First Quarter Outlook 2014

I|S|G
Investment Security Group, Inc.

Celebrating Our Third Decade of Providing Unbiased Financial Advice

> ***"Watching unconventional monetary policy being implemented is a little like watching a TV commercial for a new drug: some mild positives and a long list of nasty side effects."***
>
> **-J.P. Morgan Asset Management**

Client Q&A With ISG

On behalf of our staff and advisors at Investment Security Group, Inc., we wish you a very happy new year. Once again, we offer up our views and investment tactics in Q&A format, based on questions and concerns gathered from our client meetings and other client correspondence.

Client: Thank you for meeting with me today. I have brought along my list of issues and concerns on the economy and financial markets, but I thought we might start with a brief review of the past year.

ISG: It is our pleasure to visit with you today and, certainly, we can begin with a recap of 2013. First off, it was a good year for stocks both here in the US and in other developed markets like Europe and Japan. A proxy for global stocks, the MSCI World (ex US) Index, was up 21.6%. US stocks did even better, posting returns over 30%, a result that beat most forecasts, including our own. At the other end of the spectrum, emerging market stocks and high quality US bonds lost more than 2% and those that bet on gold were hit hard, losing over 28%.

From a broad portfolio allocation perspective, it was an unusual year in the degree of disparity in results between the best and worst performing asset classes. Diversified portfolio strategies generated reasonable results but could not keep pace with more concentrated strategies which may have bet heavily on the hot markets of 2013.

Client: Should we be increasing our exposure to one of those hot markets; namely, US stocks?

ISG: That's a complicated question at the moment. Heading into 2013, political dysfunction was alive and well, economic growth looked to remain sluggish, and a low rate monetary policy was encouraging investors – rightly or wrongly - into a stock market that looked reasonably valued to us. We took on a positive but moderate return forecast and allocated accordingly. As things turned out, US stocks raced past our generally accurate forecasts of economic and corporate earnings growth.

Client: So why the stock market surge?

ISG: No one really knows for sure, but certainly part of the reason can be tied to the Fed's aggressive policies which have forced investors to take on more risk (ie. invest in stocks) since they're not getting much these days from the banks or the bond market. Hence, Fed policy has won out over the actual economic fundamentals…at least for now.

Client: Is that good or bad?

News Notes

Please Check Your Beneficiary Designations

Account arrangements like IRA's, 401-k's, and insurance products like annuities and life insurance, are passed on via their designated beneficiaries. These designations supersede any alternate intentions that may have been stated in a traditional will. PLEASE make sure your beneficiary designations are as intended. Your ISG advisor will regularly bring this to your attention. Thank you.

Schwab Tax Information for 2013

1099 tax reporting information should be coming out in February. Frequently, amended 1099's follow so whenever possible, it pays to wait until later before turning over things to your accountant.

And for IRA Procrastinators……

Your 2013 contribution deadline is **Tuesday April 15, 2014.** The Maximum traditional / roth contribution for eligible contributors is $5500 ($6500 if you are age 50 or older). **These amounts remain unchanged for the 2014 tax year.** Eligibility requirements can be confusing so if you are unclear as to your status, check with your tax advisor.

We wish you a healthy and happy 2014!

ISG: It's a double edged sword. On the one hand, despite some reduction in their bond buying program, the Fed has clearly indicated its intention to keep short-term rates at low levels which should support stocks by keeping borrowing costs low and the bond to stock rotation in motion. But most observers note that the unwinding of the Fed's stimulus –especially if the economy has not shifted into higher gear – may not go smoothly, creating potential shocks to the financial markets.

Client: And where are we with regard to the economy?

ISG: We've seen improvements in some areas like housing and certain manufacturing sectors. Households have lowered their debt – and debt service – levels. Labor markets are limping along, but improving. Corporate balance sheets are healthy. Inflation is low. Globally, things are improving in some places and many central banks are likely to remain highly accommodative over the next year or so.

Client: That all sounds encouraging. Is there a flipside?

ISG: Of course. Government debt levels and future liabilities remain tenuous along with policymakers' resolve to do anything about it. CEO's remain tentative in their future spending initiatives due to political and policy uncertainties. Revenue (ie. sales) growth instead of cost-cutting needs to drive future earnings to support stocks and, presently, that growth remains tentative. And a biggie for us: wage woes. Weak income growth, particularly for the middle class, will constrain a big part our economy, consumer spending, which could impede our long-term growth rate.

