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QtrNotes

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Quotes:

More money has been lost trying to anticipate and protect from corrections than is actually lost in them.

Peter Lynch

Speculation is an effort, probably unsuccessful, to turn a little money into a lot. Investment is an effort, which should be successful, to prevent a lot of money from becoming a little.

Fred Schwed Jr., author, 1940

Good advice rarely changes, while markets change constantly. The temptation to pander is almost irresistible. And while people need good advice, what they want is advice that sounds good.

Jason Zweig, Wall Street Journal

Diversification among different kinds of stock asset classes works well over the years and decades, but often quite poorly over weeks and months.

William Bernstein, The Investor's Manifesto

Slow and Steady as She Goes

The economic recovery has been going on for seven years, much longer than the typical post-World War II recovery period, which has been about four and a half years on average. While the economy is still growing, over the last year growth has been slow. Industrial vehicle sales, manufacturing production, and corporate profits seem to be taking a breather.

Wages in the US have been increasing, outpacing the rate of inflation in the past quarter. Improving wages and low levels of unemployment are contributing to strong readings of consumer confidence. Until consumer sentiment sours, the economy should maintain its growth trajectory.

In spite of the gains, investors are nervous and uncertain. Many investors are willing to concede that stocks will come out ahead over time, but still feel the urge to act (or react) in an attempt to protect themselves today.

The prospect of an aging recovery, combined with lackluster growth levels, leads some to fear that a recession is due. But history teaches us that bull markets don't die of old age. The triggers for past recessions have generally been conditions that are absent today: consumer over-spending, inventory build-up, runaway wage growth, extreme corporate debt levels, high inflation, and tight monetary policy.

It seems that we are in unprecedented times, but the truth is that we always are. While the stock markets may be at numerical highs, this is not an indication of abnormal behavior nor are we in a bubble zone. Stock valuations may be at the high range of normal, but markets at these levels are by no means unusual.

Predicting the future is always dicey, whether the prediction concerns stock markets or election results. Stock market volatility is part of the ongoing investment environment, and will be in the future as well. A diversified portfolio helps minimize exposure to the markets' wild swings.

Index	*9/30/2016*	*YTD*
Dow Industrials	**18,308.15**	**5.1%**
S&P 500 Index	**2,168.27**	**6.1%**
Russell 2000	**1,251.65**	**10.2%**
MSCI EAFE	**1,701.69**	**-0.9%**
Global Bond Index	**485.68**	**9.8%**
10-Year Treasury yld	**1.60%**	

When Will the Fed Move?

Despite expectations to the contrary, there have been no interest rate increases by the Federal Reserve thus far in 2016. We have braced ourselves several times, expecting the Fed to move, but commodity price fluctuations, softer manufacturing growth, the Brexit vote, labor market expectations, and low inflation have all kept the Fed in a holding pattern. To justify an increase, the Fed and Chairwoman Janet Yellen are searching for signs of labor-market stability and signs of inflation.

As context for what a healthy job market might look like, the Federal Reserve published a paper in 2012 which concluded that the natural rate of unemployment is 5-6%, and that the economy needed some 3.5 million new jobs each year to get there. Since then, 12 million new jobs have lowered unemployment to 4.9%. While the labor market has made great strides, there is still more to be done: wages need to see further improvement and more high-quality jobs need to be created. Even so, employment has improved to a point where, historically, the Fed would have already raised interest rates several times.

The most-followed measures of inflation suggest prices in the US are increasing at about 1.5%, still below the Federal Reserve's target of 2%. Inflation has stayed low as commodity prices remain under pressure, and the US dollar remains strong. For inflation to pick up, so too must the economy; which comes first is unknown.

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Passwords: The Next Generation

The still short history of computing is a series of cyclical arms races: programmers seize every increase in computing power and speed, develop ever more powerful software, and soon outstrip the new limits to spur the next cycle of improvement. In the frantic scramble up the curve of complexity, last year's impossible goal becomes this year's hot new feature and next year's humdrum standard.

