Viewpoints

3RD Quarter 2015 *Advisory Newsletter*

Market Commentary **Fredric W. Williams**

The World is Too Much With Us…

- *William Wordsworth, 1807*

Although originally scribed more than two hundred years ago, the English poet's words were fairly apropos to 2015's market gyrations, despite it being quite unlikely that was anywhere near his original intent. Mr. Wordsworth's sonnet of the same name was a commentary on the materialistic tendencies of the first industrial revolution, but in its current interpretive iteration it could be construed as a description of the impact the global capital markets have had on our domestic indices thus far this year.

Through the first three quarters of 2015, the U.S. economy saw improving GDP growth, declining unemployment numbers, and modest increases in corporate profits – but none of this was a sufficient offset to the overseas uncertainty lapping at our shores. After flat-lining for most of the year, Sino-centric fears interrupted the dog-days of summer with concerns about both the Chinese economy and its domestic stock market, bringing significant volatility to the rest of the world's bourses.

> *"Be careful what you wish for: That's the lesson many money managers learned recently. For nearly four years, stocks had been heading in one direction – up – and some money managers were all but begging for a selloff so they could scoop up great companies at bargain-basement prices. They got their chance in August, when the Standard & Poor's 500 officially entered a correction – defined as a decline of 10% or more – with some of the market's most revered companies getting thrown out for little or no reason."*
>
> - *Ben Levisohn, Barron's 10/5/15*

Given that investors' reflexive muscle memory is still in a heightened state of alert from the Great Recession less than a decade ago, this type of volatility, despite the backdrop of a fairly constant recovery from the 2009 lows, generated a great deal of "shoot first, ask questions later" reaction from investors, with fear having usurped greed as the primary short-term motivator. As we've talked about in this space before, the more emotional decision making process of retail investors has always cast them as contrarian indicators given their inclination to sell low and buy high based on their tendency to do linear extrapolations on future market direction based off of recent, and short term, market activity.

This dynamic is driven, in part, by a reflexive thought process that focuses, in isolation, on "current price" rather than a more disciplined structure that has an objective measurement of present valuation (like P/E and similar ratios) relative to an investment's future benefits – like dividend cash flow rates into retirement. Often times this is compounded by a morphing of their perceived risk tolerance based on market conditions – becoming more risk tolerant in rising markets, and more risk averse during market consolidations, which, as you can imagine, results in the sell-low/buy-high reactions mentioned above. This interplay between emotions and stock prices was far more eloquently described by one of the last century's great money managers:

> *"Bull markets are born on pessimism, grown on skepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell."*
>
> \- *Sir John Templeton*

Roger Ibbotson[1] took this to a more granular level at a conference earlier this year, where he presented his research[2] on how this can get expressed at the individual stock selection level. The "herd" (aka retail investors) will concentrate/fixate on companies and push their shares beyond reasonable valuation levels – for reasons he refers to as "popularity". This gravitational push could be from media coverage, cocktail party chatter, or tips from someone's taxi driver's cousin's brother-in-law, but it results in, as we pointed out in our last issue, a narrowing of the advancing companies within the broader market. This lack of breadth has always been a warning indicator for the overall stock market, but we're now seeing that the driving force behind this may be the "over-popularity" of some of the individual companies at a given point in time.

Whether it's blissful ignorance on the way up, or fear and loathing on the way down, it seems worthwhile to take the herd's actions with at least a grain of salt – and far less emotion.

> *"Long ago, Ben Graham taught me that 'Price is what you pay; value is what you get.' Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down"*
>
> \- *Warren Buffett*

[1] Roger Ibbotson, Ph.D. is a professor at the Yale School of Management, Chairman and Chief Investment Officer at Zebra Capital Management, and the founder of Ibbotson Associates, which was acquired by Morningstar in 2006

[2] He co-authored the study "Risk Premiums or Popularity Premiums?" with Daniel Kim, also from the Yale School of Management and the Research Director at Zebra Capital Management

