July 2014

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Notices

Bill will be on vacation with his family the week of June 30th at Loch Highlands on Lake Wallenpaupack. Time will be spent reading, fishing, golfing, boating, biking, hiking, swimming, and playing tennis.

Bill will also be away here-and-there in July attending summer Boy Scout camp with his son David. They will attend Camp Rodney (Chesapeake Bay) and Camp Horseshoe - both in Maryland.

Are you receiving our e-mail newsletters (which are different from this quarterly newsletter)? If not, let us know by sending an e-mail requesting to be added to our e-mail newsletter list.

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MALLARD ADVISORS

Comprehensive Financial Planning & Wealth Management Solutions

THE QUARTERLY MALLARD CALL

How Optimal *Asset Location* Helps

William D. Starnes

Most investors have heard of asset allocation—"***don't put all your eggs in one basket***". However, most are unaware of the impact of having an optimal asset location strategy—"***place different types of eggs in different types of baskets***". Asset location is the process of determining and placing different types of investments into different types of investment accounts. Different types of investments refers to U.S. stocks, real estate, international stocks, U.S. bonds, international bonds, etc. Different types of investment accounts include IRA's, Roth IRA's, taxable investment accounts, 401(k)'s, etc.

Our clients have globally diversified portfolios containing a variety of types of stock funds and bond funds. Therefore, a natural question is: "Given the fact that I have a variety of different types of investments and I have a variety of different types of accounts, in which accounts should each of these investments be held?"

Why is this an important and valuable question to investors? Because by optimally matching the account type with the correct investment type, you can combine these in a way that increases the (after-tax) return of your portfolio by minimizing taxes.

How much can your after-tax returns increase?
That depends on many factors, but researchers have determined that optimal asset location adds about 0.25% to your after-tax returns - each year! On a million dollar portfolio this amounts to $2,500 each year - compounded annually. Vanguard Research (of the Vanguard Index Fund Company) determines that the value is between 0% to 0.75% annually. I personally don't think the exact number matters. What matters is that the number is positive and valuable to building wealth.

Here is a very basic example?
Let's say you have $1 million with half of this in an IRA and half in a taxable brokerage account. Let's also say your asset allocation calls for a 50% stock and 50% bond portfolio. You can do one of three things:

1. Buy all the stocks in the IRA and all the bonds in the taxable account.
2. Place all the bonds in the IRA and all the stocks in the taxable account.
3. You can put half the stocks and half the bonds in each account (or some other variation).

In our basic example, which is best? The best option would

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Announcements

Bill's Article Picked Up in National Newsletter
The ***Alliance of Comprehensive Planners (ACP)*** picked up (a shorter edited version of) Bill's article (from the last issue of *The Mallard Call*) titled "To Thine Own Self Be True" and published it in their newsletter titled *Financial Focus* which is distributed to clients of member advisors across the country.

Optimal Asset Location...Continued

be #2 - to place the bonds in the IRA and the stocks in the taxable account.

Why should stocks be in the taxable account and bonds in the IRA?

Again, in this over simplified example, stocks are better in the taxable account for a few reasons. First, they have a higher expected return and this appreciation in value will be taxed at lower capital gains tax rates (generally 15%-20%) if held in a taxable investment account. If held in an IRA, the appreciation will be taxed at higher ordinary income tax rates. Second, it is far more likely to benefit from tax losses with stocks as opposed to bonds (since stocks are more risky) and these can only be "harvested" if the stocks reside in a taxable account. Third, stocks (via the funds we use) are very tax efficient and therefore more benefit is obtained from them if they reside in a taxable account.

But it is not so simple.

Most investors don't have 1/2 of their assets in a taxable account and 1/2 in an IRA. They have many types of accounts with different account values. So realistically the ultimate decision will be messy and will vary based upon:

- The available accounts
- The value of each account
- The expected return of each asset class
- The tax efficiency of each asset class
- The clients' tax rates - for both capital gains and ordinary income
- The overall asset allocation of the total portfolio
- The types of asset classes used in the portfolio construction

Let's say you only have an IRA. Then it is simple, everything goes in the IRA! Unfortunately, it is never that simple. Taking it a step further (but still maintaining some simplicity) the basic rules are:

1. Place the highest potentially returning AND tax-efficient investments in your taxable account (e.g., stock index funds).
2. Place the highest potentially returning AND least tax-efficient investments in your Roth IRA (e.g., actively managed stock funds; REIT's).
3. Place all other less tax-efficient investments in your IRA / 401(k) (e.g., bond funds).

