The Thoughtful Investor™

First Quarter 2014

Market Outlook for 2014

Investing on the basis of market predictions is a bad idea, in part because markets tend to surprise. But with that said, it is interesting to look at expectations for the year and to keep those in the back of our mind if we see certain patterns begin to repeat. One of those patterns is the presidential cycle.

Originally developed by market historian Yale Hirsh, the presidential cycle theory maintains that:

- Markets do well in a presidential election year.
- Markets do even better in the year leading up to the election.

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Market Returns since 1932, based on the Presidential Term

Year	Return*	% of losing years
Year 1	-0.7%	50%
Year 2	-3.3%	50%
Year 3	26.2%	5%
Year 4	6.9%	20%

** Not including dividends*

What is Your Real Risk Tolerance?

At the start of an investment advisory relationship, one of the questions we typically ask our clients is "How much risk are you willing to take?" Your answer may be in terms of percent of portfolio losses, dollar amounts, loss of initial capital or a score from a risk assessment questionnaire. That information, combined with data such as years until you will need to withdraw your funds and how much money you have saved to date, is used to establish an risk-weighted investment plan we believe will allow you to have the money you need, when you need it. Equally important, it has to result in a portfolio you are willing to hold through good markets and bad.

The problem is that risk "tolerance" is relative.

When you first answered the question, a number of factors influenced your response from current market conditions to your mood, your sex and marital status, how you view your current level of financial security, job security and more.

With the exception typically of your sex, everything else is subject to change. In positive markets, people tend to be more willing to take on risk, assuming that losses can be quickly recovered. When markets turn down, risk tolerance changes. Behavioral finance has proven that losses have a greater emotional impact that gains and

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What if You Are Wrong?

It's been a long time since high school debate class, but one lesson sticks with me – the importance of being able to debate both sides of an issue.

Why is that so important? Because humans tend to be hard-wired to need an explanation to "why." Behavioral theorists maintain that when we think we know why something has happened, our bodies release chemicals in the brain that make us feel good. Unfortunately, feeling good doesn't mean we are right. And having someone take away that good feeling by pointing out our error is well…irritating.

German philosopher Friedrich Nietzsche died in 1900, but his insights still ring true today. *"To trace something unknown back to something known is alleviating, soothing, gratifying, and gives moreover a feeling of power. Danger, disquiet, anxiety attend the unknown – the first instinct is to eliminate these distressing states. First principle: any explanation is better than none…. The cause-creating drive is thus conditioned and excited by the feeling of fear…."*

To make good decisions, we need to consider the other side of the debate. We need to seek out opinions and information that might contradict what we think we know. The result is not necessarily comfortable, but it makes us better investors.

Fund Your Retirement Plans

2014 retirement plan contribution limits remain largely unchanged from 2013. As always, we encourage you to maximize your retirement plan contributions, especially when you receive a matching contribution from your employer.

Retirement plan contributions can be used to lower your taxable income, defer taxes on gains until they are withdrawn at retirement (or eliminate future federal taxes on gains in the case of a Roth plan), accumulate net worth that can be passed on to future generations, and most important, build financial security for your retirement.

If you have not yet made your contributions for 2013, make certain accounts are funded before their respective deadlines and make your 2014 contributions early to give them maximum time to grow. If you have questions about your retirement accounts or would like to establish an account, please give us a call.

Employee Contribution Limits for 2013 and 2014

Type of Retirement Plan	2013 and 2014	
	Under Age 50	50 and Older
Individual Retirement Plans*		
Traditional and Roth IRA	$5,500	$6,500
Employer-Sponsored Retirement Plans		
401(k), Roth 401(k), 403(b), 457 and SARSEP Plans	$17,500	$23,000
Small Business or Self-Employed Retirement Plans		
Self-Employed 401k (a.k.a., Solo-401k, Individual 401k, Roth 401k)	20-25% deferred compensation plus $17,500 (under 50) or plus $23,000 (over 50) up to a maximum of $51,000 (2013) and $52,000 (2014)	
SIMPLE (Savings Incentive Match Plan for Employees) IRA or 401(k)	100% of compensation up to	
	$12,000	$14,500
Simplified Employee Pension (SEP)	25% of compensation up to $51,000 (2013); $52,000 (2014)	
Coverdell Education Savings Account*		
Per beneficiary under age 18	$2,000	$2,000
Gift Tax Exclusion		
Amount that can be given from an individual to an individual without incurring gift taxes	$14,000	$14,000

