FALL 2015

ABBOT DOWNING

PERSPECTIVES

FINDING OPPORTUNITIES IN A LOW RETURN ENVIRONMENT

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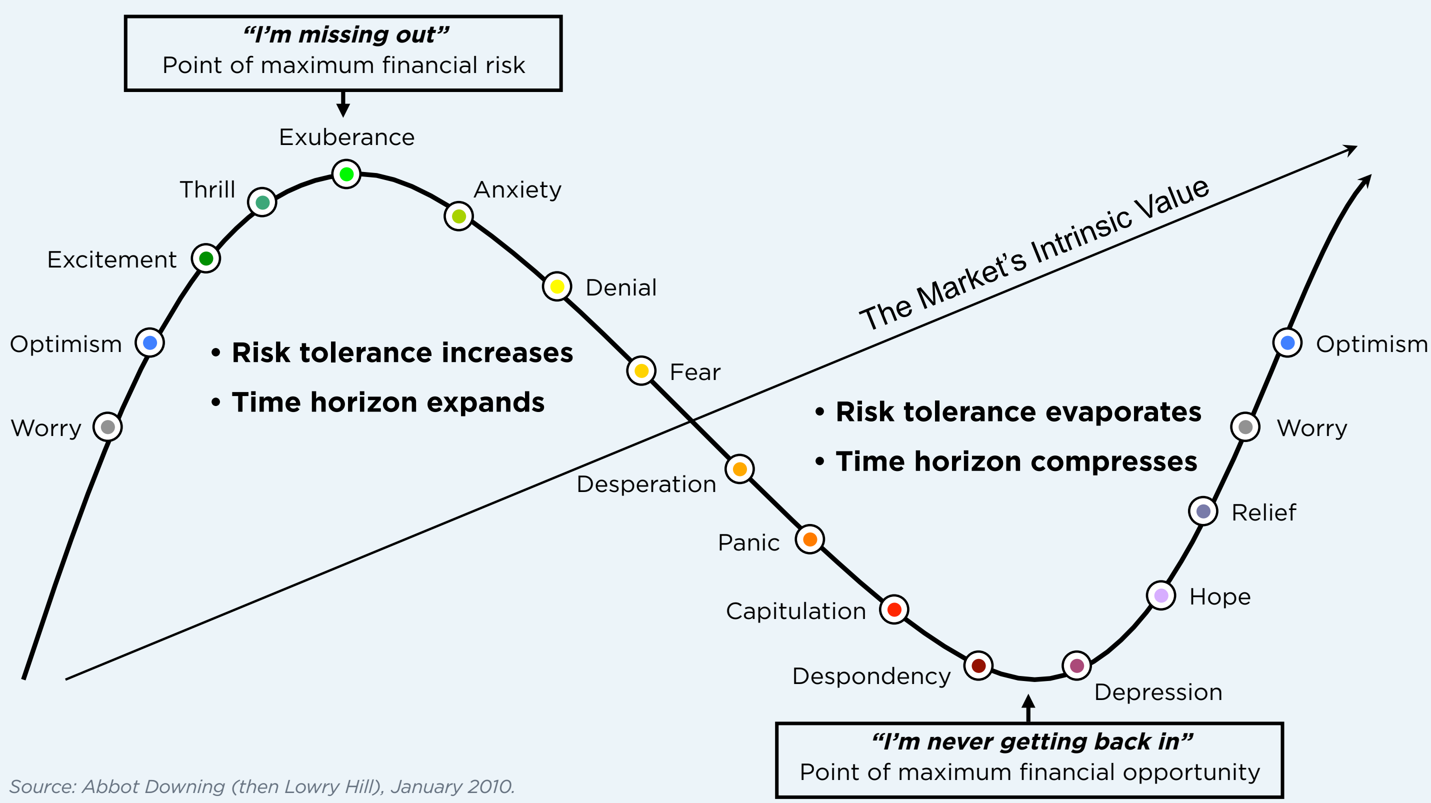
Finding Opportunities in a Low Return Environment

Market declines can be a harrowing experience for investors. That's understandable as the future subsequently seems less certain and secure as a drop in wealth is accompanied by a decline in buying power. This hits close to home with medical bills, tuition, and other expenditures becoming more expensive seemingly overnight. Investors, after all, are humans that have vulnerabilities, needs, and desires, which makes it hard to see past the immediate losses and quell the anxiety. Staying patient and disciplined with your investments is painstakingly difficult when one's livelihood is thought to be imperiled. These stressed market periods will test one's mettle, but, importantly, they tend to be fleeting and almost assuredly the long-term outcome will be positive.

Markets rarely move in straight line fashion and current indicators point to a future of lower returns as compared to recent years. In other words, we could be in store for an emotionally taxing stretch. Like others, we see certain equity markets near all-time highs, interest rates at head-scratching lows, and some asset classes about to encounter the laws of financial gravity. A low return environment is not guaranteed in the near term, as markets have an indecisive quality. However, we can say quite confidently that, over long stretches, they follow a rhythmic ebb and flow, so it's important to adjust expectations accordingly.

