ARK ROYAL
WEALTH MANAGEMENT

Helping Successful People Make Smart Decisions About Money

WINTER **2017**

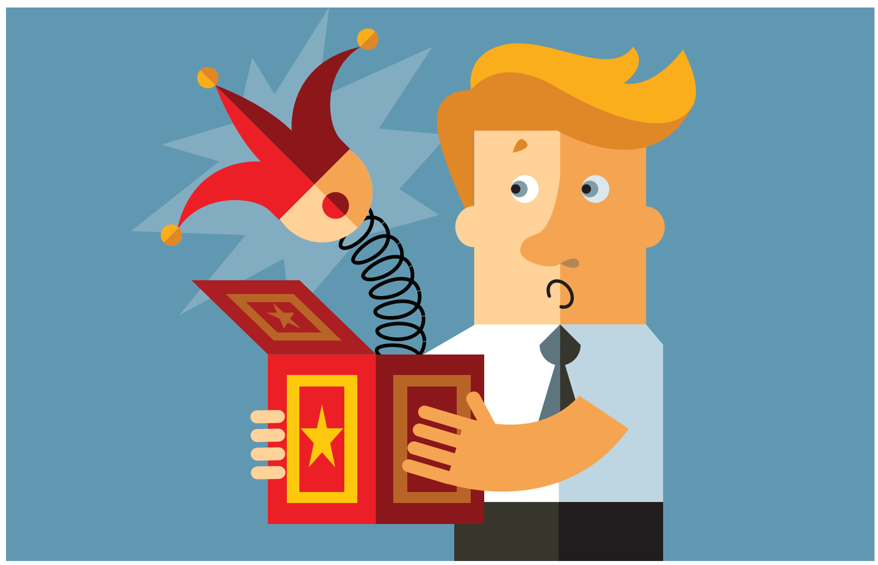
ETFs: AN INVESTMENT FULL OF SURPRISES

Exchange traded funds (ETFs) have become quite popular over the last decade and are a staple of the "in-house" managed portfolios offered by retail brokerage firms like Charles Schwab and Fidelity as well as the investment platforms of the so-called "robo-advisor" firms, like Wealthfront, Betterment and Personal Capital.

While ETFs have some appealing features (relatively low cost, available for trading *during the day*, tax efficiency) they also have some less publicized drawbacks.

The most notable drawback is that unlike open-end mutual funds, ETFs trade at a premium or discount to the actual underlying securities. Depending on the securities owned by the ETF, the discount/premium can be substantial. For example, on August 24, 2015 during a period of stock market volatility the iShares Select Dividend (DVY) fell 35% even though the underlying stocks were down only 11%. This "dislocation" between net asset value and actual market value can occur during times of market volatility. In late June of last year during the Brexit turmoil, robo-advisor Betterment (a firm offering ETF portfolios) halted trading of client accounts because of wide premium/discount spreads.

Corporate bond ETFs are especially vulnerable to meaningful premiums/ discounts due to the relatively illiquid corporate bond market. Several market mavens like Bill Gross, Carl Icahn and Howard Marks have voiced concern about potential liquidity mismatches between fast-trading ETFs and some relatively difficult to price and thinly traded corporate bonds. ETFs with foreign equity exposures can be especially prone to gaps between price and net asset value (NAV). This is in contrast with investors in mutual funds, who are assured of getting fair value or net asset value based on the value of the underlying holdings as of the close of trading.



While ETFs are marketed as providing more liquidity than mutual funds, investors should remember that liquidity doesn't necessarily equate to fair value. As with all things in life, liquidity comes at a cost.

ETFs have also become a favored investment of high speed traders and hedge funds. These "investors" tend to exit the market during times of volatility and their absence can amplify distortions in pricing.

It's crucial for investors to look at the liquidity of the underlying holdings of the ETF, or better yet, avoid buying or selling ETFs during periods of market volatility. However, many financial advisors tout this intra-day ability to buy or sell as part of their value proposition. In fact, having standing stop-loss orders on ETFs can have unexpected negative consequences (trade execution far below price stops) during times of market turbulence.

One advisor in my study group goes so far as to describe ETFs as "an investment full of surprises, all of which are bad." Whether that's accurate is for individual investors to decide, but it's certainly fair to say many investors don't fully appreciate the limitations or drawbacks of ETFs until something unexpected occurs. We encourage investors to fully understand the risks associated with any type of investment.