Client: So putting it all together, can we get back to my original question on adding more to US stocks?

ISG: Clearly, unless the economy and corporate earnings take off, stock prices after last year's run are less attractive than they were a year ago. For the defensive minded investor, that should be reason for pause since that implies today's prices reflect less margin for error . Nevertheless, the conditions that have driven prices higher (Fed policy, muddling but slowly improving economy, low rates/low inflation) are likely to persist for a while which suggests US stocks could continue their rise and even overshoot as they typically do, albeit with more volatility and rough patches along the way. So, bottom line, for our defensive minded investors, we watch and wait for a better opportunity to redeploy when there is a greater margin for error (ie. lower prices!). For those with a more offensive bent, we are in discussions right now about opportunistically adding more money to stocks, most likely via a globally oriented strategy.

Modeling for Uncertainty

Retirement spending projections have gone through a major evolution over the last ten to fifteen years. Originally, a constant average return was used as a basis for arriving at sustainable spending regimens for clients. This "perfect world" approach was easy to understand, simple to use… but clearly flawed. After all, "averages" can be misleading: Put one arm in the freezer and the other in an oven and your average body temperature may be "normal," but you are not going to feel very comfortable. The same holds true for retirement spending models using fixed returns since investment reality tells us it won't pan out that way.

Today, many advisors use methodologies incorporating "Monte Carlo" simulations which attempt to weave real world return volatility into the equation before settling on spending levels. These models assume a random sequence of returns based around an average return and a certain level of variance from that average return (ie."standard deviation").

Following the extreme declines of the financial crisis years, however, Monte Carlo critics have voiced concern that even these models are under estimating the likelihood of a significant market decline. In a 2009 study titled, "Deju Vu All Over Again," the author found dating back to 1926 significant monthly declines (ie. exceeding 3 standard deviations below average) to be about eight times more prevalent than the typical Monte Carlo based models were assuming.

In an attempt to bring financial projections closer to reality, ISG has aligned itself with a Monte Carlo methodology which factors in a greater likelihood of these extreme events taking place (ie."fatter tails" on the distribution curve).

In the final analysis, however, clients must come to realize that any long-term financial projections are rough estimates at best. Consistent monitoring of spending patterns, investment returns, inflation levels, and tax rates, along with proper "mid-course" corrections along the way will be essential to a successfully executed retirement plan strategy.

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Client: And your rationale for the different tactics?

ISG: Investors have different financial and emotional requirements. This often leads to different tactics when the outlook is cloudy…which is most of the time. Some investors will gladly settle for a smoother investment ride even if it means giving up some return by waiting for rising stock prices to be validated. For others, the opportunity cost of missing a market upswing stings more than a premature entry into stock rally which reverses itself. Your advisor's understanding of your financial objectives, resources to tackle market risks, and emotional tolerances to investing will help guide you through to the right tactics.

Client: Thank you for taking me through this. It will help me in my future decision-making. Now moving on to a new topic, I've been reading both good and bad about the prospects for non-US stocks. I've heard overall growth in Europe is still very low, Japan's grandiose plan to jump start its economy is still in a tentative state, and that China's slowing growth has negative implications throughout the global economy. On the other hand, I am reading that some of these markets are cheaper than the US. Could you provide a brief summary of your views on these markets for the upcoming year?

ISG: Certainly. In Europe, you are right, growth remains low and the euro area's structural economic and financial problems will not be solved anytime soon. However, what often drives markets are not the actual or absolute state of things, but the relative rate of change…and conditions are improving thanks to central bank support, labor market reforms, and less severe austerity measures. Prices remain attractive relative to US stocks so from a value investor's perspective, it's worth looking at. We eliminated our dedicated position in Europe but still maintain meaningful exposure through a more broadly diversified international stock portfolio and for 2014 it remains an important part of our global stock strategy.

In Japan, we agree with you that the success of its massive monetary stimulus efforts remain uncertain. Stocks had solid returns last year in anticipation of a long overdue turnaround but because we don't have a high conviction opinion as to its ultimate outcome we've not taken a dedicated position in the world's third largest economy. Stocks prices do remain reasonable and well below their 2007 peak, so we've been content to defer to our international managers who approach investing there on a company by company basis. This tactic looks to remain unchanged heading into 2014.

