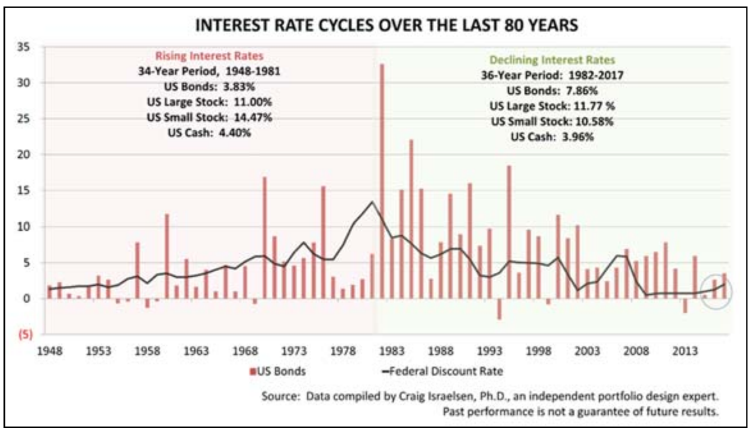
The COMPASS Chronicle

Summer 2018 *Highlighting important wealth management issues*

The Interest Rate Inflection Point And Your Portfolio

Interest rates are on the rise, and that means bond prices will decline. Here's a summary of financial history since World War II demonstrating how long interest rate cycles last and how it is likely to affect you.

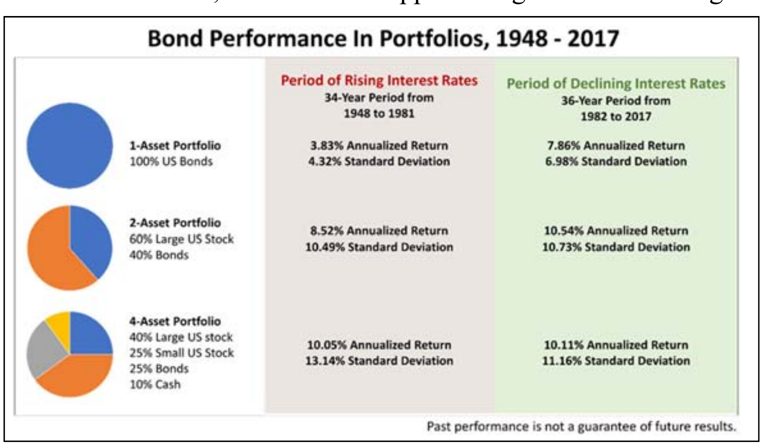


From the end of World War II to 1981, interest rates rose, as is shown in the black line in the chart. Of course, when interest rates rise, bonds prices fall because bonds paying less than the new, higher rate are less desirable and their prices adjust downward. Thus, from 1948 to 1981, the average annual return on bonds was just 3.83% annually.

Now look at what happened since the declining rate cycle began in 1982 through the end of 2017. As interest rates moved lower, the prices of bonds climbed. Bonds returned an annual average of 7.86%, for this 36-year period. Which brings us to where we are today.

Interest rates started moving up about two years ago, which means bond holdings declined in value. The Federal Reserve, which controls short-term rates — the black line — will continue to push rates higher for many years, if history is a guide. In fact, amid the strengthening economy, the Fed says it expects to ratchet rates higher again and again in 2018.

For investors who, over three decades, have grown accustomed to bonds appreciating at a rate rivalling



(Continued on page 4)

COMPASS Corner

Louis E. Conrad II, CFA®

Geopolitics, as well as international trade and tariffs, dominated the headlines during the second quarter. In addition, the Federal Reserve continued to raise interest rates. Consequently, the U.S. dollar strengthened throughout the quarter, helping the returns of small U.S. stocks, but hurting the returns of foreign stocks.

U.S. stocks performed well, but U.S. small-cap stocks performed best. The Russell 2000 Index, a proxy for U.S. small-cap stocks, generated a return of 7.7% for the second quarter, while the broader Russell 3000 Index, which also includes large- and mid-cap stocks, gained 3.9%.