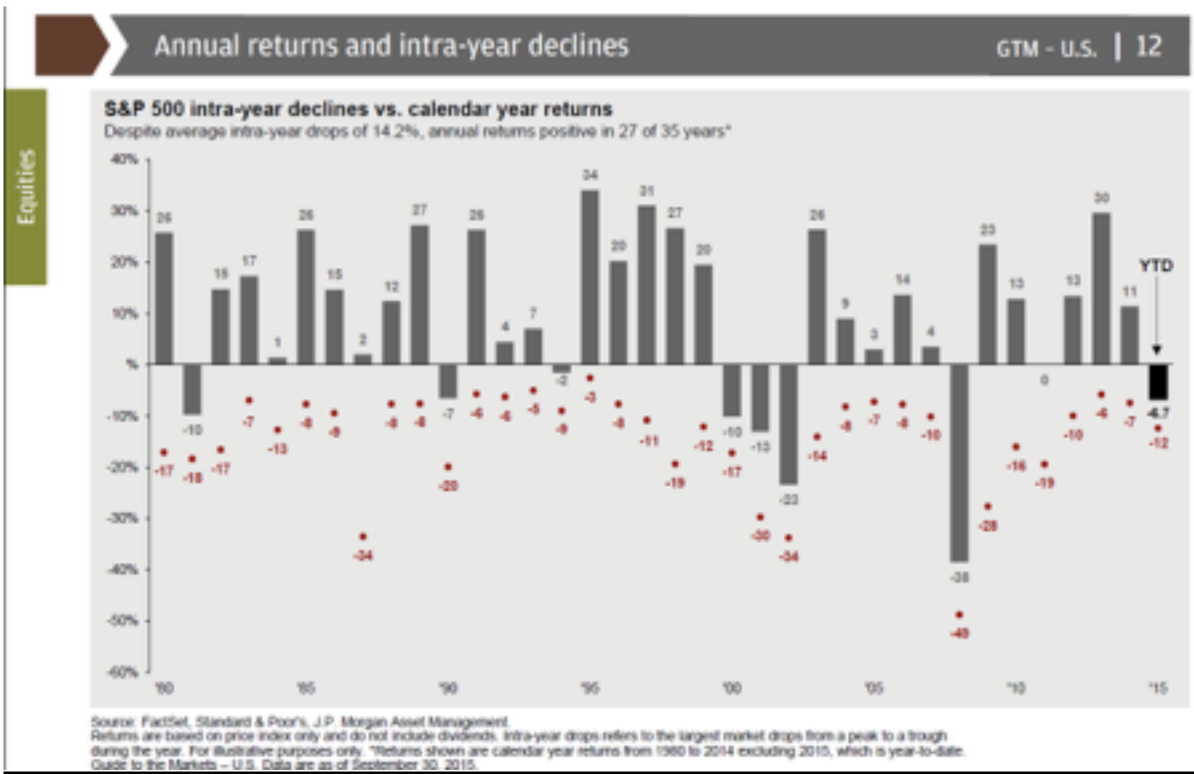
In the third quarter of 2015 the S&P 500 finally delivered on a correction. Over 3 ½ years had passed without a decline of over 10%, making it one of the longest stretches of relatively pain-free advances in history. The correction, as measured from the highs reached in the May of this year to the lows of late August amounted to a -12.4% drop. For the quarter, the S&P 500 slipped by -6.44% while developed international stocks fell over -10%. High grade bonds like US Treasuries were one of the few safe harbors, helping the Barclays Aggregate Bond Index finish with a gain of +1.23% for the quarter.

Table 2 - Index Returns			
Equities	*Percentage Change for the 3rd Quarter*	*Percentage Change for the Year*	*Annualized 10-Year Returns*
S&P 500	**-6.44%**	-5.29%	6.80%
DJ UBS Commodity Index	**-14.47%**	-15.80%	-5.67%
MSCI EAFA	**-10.23%**	-5.28%	2.97%
MSCI EM	**-17.90%**	-15.48%	4.27%
NAREIT Equity REIT Index	**2.00%**	-3.79%	6.82%
Fixed Income			
Barclays Aggregate	**1.23%**	1.13%	4.64%
Barclays U.S. Treasuries	**1.76%**	1.80%	4.35%

Among the many reasons for the pullback was the persistent downward pressure on oil prices. At quarter-end the price of Brent Crude stood at $47.60/barrel, a far cry from $113.50/barrel back in June of 2014. The energy sector responded with a –17% drop in the quarter. News over Greece faded, but was replaced with much more significant concerns over slowing economic growth in China. The prospect of the world's second largest economy cooling and subsequently lowering its appetite for commodities helped propel a reversal in emerging market stocks and the materials sector. Emerging markets, which early in the year ranked among the best performing asset classes, quickly became one of worst, down –15.2% through September. The materials sector followed suit with a -16.9% drop in the quarter. Topping that off was the Federal Reserve's decision to hold-off on hiking short-term interest rates. Investors interpreted the lack of action as a signal that the US economy was still too fragile in the Fed's eyes to risk tapping the brakes on the economy.

