FINANCIAL CONNECTIONS
GROUP INCORPORATED

1st Quarter 2016, 4/15/2016

FIRST QUARTER 2016

It was a tale of two halves. If you watched the market from January 1 – February 11, you witnessed the worst start to a calendar year ever. Alternatively, if you slept through the first half and started watching February 12 – March 31, you witnessed a good rally. The Total Stock Market Index (Wilshire 5000) was up 1% for the quarter. International developed markets were down in dollar terms 3+%.

The market decline and subsequent rise mirrored the price of oil. As it plunged to $26 per barrel (February 11th), so did the stock market. When it began to rise, so did the stock market – they were perfectly correlated this quarter.

When the link between oil and the market break (we don't know when that will be), the market should go back to reflecting on the health of the U.S economy and the global markets.

Portfolio Design

At the beginning of this year, there were white papers published that discussed the correlation between asset classes such as bonds, U.S. stocks and international stocks. One of the revelations was the stronger tie between stock and bond price movements (see related article on bonds). Add to the mix the anticipated interest rate rise (though the Fed came out the first week of April saying no additional rise – yet).

Brian and Jill felt with the changing interest rate and correlation landscape, the structural design of portfolios needed modification. We looked for alternative strategies with low correlations to stocks and bonds.

Add to this dynamic the unexpected strong market decline early in the year. In many cases, we sold mutual funds to harvest tax losses (not synonymous with investment loss). These losses will offset future taxable gains. Knowing we were revising portfolios, we left some money in cash temporarily until we researched additional funds for selection. It was not cost effective to buy funds knowing we were about to make changes. Why incur transaction fees unnecessarily?

If you would like to discuss the changes (being implemented now), please don't hesitate to contact us.

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Included with your first quarter reports is our annual ADV (disclosure statement) and Client Advocate Form (see related article).

If you would like to set up a meeting to discuss your financial plan or investments, or if your situation has changed, please contact us.

MARKET DOWNTURNS—ARE WE OUR OWN WORST ENEMY?

There's no question that we experience emotional pain and anxiety when our portfolios are losing money due to market downturns. Behavioral scientists tell us that we feel losses twice as keenly as positive returns.

But that doesn't tell us what we really want to know, which is: Other than selling at the wrong time and locking in losses, how do we make these downturns less painful?

Economist Richard Thaler conducted a stock market experiment that offers us all some insight. He asked people to select one of two investment options, one heavier weighted in stocks with higher returns and higher volatility, the other with fewer stocks, lower returns and less bouncing around. Half of the people were shown how that investment would have panned out eight times in the next year, while the other half were only shown the result once a year. In other words, some were looking at the stock market roller coaster eight times as often as the others.

You can probably guess the outcome: those who saw their results eight times a year put only 41% of their money into stocks. Those who saw the results just once a year invested 70% in stocks. The more often you look at your portfolio, in good times and bad, the more pain and anxiety you are likely to experience, and the more cautious you tend to be. (See related article "Stocks in Retirement.")

In a recent blog post, a market analyst looked at all the bear markets and bull markets going back to 1928, and found something interesting. The bull market rallies, on average, delivered 57% returns, while bear markets, on average, took away 24% of the market's value. The bull runs lasted, on average, 474 days, while bear market drops were more intense, compressed into an average of just 232 days before the next upturn.

In other words, the significant declines were only about half as large as the market gains, but they were much faster, lasting about half as long as the slow, incremental rises that are habitual to bull runs.

Combine these statistics, and you come to a few simple conclusions: bull markets don't attract a lot of attention and move more gradually than the eye-catching downturns. Bull markets, over time, generate twice the upside as bear markets do downside. And the best way to avoid the mental anguish of these occasional sharp downturns is to spend less time looking at your overall returns. You miss the two steps forward, and most important, you also miss the more traumatic one step backward.

Source: Bob Veres and http://awealthofcommonsense.com/2016/02/why-bear-markets-are-so-painful

FINANCIAL CONNECTIONS GROUP, INC.

Jill D. Hollander, CFP®, CRPC ℠, ADPA™, Financial Advisor
Brian Pon, EA, CFP®, Financial Advisor

Financial Connections Group, Inc.
21 Tamal Vista Blvd., Suite 105
Corte Madera, CA 94925
415.924.1091

Berkeley Office:
2608 Ninth Street, Suite 302
Berkeley, CA 94710
510.849.4667

EMAIL: client@FinancialConnections.com
WEBSITE: http://www.FinancialConnections.com

STOCKS IN RETIREMENT

David Levine of *The New York Times* recently wrote two articles, "Why Your Portfolio Needs Plenty of Stocks, Whatever Your Age" (2/6/16) and "How Much of Your Nest Egg to Put Into Stocks? All of It" (2/13/16). A client called wanting to discuss the articles with Jill. We decided it would be a good discussion for all of us.