**Traditional and Roth IRAs and Coverdell Education Savings Accounts have income phase-out ranges for determining tax deductibility or eligibility. Please check with your tax adviser or review literature on these retirement accounts to make certain you qualify. Employer-sponsored retirement accounts are subject to limitations with respect to employee elective contributions. Employees classified as "Highly Compensated" may be subject to contribution limits based on their employer's overall participation and the participation of other employees. Check with your firm's human resources department if you have questions about your plan. Anyone age 50 or older is eligible to make catch-up contributions. Employers are not required to permit catch-up contributions; however, since these contributions are not subject to nondiscrimination rules and eligibility is easily established, most permit catch-up contributions. The preceding information is not intended as tax or legal advice. Please check with your appropriate advisers if you have questions regarding your retirement accounts.*

Market Outlook for 2014 — *continued from page 1*

- Markets are best performing in years three and four of the current term.
- Markets are worst performing in years one and two of the new term.

The theory has been surprisingly accurate over the years, perhaps due to the self-interest of politicians to retain office for themselves and/or their parties. Howard Sun explains this rationale in Seeking Alpha as follows:

"During the first and second terms in office, presidents tend to focus on their campaign platform promises and sanction tough legislation related to tax increases, regulatory changes, government budget cuts and social policy decisions like universal healthcare coverage or tuition cuts. In the third and fourth years in office as presidents look forward to the election, they tend to use fiscal stimulus such as tax cuts or government budget increases to pump up the economy and build voter confidence for the incumbent party."[1]

One complication this year could be the mid-term elections and the issue of whether the Democrats will retain the Senate. A loss there could put an end to many goals supported by the liberal contingency, putting more pressure on keeping the economy and stock market doing well through the elections.

The good news with an active management approach is that our investment approach is designed to reflect the current realities of the market, not what might be or we hope will be. Thus, while indicators such as the Presidential Cycle add perspective, the ultimate question is — how is the market performing today?

1 http://seekingalpha.com/article/81469-the-presidential-election-cycle-theory-is-it-accurate

Rethinking Retirement for Greater Financial Security

One of your best moves for a financially secure retirement may be postponing your retirement and waiting until age 70 to fully retire.

One reason is Social Security's "delayed retirement credit," originally enacted in 1972. Over the years, the credit has grown more generous and now increases Social Security retirement benefits a retiree would receive at age 65 by up to 8% every year retirement is postponed until age 70.

If you retired in 2013 at age 62, your *maximum* monthly benefit would be $1,923, or $23,076 per year. Retire at age 65 and the maximum monthly benefit increases to $2,533; $30,396 annually. If, however, you are age 70 and retired in 2013, your monthly benefit increases to $3,350 or $40,200 per year, 33% more than retiring at 65 (Source: Social Security Administration web site). Now in theory, you have lost out on five years of benefits at $30,396, but with the higher benefit, that difference is recouped within at least 15 years and possibly shorter depending on changes in benefits over the time period.

According to data compiled by the Social Security Administration:

- A 65-year-old man today can expect to live, on average, until 84.
- A 65-year-old woman today can expect to live, on average, until 86.

And those are just averages. About one out of every four 65-year-olds today will live past age 90, and one out of 10 will live past age 95. If you are one of the longer-lived retirees, that extra $9,800 a year adds up.

Which brings up the second reason for postponing your retirement – keeping yourself busy and mentally stimulated in the years to come. A new study published by the Institute of Economic Affairs and the Age Endeavour Fellowship, London, maintains that retirement can be bad for mental and physical health. The author, Gabriel H. Sahlgren, explained that initially retirement gives most people a small health boost, but over the medium- and long-term, it causes "a drastic decline in health" in both males and females equally.

The third reason comes back to the money angle. Postponing your retirement gives your savings five more years to grow and time for you to add to the account. If you have saved $750,000 for retirement to date and earn at least 6% annually, your retirement portfolio will be in excess of $1 million by the end of the 5th year. Naturally, there can be no guarantee that your portfolio will achieve that rate of return and all investments have the potential for loss as well as gain.

While money plays an important role, there are other factors determining the right time for you to retire, including your health, your retirement plans, and other demands for your time. Rather than spending five more years in a job you dislike, you might prolong your life and live happier retired with less money. So keep the money in perspective when preparing for retirement.

When can you retire with full benefits?