What comes next in the short-run is anyone's guess, but if we look back at past corrections, history may provide some clues as to what the future holds. Our friends at Standard & Poor's have put together some useful facts that may add perspective to the current environment. The research group at S&P Capital examined past market corrections, and broke them down into three parts; depth, duration, and recovery. They found both good and bad news. First, "…the median decline after going more than 12-months since the prior decline of 10%+ was 17.7%". That's the bad news. As mentioned earlier the current decline stands at –12.4%, suggesting the possibility of further downside. Second, how long does the typical correction last? According to S&P, "…there have been 19 corrections since WWII. On average, these corrections took five months to go from peak to trough." Since this correction began in May, that puts October square on the average. It's also important to note that October has historically been the most likely of all months for a recovery to begin. And lastly, the time to recover all that was lost during the correction was only four months. Whether this correction's path sticks with the averages or not, we do not pretend to know, and the data above should not be considered a prediction. But as Mark Twain once said, "History does not repeat itself, but it often rhymes."

For more perspective on market volatility please see the bar chart below detailing the year-by-year returns of S&P 500 over the last 3.5 decades. The numbers in red represent each year's largest intra-year drop and serve as a fresh reminder that market swings are a normal part of the investment process.



<u>FIDUCIARY CORNER STEPHEN L. EDDY</u>

<u>2016 Regulatory Limits for Retirement Plans</u>

Hot off the press! On October 21, 2015, the IRS announced cost-of-living adjustments affecting dollar limitations for retirement plans in 2016. Most limits for 2016 will not change because the increase in the cost-of-living index did not hit the statutory thresholds that would trigger adjustments (the adjustments, if any, would typically be in $500 increments for contribution limits and $5,000 increments for compensation limits). Below is a chart of some of the more important plan limitations.

Important Limits	**2014**	**2015**	**2016**	**Notes**
402(g) Deferral Limit (401k, 403b, & most 457 plan elective deferrals)	$17,500	$18,000	$18,000	The maximum amount a participant can contribute through salary deferral.
Catch-up Contribution	$5,500	$6,000	$6,000	The maximum amount a participant 50 and older can additionally contribute through salary deferral.
Annual Compensation Limit	$260,000	$265,000	$265,000	The maximum amount of compensation allowed for calculation purposes. Important for contribution calculations.
Highly Compensated Employee	$115,000	$120,000	$120,000	The compensation threshold at which an employee becomes defined as highly compensated. Important salary deferral and contribution allocation testing.
Limit on Annual Additions: Defined Contribution Plan	$52,000	$53,000	$53,000	The maximum annual amount allowed to be contributed for an employee from all contribution sources (employee, employer).
Social Security Wage Base	$117,000	$118,500	$118,500	The maximum earnings level allowed to be taxed under the OASDI program. Important for calculations integrated with social security.
Key Employee Officer Comp	$170,000	$170,000	$170,000	The compensation threshold at which an employee can be considered a potential "key" employee.

PLANNING CONCEPTS

Trusts as Beneficiaries of Retirement Accounts… **Tracy Rogers**

Tracy Rogers

Retirement accounts represent a life's worth of savings. Yet when a person's life ends, his or her account passes beyond personal control and discretion. Foolish management and legal disputes can quickly eat away at a gift that was meant to last many years.

However, just because a person is no longer around to enjoy a retirement account does not mean he or she cannot protect it and ensure its proper use.

Beneficiary Woes

Qualified retirement plans, like a 401(k)s and IRAs, allow owners to name alternate beneficiaries. These beneficiaries receive control of the plan if the owner dies before exhausting its funds.

Banks or other companies that manage retirement accounts (called the "custodians") must payout the account remainder, regardless of whether the owner chose a person to receive it. If no beneficiary was named, the custodian's default guidelines go into effect, typically sending the account to the surviving spouse or the owner's estate.

Since retirement account distributions are subject to income tax, immediate withdrawal of the fund's full value will create significant taxes for its beneficiaries. To avoid this massive jump in income and continue the tax-free growth of the account's money, inheritors generally want to either keep the account in place or roll it into a new one with a different custodian. Managed, long-term distribution is almost always preferable to withdrawing a lump sum.

