December 2017 | Vol. No. 27 | A Deeper Look at Financial Planning Topics

Inflation Impact

We all know that inflation gradually erodes the value of our dollars, and you're probably aware that this is one of the main reasons for investing in the stock market. If you hide your money safely under your mattress, it becomes incrementally less valuable each year depending on the inflation rate. To keep pace, you have to find ways to make it grow at least as fast as the value of a dollar is falling.

But you may not have heard about inflation as an argument against putting too much of your retirement money in a fixed annuity, which pays you a fixed amount for the rest of your life. That safe, comfortable income stream may work perfectly for you today, but will it be enough to live on 20 or 30 years in the future?

Let's say you're 65 today, receiving $100,000 a year from an annuity to cover your living expenses. How much of your future lifestyle will that annuity pay you when you're 90?

Assuming an inflation rate of 3% a year, you would need $209,378 in that year you turn 90 to afford the same things you do today. So, your other investments would have to contribute more in that year, than what the annuity was paying you. Put another way, the annuity would be paying less than half of what you need to maintain your current expenses into the later years of your retirement. If inflation were to average 4%, the future income needed to match today's $100,000 rises to $266,584.

This is not an argument that annuities are to be avoided in all cases; a guaranteed lifetime income may have its place in some financial plans. But a few calculations on the impact of inflation can go a long way toward making the case that investments that grow over time are vitally necessary to afford a comfortable future retirement. The safety of a guaranteed fixed income is a false promise, because it doesn't protect you against the near-certain, incremental danger of yearly inflation.

Advisor Corner

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2017 Year-End Investment Market Report

The bull market continued for another year, causing market indices to soar to new heights over and over again and—ominously—also pushing valuations further beyond the long-term averages.

A breakdown shows that just about everything gained in 2017. The Wilshire 5000 Total Market Index—the broadest measure of U.S. stocks—rose 6.39% for the 4th quarter, finishing the year up 20.99%. The comparable Russell 3000 index was up 21.13% for the year.

Looking at large cap stocks, the Wilshire U.S. Large Cap index gained 6.70% in the fourth quarter, providing a 21.84% return for the year. The Russell 1000 large-cap index finished the year with a similar 21.69% gain, while the widely-quoted S&P 500 index of large company stocks gained 6.12% during the year's final quarter and overall returned 19.42% gains in calendar 2017.

As measured by the Wilshire U.S. Small-Cap index, investors in smaller companies posted a 3.56% gain over the final three months of the year, to stand at a 13.45% return for 2017. The comparable Russell 2000 Small-Cap Index gained 14.65% for the year, while the technology-heavy Nasdaq Composite Index rose 6.27% in the final three months of the year, to finish up 28.24%.

International stocks are also participating in the bull run. The broad-based EAFE index of companies in developed foreign economies gained 3.90% in the recent quarter, and ended the year up 21.78% in dollar terms. In aggregate, European stocks were up 22.13% in 2017, while EAFE's Far East Index gained 23.37%. Emerging market stocks of less developed countries, as represented by the EAFE EM index, rose 7.09% in dollar terms in the fourth quarter, giving these very small components of most investment portfolios a remarkable 34.35% gain for the year.

Looking over the other investment categories, real estate, as measured by the Wilshire U.S. REIT index, posted a meager 1.70% gain during the year's final quarter, yet finished the year up a respectable 4.18%. The S&P GSCI index, which measures commodities returns, gained 9.90% in the 4th quarter, to finish the year up 5.77%.

In the bond markets, coupon rates on 10-year Treasury bonds have risen incrementally to 2.41%, while 30-year government bond yields have fallen slightly to 2.74%. Five-year municipal bonds are yielding, on average, 1.70% a year, while 30-year municipal bonds are yielding 2.62% on average.

This was a year when investors ignored the dire headlines, North Korean missile threats, investigations of the Presidency, hurricane devastation and a rapidly-growing national deficit to produce one of the smoothest investment rides in the past century. In October, the S&P 500 index broke its all-time record of consecutive days without a 3% drawdown. The biggest single-day drop in 2017 was just under 2%.

How long can this continue? Who knows? The S&P 500 is now trading at around 18 times forward earnings, which is above the historical average of 16—which, loosely translated, means you aren't getting a bargain when you buy stocks today. At the same time, we are experiencing low unemployment rates and solid profits for American companies. The U.S. economy is growing at a 3% rate. And the psychology of the markets doesn't match what you traditionally see at market tops: people still seem to be suspicious about how long the market rally will last, unlike the normal buying frenzy that often presages the next sharp downturn. (To see what a market frenzy looks like, are you hearing more about bitcoin than you have in the past?)