Depending on when you were born, the answer may NOT be 65. The age for retirement with full Social Security benefits has been quietly moving up. Individuals born after 1937 have to work a little longer to claim full benefits. The table below shows when you can claim full benefits, based on your birth year.

If you were born in:	You can claim full benefits at age:
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and on	67

Social Security claiming strategies become more complex if you are married, widowed, divorced, disabled or have dependents. Before you decide to claim your Social Security benefits, consult a retirement specialist.

What is Your Real Risk Tolerance? *— continued from page 1*

can distort risk tolerance by making an individual (1) less willing to incur risk or (2) willing to take on greater risk to make up for lost portfolio value.

Mood is particularly volatile and can be influenced by the media, personal events, and even your perception of whether or not the country is headed in the right direction. Divorce, illness, death of a love one, dissatisfaction with one's work and other factors impact your willingness to take risks.

With that said, risk is a part of investing. While an active investment approach strives to manage risk and limit drawdowns, there will be times when your portfolio loses value or seems to plateau. While we can make no assurances as to the future performance of your portfolio, often these times are precisely when you don't want to abandon the investment approach.

There is also the question of whether or not you *need* to take risk. Sometimes we get locked in to a mental risk tolerance level that is actually higher than it needs to be. If you have sufficient savings to fund your needs with low-risk assets, perhaps there is no need to have a higher risk tolerance level in your portfolio.

To make certain risk levels in your portfolio match your risk capacity, we ask that you call and talk with us. We need to know if there are changes in your life that necessitate changes in your portfolio, and if at any time you are not comfortable with your portfolio and how it is invested. Our goal is a long-term relationship with you. Communication is a key part of that relationship.

LEGACY
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Protect Your Wealth

Accumulating wealth is just one step on the path to financial security. You also need to have safeguards in place to protect your wealth. Active management, with its focus on risk management, is one tool with the potential to limit the damage of market declines, however, you are still vulnerable to a number of other risks:

(1) Theft

To protect your personal possessions, make certain they are stored safely and that your insurance policy will replace them in the event of theft. You may need to add a rider to your policy to cover high-value items such as artwork, jewelry, furs, guns, and other valuables. You should have photographs, video records, receipts or appraisals to establish ownership and the value of the items. You also need to guard against online theft by monitoring accounts, changing passwords regularly, and taking care where and how you access your accounts.

(2) Lawsuits

Lawsuits could be sparked by your actions, the actions of a minor child, a property hazard, etc. In addition to using care in your actions, your best defense is umbrella insurance — an add-on to your auto, homeowners or renters policy. Umbrella insurance covers personal injury — damage to someone's career or reputation, invasion of privacy, wrongful entry, wrongful eviction, false arrest, false imprisonment, malicious prosecution, etc. Some umbrella policies will provide coverage if you are sued because of your service on the board of a civic, charitable or religious organization. Umbrella insurance doesn't cover everything. Punitive damages for outrageous, totally reckless conduct are not covered, for example.

(3) Overspending

Overspending can be a big problem when it comes to accumulating funds as well as when you retire. Your best defense is a budget. A budget starts with how much money you have available, less essential expenses. These are the non-negotiables that must be paid each month. From there, you move on to critical expenses such as food, transportation, and so forth. There are a number of tactics to avoid overspending from using cash to setting aside a slush fund for "discretionary" spending, etc. Figure out what works for you and use it faithfully.

(4) Property destruction

Your best defense against property destruction is a good insurance policy, starting with replacement value insurance. With that said, insurance policies have exclusions. A policy may limit recovery for losses to a vacant property; losses caused by an automatic sprinkler system intended to fight fires; leaks caused by freezing pipes; disasters – both natural and man-made-such as earthquake, flood, war, terrorism, and nuclear hazard. The scope of these exclusions can be exceedingly nuanced. Another group of exclusions relates to causes of loss which are hidden or slow-moving, such as faulty design or workmanship, mold or corrosion, and wear and tear.

Read your policy and know when you are NOT covered. Know the geographic risks of your area. If you are in a flood plain or vulnerable to ocean surges, federal flood insurance is a good idea. Earthquake and hurricane insurance can also be added to your policy, typically with high deductibles.

(5) Medical expenses

This whole topic is in flux until we find out what the re-designed health insurance market really looks like. But, even when health insurance covers the cost of a medical procedure or care, affiliated costs, such as the loss of wages for the individual and caretakers, need to be considered. Disability insurance is one possible precaution.

This is not a comprehensive list of the risks you may face. Talk with your financial or insurance adviser before taking action.