P 500 opened up January 1st 2015 at 2058. Nearly two years later, we now sit at 2141. The Dow has gone from 17823 to 17897 in the same period. Now, that's what I call going sideways!

In reading so much investment material every month, I am often struck by the general and erroneous belief that a buy & hold strategy is the best one to follow. In fact, if you Google the term you'll come up with 328,000,000 results.

The one common theme I see when I read about it (if I read it at all) is that the supporters of this strategy are people who write about money...not people who actually manage money for a living.

Kenneth Solow, one of the partners of the Wealth Management firm – Pinnacle Advisory Group - that I am establishing a strategic alliance with, wrote an excellent book on the subject: **“BUY and HOLD is STILL DEAD (AGAIN)”**

Michael Kitces, a nationally recognized authority on financial planning, and also a partner with the firm critiqued the book in this way: 'Managing a portfolio isn't “Buy and Hold” versus “Market Timing”... there's a third option: modest tactical shifts to asset allocation, based on long-term predictive factors. This is crucial for investors who have limited time to accumulate – and decumulate – a retirement portfolio'.

So, to summarize, it is unwise to get out of the market. You'll never know when to get back in. Also, unless an investor is divinely gifted with the ability to time the market...and I've never met that person yet, tactical and strategic asset allocation is the only way to build a risk-managed portfolio. Without this strategy, you most likely will experience destruction of capital.

When to Sell a Stock

You sell a stock when the reason you bought the stock no longer exists.

Sell when your stock is fully valued and has little further upside potential.

It's a great time to sell when you have found something better to invest in.

Your stock has a shockingly high price-to-earnings ratio (P/E).

The company's competitive advantage is in danger.

The company makes drastic changes in its direction or leadership.

The company's sales are stalling or falling.

The company's profit margins (and earnings) are shrinking.

The company recently cut its dividend payment.

Finally, sell a stock that has lost the maximum amount you were prepared to lose.

Should You Risk Keeping a Highly Appreciated Investment?

What do you do with an investment that has gone up in value? For some people, the threat of a large tax bill keeps them from selling, even if they know the investment’s growth has thrown their portfolio out of balance.

So what is more important: Saving tax dollars or reducing risks in your portfolio? Depending on the investment’s value, your other assets, and your time horizon, taking profits and paying taxes now could potentially make more sense than assuming a greater risk of loss down the road.

Here are some questions you should ask if you have a highly appreciated asset or investment that you are considering selling:

Have you held the investment for at least one full year?

If you have, then the gain could be subject to the lower capital gain taxes. If not, any profits you realize from its sale will be taxed at your ordinary income tax rate which in many cases could be higher than your capital gains tax rates.

Will your taxable income decrease in the future?

If so, you may fall into a lower tax bracket and qualify for a lower tax rate on long-term capital gains later on. See below for the 2016 tax rates

	Married filing jointly / Qualifying widow or widower		
Tax rate on ordinary income	*over*	*to*	Rate on LT capital gains
10%	$0	$18,550	0%
15%	$18,550	$75,300	0%
25%	$75,300	$151,900	15%
28%	$151,900	$231,450	15%
33%	$231,450	$413,350	15%
35%	$413,350	$466,950	15%
39.60%	$466,950		20%

(PLEASE BEAR IN MIND THAT THESE RATES ARE SUBJECT TO CHANGE!)

When do you expect to need the money from the investment?

Maybe you don't expect to tap this asset for another 5 or 10 years. But doing so could possibly expose your portfolio to a greater degree of risk over the long term.

The capital gain taxes may be a relatively smaller price to pay for the comfort that comes with a properly diversified portfolio. Plus over time, your diversified investments might potentially be able to recover the full amount you paid in capital gain taxes.

Although diversification does not guarantee against the risk of loss in a declining market, it can help you to reduce the market volatility risk of your portfolio.

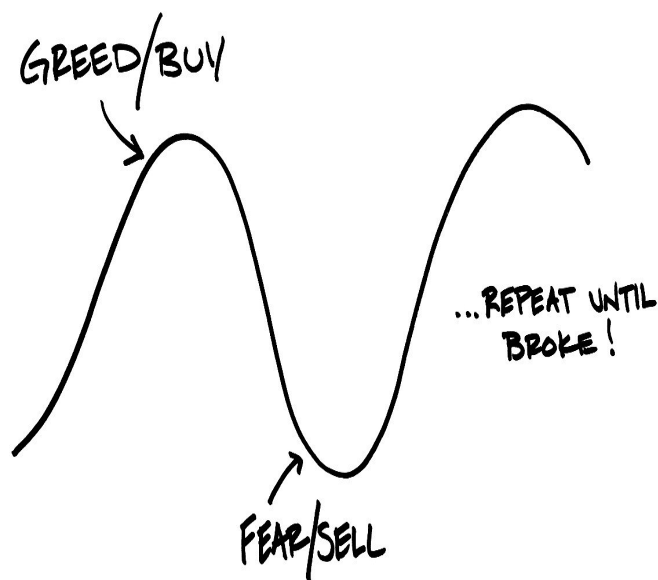
Do you need the investment at all?

If you feel you have sufficient funds to last the remainder of your life, you may never need this investment at all. That being the case, you may consider leaving the investment alone and letting it pass to an heirs upon your death. Whoever receives the investment might be able to assume a step-up in cost basis, resulting in a smaller capital gain tax bill.

WHY MOST INVESTORS LOSE MONEY IN THE STOCK MARKET?

I was going to write a grand explanation of why the typical investor has a hard time making money buying and selling stocks. Then, I came across an illustration which summed it up perfectly.

My English teacher in college always wrote in the side margin...'the less said, the best read'. So in that spirit, here is the explanation you've no doubt been waiting for:



Good luck and stay vigilant!