As we enter a phase where outsized performance looks increasingly elusive, there are positive steps you can take in preparation. It makes sense to take a closer look at what's ahead, understand potential effects on stocks and bonds, and find opportunities wherever they may exist (and to whatever degree).

The Cycle of Investor Emotions



Source: Abbot Downing (then Lowry Hill), January 2010.

It is also important to address how low returns can affect the larger entity – your family and/or foundation – and discuss the long-term outlook as well as immediate concerns with appropriate individuals. Taking these steps will help you build on your strategic plan and create a stronger family vision.

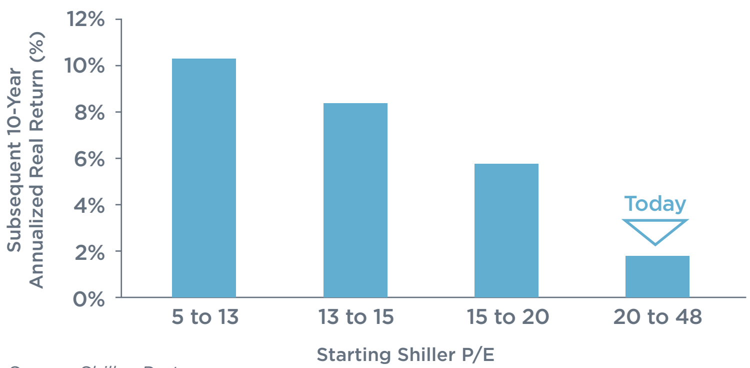
The Impact on Equity Investments

While the long-term trajectory for stocks is fairly predictable, the short-term can be subject to some theatrics. That shouldn't be news to you, but market swings are usually met with irrational dread nonetheless. The irrationality of the short-term is a function of investors trying to process an unrelenting barrage of information, coupled with human fallibility and counter-productive instincts.

At Abbot Downing, we use valuations as a key factor in determining where a stock may be headed. We know that the further markets move away from fair value, the nearer the course correction gets and the sooner we approach the moment when valuations invariably start to impose their will.

Today, after several years of strong equity market performance, market valuations have become very rich. For instance, the Price/Earnings (P/E) multiple for the S&P 500, a bellwether valuation metric, is above its historic averages. For further evidence, look to the chart below. The higher the P/E ratio, the lower the 10-year annualized return for the S&P 500, going all the way back to 1925.

S&P 500 Index (1925 – 2014)



Source: Shiller, Pertrac

The Shiller P/E multiple (also referred to as the cyclically adjusted price-to-earnings ratio) uses ten years of inflation adjusted average earnings in its denominator. It has good long-term predictive power, but can be of lesser utility as a guide for nearer-term market movements.

Not all is lost, as there are alternatives and tactics to employ if equities shift onto a lower return path. For starters, not all stocks are created equal. There is a great deal of variation on a country and regional basis. Foreign countries have different monetary policies, demographic profiles, and growth prospects, which opens the door for opportunity.

Another option, covered call writing, could augment your equity allocation. This strategy essentially sells away upside participation above a certain threshold for a given security in exchange for current cash flow. The strategy increases portfolio yield and smooths returns with the added income mitigating some of the financial

Keeping the Family Focused on the Big Picture

In preparing for, and enduring, periods of low returns, it is important to help family members keep the situation in perspective by reinforcing strategic messages. Our Planning, Family Dynamics and Education team suggests discussing the following concepts:

- **Financial fluency:** Help family members understand how budgeting and cash flow might need to change when returns are modest and how this affects lifestyle needs and family goals.
- **Lifespan risk perspective:** Revisit definitions of and appetites toward risk and consider individual concerns, questions and anxieties when markets are unstable. Also, think about risk appetite with regard to experiences, relationships, change, future planning, etc.
- **Planning outlook:** Take the long view on investments — financial investments, family investments, philanthropic investments. Don't let specific market events derail your comprehensive plans.
- **Diversification:** Use diversification as a hedge against financial head winds, of course, but also encourage diversification of experiences (not everything needs to have a dollar sign attached) to serve the family during all types of cycles.
- **A strategic course:** Develop strategic plans to accommodate obstacles, challenges, opportunities and risks in support of a defined vision, as opposed to being easily derailed by disappointments or taking a haphazard reactive approach to life events.

Estate and Tax Planning Opportunities in a Challenging Return Environment

1. **Consider additional wealth transfer opportunities.** It is almost counterintuitive to talk about giving away more assets when your portfolio returns are modest. However, there are a couple of techniques that still work well in a lower return environment. In particular, grantor-retained annuity trust, loans, and charitable lead trusts are more attractive when interest rates are low or returns are more volatile. If you would like to explore these ideas for your situation, talk to your Abbot Downing relationship manager.