Turning to China, we think fears of a hard landing are misplaced. Economic growth remains 2-3 times greater than our own economy and we are encouraged to see China's new leadership addressing the cyclical and structural imbalances in their economy. There are no guarantees, however, that they can successfully manage them without a major disruption so any investment strategy there must be prepared for higher volatility given these uncertainties. Stock prices after last year's 7% decline look attractive making stocks in this region an important part of any long term emerging market stock strategy.

Client: Speaking of emerging markets, I noticed you recently eliminated an emerging markets holding in my account. Have you altered your views on this asset class?

ISG: Despite some potential short-term issues affecting some of these regions, the long-term prospects for emerging markets remain positive. We've recently refined, however, our investing tactics with regard to this asset class. It's no longer an all inclusive affair. Investors are now scrutinizing much more closely and are more discerning between the "haves" and "have nots." We believe our replacement strategy better reflects our more selective participation in this overall space.

Client: Thanks for the clarification. Turning now to the defensive assets in my account, you've written extensively in past newsletters about the challenges facing bond investors due to the eroding effects of rising rates on bond prices. Two years ago, I enjoyed double digit returns from that part of my portfolio. Last year's return was around zero. If I hold these assets for portfolio "ballast" as you like to call it, are we locked into these dismal type returns for the foreseeable future? Are you considering any new tactics for this part of my portfolio?

ISG: First, the easy money days of getting stock type returns from your bond strategies are clearly behind us. One can engage in more aggressive tactics to juice bond returns that bring in additional credit, currency, and even leverage risks but these are not "apples to apples" to our core bond strategies

and when holding such strategies –as we are now - we tend not to include them when tabulating your defensive holdings.

Second, it's important to understand that interest rates may not rise as quickly and as much as feared. The economic recovery remains fragile and as we said earlier the Fed's intention is to keep short term rates low. Even so, longer rates, which are harder for the Fed to control, may spike some in anticipation of higher inflation down the road, but bond managers can make adjustments to their portfolios which soften the negative effects of these kind of rate increases.

Finally, as rates rise over time, the compounding effects of higher bond rates begin to offset the decline in bond prices. Over reasonable time periods, say three years or so, traditional bond strategies have historically generated positive results during rate increase cycles, so we'd have to envision a very harsh rising rate environment before seriously considering more dramatic alternative measures.

Client: So it sounds like you're saying many of the active managers you use are making internal adjustments to deal with the rising rate issue. But are you making any other changes?

ISG: There are other flexible mandate type of strategies that we've used in the past which have additional tools to generate return when rates rise… and we've been carefully replacing some of your bond allocation with alternatives like low leveraged commercial real estate and loan programs but all in all, we're staying the course at the moment… especially when stocks are acting a little shaky at the moment. Bonds are like insurance. You don't need them until you need them.

Client: Ok, any final thoughts?

ISG: Sure. Most importantly, thank you for your confidence in us over the years. Having "stewardship" over your financial resources is a serious assignment. The charge of ensuring your financial security requires for most a diversified approach which "hedges" its bets since the financial planning penalty for being on the wrong side of a big, concentrated bet is too severe. Intuitively, a diversified portfolio is always going to hold some investments that are performing less than others in any given period, but that does not invalidate the longer-term portfolio benefits of owning a variety of asset classes and investment strategies with different risk and return drivers. The global macro climate seems to be improving…but that does negate the fact that there remain many economic and financial imbalances that could lead to an unusually wide range of financial market outcomes, both good and bad. A portfolio designed to handle many possible outcomes is at the present time the appropriate tactic for most investors. Until our assessments tell us otherwise, we will remain disciplined in implementing this approach.

Future Medical Expenses

Out-of-pocket medical expenses should be an important part of every retirement planning discussion. Medicare typically covers 80% of medical costs, with the remaining 20% offloaded to the client. Premiums can go up to more than $300 a month for higher tax bracket clients…who are also paying more for Part D (prescription drug) coverage.

Supplementary coverage can help but it doesn't completely solve the problem. According to a study done in 2010 by the Boston University Center for Retirement Research, median out-of-pocket costs over a retirement from age 65 through age 100 are estimated at around a quarter of a million dollars. (you can find the research at : **http://crr.bc.edu/working-papers/how-much-is-enough-the-distribution-of-lifetime-health-care-costs/).**

This is important information to keep in mind when asking the question, "How much is enough for retirement?"