And indeed, not all stocks have prospered despite the rise in indices. A company called Range Resources lost 54% in 2017 due to continuing low fuel prices, and firms you've heard of incurred significant drawdowns, including General Electric (-43%), Mattel (-43%), Advance Auto Parts (-42%) and the Apache oil and gas company (-34%).

Eventually, there will be a broader bear market which will see most stocks lose value. It will be impossible to spot by forecasters, but will seem inevitable with the benefit of hindsight. The important thing to remember is that few people have ever become extremely wealthy by timing the market and jumping out because they think they can predict the next downturn. Many have gotten significantly wealthier by holding on whenever the raft hits the rapids. We missed the rapids in 2017, but everybody knows they're coming—someday, though perhaps not soon. Let's make sure we have a tight grip anyway.

Why Rebalance?

You probably know that your investment portfolio is being rebalanced on a regular basis, but you might not know why. Is it for higher returns? For maintaining the agreed-upon balance of investments that is in your risk tolerance comfort zone? Does rebalancing help manage portfolio risk?

The answer to the above is “yes,” “yes,” and “yes,” but with a qualification. Rebalancing an investment portfolio is most importantly a form of discipline, a way to reduce the impact of those dangerous emotions of greed and panic on the investment process.

Rebalancing is necessary because all of the moving parts in your portfolio rise and fall at different times and degrees. During a bull market, stock prices rise faster than bond values, causing them to make up a larger percentage of the portfolio than you signed on for. Similarly, when the bear growls, stocks will fall faster than bonds, causing your portfolio to become more conservative. Real estate investments and commodities often rise or fall at different times than stocks or bonds, pulling your overall percentage allocations away from the target mix.

So, what does rebalancing accomplish? When you rebalance, you’re selling the assets that rose in price and buying the ones that went down. This discipline results, over time, in consistently buying when an asset goes on sale, and selling when the asset becomes more expensive.

There are three ways to rebalance. The easiest is to use whatever new money is coming into the portfolio, monthly or quarterly, to buy the assets that have gone down, allowing you to make consistently fine adjustments that keeps the portfolio at its prescribed allocations.

Another possibility is to rebalance at certain times of the year—every three, six or 12 months.

Or you could follow the most complicated process, and rebalance whenever assets deviate by more than certain set percentages from the baseline asset allocation.

A recent article on the Seeking Alpha website notes that rebalancing reduces portfolio volatility, because you are not allowing the stock allocation to rise in the portfolio during bull markets (which would set you up for a bigger drop when the market rise turns into a bear market).

An illustration in the article, using a simple mix of 60% stocks and 40% bonds shows that rebalancing using the percentage deviation method would have led to higher overall returns from the beginning of 2000 to January 2016. It found that wider bands produced higher returns (and fewer rebalances), although of course there is no guarantee that this would be the case in the future.

But perhaps most importantly, rebalancing gives you back, over and over again, the portfolio that you expected when you started, the portfolio whose expected long-term returns are incorporated in your financial plan, the portfolio you were most comfortable with when the investment process was first discussed. And when it comes to making decisions in a time of crisis, having a rebalancing policy in place ensures that they will be made with discipline, rather than emotion.

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Qualified Charitable Deductions and the New Tax Law Changes

The recent tax law changes have made it harder to claim some itemized deductions and raised the standard deduction, which is the threshold at which itemizing your deductions becomes beneficial. Some itemized deductions, such as tax preparation fees and investment adviser fees have been eliminated completely. Other deductions for state and local income and property taxes have now been limited to no more than $10,000. Some deductions, most notably the mortgage interest deduction and charitable deduction have remained intact, with only minor changes. The net result is that most filers will be able to claim less deductions. This, combined with the new higher standard deduction, reduces the tax advantages of claiming charitable deductions.

For those over the age of 70-1/2 who have IRA accounts and are subject to required minimum distribution (RMD) rules, IRA distributions sent directly to a charity can have a powerful tax benefit. Up to $100,000 of IRA distributions sent to charities are not reportable as income on your taxes, while also satisfying your RMD requirements for the year. This results in lower reportable income which may also reduce the taxable portion of your Social Security, and possibly even lower your Medicare premiums in future years.

In short, if annual charitable donations are a part of your current lifestyle, there are more reasons than ever to consider making these donations from your IRA accounts.