International stocks suffered, especially the emerging markets, which fell 8.7% for the quarter. The MSCI EAFE Index, comprised of developed market, non-U.S. stocks, struggled less than the emerging markets, but were still down 1.2%.

U.S. bonds overall declined slightly (-0.2%) during the second quarter as interest rates rose marginally. Though the broad bond market lagged, there were some pockets of strength. Specifically, exposure to short-term bonds, floating rate debt, and high-yield bonds all contributed positively to client portfolios.

Geopolitical and trade conflict still hang over the capital markets as we enter the back half of the year. Tariffs reduce corporate profits and economic activity, as well as result in inflationary pressure. We are somewhat cautious on stocks in the near term as we await clarification on the trade and tariff front.

Four Smart Tools For College Savings

The cost of a college education isn't getting any cheaper. According to the College Board, average annual tuition and fees for a four-year public college for the 2016-17 school year was $24,930 for out-of-staters and a year at a private college cost $34,480. And those sobering price tags are increasing much faster than the overall cost of living.

To help you get ready for your child's expenses for higher education, consider these tax-favored techniques.

1. Section 529 plans. This has become far and away the most popular way for parents to save for college. These plans are operated by states and enable you to set aside almost unlimited funds for the future education of the beneficiaries you name—usually, your own kids. The money you contribute grows tax-deferred, and distributions you use to pay for tuition, fees, and other "qualified expenses" aren't taxed. If you opt for a plan from your own state, you might even be able to deduct your contributions on your state tax return. But some tax reform proponents have 529 plans in their sights, so you may want to lock in tax benefits now.

2. Custodial accounts. Before 529 plans, these were a standard way to save for college. You set up a custodial account under your state's Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA), and a custodian—probably you—manages the funds for the child's benefit until he or she reaches legal age in your state and gets access to the money.

That's a chief drawback to this approach—that just when your children are old enough to go to college, they can tap the money you've saved for whatever they like. There's also the "kiddie tax." Most investment income above an annual threshold ($2,100 for 2017) that a dependent child under age 24 receives will be taxed at the top tax rate of the child's parents.

3. 2503(c) trusts. This type of trust, also called a minor's trust, is designed to provide funds for beneficiaries' college expenses. Like custodial accounts, 2503(c) trusts have been available for years but lately have taken a back seat to 529 plans.

With a 2503(c) trust, the income is taxed directly to the trust, so there's no kiddie tax problem, and assets aren't released to a beneficiary until age 21. However, because the trust tax brackets are narrow, you may still pay tax at a rate that's higher than the child's own tax rate.

4. CESAs. A Coverdell Education Savings Account (CESA) is like an IRA used for education instead of retirement. (It was originally called the "Education IRA.") Payouts for most college costs are tax-free. But the annual contribution limit is just $2,000—compared with much higher limits for 529 plans—and it hasn't budged in years.

But money in a CESA can be rolled over tax-free for the benefit of multiple beneficiaries. Money in a CESA may also be applied to tuition for private primary and secondary schools. For 529 plans, only $10,000 per year may be used for such purposes. ●

10 Years After The Great Recession

Ten years ago, the economy was bleak. The U.S. was in a recession. The subprime mortgage crisis was undermining Bear Stearns, Lehman Brothers, Countrywide Financial, AIG, and other major financial institutions; General Motors looked like it might go out of business. Then, in a story for the ages, the nation bounced back and led the world out from The Great Recession.

Over the last 10 years, a dollar in America's 500 largest public companies grew to $2.48. From the stock market's low point on March 9,

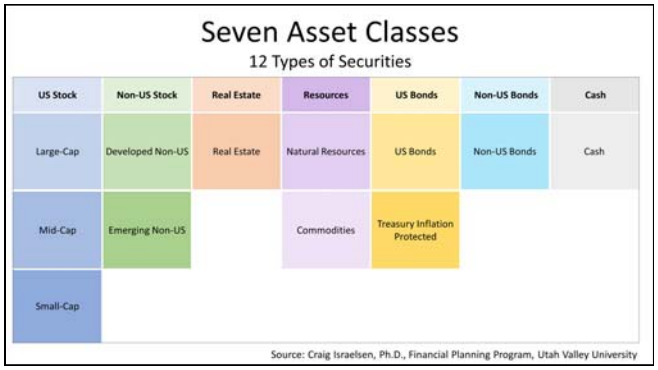
2009, a dollar appreciated in value 4.75 times, to $4.72 – a 372% return!

