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The Bulldog Bulletin

1ST QUARTER 2017

The Practical Implications of Investment Theory

Many investment principles used to develop investment portfolios are derived from one investment theory — the Capital Asset Pricing Model (CAPM). What exactly is this theory and how does it apply to your investments?

The CAPM was developed over 50 years ago by Harry Markowitz, who won a Nobel Prize for his work. His theory centers on the concept that adding an asset to a portfolio that is not highly correlated with other assets in the portfolio can reduce variation risk. Before his theory, it was common practice to look for undervalued assets to add to a portfolio. His approach evaluated how a particular asset would impact a portfolio's risk and return. Whether it makes sense to add that investment to the portfolio depends as much on how the asset's return will vary with returns of other portfolio assets as on its own return prospects.

This theory provides the underlying rationale for asset allocation. The key is that the returns of different assets do not behave in the same manner during different economic times, so adding different assets can reduce the volatility in that portfolio. While the return of a diversified portfolio may be lower than that of investing solely in the best performing asset, it is typically viewed as an acceptable trade-off for reduced risk. Many people have also realized that it is difficult to identify the best performing asset in any given year, so a diversified portfolio provides more consistent returns.

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Avoid These 5 401(k) Plan Mistakes

All too frequently, people make mistakes with their 401(k) plans that cost them more than they realize, sometimes preventing an early or on-time retirement. Consider these five common 401(k) mistakes and how you can avoid them:

1. Believing That Simply Contributing to Your 401(k) Plan Is Sufficient

Again and again, people believe that spending carelessly is okay as long as they are also contributing to their retirement fund. Not true. Simply contributing to your 401(k) plan does not necessarily mean that you are going to have a comfortable retirement.

Your goal should be to contribute the maximum annual limit — $18,000 for people under 50 years of age and $24,000 for investors 50 years of age or older. Contributing at that level clearly isn't realistic for everyone, and certainly some level of contribution is better than nothing. But living well within your means today — taking control of your spending so you have some left over at the end of the month to sock away in a retirement fund — can mean a more comfortable retirement tomorrow.

2. Using Your 401(k) Plan as a Savings Account

When you go through a major life event, such as a job change, the birth of a child, sending kids to college, or a divorce, it can be tempting to cash out your 401(k) plan to get you through that rough patch. Indeed, the lure of the now can be difficult to resist, but the point of a 401(k) plan is to give yourself a comfortable tomorrow.

Withdrawing from your 401(k) plan today not only puts a dent in the balance that will compound over

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Practical Implications

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Some of the investment implications that have been drawn from this theory include:

- ❍ A properly diversified portfolio will combine assets that do not have highly correlated returns. Thus, when one asset is declining, other assets may be increasing or not decreasing as much.
- ❍ Rather than focusing on each investment's risk, investors should consider their portfolio's overall risk.
- ❍ Including a small percentage of a volatile investment may not increase a portfolio's overall risk, provided that investment's returns do not vary closely with other assets' returns in the portfolio.
- ❍ When small portions of stocks are added to an all-bond portfolio, risk initially decreases, even though stocks are more volatile than bonds. Thus, an all-bond portfolio is not the lowest risk portfolio.
- ❍ Investors should consider how varying percentages of different asset classes will affect their portfolio's risk and return before deciding on an asset allocation.

Managing Your Portfolio

Consider this investment process to incorporate this theory:

- ❍ **Determine your risk/return preferences.** You should assess the potential downside as well as upside for various investments to get a feel for how much risk you can tolerate.
- ❍ **Decide on an asset allocation mix.** Your asset allocation strategy represents your personal decisions about how much of your portfolio should be allocated to various investment categories. After considering your risk tolerance, time horizon for investing, and return needs, you can form a target asset allocation mix. Within broad investment categories, make allocation decisions for each category. Not only will each individual's allocation strategy differ, but your strategy will vary over time.
- ❍ **Select individual investments.** Investigate a wide range of options, but make sure you understand the basics of each, examining their risk types as well as their historical rates of return. Your selections should fit in with your overall asset allocation.
- ❍ **Rebalance periodically.** Over time, your asset allocation will stray from your desired allocation due to varying rates of return on your investments. Determine how much variation you are willing to tolerate, perhaps 5% or 10% from your desired allocation. If portions of your portfolio have strayed more than that, you should take steps to get your allocation in line. However, first determine if there are ways to do so without incurring tax liabilities. Selling assets from taxable accounts may result in taxable transactions. Instead, you may want to make new investments in underweighted assets, redirect periodic income to other asset classes, or take withdrawals from overweighted assets.