The most powerful computers in use today aren't just calculating economic projections and hurricane tracks: they're also used by the criminal world to crack passwords and hack networks. In response, online companies plead with users to use ever more complex passwords. The weakest point in every "secure" system is usually the most careless user.

In the savage race against hackers, password complexity is actually less effective than password *length* – and many websites are beginning to allow for much longer passwords than before. A 7-character password can be broken in a quarter of a second, but a 22-character password can take years of computing time to crack, as long as it's reasonably complex.

Retirement Plan Required Withdrawals

The first wave of baby boomers hit another milestone this year: they began to turn 70½ this summer, which means that they must begin to take required minimum distributions (RMDs) from their IRAs and other retirement accounts. Taking distributions correctly can be a complex challenge.

The portion of the tax code which allows us to shelter money tax-free in regular IRAs, 401(k) and 403(b) plans and other retirement accounts also demands that we ultimately begin withdrawing those funds so that they can be taxed. The IRS specifies withdrawal rates on a schedule calculated to take out an ever-increasing percentage as we age, but not deplete the account within a normal lifespan.

Exceptions are made in some cases – for example, if you have a 401(k) or pension plan, are still working, and own less than 5% of the company, you do not have to take an RMD from that account. Roth IRA accounts are always exempt, and inherited IRAs follow different rules. But most retirement accounts are subject to RMD, and the money withdrawn is usually taxed as regular income at your marginal rate. The penalty for failure to make your required withdrawal is heavy: the base fine is a whopping 50% of the required amount, and you still have to take the RMD (and pay taxes on it).

Withdrawals may be taken at any time of the year, and can be drawn as a lump sum or as regular income, monthly or at other intervals. The deadline for most RMDs is December 31, although you may delay your first required withdrawal until April 1 the following year. But this will force you to take two years of withdrawals in the same tax year, and that can be a poor tax strategy.

If you hold multiple accounts (IRAs, pension accounts, 457 and 401(k) accounts), you may wish to consolidate these assets to simplify the process. If you do not, you are not required to take proportionally from each account held, as long as the total taken is enough to satisfy the aggregate total for a given year. 403(b) plans do not permit this convenience: you may roll your 403(b) over into an IRA for consolidation, but unless you do so, you must satisfy your IRA and 403(b) RMDs from those respective accounts.

If you don't need the funds from your RMDs to cover your living expenses after age 70½, you may choose to donate some or all of those funds: you can contribute up to $100,000 each year directly from your IRA accounts to qualified charities. The donation must be paid directly to the charity of your choice, and you will not owe taxes on those funds – although you won't be able to take an additional tax deduction for the charitable contribution.

If you have any questions about your RMDs, please give us a call. If you have just turned 70½, or are about to do so, you can expect a call from us as we make sure that your distribution requirements are taken care of well before the IRS deadlines.

Markets and the Election

With one presidential debate behind us, investors are starting to wonder: how will the election affect the markets and my portfolio?

Historically, the stock market dislikes uncertainty, and this year's election is far from certain, inspiring more controversy and angst than usual. This will likely increase market volatility. However, even as we anticipate market volatility to tick up over the next several weeks, history reminds us that the stock market will not fall off a cliff as a result of the next president. The candidates have different tax proposals and ideas regarding the direction of the country and the economy, but any plans will still have to pass Congress. The US economy is nimble, and can adapt to policy changes.

If you find yourself nervous about the election outcome, we recommend focusing on what you can control today, such as spending, saving, and retirement plans. For our part, we will continue focusing on what we can control on your behalf, such as asset allocation, tax optimization, and rebalancing. We are combing through portfolios, taking profits and aligning them to target allocations. We are replenishing cash and short-term bond allocations for folks withdrawing money from their accounts. For savers, market volatility can be beneficial, creating an attractive time to put some money to work.

Please do your best to block out the election noise – and do your part this November by getting out to vote.