For the past decade, what makes America exceptional was in plain sight but difficult to see in the moment. It's never easy to see why U.S. stocks would gain in value. The current period is no different.

Share prices plunged 10.2% in early February, on inflation jitters, and again in March, on fears of a trade war. In April, *The Wall Street Journal* warned of a long period of weakness

Soaring Stocks Raises Importance Of Diversifying

The concept of diversification is vital to investors: Don't put all your eggs in one basket so they won't all get smashed if you trip and fall. It's better to spread your wealth over a broad financial spectrum of investments, but avoiding pitfalls isn't as intuitive as it may seem. This is especially important to remember when stocks are soaring and portfolios can get overloaded with stocks and human nature is to get greedy and overly optimistic about a continuation of the current trend.



Source: Craig Israelsen, Ph.D., Financial Planning Program, Utah Valley University

Retirement investors sometimes think broadening asset allocation is as easy as plunking 401(k) contributions into a fund investing in the Standard & Poor 500, which is called a "broad market index." But 500 stocks is not a diversified portfolio. It diversifies exposure in a single asset class — namely, large U.S. companies with a market capitalization of more than $10 billion. That's not a broadly diversified portfolio.

In 2008, when the financial crisis hit, many investors held portfolios loaded up on U.S. stocks. That year, the S&P 500 fell 38%. If more of their holdings had been in bonds, particularly U.S. Treasurys, the crisis would not have hurt their portfolios as badly. The Bloomberg Barclays U.S. Aggregate Bond Index, representing U.S. Treasurys, corporates and other investment-grade bonds, gained almost 6% in 2008, as stock investors scrambled to a less risky place for their money.

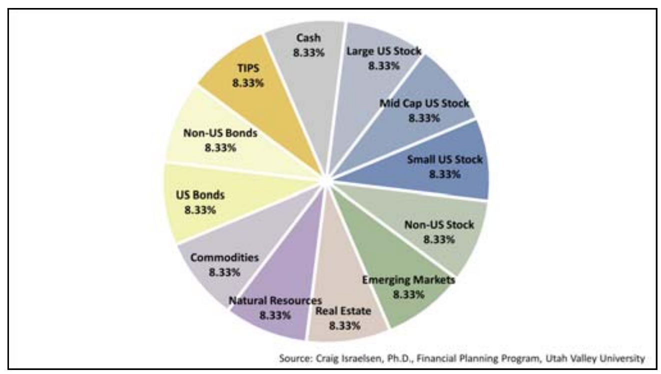
Diversification is like salsa. You can't make it with tomatoes alone. You blend in onions, garlic, cilantro and jalapeno to create the right recipe for you. Diversifying requires adding more than large-cap stocks.

The classic meat and potatoes portfolio of stocks and bonds became popular in the 1930s. The same way we've learned since then that adding vegetables and salads improves your odds of good health, increased understanding of finance tells us adding additional types of assets to a portfolio improves the odds of a retirement portfolio surviving longer.

A portfolio spanning seven asset classes and allocated equally across 12 different types of securities provides an example of the rigor, discipline, and wisdom of diversification. Stock mutual funds or exchange-traded funds diversify a portfolio across indexes of large-, small- and mid-sized companies, as well as different types of bonds.

Funds and ETFs, whose holdings mimic indexes to represent broad categories of stocks or bonds cost about 1% a year less than an actively managed mutual fund or ETF. Saving 1% in investment expenses may not sound like much but, it adds up over the long term, due to the magic of annual compounding once hailed by Albert Einstein "as the eighth wonder of the world."

Another way of looking at a diversified portfolio is as a pie apportioned in slices. In this example, the portfolio is comprised of 12 equal slices of different types of securities. In practice, the apportionment can be tweaked to suit your risk tolerance and personal taste.