Paying Attention to Asset Location is a Free Lunch

We pay attention to asset location at Mallard because it is a "free lunch". Typically, most methods of building wealth rely on one of two things. The first is painful sacrifice such as reduced spending or working longer. The second is by taking on additional risk. However, there are also some free-lunch methods of wealth building that are painless - and asset location is one of these. There is no sacrifice and no need for additional investment risk.

Is this easy to implement?

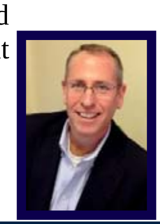
In order to implement an optimal asset location strategy, an advisor must consider ALL investment accounts - 401(k)'s, IRA's, insurance accounts, U.S. savings bonds, etc. It also takes more time (or technology) to implement optimal asset location across a variety of accounts as opposed to simply having the same allocation in every account (which is not tax efficient). So, it takes a comprehensive approach and a commitment to the value it provides.

What is the downside?

The biggest downside has to do with the natural fact that optimal asset location will result in having very different asset allocations in different accounts. This means that over the last year, if you had mostly bonds in your IRA, the returns of that account would be flat, while your Roth IRA or taxable account had outstanding returns. How is that a downside? It is not! Remember, all of the accounts (in aggregate) work together as a team to achieve your overall asset allocation resulting in your selected risk/return level. The accounts don't compete with each other for returns. So the only downside is that investors will occasionally lose sight of this important fact and try to "reposition" one account like another only to destroy the well-conceived overall investment plan. In other words, investor behavior could result in more taxes and an inappropriate asset allocation.

Are there other advantages?

One advantage of placing high (expected) returning assets that are tax efficient, such as stock index funds, into a taxable account is the estate related income tax savings. For example, at the death of an individual, assets held in taxable accounts get a "step-up" in cost basis at death, thereby largely eliminating the income tax liability associated with these assets. For example, if you have a $500,000 taxable account at death with unrealized capital gains of $300,000, at death those unrealized capital gains disappear saving the heirs about $60,000 (20% x $300,000)!!!



Bill Starnes is the founder and senior advisor at Mallard Advisors, LLC

Everything was up -- stocks, bonds, inflation hedges, and real estate. Even emerging market stocks (and bonds) had a strong comeback year-to-date after poor returns last year.

Investment grade U.S. bonds have exceeded expectations with twelve month returns of 4%. One year ago, bond investors experienced losses of -2.5% in just three months! As I mentioned at that time, bond returns are unpredictable in the short-run (even if you expect interest rates to rise) and bonds should be kept as downside protection. Thankfully, most clients listened, held and have experienced very good returns since then.

After such excellent stock returns in 2013, many investors expected stocks to take a break in 2014. It's been amazing to watch the market hit new all-time highs over and over while many market timers remain in cash. As usual, the market is a contradiction in expectations.

Total Return as of 6/30/2014

.	June	2nd Qtr	YTD	Last 12 Months
PORTFOLIOS**				
60% Equity	1.4%	3.7%	5.6%	16.0%
40% Equity	1.0%	3.1%	5.1%	12.1%
STOCKS				
Larger-Cap	2.1%	5.2%	7.1%	24.4%
Smaller-Cap	5.0%	3.7%	6.4%	26.3%
International - Developed Mkts	1.7%	5.0%	5.8%	22.3%
International - Emerging Mkts	3.0%	7.4%	6.9%	13.8%
Real Estate	1.1%	7.0%	17.6%	13.2%
Inflation Hedges*	4.5%	8.3%	11.3%	26.8%
BONDS				
Investment Grade Bonds	0.1%	1.9%	3.9%	4.2%
Emerging Local Market Bonds*	1.1%	4.6%	6.5%	4.1%
TOTAL CASH				

** Each asset class is represented by a relevant Vanguard Index fund except for Inflation Hedges where the Morningstar Category average for **"Natural Resources"** is used, and for Emerging Local Market Bonds where **PIMCO Emerging Local Bond** is used.*
*** Each portfolio is represented by a Vanguard Lifestrategy Index fund.*

As you can see in the table of returns, the rest of the world is not doing as well as the U.S.

Looking over the other investment categories, real estate investments, as measured by the Vanguard REIT Index, rose 7% for the quarter, and is standing at a remarkable 17.6% gain for the year. Inflation hedges rose 8.3% this past quarter, posting a gain of 11.3% for the year.

Most market participants expected bond rates to rise in the first half of the year, but once again bond returns surprised the experts. The Bloomberg U.S. Corporate Bond Index now has an effective yield of just 2.90%.

Depending on where you look, the economic news has been somewhat scary. The U.S. economy's GDP dropped 2.9% in the first quarter of the year--an enormous hit which has been largely blamed on the weather. There are also positive signs, particularly in the statistics for housing demand. The pending home sales index for contracts to purchase previously-owned U.S. homes rose 6.1% in May, the largest advance since April 2010. The rise in the overall REIT index suggests a strong bounce back in the real estate industry overall.

