The Thoughtful Investor™

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Finding the Market's Bottom

The best time to invest –
at market bottoms
The hardest time to invest –
at market bottoms

Selling can sometimes be the easier part of active management. As the market approaches overpriced levels, the bears are often out in force, warning of forthcoming doom. Investors who have watched their profits soar, start worrying about keeping their gains and listening for cracks in the market. As markets appear to be approaching unstable levels, setting a sell trigger at a 3- 4% market decline may be all you need. But to be successful at active investing, we have to make two good calls. The first is when to move to the sidelines, the second is when to buy back into the market. And that can often be the harder decision.

By the time the market reaches a bottom, investor mood is typically at its worst. Rather than jump back into stocks, many individuals are ready to swear off investing in the financial

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The New Retirement Worry: Outliving Our Brains

The #1 worry of retirees, according to a number of surveys, is that they might outlive their money. But there's a new worry gaining speed – the fear of outliving our brains.

The good news is that as fears go, it is considerably overrated. And there is actually quite a bit we can do to change the odds of losing mental capacity as we age.

Years ago, a friend who worked in law enforcement explained that many people die of bullet wounds, not because the wounds are mortal, but because they believe they are supposed to die when they are shot. Aging can be much the same, where dementia is accepted because people think it is supposed to happen. In reality, people have much greater control over their mental health than they realize, starting with how the brain is used.

First the statistics. Dementia is on the rise because people are living longer. Starting at age 65, the risk of developing dementia doubles every five years. According to the Center for Disease Control and Prevention, by age 85 years and older, between 25 and 50% of people will exhibit signs of Alzheimer's disease or other forms of dementia. These signs can be relatively mild or incapacitating. In the early stages, people experience some memory loss which progresses to marked memory loss, then to a decrease in thinking ability such as decision making. Later the disease leads to the loss in the ability to perform activities of daily living or recognize loved ones. If you make it to 100 without showing signs of dementia, the odds are you never will.

While heredity plays a part in the likelihood of developing dementia, our lifestyles also contribute.

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The $55 Billion Dilemma

Charlie Munger, vice-chairman of Berkshire Hathaway Corporation, once said, "It takes character to sit there with all that cash and do nothing. But I didn't get where I am by going after mediocre opportunities." At the end of June 2014, Berkshire Hathaway was sitting on $55 billion in cash, with nowhere the company was willing to invest it. Munger and Warren Buffett have focused on holding a limited number of positions in their portfolio, allowing them to intimately understand their investments and influence the direction of the companies. But that also limits the potential deals available to the investment company.

For investors, small can actually be better than big in many circumstances. There's a nimbleness and ability to take advantage of innovative emerging businesses and small opportunities that disappear when the required size of the investment increases. Peter Lynch excelled at managing Fidelity Magellan, until the fund became too large and began to move markets when it took or sold a position.

The California Public Employees' Retirement System (Calpers) is the largest U.S. public pension plan with nearly $300 billion in holdings, but has had trouble managing its investment risk. During the financial crisis of 2008-2009, assets dropped in excess of 36% to $165 billion. Now Calpers is looking at ways to reduce its risk by exiting investment areas such as commodities and hedge funds. But when you look at the numbers, those are relatively small elements of the portfolio at less than 1% and 1.5%.

Small investors really do have the edge in some aspects of investing.

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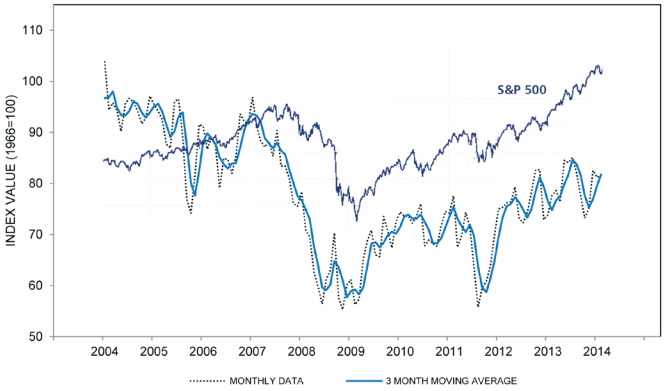
markets. While that might seem like a rational approach at the moment, buying at market bottoms, when securities are selling at depressed prices, can supercharge portfolio returns.

