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Celestial
WEALTH MANAGEMENT

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I. What is the real value of a high quality financial advisor?

What makes one car with four doors and four wheels worth $200,000 and another worth $20,000? While all of us can answer this question, my guess is that each of my client's answers is different. The value of a high quality advisor is often different for different investors. **Many investors lack the time, willingness, temperment or the ability to confidently handle their financial matters.** That is why this profession exists. For many people, they are just too busy living their lives to manage their own finances. Working with a high quality advisor as opposed to a salesman may provide confidence. I think it is probably impossible to actually quantify the value a good advisor can bring to the table, but the value is very real to many clients. In my opinion, because many investment assets are advised, investors have already indicated that they strongly value professional investment advice.

The **most significant** opportunities for high quality advisors to add value do not present themselves consistently, they intermittently show up over the years, often during periods of investment euphoria or distress. These periods can tempt anyone to abandon a well thought out plan when an investor's fear or greed overwhelms them. At such times, a high quality advisor can add value by providing advice when needed most.

Recently the proliferation of online tax software such as TurboTax and Intuit has allowed many individuals to do their own taxes, bypassing an expert like a CPA. Are you really saving money by doing your own tax return? Could you have spent that time doing something more lucrative or enjoyable? Might a quality CPA save you from paying more tax than is necessary? If you believe an expert can add value, you see the value even if it can't be quantified.

In the pages that follow, I am going to open up a playbook that could add more value to your investment experience. The ideas that follow may or may not apply to your situation but are ways you may potentially create a more tax-advantaged portfolio regardless of what the financial markets are doing. These are strategies that quality advisors use to potentially enhance the after-tax returns of client's wealth.

II. Four Keys to Potentially Enhancing Returns

1) I believe creating a sound investment portfolio begins with that specific individual's needs. Most of us strive for the returns we need to achieve our goals while taking a level of risk in which we are comfortable. For many of us that means minimizing the chances of wealth destructive large portfolio losses. Market performance and headlines ebb and flow far more often that do your investment objectives. Not reacting to the ever-present noise and sticking to a plan can add tremendous value. Here is a chart that depicts what I mean. This is a hypothetical $100,000 invested in 1998 in the S&P 500 Index (green). Most marketing by investment firms focuses on not missing the best days of the market (blue) and how lousy your returns would be, but I have actually found someone who dug through the data to find out what would have happened if investors missed the 10 worst days of the market each year (red). The startling difference shows the impact of large losses. Your money just has to work harder for you when you have large losses to make up for. This data makes the case for risk management for me. By not spending the bulk of your time making up previous losses, you spend more time compounding your wealth.

All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and may not be invested into directly

2) A portfolio's various investments produce different returns over time, rebalancing at least annually is a simple way to keep your portfolio aligned with your objectives. **The goal of a rebalancing strategy is to reduce volatility rather than maximize return.** An investor wishing to maximize long term returns with no concern for volatility should just have a 100% equity portfolio and cross their fingers. Not too many of us have zero concern for volatility. Whether you are in a bull market or a bear market, selling or trimming back the invstments that have done well and adding or adding more to the worse-performing investments feels counterintuitive to most of us. The most common question I get asked is *why would I sell it, it **HAS** done so well*….and *why would I invest in that, it **HAS** done so poorly*. Having the discipline to rebalance when it is needed most is hard. That is where the value of a quality advisor can be extremely additive. ***"I'm convinced that everything that's important in investing is counter intuitive and everything that is obvious is wrong."***

That quote is from Charlie Munger. Munger has worked alongside Warren Buffett for more than forty years managing Berkshire Hathaway. I firmly believe what he is saying and I have seen it work firsthand. I can't tell you how many investment ideas seem to make sense and then they don't do well and how many that I am completely scared to make end up doing phoenomenally well.

3) What about the impact on asset location as opposed to asset allocation? **The allocation of assets between tax advantaged accounts such as 401(k)s and IRA(s) and taxable accounts is a tool that can add value each and every year and the potential benefits can compound over time.** When looking at an investment portfolio, it is often advantageous to look at your entire situation and use the account structure to your advantage. For instance, holding more tax-efficient investments in a taxable account and by holding your taxable bond allocation within an IRA or 401(k) can add additional return each year without any increase of risk in the overall portfolio. The reason is that interest paid out by bonds is taxable at current interest rates. If that interest is instead captured within and IRA or 401(k), that interest is not taxed. That can be an advantage up to the top marginal tax rate of 39.6% + the ACA (affordable care act) tax of 3.8% on higher earners. By having interest paying vehicles and tax inefficient investments such as commodities, REITs or highly active managers in IRAs and 401(k)s you keep up to an extra 43.40% of your return. Additionally, by having investments that often have deferred capital gains in taxable accounts, they have the potential advantage of a larger step up in cost basis when the assets go to the next generation. This is an example of why I think it is important to look at your entire invstment portfolio rather than just individual pieces. However, many investors don't look at a portfolio in that way.