Where do we go from here? <u>The long bull market that started in March 2009 and the economic expansion that started nearly at the same time are both among the longest since the Civil War</u>. Bull markets have to end eventually; we all know that and this one is about 18 months overdue (based upon historical correction cycles). However, this growth period has been more like a marathon than the usual recovery sprint after a recession; the economy has grown at a 2% annualized rate since 2009, which is below the long-term average, and considerably below what is normal during a recovery from economic malaise. Marathon runners --at least in theory--can keep moving longer than sprinters. Is that the case today?

This may be the perfect time to celebrate the fact that we've managed to stay invested during fearful times, when government shutdowns, European banking crises and the threat of another meltdown at home were driving others away from the improbable upward trend. **Naturally, we will all be tested again—likely soon.**

Since 2009, only the brave have stayed the course, and they earned the rewards of what, in retrospect, has been one of the most generous bull markets in U.S. history. How much more is in store for them, or <u>when, how long, or how deep</u> the inevitable correction will be, is not something we mortals are given to know--despite the loud predictions you will hear from economists and pundits whose crystal balls are no more clear than yours or mine.

What Makes the Stock Market Move?

William D. Starnes

The stock market moves up and down each day, week, and year. Sometimes it seems obvious what leads to changes and at other times there seems to be no reason for the stock market moves. Unfortunately, watching the news does not clarify reasoning with announcements such as: "The stock market dropped today with unemployment numbers being released that were outstanding (but worse than expected)". Hold it. If unemployment is going down, why did the market plummet?

Does the market change due to natural disasters, business profits, interest rates, inflation, trading volume, politics, monetary policy, technological breakthroughs, economic growth, or investor emotions? The answer is YES - all of these things at the same time.

Ok, then, what about just the big moves? What drives the biggest moves in the stock market?

Sometimes it is very clear why markets fall, such as the 7% drop after the terrorist attack on 9/11/2001. Since the year 1885, there have been 145 days where the market changed by 5% or more. However, only 35 of these moves can be traced back to a significant event. In other words, using news stories to predict large market moves would not be wise. The boring reality is that there are so many moving parts it can be very difficult to even understand why the market moves the way it does. There is plenty of "news" reporting of what is happening in the world that affects markets, and also plenty of disagreement over WHAT actually caused the market changes.

The market moves on new news, and that news is unknown, unpredictable, and random.

Stock prices already reflect past news and all available information about the economy. Further, the prices also reflect the probabilities of future events. However, it is certainly NEW news that moves values of business (i.e. stocks) and markets each day. The problem with news is that it is random and unknown until the news is released. The moment the news is released, it is immediately reflected in stock prices because that news is available to all market participants at (almost exactly) the same time.

Some economic data is released at regular intervals. However, it is not the literal interpretation of the data that is important; it is the data compared to what the market already assumed. In other words, markets are not moving in response to the announcement itself, but in response to the difference between what the traders expect (i.e., what is already baked into the market cake) to be announced and what is actually announced. This is why the market will move higher on bad news (i.e., news that was not as bad as expected); and/or lower on good news (i.e., news that was not as good as expected). Again, this occurs because the market has already priced expectations into market prices!

Have you ever heard yourself saying, "The economy is getting worse, I better get out of stocks", or "I think coal is the wave of the future, I better invest there"? “Stocks are going up, I better buy now, before it is too late!”

Unless you have insider information (which is illegal to trade on), there is nothing you know that is not already reflected in stock and market prices. In other words, the market is already reflecting the best guess of an outcome. It is already baked into the cake. The market is aware of everything and stock prices reflect this. Unless you know something the market does not know, you can’t beat it.

As an example of how the market works, if you have a large jar filled with jelly beans and asked 1,000 people to guess the number of jelly beans in the jar, the guesses would be across the board. However, the average guess (i.e., the market) would be very close to the actual number of jelly beans. Similarly, in the stock market, the investors drive prices towards the likely most fair price (based upon the information that is currently available). Therefore, the market as a whole does an excellent job at determining prices.

Although it is fascinating to observe and understand the market’s reaction to economic data, investing on the basis of these data releases is best left to stock traders or those willing to lose a lot of money in a short period of time.

Stocks can and will rise and fall for a number of reasons. But you are fooling yourself if your investment plan relies on your ability to consistently call these moves. Why? Again, because the market moves on new news, and that news is unknown, unpredictable, and random. Therefore, you must come to the unavoidable conclusion that market moves are unpredictable and random.

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