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# QtrNotes

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**Pimco Update:**

On September 26, the news hit that Bill Gross, co-founder and chief investment officer of bond fund management giant Pimco, had left the firm. We acted quickly, informing all our clients of our decision to sell positions in specific funds for which Gross had been the lead manager.

Pimco has been the leading player in the bond fund business for the last two decades. The firm employs some of the smartest minds in the business, and has tremendous depth of talent in its ranks even without its former star.

Since Gross' departure, we have spoken with Pimco management about the other Pimco funds we use, tactical bond funds that we have retained in the portfolios we manage. The primary manager for these is Rob Arnott; Gross' specific management of positions in these funds was not material. We continue to be confident in Arnott's management, and his asset allocation decisions remain sound for our clients' needs.

## Cheap Money, Mixed Markets: Not Much Has Changed

The year started on a frigid note as winter chilled our spending habits, sending GDP down 2%. Next came a wave of heat as the economy turned the corner to jump 4.6% in the second quarter. For the third quarter, GDP growth is forecast at 3%, a moderate pace. The overall stock markets have generally trended higher this year, but this performance is a reflection of strong returns in the S&P 500 (up 6.7% year-to-date), offset by negative returns in small caps and international markets and moderate returns from measures such as the Dow, up just 2.8%.

| *Index* | *9/30/2014* | *YTD* |
|---|---|---|
| **Dow Industrials** | **17,017.11** | **2.8%** |
| **S&P 500 Index** | **1,968.96** | **6.7%** |
| **Russell 2000** | **1,101.67** | **-5.3%** |
| **MSCI EAFE** | **1,846.08** | **-3.6%** |
| **Global Bond Index** | **461.32** | **1.6%** |
| **10-Year Treasury yld** | **2.51%** | |

The headlines touted record peaks for the Dow and S&P 500 in early September, but the markets all pulled back late in the month. Most signs suggest this bull market, now in its fifth year, still has room to run, but every little pullback makes investors worry about a larger correction.

However, recent economic data does not suggest another US recession in the near future. Industrial activity, employment, and consumer sentiment numbers all show continued improvement. The US economy is growing, proving more robust than the economies of the rest of the developed world. The Federal Reserve is holding interest rates down. Credit conditions still offer cheap money for borrowers, and default rates are declining. Demand for stocks is high, with US investors starved for meaningful yields from bonds, and foreign buyers increasingly looking to invest in our relatively stable economy and the strong US dollar, and to diversify away from their own markets, where interest rates are even lower.

We continue to be concerned that, while the US economy is growing, the level of growth remains slow by historical standards. Unemployment continues to fall, but there is slack in the labor markets, and wages aren't improving for many Americans. Depressed wages have been partly reflected in the record profitability of the world's largest companies, which are operating at record profit margins. This cost-cutting has largely been exhausted, and there is now little fat remaining to be trimmed. In fact, smaller companies are starting to see profit margins decrease as competition for business heats up.

Profits have also been supported by low credit and financing costs. But cheap debt is temporary. Interest rates will eventually rise. Fortunately, corporations appear to be anticipating this, preparing for higher rates in the future by issuing longer-term bonds to lock in the current low interest rates.

The Federal Reserve continues to do its best to support the economic recovery, and has been bold in stating its intention to keep interest rates low for some time. The Fed's support has helped boost asset prices, with the result that the US stock market is now slightly more expensive than it has been historically: stocks in the S&P index are currently priced at about 19 times annual earnings per share. In the current low-inflation, low-interest-rate environment, it would be reasonable for the market to trade with a price-to-earnings ratio in the low 20s. We would like to buy stocks at cheaper prices, but trying to time the market is not a reasonable or prudent investment strategy.

Considering the risk inherent in stock prices, we continue to maintain our allocation to bonds as a prudent means of diversification. Current estimates suggest interest rates might begin to rise in 2015, but it could be even later. The Fed, under Janet Yellen, continues to be skittish about allowing rates to rise too quickly.

Ultimately, if too much cheap money is pulled out of the market, especially too quickly, then stocks

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1500 San Remo Ave., Suite 176
Coral Gables, Florida 33146
305.669.2119
www.firestonecapital.com

jack@firestonecapital.com
carol@firestonecapital.com
carlos@firestonecapital.com
anthony@firestonecapital.com

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## Safety in Numbers: Digital Succession

What will happen to your digital "assets" if something happens to you?