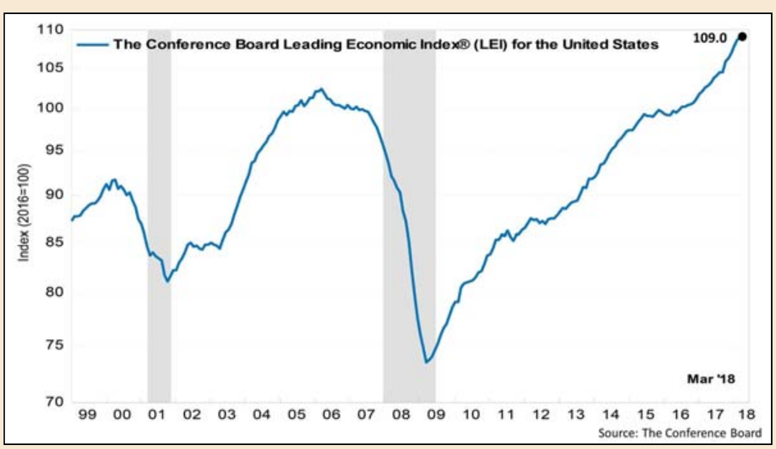
Source: Craig Israelsen, Ph.D., Financial Planning Program, Utah Valley University

Periodically, one component of your portfolio is bound to outperform its historic norm. An 8.33% position grows in value to represent 10%, 12%, or more of the total portfolio and other allocations shrink. Correcting these imbalances periodically recalibrates your portfolio to your goals and preferences. Rebalancing is another mathematical wonder.

The bottom line is that a low-expense quantitative discipline for managing a portfolio, when combined with personal financial planning to pay for long-term goals, does not guarantee you will get everywhere you want to go in life. But it gives you a clear road map to improve your chances for getting there. ●

and cracks in global growth. Things looked bleak.

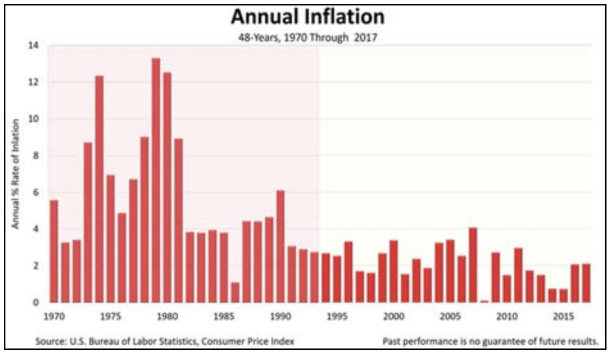
We're here to remind you that U.S. leading economic indicators released in April continued a long surge far beyond the highest point of the last expansion. This key forward-looking composite of 10 indicators points to solid growth for the rest of 2018. Despite the headlines, increased market volatility, and a weak first quarter return on stocks, very strong economic fundamentals remain in place. We're here to help you manage your portfolio for the long run. ●



Source: The Conference Board

Inflation: A Portfolio Risk That Never Dies

The threat of inflation is nothing like the double-digit affair of the 1970s, but it's still there. Dormant for years, inflation may seem irrelevant, but it remains a risk. Here's a short lesson for managing this risk.



In the 48 years after it raged in 1970, inflation was a tale of two times, distinctly different but equal in length. The first 24 years was a high-inflation period and low inflation marked the last 24 years.

The median Consumer Price Index, a widely-watched inflation barometer, was 3.8% for the 48-year span. However, the CPI topped 3.8% just once in the past 24 years, while hitting 3.8% or higher in 18 of the previous 24 years.

