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PINNACLE QUARTERLY

The Market

Impressive Resiliency or Too Much Complacency?

The Investment Team

How To Set Investment Goals
Andrew Krone

Reverse Mortgage: A Possible Back-Up Plan
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How To Set Investment Goals

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A sound investment plan begins by determining your objectives while understanding any limitations or constraints that may exist. While most objectives are long-term, a plan must be designed to persevere through changing market environments and be able to adjust for unseen events along the way. If you have multiple goals then each of these goals needs to be taken into consideration. Once developed, a plan needs to be reviewed at regular intervals.

Consideration should be given to your time-horizon for each goal within the plan. For example, if college education expenses will be incurred in 10 years, while retirement is 25 years off, then the plan needs to consider these different time-horizons and plan accordingly.

Understanding your time-horizon will impact which investment strategy you select for your portfolio. The shorter the time period to achieve a particular goal, the less risk you would want to take, because a significant market drop may impact the amount of money available to withdraw or the opportunity to benefit from a market rebound later. It is also important to give some thought to your tolerance for market volatility and loss, as well as your ability and willingness to contribute money into the plan each year. Higher returns often come with greater risk, so the trade-off is one that needs to be understood and chosen carefully.

Create a Plan

Without a plan, many investors take an ad-hoc approach to building a portfolio, focusing on acquiring popular investments rather than considering how the entire portfolio is constructed to meet their objectives. Many investors' actions are influenced by the performance of the broad stock market, with a tendency to increase stock exposure when markets are moving higher and reducing stock exposure when markets are falling. This behavior may result in investors buying high and selling low and may cause them to underperform market averages by substantial amounts over long market cycles. Mutual fund flows confirm this notion, with individual investors buying equity mutual funds just prior to market peaks and selling them just prior to market bottoms.

Diversify

The value of diversification should not be ignored. It is important in building a portfolio to select a combination of assets that offer a reasonable chance to achieve your objective because asset allocation is responsible for almost 90% of a diversified portfolio's return over time. Recall that from 1926 through 2013 a 100% bond portfolio returned an average 5.5% annually, while a 100% stock portfolio returned an average 10.2% each year. A 50% bond, 50% stock portfolio returned an average of 8.3% each year. But, over shorter periods, the results can vary significantly from these long-term averages. For example, for the period 2000 through 2013, U.S. stocks returned an average 4.3% annually, while U.S. bonds returned an average 5.7% annually. Looking forward, the return for bonds may be lower than that achieved over the past 10 to 15 years because interest rates are most likely to be increasing over the next decade, resulting in lower bond prices.

A portfolio's risk is often reduced by diversifying across both asset classes (stocks and bonds) and also within each asset class. Various asset classes and sectors of the market often perform differently from one another and diversification spreads the risk and the opportunity. Owning a diversified portfolio with exposure to many different asset classes and segments allows you to participate in stronger areas of the market and reduce the impact of the weaker areas.

If you follow these steps in setting investment goals and implement a detailed plan for achieving them, you will be well on your way to achieving financial success and peace of mind! If you would like to explore how to meet your goals or how well you are diversified, a Pinnacle Wealth Manager would be pleased to help.

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Reverse Mortgage: A Possible Back-up Plan

Carol Harlow
Wealth Manager

The numbers are staggering: Baby boomers are turning 65 at a rate of about 10,000 a day. According to the PWC Employee Financial Wellness Survey, roughly half of all baby boomers have saved $100,000 or less. For this generation, retirement may last 30 years or more and and will be expensive. Basic living expenses such as groceries, fuel, and electricity will stretch budgets, leaving little money for hobbies and other leisure activities that the boomers enjoy today.

Despite being eligible for Social Security, some seniors may decide to work longer or take a part-time job in retirement to make ends meet. Others will downsize, ‘right-size’ where they can age in place, or sell a second home if they have one. For those who are homeowners, a reverse mortgage can offer an additional way to provide a source of income during retirement.

Reverse mortgages come in a variety of flavors. One of the popular reverse mortgage programs is the Home Equity Conversion Mortgage (HECM). The purpose of a HECM is to convert part of the equity of your home into cash. If you are 62 or over and have a primary residence with equity that is greater than half the value, you may be eligible for a HECM. This is the only reverse mortgage program run by the Federal Housing Administration (FHA) to help seniors.

The proceeds from the HECM can be used for any purpose. The loan is required to be paid back when there is a maturity event (such as the sale of the house) or when the owner permanently leaves the home. The home must be maintained properly and the financial obligations such as real estate taxes and insurance must be paid.

The initial costs of a reverse mortgage can be high, so if a homeowner is considering relocating in the next few years, this type of loan might not make sense. Also, if the homeowner wants to leave the house as an inheritance, a reverse mortgage is not likely a good option. There may be other options that could be less expensive depending on the situation, so some initial research is worthwhile.