One of the biggest problems with inherited IRAs is the penalty for late withdrawal. Distributions are required every year. Failure to take out one of these required minimum distributions (RMDs) in time results in huge penalty fees and, in some cases, a complete restructuring of the payment schedule. Mistakes in handling inherited accounts are easy to make and usually irreversible.

What makes a Trust "Qualified"?

1. The trust must be valid according to state law.
2. It must either be irrevocable or become irrevocable upon the owner's death.
3. The trust beneficiaries must be easily identifiable.
4. A copy of the trust document has been provided to the custodian of the retirement account.

Trusts as Beneficiaries

A trust is a legal entity created to own or manage property in place of its "grantor" (creator). If a grantor relinquishes control, the trust begins to operate as independent party. These "irrevocable trusts" are treated as individuals for tax and legal purposes. Retirement accounts and wills can name qualifying irrevocable trusts as their beneficiaries because they are considered legal individuals.

Like a will or retirement account, trusts distribute property to predetermined beneficiaries. Instead of giving property to another person directly, a grantor can give it to a trust and have it do the distribution on his or her behalf. This means a grantor can use a qualifying irrevocable trust to act like a conduit between a retirement account and intended beneficiaries. Here is how it works:

- The owner of the retirement account creates a trust and names it the beneficiary of the account. He or she establishes how the trust will receive money from the account and names the beneficiaries (primary and secondary) to whom the trust must pass account distributions.
- Because distributions are affected by the age of the beneficiary, the owner must file paperwork with the account custodian so it can apply the trust's beneficiary information to the account. This is referred to as making a trust "transparent" and it allows a retirement account to make distributions to a trust as if it were a person.
- Upon the death of the owner, the trust will either remove the lump sum of the account or begin taking annual distributions (RMDs are determined by the trust beneficiary's age).
- After receiving distributions, the trust will either immediately pass them on to its beneficiaries or hold onto the money depending on whatever guidelines the trust creator had predetermined. Distributions are taxed as regular income regardless of who receives them.

Advantages

The question now is: Why bother? If the taxation, payments and required timelines are all based on the final beneficiaries, what is the use of sending it through a trust? Does the trust even change anything?

Creating a trust is a measure of control and security. Rules imposed by a trust allow an account's original owner to protect his or her money from going to unwanted parties or being put to improper use. If one of the beneficiaries is a minor, a trust might restrict his or her access to distributions until a certain age to prevent unwise spending. Since it is a legal individual, a trust can also keep account money outside of a beneficiary's ownership, protecting it from creditors or divorce lawyers.

Additionally, trusts can switch from a primary to secondary beneficiaries after distribution has begun. Even if the primary beneficiary dies shortly after receiving distributions, the grantor still has predetermined who receives remainder of the account's value. If the account had been given directly to the primary beneficiary, he or she would have selected the next beneficiary, possibly a person the original owner would not have wanted benefiting from the account.

Aside from this added control, trusts also shoulder the responsibility of taking out minimum distributions and ensuring the money is handled in the most efficient way possible. If a professional manages the trust, he or she will have experience in handling scheduled distributions and is obligated to act in the best interest of the beneficiaries. This can greatly reduce stress for beneficiaries and eliminate the chance of losing money to withdrawal penalties or complications.

Complex Vehicles

The regulations placed upon beneficiaries of retirement accounts can get complex. Spouses, non-spouses, estates, trusts and charities all have different regulations and planning that require cooperation between account custodians, trustees and legal representatives. For these reasons, things are more complex for the person inheriting an account than they are for the person naming the beneficiary.

Trusts shift the complexity of retirement accounts onto trained professionals. Creating and naming a trust beneficiary of a retirement plan can greatly reduce stress for loved ones and prevent funds from being lost to mismanagement.

Always contact legal and estate planning professionals when working with trusts or protecting the future of your accounts. The design and legal consequences of beneficiary trusts are extremely complex. Always work with legal representatives who are experienced in trust creation and estate planning.

Consider Parting with Paper… **Missy Lyon**

The misuse of non-public information has been around for decades. It's not a new problem. What is new is how quickly we can find out it's happening – and stop it, before our accounts are drained and our personal information is compromised.

People often view their computer as the "enemy" - and blame the machine, or sometimes technology in general, for most instances of identity theft.