2. **Share teachable moments.** If spending adjustments are necessary due to low returns, discuss changing cash flow scenarios with family members and how a tighter budget could affect current lifestyle while maintaining the long-term family vision.

3. **Revisit sources of cash flow.** If you rely on your portfolio to support your living expenses, review your asset allocation with your portfolio manager. The assumptions originally used when designing your portfolio may have changed. Determine how much of your liquidity needs will come from portfolio income and how much from liquidations or cash allocations.

4. **Consider converting IRAs to Roth IRAs.** This planning strategy can be used for a portion or the entire balance of the IRA. If the value of your IRA is depressed, it may be a good time to pay tax on the converted funds in exchange for tax-exempt status for the rest of your lifetime. In addition, you have the benefit of waiting until your tax return is filed to determine if you want to "undo" the conversion. This may be appropriate if the value decreases after the conversion.

5. **Take a non-conventional approach to reduce the impact on the Alternative Minimum Tax (AMT).** Deferring income and accelerating deductions are intuitive but many actions with AMT are counter-intuitive. For example, accelerating certain deductions when you are in an AMT situation may be counter-productive. Additionally, if you know you will pay AMT, it may benefit you to accelerate certain items of ordinary income or short-term capital gains which may mean you pay a lower overall tax.

loss and corresponding anguish when stocks fall. A covered call program has various sensitivities, but it is still a sensible alternative in a low return environment.

What About Fixed Income?

With bonds, future performance is fairly predictable at the time of acquisition, at least more so than for stocks. So we'll be blunt — we expect lower returns from bonds. Yields are currently at perhaps previously unimaginable lows. If rates do rise, there will be pedestrian returns at best, and negative returns may be in the cards during some stretches. Even if rates stay put, the market yield you earn is quite low. The only way bonds can be strong performers is if yields fall further still, which is mathematically limited.

Yet, we wouldn't suggest hitting the cancel button with fixed income. The predictability can, perhaps curiously, be a valuable asset in a low return environment. Bonds have positive cash flow and tend not to exhibit much volatility. The predictability element inherent in bonds can be the invaluable ballast in a portfolio during those gut check times when markets aren't cooperating. In addition, bonds tend to be low cost and are typically liquid. These features can be liberating by allowing you to use your illiquidity and fee budget in less trafficked, less efficient investment areas to bolster overall results.

Fixed income may lack some sizzle in a paltry rate environment, but its total package can put a governor on emotions and at the same time make a portfolio's sum greater than its parts.

Pockets of Opportunity

Despite a cloudier forecast, there are other pockets of opportunity that can help you make the most of a low return environment. Attention to details related to taxes and fees is crucial during periods of lower returns.

Take steps to minimize taxes

A low return environment might present asset location and tax loss harvesting opportunities. Asset location tactics place tax-unfriendly investments (for example, high yield debt) into tax-friendly entities (for example, an IRA), and vice versa, to help enhance after-tax results.

Tax loss harvesting involves selling a security with an unrealized loss and simultaneously purchasing a proxy security, that's not substantially similar, then holding it over the ensuing 30 days. The trade is then reversed after the wash sale waiting period expires. If well executed, pre-tax returns remain largely unaltered and after-tax performance is improved.

All told, while the quantity of pre-tax returns may be on the low side, there may be more opportunities to improve the quality of results on an after-tax basis.

Examine fees

While fees tend to be inelastic, it's human nature to feel that a 1% fee stings a little bit more when your gross return is 4% as compared to 8% or 10% or even higher. When every little bit counts, an examination of fees could yield some areas for improvement.

For starters, consider active managers vs. cheaper, comparable passive solutions. Some active managers are worth it. Many earn their premium compensation by delivering strong performance without inordinate amounts of risk. These skilled managers will be of increasing value in a low return environment and shouldn't be ideologically dismissed. However, other active managers may be little more than passive solutions in disguise, with a heftier price tag.[1] Do the homework: investigate active managers and pay the higher fees only when you're getting something extra in return. After all, sometimes you get what you pay for.

Manage your expectations, manage your wealth

Nobody knows precisely when we will enter into a low return environment, how severe it may be, or how long it will last. However, with prudent expectations and some forethought, your portfolio and your family will have a foundation to ride out the rougher periods and achieve long-term success.

For more information on what to expect in a low return environment and how to find opportunities where they exist, read our recently published Navigating in a Low Return Environment white paper. Contact your Abbot Downing relationship manager to continue the discussion about proactive steps to take with your portfolio.

To learn more about additional Abbot Downing perspectives, please contact your relationship manager or visit our website.

www.abbotdowning.com.

[1] Antti Petajisto, *Active Share and Mutual Fund Performance*, Financial Analysts Journal, Volume 69, Number 4 (2013).