Please call if you'd like to discuss your investment portfolio in more detail. ❍❍❍

Invest at Your Own Risk

From March 2008 to February 2009, a 100% stock portfolio lost over 43% of its value, and those with a 60% stock portfolio lost a quarter of their value (Source: *Retirement Researcher*, September 22, 2016).

Did you stick to your asset allocation during that time? Many didn't because they just couldn't stand the extended volatility.

While that was a pretty extreme period of time, the fact of the matter is that your risk tolerance is one of the most important factors in investing. As you probably know, risk tolerance is the amount of risk you're comfortable with taking when investing.

In your portfolio, stocks and bonds play different roles. Stocks are intended to drive the growth of your portfolio and bring the highest return; but without question, they are also riskier.

Bonds tend to be the stability of your portfolio. They may slow down your growth, but they're more dependable and less risky. It is wise to have a combination of stocks and bonds to keep you on track to meet your financial goals; but the real question is, what ratio is right for you?

Think of a 10-point scale, with 10 being the riskiest and 1 being the least risky. You need to make sure you know where you fall on that scale.

For most of us, investing is about meeting long-term financial goals, so making your portfolio match your risk tolerance is key to staying disciplined. When you get your risk tolerance right, you are less likely to bail during market turmoil and should feel more secure with your asset allocation.

That's not to say you should always keep your risk tolerance the same. It's important to think about it at least annually to make sure you are still comfortable with it. Please call to discuss this in more detail. ❍❍❍

5 401(k) Mistakes

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time; but if you're not yet at retirement age, the Internal Revenue Service may send you a hefty tax bill for withdrawing that retirement money early.

To the extent that you can, leave your 401(k) alone to grow until your retirement. Use other cash assets for those inevitable rainy days.

3. Fearing Diversification

Diversification is a risk management technique that mixes a wide variety of investments within a portfolio. It's based on the idea that a mix of different investments may yield higher returns with lower risk than any individual investment.

A good rule of thumb is to invest more in equities the further you are from retirement and then gradually increase your bond allocation over time to help make that shift from a growth orientation toward an income orientation. The point is this: a blend of investments is important and requires adjustments along the way.

4. Not Participating in a Company Match Program

If your bank gave you $10 every time you deposited $10, would you accept that? That's what many companies offer through their 401(k) matching programs. Yet, surprisingly, many people don't participate.

Simply put, in almost every case, not participating in your company's 401(k) matching program does not make sense. Figure out how to budget your monthly take-home pay accordingly so that you can contribute at least as much as your employer will match (most match 50 cents or $1 for every $1 contribution, up to a certain percentage of the employee's salary).

5. Suffering Analysis Paralysis

Is your retirement fast approaching and the anxiety has you avoiding the details? Are you just out of college and feel as though you have a lifetime to accumulate enough for retirement? Whatever your situation, it is better to be prepared for retirement than not. The mistake here is either failing to tap the benefits a 401(k) plan offers (like company matching) or setting up contributions and then failing to pay attention to how they are allocated and making necessary adjustments.

If you feel like you may be making some of these mistakes or would simply like help preparing your investments for retirement, please call. ❍❍❍

Does Buy and Hold Still Make Sense?

If you feel the stock market has been turbulent the last couple of years, you would be right. Consider these facts from the summer of 2014 (Source: InvestingHaven.com, July 2016):

- ❍ Crude oil went through its sharpest correction ever, losing more than 70% in 18 months.
- ❍ The dollar rally was the sharpest in many decades.
- ❍ Stock markets went through three flash-crashes never seen before.
- ❍ Many individual stocks lost between 50% and 70% of their value, as stock indexes remained close to all-time highs.

During what we think of as normal times, stocks increase over time with slight market corrections. But in the last few years, central bank policies have disrupted normal market behavior, which has caused some difficult market conditions. Some call it a whole new world of investing. So does a buy-and-hold investment strategy make sense in these times? There are various views on this, but the consensus seems to be that it still works, although you may need to do it differently than in the past.

There are several advantages to buy-and-hold investing:

- ❍ Fewer commissions because you are not trading as often.
- ❍ Tax benefits, as the IRS taxes long-term gains at a lower rate.
- ❍ People feel less likely to get out of the market during periods of turmoil.
- ❍ Not needing to pay attention to the market as much by sticking to the strategy.

The last point is exactly what is different about today's buy-and-hold strategy. You still need to keep an eye on your strategy. The new requirements for a successful buy-and-hold strategy include:

- ❍ Only consider buying stock in best-in-class companies with a decent track record for growth.
- ❍ Hold a diversified portfolio so you are not subject to the risk of an individual company.
- ❍ Be ready to get out of any stock once it falls 10% or more from the price you paid.
- ❍ Rebalance your portfolio on a regular basis by scaling back portions of your buy-and-hold portfolio that do better than other parts.
- ❍ Get rid of investments that no longer meet your needs. If you put the portfolio together when you were in your thirties and are now in your fifties, your objectives and risk tolerance have probably changed.