If you can start seeing your computer as an ally in the fight, rather than the cause of the problem, you can swiftly minimize how much personal information is floating around where it could potentially be misused.

First, take easy steps to eliminate paper brokerage and bank statements. Arrange to have all of your asset-related statements delivered to you electronically. The statements themselves are not being sent via an e-mail, you receive an e-mail "alert" from the company each month letting you know when the current statements are available for viewing. At that point, you log on to the firm's website with a unique user ID and password you created for that particular site. Most companies prompt you to change those every 45 to 60 days. Having statements containing assets sitting in an unattended mailbox or a shredding bin is what a thief hopes for. Some banks' statements print the first 3 digits of your social security number, others print the last four. Some IRA and 401-K statements list primary and contingent beneficiaries' full names, so it isn't hard to deduce a mother's maiden name. Most of us don't utilize a monthly check list and don't know exactly which days our paper statements should arrive in the mail. Trying to collect and manage paper statements on a monthly basis is time consuming and shifting to electronic delivery plugs one way personal data can escape.

Along those same lines, eliminate any paper statements for credit cards and other debts. Again, these can be set up for an online notice to come to your e-mail inbox and then you can be in control of when you review and/or print your credit card, mortgage or car loan statements. Paper statements in a mail box, can inadvertently provide unauthorized access to your spending history – but worse, each of your paper statements has a section where an address and phone number change can be entered. Once the address for your MasterCard has been changed, then identity thieves can go to work charging as though they are you – and not paying the bill. This is especially true if you pay your full balance monthly because you wouldn't be expecting to receive a paper statement in the mail.

If your bank offers electronic bill-pay, take advantage of it. Your paper checks have important information on the bottom of each – including your bank's routing and transfer number, your account number and most importantly your signature. Mailing your bills through the U.S. Mail opens you up to additional risk. Think of how many people view your paper check at each vendor's facility – starting with the mail room and ending with the final credit to your account. Using your bank's electronic bill-pay system not only keeps that information in your hands, it eliminates late payments and associated fees, the cost of stamps and the worry about how many people are handling your check. Bill-pay is different from going onto the company's website and setting up an electronic funds transfer (EFT). Bill-pay is you and your bank *Pushing* money to the recipient. You control all your payments from one website and one set of log-in credentials. When you set the transactions up on the merchant side, you are giving them permission to *Pull* money from your account. The end result is the same, but it's easier and more efficient to keep track of your transactions when they queue up on one website, rather than having money pulled at various times from different websites.

Next is a short-list of practices that should be second nature to all of us…..Never click on links in e-mails from people you don't know. Don't give out personal information as the result of an inbound phone call, even if your caller ID feature confirms the origination as a valid caller. If you receive an e-mail from a company you do financial business with asking for personal information, politely hang up and call the business back – don't use e-mail for account numbers and never e-mail your Social Security number. Choose user ID's and passwords that contain a mix of characters and would be hard to guess…and change them frequently. Don't log onto websites where your personal information will be requested from a location that isn't secure or via wi-fi that isn't protected, like a library or coffee shop. And as tempting as it is, don't allow websites to store your user ID's and passwords for convenience sake. Shred anything paper that has your name on it before discarding, including unsolicited credit card offers, receipts and labels from prescription medications, pre-filled catalog covers and order blanks, and anything with a full or partial social security number or birthdate.

Partner with your computer to keep your personal information safe. Update your firewall and antivirus software periodically and keep your operating system current. Identity thieves look for the low-hanging fruit such as paper checks, signed credit card receipts left on restaurant tables, logging into bank and brokerage accounts via unsecure internet connections, and so on.

Everyone is entitled to a free credit report from each of the three reporting agencies on an annual basis. Request yours from Experian, TransUnion and Equifax, and immediately report anything you believe to be incorrect to the credit service.

INSIDE THE MARKETS **FRANCIS J. DAVIES, III**

Less than zero…

The global financial implosion that devastated financial market in 2008 and 2009 had a profound effect on economic conditions. This influence remains strong today, six years into the official 'recovery'. Confidence in the banking sector will likely never recover. The impact is especially clear in our business of investing, particularly in defining risk.

The years leading up to the events of 2008 saw an expansion in wealth primarily fueled by steady increase in the value of real estate. Those prices were not driven by demand; rather it was the easy access to financing at low interest rates with little attention to risk. That was because the mortgage originators were not lending their own funds. They merely wrote up the loans, bundled them into AAA fixed income products, sold them to pensions, insurance companies, banks and collected massive fees.