There is no failsafe method of determining market bottoms, however, there are patterns that repeat:

- Heightened pessimism signals proximity to the bottom. This may show up in sentiment indicators, heavy redemptions of mutual funds resulting in forced selling by the fund managers, and oversold indications.

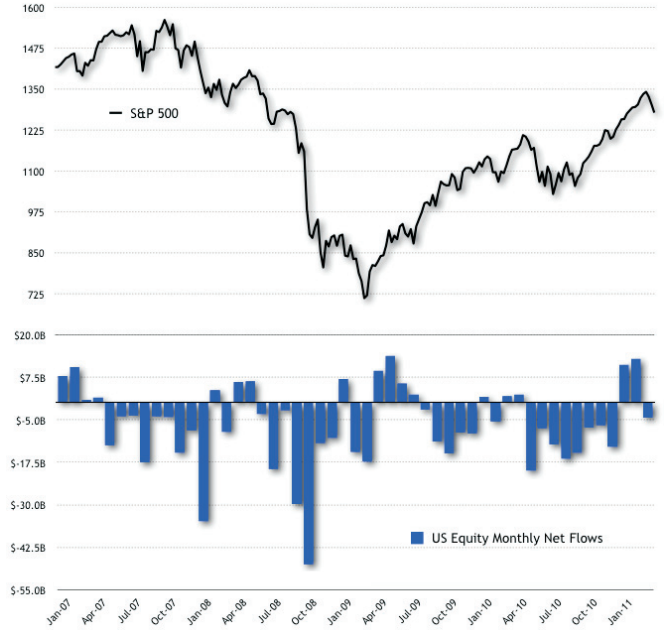
University of Michigan Consumer Sentiment Index Compared to the S&P 500



Source: Standard & Poors, University of Michigan/Thompson Reuters

- Unusually high volume at or near a price bottom can signal a market turning point. When investors begin to sell everything, desperate to get clear of a falling market, they force the index down on high volume, setting up a potentially profitable buying opportunity.

U.S. Equity Flows Compared to the S&P 500



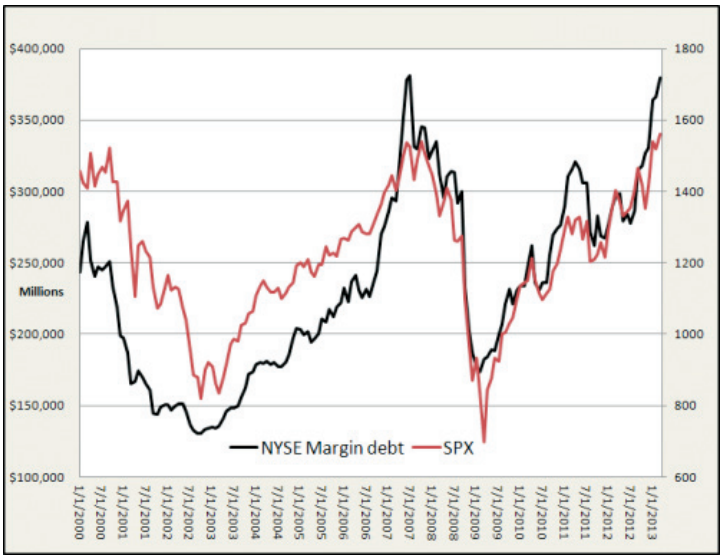
Source: Standard & Poors, Investment Company Institute, TheShortSideofLong.blogspot.com

- When bad news comes out and the markets don't go down, the bottom may be at hand. Failing to react to bad news may mean the market has already priced too much bad news into a stock.
- A higher bottom (#2) or double bottom occurs on receding volume. Lower volume indicates that selling pressure is easing. With this indicator, investors should not re-enter the market until the signal receives confirmation by reaching the peak between the two bottoms.

