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RB Capital Management, LLC

986 W. Alluvial, Suite 101
Fresno, CA 93711
(559) 432-6100
(559) 432-6110 Fax
rob@rbcapitalmanagement.com
www.rbcapitalmanagement.com

Rob Ballan
Portfolio Manager

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How Much Flexibility Is Too Much?

When it comes to flexibility in a financial plan, it's a delicate balancing act: it is important to maintain enough flexibility that your financial plan can accommodate unexpected events that are out of your control. On the other hand, a sound financial plan needs to be firmly grounded by factors you can control so that even in the face of unexpected events, following your financial plan gets you to where you want to go.

When you develop a financial plan, you have to make certain assumptions, many of which are out of your control. Yet you can develop a financial plan with assumptions about these factors even in the absence of a crystal ball.

Taxes — The notoriously complicated U.S. tax code will affect your financial plan in a number of ways. For one, your effective tax rate will change as your income changes. Also, changes to the tax code itself can affect your financial plan, often dramatically. Fortunately, changes aren't typically made every year; and because Congress sets tax policy, most changes in the tax code are announced in advance of taking effect — allowing you time to plan how those changes might impact your financial plan.

Income — We all hope, of course, that our income will rise as we move forward in our careers. Typically, those kinds of income changes are predictable. More dramatic yet still predictable income changes can happen when one spouse voluntarily stops or starts working. The loss of a job or dramatic decrease in work hours can cause unexpected changes in income.

Health — Your health and the health of your spouse are significant factors in your financial plan for two reasons: first, because health is a big determinant of one's ability to earn income; and second, because health-care costs are often one of the largest expenses, especially for older people. As you age, it's important to think about changing your assumptions about your health. Maybe you reduce the income you expect because you won't be able to work long hours. Or you increase the health-care-related expenses you plan for. You can also take steps to mitigate the impact of health changes.

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Diversification: Not Just for Stocks

Most investors know that one of the best ways to manage risk in a stock portfolio is to diversify. But ask the average *bond* investor how to cut risk, and the answer is likely to focus on safety: Treasury securities and federally insured CDs. After all, what could be safer than guarantees that come from the federal government?

The problem with this answer is that it ignores reward. When you settle for the highest level of safety, you have to settle for low rates of return (reward) too — and sometimes that reward barely keeps up with inflation.

Yet another concern is the fact that interest rates don't stay in one place. When rates are rising, investors with maturing bonds can obtain higher income by reinvesting. But when rates are falling, they face the unpleasant prospect of settling for a lower yield to maintain the same credit rating and target maturity.

One way to solve those concerns is to add stocks to your portfolio.

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How Much?

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Life — Beyond job losses and health events that can affect your financial plan, other major life events can have a big impact as well. Whether it's good or bad, expected or unexpected, events like the birth of a child, marriage or divorce, a spouse's death, or a relocation will affect your financial plan. Some you can plan for, some you can't; the point is to be aware that these kinds of events will impact your financial plan.

Economy — For most of us, our financial plans are based on the assumption that our investments will earn a certain average return in the market. Those assumptions affect decisions we make about our plans. For example, the amount you need to save every month to retire at age 70 may be larger or smaller the higher or lower your assumption about investment returns. The best way to make these assumptions is to base them on long-term historical returns in relevant market indices.

Because there are so many factors affecting your financial plan that you can't control, it's critical to know the factors you can control and to stay on track with your plan in those areas.

Live within your means — When you keep your expenses (including savings and investments) less than your income, you give yourself more flexibility to accommodate unexpected changes that you can't control. If you have some breathing room in your budget every month, you can more easily accommodate, for example, a higher tax rate or economic downturn without having to alter your financial plan.

Have a rainy day fund — Have at least three to six months worth of living expenses in an easily accessible, liquid fund that you can draw upon in the event of a rainy day — an emergency or unexpected situation. This savings should be set aside from all other savings and investments and only used for true emergency expenses — like in the case of a job loss or illness. With an adequate rainy day fund, you can deal with unexpected events without having to erode your financial plan.

Revisit your plan regularly — The number-one key to achieving your financial goals is to review and, if necessary, revise your financial plan regularly — at least once a year. That way, you can make adjustments for all the factors out of your control that have changed for better or worse. If you haven't revisited your financial plan in the last year or if you need to develop a plan, please call. ❍❍❍

A Portfolio Tune-Up

The need for rebalancing is part of the nature of investing. Since different investments earn different rates of return, their values grow at different rates, changing the weightings in your portfolio. These changes can cause your portfolio risk to increase or decrease, making rebalancing a necessary part of portfolio maintenance.