Developers overbuilt in many regions, creating a glut that took years for the market to absorb. High risk property loans were hidden on the balance sheet of virtually every large financial institution in the world. What could possibly go wrong? Cracks began to show well before the actual crash. Housing starts started to drop in October 2006 and real estate prices declined through 2006 and 2007. With much of their assets tied up in rapidly declining mortgage debt, bank liquidity vanished.

As mortgage defaults became endemic, the market for mortgage backed securities and collateralized debt obligations imploded. Treasury Secretary Hank Paulson created a fund to purchase the most toxic debt in November 2007. As the collapse snowballed, Bear Stearns went down in March 2008, Lehman Brothers followed in September. The day after Lehman, AIG, a huge insurer, was taken over by the government.

The Dow Jones started 2007 around 12,500, in November 2008 it went below 7,600, a decline of 40%. In an unprecedented move, the Federal Reserve dropped the Fed Funds rate to zero in a desperate attempt to restore stability to an international banking system near collapse. The market eventually bottomed in March 2009 below 6,600. The crisis led to recession conditions in the U.S. that lasted from December 2007 until June 2009.

While it has been six years since the ‘recovery’ ostensibly began, the extreme interest rate tactics of 2008 remain in place. This is partly due to the anemic pace of the recovery. Domestically, it was also the result of a Congress unwilling to govern. With no hope of simulative fiscal policy, or any meaningful legislation, coming out of Congress, the job of caring for the economic recovery is fully in the hands of the Federal Reserve. To quote the former Chairman of the Federal Reserve:

> *“The Fed has been using easy money because the economy has needed a lot of support. A better policy would be a better mix of monetary, fiscal, and other policies. The fact that the Fed is the only game in town means the Fed has to do too much.”*
>
> *- Ben Bernanke*

The global dependence on central bank policy has reduced the significance of the normal elements of the economic cycle. Natural movement through periods of economic expansion and contraction are constrained in this hot house world of zero rates. Without the usual backdrop of growth and recession, investing has also become somewhat stilted. Investors seek to buy low and sell high, a calculation based on price vs. return. The difference between the expected return on a security or portfolio and the riskless rate of return (the yield of a riskless security – often short term U.S. treasuries) is the risk premium. For six years, the riskless rate of return has been zero.
Markets now fixate on the possibility of deflation in global trade prices. The fear of a wave of deflation underlies the ferocity of the reaction to the Chinese currency devaluation in August. When demand is strong, cheap goods are welcomed. When conditions are less robust, declining prices can cause businesses and consumers to postpone spending in anticipation of lower prices. This leads to further weakening and lower prices in a vicious cycle.

Asset prices are now driven largely by expectations of inflation (or growth) vs. deflation (economic slowing.) As a result, all asset prices tend to move together. Investors are willing to take on more risk when there is a possibility of future economic growth and this appetite retreats when there are signs of slowing. This behavior has been labeled a “Risk On, Risk Off” investment environment.

Under normal conditions, expectations for inflation would increase the value of hard assets like oil, natural gas, gold and real estate and decrease the value of financial assets like stocks and bonds. Commodities have an intrinsic value that is viewed as a hedge or protection from inflation, so their prices generally move the opposite direction to stocks and bonds. The preeminence of a single factor – deflation – has reduced the distinction between assets. This makes it more difficult to create diversification within a portfolio. While the investing environment now looks more constructive, markets will be more dependable when they are based on economic fundamentals.

OPA's Client Workshop & Appreciation Reception – Look for our save the date early next year as we're aiming for an event in the Portland area once the warmer weather has returned with our snowbirds.

Lastly, please feel free to regularly to visit our evolving website (www.oldportadvisors.com) as we continue our rebranding efforts and build out more of our online capabilities.

Old Port Advisors was founded more than 20 years ago as Investment Management & Consulting Group (IMCG), with a vision to create a boutique independent investment management firm centered on the best interests of our clients. Our principles were simple and still ground us today: a values-driven, personalized, collaborative, and strategic approach to investing, wealth management, and fiduciary consulting. We changed our name to embark on the next 20 years, but our leadership and our calling remain. We're excited to build on our past experience and success to deliver on our promise of building a secure future for our clients.