The table below shows the average yearly returns for seven distinct types of investments over the two 24-year periods. Some important observations:

Inflation And Performance Annually, 1970 - 2017

		Large US Stock	Small US Stock	Non-US Stock	US Bonds	US Cash	Real Estate	Commodities
Low Inflation Years 24 Years with Below-Median CPI	Average Nominal Return	13.08	13.76	10.91	6.39	2.45	12.58	(1.97)
	Average Real Return	10.80	11.44	8.67	4.27	0.41	10.30	(4.03)
High Inflation Years 24 Years with Above-Median CPI	Average Nominal Return	10.82	12.61	11.33	9.03	7.39	14.26	21.98
	Average Real Return	4.70	6.26	5.21	3.00	1.33	7.86	15.13

Source: US Bureau of Labor Statistics, Consumer Price Index; Standard & Poor's Corp.
Past performance is not a guarantee of your future results.

- Large U.S. stocks' nominal return in the low-inflation era was 13.08% and, after subtracting the small CPI increase, 10.8%. In the high-inflation years, a 10.8% nominal return shrunk to 4.7% after inflation. High CPI slashed real returns after inflation in half, a frightening risk to a retiree on fixed income.
- Stocks held up well in low-inflation times, because bonds — their chief competitor for investor capital — were yielding less income. Stocks performed okay in high-inflation periods, too. An escalating CPI eroded the value of bonds' interest income. Longer-maturity bonds suffered.
- Money market instruments are never big interest payers. But shorter-term income investments go up with inflation. They've been good for times of rising inflation.
- Real estate performed well in low-inflation years, which foster lower mortgage payments that encourage home buying. Yet real estate also performed in the high inflation era.
- A real wild card for investors in securities over the last 48 years was commodities. Oil companies dominate commodities in this class of securities, but it also reflects prices of gold, food and raw materials. Historically, prosperity increased demand for goods and boosted commodities prices. Low inflation meant the opposite happened.
- It's easy to think commodities are irrelevant, but long-term financial history indicates otherwise. The fact that they were losers after years of good stock returns demonstrate why they remain important in a diversified portfolio. If you did not have some investments underperforming, you're not properly diversified. ●

Interest Rate Inflection Point

(Continued from page 1)

stocks, the future seems likely to be very different, which especially affects the demographic bubble of baby-boomer retirees, who have long favored bonds for producing reliable income.

To understand the effect the new rising rate cycle might have on your portfolio in the years ahead, this table gives you the key facts.

The 11% annual return on stocks and the return of about 4% on Treasury Bills stayed approximately the same through both the rising and falling interest rate cycles. However, the 3.8% average annual return bonds in the rising rate cycle from 1948 to 1981 was less than half the 7.86% annually averaged on bonds during the 1982 to 2017 period. This poses a new kind of risk that many investors have never experienced before.

During the rising rate cycle, when the average annual return on bonds was a measly 3.83%, stocks and 90-day Treasury Bills averaged about the same annual return as they did in the falling rate cycle. The performance of stocks, bonds, and cash over this period demonstrates why diversification and a strategic approach are so important to long-term investing.

Shorter maturity bonds — due in three- to seven-years, as opposed to 10, 20, or 30 — are less susceptible to interest rate risk than longer maturity bonds with more years to run paying your interest before returning your principal.

These illustrations do not reflect the impact of inflation, which adds another dimension and requires a separate discussion. The takeaway here is that rates may be at the start in a new long-term cycle and clients can rely on our advice on the best way to manage this risk. Please do not hesitate to contact us with questions. ●

Large-cap US equity represented by the S&P 500 Index. Small-cap US equity represented by the Ibbotson Small Companies Index from 1970-1978, and the Russell 2000 Index starting in 1979. Non-US equity represented by the MSCI EAFE Index. Real estate represented by the NAREIT Index from 1970-1977 and the Dow Jones US Select REIT Index starting in 1978. Commodities represented by the Goldman Sachs Commodities Index (GSCI). As of February 6, 2007, the GSCI became the S&P GSCI Commodity Index. U.S. Aggregate Bonds represented by the Ibbotson Intermediate Term Bond Index from 1970-75 and the Barclays Capital Aggregate Bond index starting in 1976. Cash represented by 3-month Treasury Bills.

COMPASS Wealth Management 290 Baker Avenue, Suite N101, Concord, MA 01742-2193 P (978) 254-7040 F (978) 254-7039 www.compassinvest.com