However, for some people, a reverse mortgage can be a good option. Ultimately, the borrower should review the details of the loan and understand the benefits, the cash-flow created, and the parameters of what they give up. (For an estimate of the fees and the payout, go to the calculator at www.reversemortgage.org and enter the data points.) The loan amount depends on the age of the borrower(s), the appraised home value, current interest rates, and the FHA lending limit of $636,150. The older you are and more valuable your home is (with no mortgage), the more you will be eligible to receive.

There are a variety of ways to take the proceeds. A popular and often recommended strategy is to take the home equity line of credit and only borrow some of the money up front so that the remainder stays available but unused. This method allows the proceeds, or the extension of credit, to grow at the current interest rate. The amount of the line of credit increases by a predetermined amount, based on the previous month's credit line balance and the interest rate. The interest rate will be variable. This is one of the most attractive features of the HECM because the borrower only pays interest on the balance borrowed and not the unused balance.

Every situation is different and a reverse mortgage is just one tool in an advisor's tool kit for clients in retirement. The HECM is only one of several types of reverse mortgages on the market today. It is not for everyone and the program is complicated, but when it is understood properly and used responsibly, a reverse mortgage can be a solution to an otherwise limited cash flow situation.

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MARKET REVIEW

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The second quarter saw financial markets deliver further gains, which was a continuation of the animal spirits that were unleashed in the wake of the U.S. election. Both stocks and bonds rose during the quarter with the S&P 500 making its latest record high in mid-June. Outside of the U.S., international stocks have picked up steam and are outperforming for the first time in several years. Commodities were the exception, as they were dragged down by crude oil prices that tumbled again. By the end of the quarter, stocks had drifted ever so slightly off their highs, but remained firmly in positive territory on the year. Meanwhile, interest rates were beginning to creep higher again.

Where's the Hangover?

Earlier this year we wrote about how we've been anticipating a market hangover from the euphoria that started late last year. A hangover was evident in some areas of the market like bonds, gold, and other safe havens that rallied. But so far, equities have been a bastion of strength, as the S&P 500 Index hasn't had a drawdown of even 3% this year. While the broad market has remained relatively calm, it has masked a dramatic difference in performance between so-called "growth" sectors (like Technology and Health Care) that have led by a wide margin and "value" sectors (like Financials and Energy), which have trailed. It has been a stark reversal from what occurred immediately following the election, when value sectors soared into the end of the year. In other words, so far, the hangover may have taken the form of an internal rotation within the market, as opposed to a decline in the index itself.

While the market's resiliency is impressive, the potential for a hangover has not completely gone away. Contrary to expectations from just a few months ago, very little progress has been made on the political front. From a market standpoint, a big reason that stocks rallied immediately following the election was the result of investors quickly anticipating the likelihood of several business-friendly pieces of legislation being easily passed with a Republican controlled White House and Congress. However, priorities of the administration that have been discussed (health care reform, fiscal stimulus, and infrastructure spending) are all on hold at the moment.

For now, investors seem to be recalibrating their expectations, but not abandoning hope that these items will still get done. However, if it becomes more apparent that some of it may not be achievable after all, it could cause a sudden setback in the market. Indeed, there are reasons to believe that the market may be overly complacent about the possibility of major political disappointments. For instance, measures of market volatility sank to multi-year lows during the quarter, which is often a contrary signal that things are 'too quiet.' If a correction does materialize, it may be an opportunity to nudge portfolio equity weightings a little higher, as we don't believe this would halt the economy in its tracks. Growth may continue along at a more sluggish pace, but the market outlook doesn't depend solely on assistance from Washington.

Economic Rebound

On the economic front, after another weak performance in the first quarter with GDP growth of only 1.4% (revised up from only 0.7% initially), all indications are that a rebound occurred in the second quarter. In fact, a forecasting model produced by the Atlanta Federal Reserve Bank suggests growth climbed back to 2.6%. Looking ahead, the economy should continue to be supported through the remainder of the year thanks in part to a recent improvement in overall financial conditions caused by a fall in both interest rates and oil prices during the quarter. Along with ongoing steady gains in the labor market, this should help to lift consumer spending over the second half of the year.

Perhaps more importantly, while the overall trend in growth still has not meaningfully accelerated, corporate earnings have recovered significantly. The growth rate in earnings jumped to nearly 15% in the first quarter from a year earlier—the third consecutive quarter of gains after the earnings recession that occurred in 2015-16. Corporate America has displayed a remarkable ability to grow earnings (thanks largely to rapid technological innovation that has helped lower costs), even though revenue growth has been restrained by low GDP growth. If any progress is made on corporate tax reform along the lines of what has been proposed, that could give another boost to earnings and help prolong the cycle.