Higher Bottom Occurs

- There is a decline in the number of stocks hitting 12-month lows on the NYSE, and a broad number of stocks in the S&P 500 Index that begin increasing in value.
- The NYSE Margin Debt number begins to rise, indicating that stock traders are more confident that stocks will increase in value and are borrowing more money on margin to buy stocks.

New York Stock Exchange Margin Debt and the S&P 500 Index



Source: Schaeffers Investment Research, http://schaefferstradingfloor.com/

- Financials, consumer cyclicals, technology (especially semiconductors) and transportation begin to show absolute or relative strength. These sectors tend to lead recoveries.

These are just a sampling of the many ways analysts try to identify market bottoms. There can be no guarantee as to the accuracy of market bottom signals, but when multiple signals start indicating the market has bottomed and is beginning to recover, it's time to pay attention.

One of Those Facts That Isn't

The following "Buddha" quote seemed ideal to begin this article, but after taking a moment to verify the quote, it turned out to be one of those great Buddha *non-quotes*. Which seemed to make it particularly appropriate to start this article with…

"Believe nothing, no matter where you read it, or who said it, no matter if I have said it, unless it agrees with your own reason and your own common sense."

Not Buddha

Today we are inundated with information from authorities in every field. But all too often, the assumed "facts" may not be true. How often have you read an article stating something along the lines of "90% of *professional active fund managers underperform the S&P 500*"? Usually the statement is used to explain why it is futile to try to actively manage investments and that the best investment is a buy-and-hold index fund.

Rob Isbitts, founder and chief investment strategist of Sungarden Investment Research LLC, with assistance from Mark Jakupcik, research analyst at Sungarden, decided to find out if the statement really was true, since it failed to meet the test of his own reason and common sense. The full study and its methodology can be found at www.hedgedinvesting.com.

Summarizing their findings, the study states: *Specifically,* ***there were no time periods in which the S&P 500 outperformed 90% of mutual funds.*** *The index was a middle-of-the-road performer in most of the 24 separate time period/peer group combinations we studied. There is a noticeable tendency for the index to perform better than its active peers during friendlier market environments. During the two bull periods, the index outperformed 80% and 63% of its peers. However, during the down market cycles (bear), the index beat only 34% and 38% of its active management competitors. This is one of the most consistent conclusions we have seen in this and other studies – that active managers, in the aggregate, are effective in curbing some of the losses in the worst of times.*

In today's world of instant communication, tweets, blogs and an internet with instant outreach across the world, manipulating information has never been easier. Falsehoods are spewed out as facts, partial truths are used to distort reality. While Buddha did not say it, there is great value in questioning the facts and applying your own judgment to the statements of others.

Sometimes the data may be correct, but the manner in which it is used is misleading. Averages are often misused to create a false impression. For example, longevity statistics make it sound as if life spans have more than doubled in the last 75 years. If deaths of infants and children under five are removed from the calculation, there is still improvement in longevity, but by no means as dramatic. The big improvement has been in mortality rates for the under-five age bracket.

It is tempting and certainly easier to believe what we are told without questioning the source or the motives behind the statement, but in doing so, we risk being manipulated and misled.

The New Retirement Worry: Outliving Our Brains — *continued from page 1*

One interesting Alzheimer factoid is that the more years of formal education you have, the less likely you are to develop the condition. The reason may be neuroplasticity – the brain's inherent ability to adapt and change through life. Brains are meant for changing and adapting. By deliberately seeking out mental stimulation and learning new skills, you can train your brain throughout life for health and productivity.

