April 2016 Thoughts and Insights

What can we do to make money again? This question was recently asked to us by a client during our annual investment review and I think the question is so honest, direct and real that I am using it as inspiration for this quarter's commentary. The past several years have been the most difficult years to invest, especially for retirees, due to interest rates being so low for so long. Since a picture is worth a thousand words, below you will find the yield on the 10 year treasury since 1962.

You will notice that the yields (or interest paid to holders) are at their lowest in our investing lifetimes, and below 2.5% for the past 5 years. The 10 year treasury is the most important world-wide economic indicator as it is considered the "risk free rate", and is the standard that all other investments are compared to. Today the rate is 1.73%. Otherwise stated, if you bought a treasury today and held it for 10 years your annual investment return would be 1.73%. Since we cannot plan a retirement based on 1.73%, we must invest in other assets such as stocks, corporate bonds, preferred stocks, international stocks and bonds, and commodities. This forces us to invest in securities that take on more risk. By definition, the greater the risk the greater the return, but the greater the losses could be. Our job over the past 5 years has been to seek investments that return greater than 1.73% that hopefully don't have losses. However, since avoiding losses is impossible we look to spread the risk across asset classes and sectors.

I think this is the perfect time to talk about each of our investment classes and give insight as to why we selected it, what our expectations are, and any changes we may have made. I will proceed in the same order of our reports, listing commodities first.

Precious metals: We strive for an allocation of less than 5% in all portfolios as a protective measure against inflation and as the world's safety asset. We consider it portfolio "insurance" as investors flock to this asset class in times of extreme uncertainty. Over the 8 years we have owned this class, we have been up 100% and down 25% in the most recent years. However, it is up this quarter 14% due to excessive fear of a recession during January and February.

Equities: Client's allocations to this sector range from 0-70% depending on their risk tolerance. These are the securities that have the highest likelihood of creating long term growth, yet they do carry risk. The market is made up of 9 economic sectors: technology, consumer discretionary, financials, healthcare, industrials, staples, energy, utilities and materials. Our goal is to try to outperform the market but with less risk, so we choose which sectors to over and underweight. In 2015 and early 2016 we added to our consumer staples, consumer discretionary and industrials, and reduced exposure in financials, healthcare and emerging markets. We are maintaining our energy positions as we feel the pipelines will recover. We have invested in pipelines for over 10 years because of the +7% yield, and we have not seen much price movement until the past 9 months. Our pipeline investments are a perfect example of how we accept some risk in order to earn higher returns, but unfortunately, price movements are not always in our desired direction over the short run.

There is quite a bit of talk from the media about equities being fully priced. However, from an economic perspective we do not believe that the US economy will enter a recession. Growth will continue to be painfully slow but still upwards, and we believe that equities should still be owned.

Fixed income: We used to call this sector "bonds" because when the risk free 10 Treasury was at 5%, we could buy investment grade bonds at 8%, clip the coupons and generate the income clients needed to live from. Now that rates are below 2% we are forced to look for investments that have higher yields, but we still try to seek out those investments with the lowest possible risk. In addition to owning direct issue bonds we have added funds and preferred stock to the low risk, preservation of principle portion of our portfolios. We long for the days when we could put excess cash in a money market fund that paid 4%. Those money markets don't exist anymore, and now carry a minimum holding period of 3 months to earn less than 1%. So for this category we own a wide variety of fixed income investments including municipal bonds, TIPS, floating rate funds, and high yield funds. We sold our international bonds due to too much risk for not enough return, which was a very prudent move in hindsight.

So, what can we do to make money again? Given that the Fed has decided to wait even longer to raise rates which means lower for longer, our stretch for yield will not subside anytime soon. So we will continue to focus on accumulating cash flows through dividend growth, dividend yield, corporate bonds (including high yield), and exposure to hard assets that spin off an income stream like REITS and pipelines. We will remain diversified across asset classes, select industries that will outperform, and keep our fixed income maturities short so that when they mature we will be able to reinvest in a 10 year treasury at 5% again.

As always, we remain dedicated to serving your investment needs according to your goals. Please call or write with any questions or concerns you may have or if you'd like to chat a bit deeper about economic outlooks, Fed policy, or why we don't think Trump will be elected president.

All our best,

Michelle and Jim