Typical recommendations industrywide suggest that when people retire, they reduce their exposure to stocks in favor of bonds. The problem, Levine asserts, is we don't really know our time horizon. His metaphor is: "Just as a sailor sees but never reaches the horizon, the same is true for nearly all investors."

If you look at the "averages" in longevity, a 65 year-old woman would assume approximately 20 years. The problem is what if you're wrong? What if you live to 95 or 100? (Jill can hear the groans already.) The reality is if you do live to 100 because you have access to good medical treatment, are educated, etc.—all reasons people live beyond the average, then it isn't unrealistic to assume your investment horizon is actually 30-35 years, not 20.

The mistake a person could make is withdrawing money assuming life ends at 85 and then living longer and running out.

While we do agree with Levine in theory, there are a couple of practical issues that deserve attention.

First is the psychological toll that down markets presents (see related article Market Downturns…). It is hard to live through it and know that eventually they end. A "poor" market always recovered—eventually.

Second, when there is a market decline, withdrawals may continue because a client needs the money to live on. Hence the money is not available to grow when the market goes back up. Some people handle this by withdrawing less when the market declines and more when the market rises. But the premise still assumes the percentage of withdrawal is reasonable and scenarios show the rate will permit money to be available at the end of life.

Below are the links to the articles.

http://www.nytimes.com/2016/02/06/your-money/why-your-portfolio-needs-plenty-of-stocks-whatever-your-age.html?_r=0

http://www.nytimes.com/2016/02/13/your-money/how-much-of-your-nest-egg-to-put-into-stocks-all-of-it.html

CLIENT ADVOCATE LETTER

There has been much discussion about how to handle our clients as they age. Recently, the Securities and Exchange Commission has issued a "Best Practice" Notice recommending that firms require clients to advise us who we should contact if we notice behavior that is not usual based on previous interactions.

As a result, we drafted a Client Advocate Form. It does not replace your Power of Attorney. Rather, it allows us to notify someone you designate to be notified if we perceive your behavior is different than usual.

Included in this package is our form. We would appreciate it if you would complete it and return it to our Corte Madera address. As always, please call us with any questions. We appreciate your participation.

BONDS AND THEIR RELATIONSHIP TO EQUITIES

Before we discuss their relationship, we want to define our terms.

Bonds

They are debt instruments. A lender loans money for the promise to be repaid at a later date in with interest. A mortgage is a debt instrument. The bank loans a homeowner money to buy a house in return for the value of the loan repaid plus interest. As investors, we buy mutual funds that hold a basket of bonds. We expect to be repaid our initial investment plus interest.

Equities/Stocks

A stock or equity represents ownership in a company through the purchase of shares. We buy equities through mutual funds that hold multiple companies' stocks. Equity mutual funds will ebb and flow with market fluctuations. Equities may gain or lose money.

Correlation

This is a measure of the relationship between different investments. If two investments are perfectly correlated, they have a mathematical relationship of 1.0. They move in sync. If they are totally uncorrelated, they lack a relationship, which is represented as 0. A negative correlation is when one investment rises while the other investment falls.

Portfolio Diversification

One of the goals in diversification is to own investments that have a variety of correlations, including negative correlations.

Recent Correlation Changes

Some people ask why own bonds when an investment doesn't have the potential to grow as much as equities do. One of the reasons is to reduce volatility. Historically, when stocks declined, bonds either retained their value or declined less, thus offering a cushion to a portfolio.

Unfortunately, since 2007, stocks and bonds have become more correlated—meaning they both are rising and falling at the same time though not necessarily to the same degree—which challenges the maxim that stocks and bonds move in opposite directions (uncorrelated).

Previously, we looked for mutual funds with minimal or negative correlations to stock. With the narrowing of correlations between stocks and bonds, we are researching mutual funds that strive to have minimal to negative correlations over time to both stocks and bonds. No approach works 100% of the time but we are adding funds to provide further diversification to portfolios.

If you would like to discuss your portfolio, please don't hesitate to contact us.

Jill D. Hollander

Brian Pon

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