For many of us, every year sees an increase in the amount of important material we own that exists only on computers – and, in many cases, only online.

Photo albums and cloud-based media, scanned documents and computer backups, social networking profiles, email archives, blog posts. Old emails may seem unimportant, but one of them could be the last letter you receive from a loved one.

Take a moment to think about an "estate plan" for your digital self. Can your spouse log in to your accounts? Will your adult children be able to retrieve family photos?

Some social media and webmail sites, such as Facebook and Twitter, have established policies for handling the accounts of deceased users. These policies can and do change, and may not be in your best interest. A better safeguard is a password and user data archive – a password manager or a typed list will work, as long as it's secure from hackers.

Be certain to keep it updated when you open new accounts! In fact, an archive of this kind can also help you face another inevitable moment: when a security breach forces you to change all those passwords. (Again.)

## Status Quo

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may fall. But historically, when the Fed begins to raise interest rates from very low levels, stock prices on average still rise. The credit cycle is not currently suggesting we should get out of stocks.

The fears which haunt us today were also on the top of our minds back in January. Our greatest worries have been fairly consistent in recent years: stock valuations are high, interest rates are too low and likely to rise, the economy is growing but meagerly, government deficits are falling but government debt is still rising. Even in a healthy economy, equity markets don't go up forever without volatility.

Our collective opinion is that we should not be looking at any dramatic changes in our allocations. We are not considering liquidating equity holdings; rather, we are rebalancing those portfolios which have gotten materially out of balance. We are maintaining a diversified approach, holding a broad range of assets, each having its own risk and reward attributes. We are cognizant of the rising risks and have favored higher-quality stocks, such as dividend payers, and lower-duration bond holdings in anticipation of rising rates. These approaches are intended to help us weather the next correction – which is, unfortunately, inevitable at some point.

## Protect Your Tax Refund By Reducing It

As fall arrives, it's time to think about the usual year-end tax planning strategies: maximizing retirement account contributions, charitable giving of appreciated assets, tax loss harvesting, spousal IRA or Roth IRA contributions. Check in with your accountant, and with us. Review your income and withholding for the year to date. Have you paid enough in withheld taxes to be penalty-proof? Have you paid too much?

Standard advice for years has been to avoid overpaying taxes, since the excess is effectively an interest-free loan to Uncle Sam. This is less convincing in the current climate of very low interest. But there's another, much more compelling reason to keep your refund as small as possible: the explosive growth of tax return fraud and theft.

Fraudulent tax return filing, based on stolen identity details, is now the biggest criminal problem facing the IRS. There's little an ordinary person can do to prevent it, other than basic precautions against identity theft. File your taxes as early as possible: the basic fraud occurs when a criminal uses your Social Security number (illegally obtained) and name and address (easily learned) to file an entirely bogus return online, claiming a refund in the form of a negotiable debit card. If the thief files before you do, your return will be rejected, and you'll have to start a new course of paperwork to address the fraud.

As long as you report the identity theft properly, you won't be held liable for the bogus refund the IRS paid out. But if you're owed a legitimate refund, you'll have to wait months for it – even a year or longer. Nearly three-quarters of all US tax payers receive a tax refund, averaging $3,000. That's over $300 *billion* in potentially delayed payments.

It's always a nice moment when the IRS sends you a four-figure check. But is it worth the risk? The IRS can't delay your refund if you are not owed one.

## 529 Plans and the Florida Prepaid Plan

529 plans are a terrific vehicle for grandparents to help grandchildren by funding their college education. Growth on 529 accounts is tax-free, as long as the funds are used for qualified college expenses. But if parents or students expect to apply for financial aid, distributions from 529 plans funded by grandparents will be treated as belonging to the student, counting heavily against their eligibility.

There are ways to minimize this impact, such as transferring 529 plan ownership to the parents in advance. Although the grandchild is still the beneficiary, the 529 holdings will be counted as part of the parents' assets, not the student's, and will weigh less heavily in the eligibility calculations. Another option may be to delay 529 distributions until the later years of college, allowing financial aid to cover the earlier years.

For those using the Florida Prepaid program, September brought welcome news of more than 40% reductions in the cost. The reductions apply only to recently inflated prices: the plans with the biggest refunds are likely to be those established after 2007, when large price increases were implemented. If a lump sum was paid in full in advance, expect a healthy refund, or lower monthly payment amounts in future for those using payment plans. Refund checks are expected to be mailed out in October.