BEWARE THE MAN (OR WOMAN) WITH TWO HATS: IS YOUR FINANCIAL ADVISOR ALWAYS WORKING IN YOUR BEST INTEREST?

Are ALL financial advisors required to put your interest ahead of his/her own? That seems like a simple question. A recent survey found that nearly half of Americans mistakenly believe the answer to that question is "yes." The same survey found that 82% didn't know the difference between a financial advisor who is a fiduciary, and one who is not.

I see this misconception firsthand almost on a weekly basis. Last month I met with a gentleman who was seeking an advisor. He shared that he believed a fiduciary advisor was more important than a fee-only advisor. He proceeded to tell me he'd met with a financial advisor who was in the Dave Ramsey "network" and who was a fiduciary. However, at their second meeting this advisor had recommended an annuity. This gentleman was astute enough to be leery of an annuity, but still believed the advisor was serving in a fiduciary capacity.

Unfortunately for consumers, the current regulatory landscape allows some financial advisors to wear "two hats." One minute the advisor is wearing a fiduciary hat, making recommendations that put the client's interest first, and in the very next breath he/she takes off the fiduciary hat to recommend an investment that involves a commission, an arrangement where the advisor isn't required to put the client's interest first. No wonder investors are confused.

Long ago the medical profession understood the potential conflicts of interest if a doctor could also receive compensation from selling patients prescription drugs. Imagine a scenario where you went to see a doctor for what you thought was the flu. A doctor must treat patients like a physical fiduciary (do no harm). The doctor performs an exam, and perhaps a test, and determines that indeed you do have the flu, and prescribes drugs for treatment.

But imagine a scenario that after the diagnosis, the doctor could also sell you the drugs you needed. And what if he needn't sell you the one that was best for you, only the one that is suitable for your condition. And to make matters worse, what if he was under no obligation to disclose to you that he made 3x the profit from Drug A versus Drug B?

Unfortunately, this is the scenario many consumers face dealing with financial advisors. Earlier this year, the Department of Labor adopted a rule that financial advisors working with retirement assets (including IRAs) must serve clients in a fiduciary capacity starting in April 2017. Of course, nearly all brokerage firms have fought the implementation of this ruling, because they fear being required to put the client's interest first will hurt profits.

I've never understood why a financial advisor wouldn't want to serve their client's best interest all the time. It's like the adage, character is doing the right thing when nobody's looking. I would contend that when working with a financial advisor, the best route to take is to work with an advisor who is all fiduciary, all the time!

> "I've never understood why a financial advisor wouldn't want to serve their client's best interest all the time."

WHAT HAPPENS IF YOUR LONG-TERM CARE INSURER FAILS?

Many consumers were surprised by John Hancock's announcement in October that they would exit the long-term care insurance (LTC) market effective December 1. Hancock was the third largest LTC carrier in the country, as measured by premium dollars written last year.

The LTC insurance market has been under increasing stress in recent years as low interest rates have combined with rising medical costs above the core inflation rate and an aging population to create a "perfect storm" of bad news for insurance carriers. UNUM, Guardian, Aetna and Hancock have all decided to exit the LTC market in recent years. Earlier this year two units of Penn Treaty American focused on long-term care coverage became insolvent, with approximately $4 billion of projected long-term care liabilities.

There are a little over 7 million people covered by LTC policies in the US, which leaves about 36 million seniors with no coverage. Given the dynamics at play, it's important to know some of the "what ifs" should the worst happen.

Say your existing carrier, like John Hancock, decided to exit the market. What does that mean for you? Exiting the market simply means the insurer isn't writing any more coverage. The company's existing contracts are still their responsibility and they continue to collect premium and pay benefits. Occasionally, an insurer who exits the market may elect to sell their LTC contracts to another insurer, but doing so does not change the contract terms, only the entity now responsible for the policy.

What happens to your policy if your insurer goes bankrupt? North Carolina has an insurance guaranty association that protects consumers in the event of an insurer's bankruptcy. In North Carolina, coverage is capped at $300,000 of benefit per policy. It would be an extreme circumstance that would result in someone owning a policy that would exceed that benefit, but it could happen. For example, a person with a $5300 monthly benefit with a 3% inflation rider and 5-year benefit period would likely exceed the $300,000 policy guarantee.