While you should definitely rebalance when your financial objectives or life circumstances change, you also want to rebalance on a regular basis. There are three basic methods to consider:

- ❍ **Rebalance annually.** Choose a date to rebalance, perhaps at the beginning of the year, when you receive your annual statements, or at the end of a quarter. On that date every year, compare your current allocation to your target allocation. Any allocations off by more than 5–10% would require rebalancing. Once you have rebalanced, don't be tempted to make other rebalancing changes during the year. Wait for your next rebalancing date.
- ❍ **Rebalance when your allocation differs from your target allocation by a designated percentage.** With this type of rebalancing, you monitor your portfolio more frequently, perhaps monthly. Once your allocation moves from your target allocation by a predetermined percentage, perhaps 5–10%, you rebalance your portfolio.
- ❍ **Rebalance based on current market conditions.** With this approach, rather than one specific percentage for each asset class, you might have a target range. For instance, you might allocate anywhere from 30–50% of your portfolio to large-capitalization stocks. Depending on your views of the market, you might want to allocate near the low or high end of that range. Thus, your allocation will change as your views about the market change.

There are many ways to accomplish changing your allocation among investments. You can purchase additional amounts of the investment that is underrepresented in your portfolio. You can sell investments in overrepresented portions and invest the proceeds in underrepresented portions. Any withdrawals can be taken from overweighted investments. Income from your portfolio, such as dividends and interest, can be invested in underweighted investments. Ultimately, you need to consider tax ramifications and your own individual investment preferences. ❍❍❍

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Diversification

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Another consideration is to diversify your bond portfolio across several dimensions, including maturity, safety, and yield. Here are some choices to consider to deal with these challenges:

Laddering

A bond ladder is a way for buy-and-hold investors to diversify within the same asset class and risk category. The purpose is to soften the impact of rapid changes in interest rates and obtain a smoother cash flow from interest payments.

The way to construct a ladder is to spread your assets equally among an array of maturities so that only a portion of your portfolio matures in any one year. Instead of concentrating in bonds that mature in six years, for example, you might create a portfolio consisting of bonds that mature in two, four, six, eight, and 10 years. When the shortest bond matures, you use the funds to buy a bond that matures in 10 years. If rates are lower than when you bought your first 10-year bond, you can still enjoy the relatively higher yields of the rest of your portfolio.

Adding Bonds from Higher-Risk but Relatively Safe Issuers

Whatever level of safety you prefer, nearly everyone has a price at which taking on more risk makes financial sense. Investment professionals calculate that price based on the difference between the yields of bonds with the same maturity but from qualitatively different kinds of issuers.

These differences are referred to as yield spreads and reflect how much more investors need to be paid to accept the risk of the borrower. As economic conditions change, these spreads change, becoming narrower or wider. When spreads are unusually wide, bond professionals see value on which investors can capitalize.

Adding Geographic Diversity

If you own municipal bonds, are they only issued from inside your home state? While such bonds generally offer the added advantage of exemption from state income taxes, diversifying your holdings to include bonds from other states offers three types of potential benefits: 1) higher yields, 2) better credit quality, and/or 3) exposure to different regional economic risks and opportunities.

The same can be said for investing in the debt of foreign governments. While foreign bonds carry the additional risk of currency exchange rates, for investors with large portfolios, adding small amounts of currency risk can actually reduce the overall volatility of the portfolio.

If you think you could benefit from greater diversification in your fixed-income portfolio, please call. ❍❍❍

Why Everyone Needs an Estate Plan

Estate planning isn't only for the rich. It's for everybody who cares about how their passing affects those they leave behind. And it all starts with a will.

The Advantages of a Will

A will is the basic estate planning document. When you die without one, you are said to have died "intestate," which means you leave a host of decisions to state law and the courts. A will can specify who is to receive what funds and assets you leave behind, as well as name a guardian for your children. And while *in and of itself* a will doesn't help shelter your money from estate taxes or keep your estate out of probate court, it can be instrumental in achieving both objectives by moving your assets into trusts.

The Role of Trusts

Trusts are legal entities that assume ownership of assets and designate beneficiaries to whom the assets pass directly when you die. Trusts can offer four key advantages:

- ❍ They remove money and other assets out of your estate, meaning they are exempt from federal estate taxation when the assets are distributed to beneficiaries.
- ❍ They can be used to distribute your assets to different parties than those specified by state law, including siblings, grandchildren, or charities, in any amount you choose, under specific conditions (like children reaching a certain age) and for specific purposes (like paying for an education).
- ❍ They avoid probate, which means they pass to beneficiaries without delay or attendant legal expenses.
- ❍ They keep your decisions private, as only your attorney and beneficiaries know what your decisions were.