At one time you could feel comfortable that your long-term buy-and-hold strategy would be relatively smooth with solid returns. However, the up-and-down market is now taking your portfolio for a bumpy ride that could result in significant losses. The bottom line is that we are in different times, and you have to be diligent about watching your investments. ❍❍❍

FINANCIAL DATA

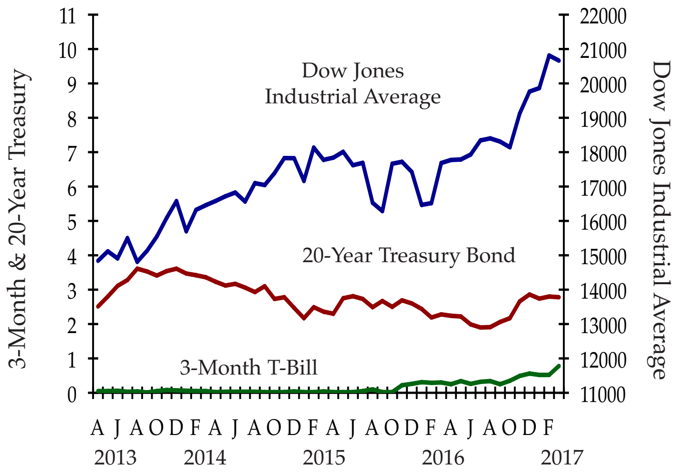
Indicator	Month-end Jan-17	Feb-17	Mar-17	Dec-16	Mar-16
Prime rate	3.75	3.75	4.00	3.75	3.50
Money market rate	0.31	0.32	0.32	0.29	0.26
3-month T-bill yield	0.52	0.52	0.78	0.56	0.30
20-year T-bond yield	2.74	2.80	2.78	2.86	2.28
Dow Jones Corp.	3.22	3.17	3.22	3.17	3.04
30-year fixed mortgage	3.73	3.60	3.68	3.68	3.24
GDP (adj. annual rate)#	+1.40	+3.50	+2.10	+2.10	+1.40

Indicator	Month-end Jan-17	Feb-17	Mar-17	% Change YTD	12-Mon.
Dow Jones Industrials	19864.09	20812.24	20663.22	4.6%	16.8%
Standard & Poor's 500	2278.87	2363.64	2362.72	5.5%	14.7%
Nasdaq Composite	5614.79	5825.44	5911.74	9.8%	21.4%
Gold	1212.80	1255.60	1244.85	7.4%	0.6%
Consumer price index@	241.40	242.80	243.60	0.9%	2.7%
Unemployment rate@	4.70	4.80	4.70	2.2%	-4.1%
Index of leading ind.@	124.70	125.50	126.20	1.8%	2.5%

\# — 2nd, 3rd, 4th quarter @ — Dec, Jan, Feb Sources: *Barron's, Wall Street Journal*

4-YEAR SUMMARY OF DOW JONES INDUSTRIAL AVERAGE, 3-MONTH T-BILL & 20-YEAR TREASURY BOND YIELD

APRIL 2013 TO MARCH 2017



Past performance is not a guarantee of future results.

NEWS AND ANNOUNCEMENTS

ASSET CORRELATION: WHAT IS IT AND HOW DO YOU USE IT?

Asset correlation is the measure of how assets move in correlation to one another. Highly correlated assets move in the same direction at the same time, while negatively correlated assets move in the opposite direction from one another — one moves up as the other moves down.

The theory of asset correlation is that you can reduce risk and increase returns by investing in asset combinations that are not correlated. The basic rule has been that equities go up when economies do better, and bonds do better when economies go down. Their low correlation to one another is why this has been effective over the years.

Having a mix of bonds and stocks in portfolios has always been a basic investing concept; but today's market is not as predictable or stable, and the way they move is changing. Over the past year, bond markets have become more highly correlated to equities.

This change in correlation has become a new risk factor investors need to think about when developing their asset allocations. It's not just about the percentage of bonds in your portfolio anymore, but the types of bonds as well. The new thinking is that you have to plan your investment strategy around volatility because of the change in bond behavior.

DIVERSIFICATION IS STILL THE KEY

With correlations increasing among equity classes, investors need to be diligent about their portfolio strategies to ensure sufficient diversification. You may want to do some research on your portfolio to see how your asset correlation has shifted over time, so you can focus your rebalancing efforts on these fluctuations.

The bottom line is that traditional asset allocation must be done in a smarter way to reduce risk and increase returns in your portfolio. Please call if you'd like to discuss asset correlation in more detail. ❍❍❍

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