4) What about those investors who are taking income from portfolios? Are there ways to maximize the after-tax income? Of course there are. **Quality advisors that develop income plans for clients can add enormous value by potentially minimizing the taxes paid over your lifetime**. This process alone could hold the key to an advisor's value to a client. One example is to work with your CPA and your advisor to assess how much in IRA assets could be distributed in a given year without triggering a tax on social security income. Once retired, often an investor's income drops dramatically allowing IRA assets to be disbursed at lower rates. This typically occurs between 65 and 70. Secondly, after age 70, by taking income in the following order, you can potentially lower your tax bill. *

    i. First, take your mandatory IRA distributions (which are fully taxable)
    ii. Next, if applicable use cash flow from investments held in taxable accounts (dividends, interest)
    iii. Thirdly, incorporate Annuity income, insurance policy income or Roth IRA distributions to reduce the amount of tax advantaged account withdrawals and subsequent taxes paid.
    iv. Fourth, sell taxable assets that would be taxed at capital gains rates, if those are lower.
        1. In general, investors should use taxable assets prior to tax advantaged assets. The acceleration of income taxes and loss of tax-deferred growth can negatively affect your wealth over time, resulting in lower success rates.
    v. Lastly, distribute from tax advantaged assets such as 401(k)s and IRA(s)

*Every client's situation is different, so a client's specific financial plan may involve spending in a different order. Please consult your CPA or tax professional regarding your specific situation. A more detailed analysis can be found in *Spending From a Portfolio: Implications of Withdrawal Order for Taxable Investors* (Jaconetti and Bruno, 2008). Many investors don't think about withdrawal order or have not had a conversation with their advisor about it. I take into account your entire situation when advising a withdrawal plan during retirement. I believe creating outcomes that seek to provide income, capital preservation and inflation protection are the basics for a sound investment plan. **Whether it happens this year, next year, or five years from now, everyone should think about how their wealth may be impacted when interest rates change direction.**

III. Stock Market Update

The Dow Jones Industrial Average rose over 18,000 back in December, 2014 (blue line on chart). It has been unable to make a sustained move above that level and currently trades at 17,900 as of June 4th. It seems that ever since the Fed's six year run of QE (quantitative easing) ended, the stock market has become listless. Momentum investors have far less stocks to choose from and are being driven into smaller and smaller sectors of the market. Ex-Fed Chairman Alan Greenspan spoke recently about the Fed's low interest rates. "been responsible for the rise in P/E multiples…and when rates normalize, that will reverse." Adding, "We can't argue that we are extremely overvalued in the marketplace." I think most investors should look for risk management via diversification, stop loss strategies and hedged equity while continuing to participate in global financial markets.

All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and may not be invested into directly

As you already know, much of the cause of the 2008-2009 financial crisis was driven by too much debt. What you may not know is that according to the McKinsey Institute, the world added $57 trillion more debt from 2008 through Q2 2014. A rise of 40%! U.S. corporate debt is on pace to set another record this year as was the case in 2012, 2013 and 2014. That would probably not be possible without the Federal Reserve's zero interest rate policy.

On June 4th, remarks from IMF (International Monetary Fund) managind director Christine Lagarde pleaded with the United States Federal Reserve not to raise interest rates until at least 2016 (an election year) due to unkown consequences in global markets. I doubt that interest rates would be raised in an election year for fear of causing a dislocation during the election process. Because of these points and the lackluster performance of the U.S. economy, <u>my base case belief is that the Fed has boxed themselves into a corner and despite talking about raising interest rates since 2013, it may be until 2017</u>

before rates do indeed rise. That being said, volatility is returning to the bond market and is causing whipsaws around the world. This presents opportunity as well as trouble. Depsite a few pockets of value, I continue to think most bonds in the U.S. offer return free risk at this point. There may be better ways to invest the conservative portion of one's portfolio.

IV. Investment Ideas

- **Rather than trying to "beat the market", focus on beating the rate on cash. Plan for lower volatility and liquidity while seeking positive returns to outpace inflation.**
- Equity valuations are very rich but masked due to the distortion of the Treasury curve. I believe volatility will return to the markets and think long/short managers are best positioned to capture this volatility by owning companies with strong businesses, barriers to entry, and good valuations and selling short weaker companies with high debt loads that have risen sharply with the broad market rally. I think this strategy of hedged equity may have the potential to produce attractive risk-adjusted returns if and when investors begin to question the valuations of companies. Stock investing involves risk including loss of principal. No strategy ensures success or protects against a loss. Long positions may decline as short positions rise, thereby accelerating potential losses to the investor.

- In 2013, the Affordable Care Act began implementation. There will be many winners and losers in the healthcare industry as a result of the biggest change in the healthcare industry's history. With the largest portion of the U.S. population entering their golden years, healthcare needs will become even more important. Long/short Healthcare seems to be a very attractive way to invest in a sector with lots of potential and lots of potential pitfalls. Investing in a specific sector involves additional risk and will be subject to greater volatility than investing more broadly.

- While there isn't a current shortage of energy on the planet, it is taking more and more energy to discover, drill, transport and refine it. Long term demand should continue to grow globally, particularly in China, India, and other developing countries.

- Potential food shortages due to inclement weather and higher demand from the emerging Asian middle class could result in a boon to agricultural land and potash fertilizer companies. International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

- Tight supply and a depressed single family home market are combining to keep apartment buildings full while driving rents higher. The number of potential renters continues to expand as a large cohort or echo boomers enters the workforce. Rents have been increasing as the desire to remain mobile and inability to secure home financing keeps renting attractive. In addition, low supply of new rental units should allow this space to flourish. Apartment REITS typically offer dividends and potential appreciation opportunities. Investing in Real Estate Investment Trusts (REITs) involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained. The payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time.

- Precious metals mining companies have been extremely beaten down over the past two years. Mining is an industry that spans hundreds of years. These companies have been through good times and bad. Companies that mine for commodities are often highly cyclical, meaning they have sustained moves both up and down. When investing in the mining space it is important to be a contrarian. Ideally, I believe you would want to accumulate miners when sentiment is poor around them and sell them when sentiment is positive. Historically this has been a good strategy.

No strategy ensures success or protects against a loss.
Asset allocation and diversification does not ensure a profit or protect against a loss.

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Regards,

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