There are many different types of trusts, with almost as many different purposes as there are life circumstances.

Beyond Wills and Trusts

Estate planning involves more than trusts and wills. First and foremost, it requires identifying all of your assets, establishing who owns them, and assessing their financial value. It involves determining you and your spouse's need for future expenses, including retirement and long-term health care. It can also involve giving people the power to pay your bills and make decisions about medical care when you're incapacitated.

If you haven't started to plan your estate or believe your current plan needs updating to reflect changes in your life or the estate tax law, please call. ❍❍❍

Financial Data

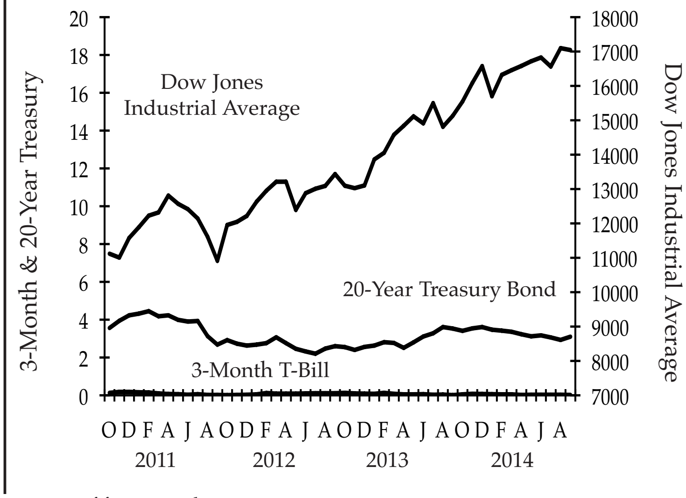
Indicator	Jul-14	Aug-14	Sep-14	Dec-13	Sep-13
	Month-end				
Prime rate	3.25	3.25	3.25	3.25	3.25
Money market rate	0.40	0.39	0.42	0.43	0.42
3-month T-bill yield	0.03	0.03	0.02	0.07	0.01
20-year T-bond yield	3.06	2.93	3.10	3.61	3.53
Dow Jones Corp.	2.81	2.72	2.90	3.11	3.09
30-year fixed mortgage	3.81	3.69	3.81	4.21	3.86
GDP (adj. annual rate)#	+2.60	-2.10	+4.60	+2.60	+2.50

Indicator	Month-end Jul-14	Month-end Aug-14	Month-end Sep-14	% Change YTD	% Change 12 Mon.
Dow Jones Industrials	16563.30	17098.45	17042.90	2.8%	12.6%
Standard & Poor's 500	1930.67	2003.37	1972.29	6.7%	17.3%
Nasdaq Composite	4369.77	4580.27	4493.39	7.6%	19.1%
Gold	1285.25	1285.75	1216.50	1.2%	-8.3%
Consumer price index@	238.30	238.30	237.90	2.1%	1.7%
Unemployment rate@	6.10	6.20	6.10	-12.9%	-16.4%
Index of leading ind.@	102.40	103.60	103.80	5.6%	7.5%

\# — 4th, 1st, 2nd quarter @ — Jun, Jul, Aug Sources: *Barron's, Wall Street Journal*

4-Year Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield

October 2010 to September 2014



Past performance is not a guarantee of future results.

News and Announcements

Calculating an Investment's Basis

Your capital gain or loss on the sale of an investment equals the proceeds from the sale less your basis (the cost of acquiring the investment). When you purchase an investment, your basis equals the price you paid plus any fees or commissions. While the calculation is fairly straightforward, other factors can affect your basis calculations:

- Reinvested dividends are added to your basis at full market value plus any fees or commissions.
- The basis of any investment received as a gift is the donor's original basis plus any gift tax paid by the donor. However, if you then sell the investment at a loss, your basis is equal to the lesser of the donor's basis or the investment's fair market value on the date of the gift.
- For inherited investments, the basis is the market value on the date you inherited the investment, typically the date of the donor's death.
- Your basis in stock that has been split is the same as your basis before the stock split. Your per-share basis, however, will now equal your total basis divided by the number of shares you own after the split.
- When you exercise a stock option, your basis equals the price you paid for the shares plus any fees or commissions, which may be lower than market value. Shares must be retained for at least one year after purchase and for two years after receipt of the option, or any gains will be taxed as ordinary income.

Please call if you'd like help calculating your basis in an investment. ❍❍❍

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