Increasingly, consumers turn to us for help in devising long-term care plans (with insurance and other strategies) for themselves or their parents. **As fee-only planners, we are not compensated in any way from the sale of any insurance product.** We stress to our clients the importance of making financial decisions by design rather than by default. Evaluating how to structure one's long-term care coverage is just one example of the benefits of our comprehensive financial planning approach.

"Given the dynamics at play, it's important to know some of the "what ifs" should the worst happen."

IN THE NEWS

Do you live in the Lake Gaston area?

Please join us January 24th for a lunch and learn at the Chamber of Commerce conference center. Our presentation is titled "Investment Strategies for 2017 and Beyond."

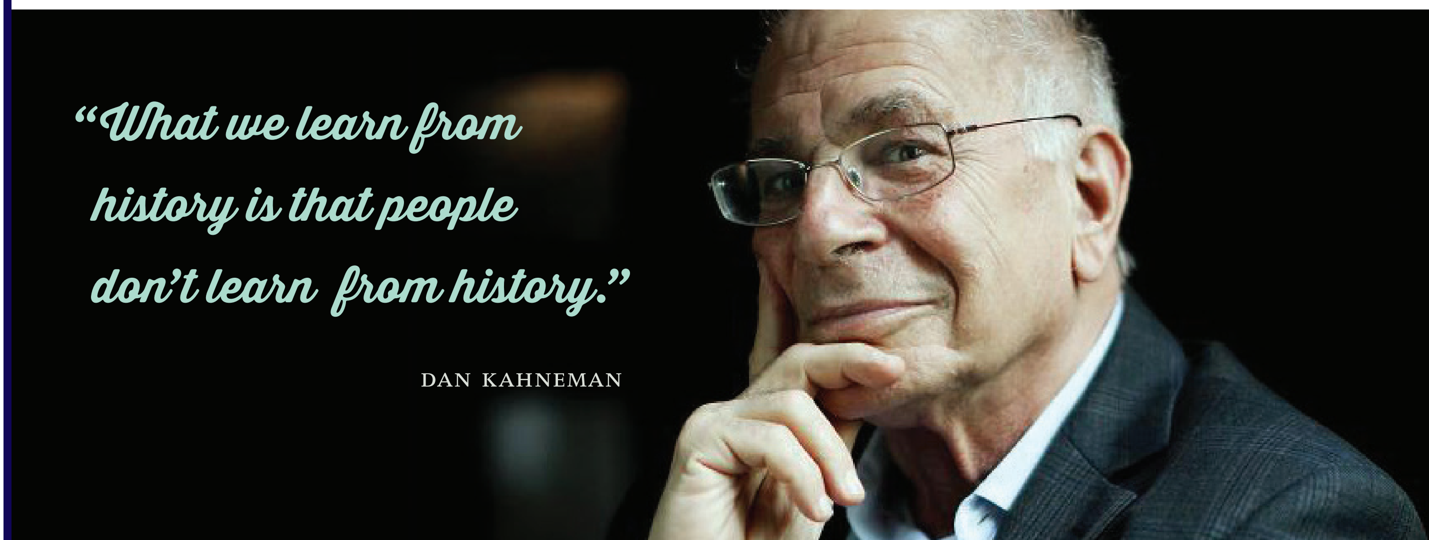
Reservations are required, please contact Lisa Shirley (252) 365-5656 for more information.

MARK YOUR CALENDARS • Wake Tech Plus 50 Expo

Wednesday, March 15 from 1–4 pm at the Wake Tech Western Campus. Mike Palmer will be among the presenters at this lifelong learning event.

For more information contact Lorrie Iwinski at Wake Tech (919)532-5650.

Mike Palmer is a contributing writer on a three-part series on **Behavioral Finance** in *Medical Economics* magazine. His first installment will appear in the March 25 issue.



The CORNERSTONES *of* ARK ROYAL WEALTH MANAGEMENT

To nurture a culture that puts our client's interest first—always

To be truthful at all times, to be intellectually honest with ourselves and with our clients, even if it isn't what they want to hear

A commitment to lifelong learning, and a passion for applying our wisdom efficiently and effectively every single day

Align what you say, what you do and what you think to honor yourself, your family and our firm