In addition to seeking new experiences and skills, keeping a healthy mind is very similar to keeping a healthy body:

- Avoid head injuries. Traumatic damage to the brain can show up years later in higher rates of dementia.
- The same risk factors that contribute to heart disease, stroke and type 2 diabetes – high blood pressure, obesity, poor eating habits, etc., contribute to poor mental health, in part through damage to blood vessels that supply oxygen to the brain.
- Avoid smoking; smokers have twice the risk of developing Alzheimer's as nonsmokers.
- Increase physical activity. Regular physical exercise can lower the risk of developing Alzheimer's by up to 50%. A Japanese study found that among 265 people with both normal mental function and mild cognitive impairment due to Alzheimer's, after one year of moderate exercise intervention, 70% of participants showed significant improvement in memory function. The more the participants exercised, the greater the improvement.
- Have a diet rich in fruits and vegetables. These foods provide folic acid and other B vitamins to help the body reduce homocysteine, a toxic amino acid associated with high rates of Alzheimer's.
- Maintain social engagement; emotional health is a critical part of mental health.
- Participate in intellectually stimulating activities. Challenging intellectual activity builds up rich neural connections that function as insurance against later brain-tissue losses, just as well-developed muscles maintain their integrity longer during periods of inactivity than atrophied muscles.
- Seek new experiences that require you to think in different ways.

Just as there are steps to take to avoid outliving our money, there are steps you can take to avoid outliving your brain. And just like investing, the earlier you put those steps into practice, the greater your probability of success.

LEGACY
INVESTMENT STRATEGIES

What to Do If You Inherit an IRA

Traditional IRAs were established in the U.S. by the Employee Retirement Income Security Act of 1974 (ERISA) and became effective in 1975 with an initial annual contribution limit of $1,500 or 15% of wages/salaries/tips. Today, an estimated $5 trillion dollars are held in IRAs and these accounts are showing up more frequently as inheritances.

The ownership of an inherited IRA depends upon the beneficiary designation established by the original account holder. This designation trumps any distribution of assets in the will.

If you inherit an IRA, you have a number of options:

A spouse beneficiary of an IRA can:

1) Roll over the IRA to a new IRA that is in his or her own name. This allows beneficiaries and the required minimum distribution schedule to be reset and is typically the most flexible approach.
2) Transfer the IRA to an inherited IRA, held in the name of the original account holder and follow the distribution requirements outlined below.
3) Cash out the IRA through either a lump sum distribution or allocated over five years, paying income taxes as distributions are made.

Non-spouse beneficiaries have two choices:

1) Cash out the IRA through a lump sum distribution or over a period of five years.
2) Transfer to an "inherited" IRA held in the name of the original account holder for the heir's benefit.

With a lump sum distribution, income taxes are paid all at once, however, there is no 10% early withdrawal penalty. The lump sum distribution counts as income on the individual's tax return and may bump the heir into a higher tax bracket. A better alternative may be to make distributions over a five-year period to minimize the impact on the individual's tax bracket.

Transferring to an inherited IRA allows the beneficiary to receive distributions over a longer period of time, stretching out the taxation of distributions. The stretch period will depend on the age of the original IRA holder. If the account holder was under age 70½, the minimum required distribution is calculated based on the heir's expected lifetime and must start no later than December 31 following the year of the original account holder's death.

If account holder was over age 70½ at the time of death, the heir's options include cashing out the account or annual distributions spread over the longer of the original account holder's or the heir's expected lifetime, beginning no later than December 31 following the original account holder's death. (If the original account holder did not take an RMD in the year he or she died, the heir must take the distribution by the end of that year.)

What you do not want to do is to transfer or rollover the inherited IRA to an IRA in your name. That counts as a lump sum distribution, triggering taxes on the full balance. An inherited IRA does not need to stay with the original custodian, but may be established at a custodian of your choice.

For more information on how to best manage an inherited IRA, contact our office and we will review your options and how your inheritance can best work to your advantage.