Shifting Sands with Central Banks

The U.S. Federal Reserve continued its campaign of gradual interest rate increases by hiking rates a quarter point for a third time in June. The bigger news came from their announcement that later this year they intend to reduce the size of their massive $4.5 trillion balance sheet. Just as large-scale asset purchases had never been attempted before, reversing them is also untested, and therefore the possibility for unintended consequences causing volatility certainly exists. So far, market participants have taken the Fed at their word that they'll continue to proceed cautiously in removing the punch bowl. But business cycles have historically ended due to the Fed becoming overly restrictive, so investors will need to be on guard despite assurances from central bankers.

Another big change during the quarter came from the European Central Bank, which began to lay the groundwork for an announcement regarding the winding down of their own monetary accommodation. If true, it would be a significant development in that another major central bank would be joining the Fed in reigning in the monetary support that markets have become accustomed to. However, for the time being, overall stimulus will continue to increase, even if the ECB decides to taper their asset purchases next year. For the next several quarters at least, both the ECB and the Bank of Japan will be providing plenty of liquidity to global markets, despite the Fed moving further down the path of tightening. All told, it does not appear that the actions of global central banks will translate into a restrictive posture for the next 12 months or so. Beyond that, it could be a different story.

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Portfolio Positioning

Overall, portfolio volatility is being kept close to neutral. While there is still plenty to be encouraged about, late in an expansion with elevated market valuation is not the time to be taking unnecessary risk. However, there are areas of relative value to take advantage of within asset classes. For instance, within the U.S. equity allocation, we continue to carry a tilt towards cyclical sectors like Financials and Homebuilders, while remaining underweight in defensive and late cycle sectors like Utilities and Materials.

In addition, we increased our allocation to international equities to a modest overweight during the quarter. There have been notable improvements in many global markets this year, such as an uptick in economic growth, a reduction in political risk, and rising earnings growth. When combined with more attractive valuation, it may finally be time for international stocks to play catch up after several years of underperformance.

Within fixed income, we are carrying an underweighted position to interest-rate sensitivity through a reduction in the highest quality bonds that are the most exposed to potential losses if rates rise. We are also positioned to be overweight to credit-sensitive areas and very short-maturity bonds, both of which should defend much better in a rising rate environment.

In commodities, we continue to carry an over weighted position to gold, relative to the broad commodity index which has significantly outperformed this year. However, with liquidity possibly peaking due to central bank tightening, it may be a candidate to be reduced in the second half.

Conclusion

The second quarter was another positive one for financial markets. Longer-term, we continue to believe that stocks are in the midst of a cyclical bull market that began in February 2016, and should be able to proceed as long as the business cycle remains intact.

Of course there are potential risks to guard against that could cause a correction at any time, including Fed tightening, lack of progress on business-friendly legislation, and overvaluation. But there still seems to be a healthy dose of skepticism which has prevented many participants from fully embracing this move in the market, suggesting that outside of short-term pullbacks, there is more room to run before this bull finally tires.

Pinnacle's Three Dynamic Strategies

PRIME SERIES

Pinnacle's Prime Series offers investors an array of actively managed portfolios that are globally diversified and designed to provide market-like returns with less risk. Our Prime Series is comprised of five distinct options that include conservative portfolios that prioritize stability and income, moderate portfolios seeking a balance of stability and growth, and growth portfolios designed for appreciation and growth.

The Prime Series portfolios are managed by our experienced investment team to pursue value anywhere in the world—in any asset class—and evaluate opportunities using both qualitative judgment and quantitative tools. Our over-arching strategy is based on long-term economic themes where we build our portfolios in line with the strengths and weaknesses in the market. Our investment team evaluates the qualitative and quantitative data and adjusts our portfolios accordingly. These portfolios have been managed by our investment team since 2002 through all market cycles and have a GIPS verified track-record. The Prime Series should appeal to clients who want an active, tactical management strategy that blends the best of qualitative judgment and quantitative tools.

MARKET SERIES

Pinnacle's Market Series provides an investor with a globally diversified portfolio that is primarily managed with strategic asset allocation and complimented with tactical management in a smaller portion of the portfolio. The strategic holdings are low cost and efficient, and the satellite portion provides a way for the portfolio to increase return potential when markets are cheap, and dampen risk when markets are expensive or volatility increases.

The series offers three portfolios to investors: Conservative, Moderate, and Appreciation. The strategic allocation comprises 70% of the portfolio and is diversified across twelve asset classes that are systematically rebalanced to retain targeted allocations. The tactical allocation comprises 30% of the portfolio and consists of U.S. stocks and fixed income securities. The tactical satellite includes the flexibility to move between stocks, bonds, or cash, and rotates between them depending on market valuations and technical conditions. By combining both strategic and tactical strategies, the Market Series offers the benefits of both passive and active management.

QUANTITATIVE SERIES

The Pinnacle Quantitative Portfolio provides investors with an actively managed portfolio that uses a 'Core and Satellite' approach to combine tactical asset management and quantitative analysis. The Core strategy invests approximately 60% of the portfolio in our Dynamic Moderate Growth model, which strikes a balanced approach between capital appreciation and income. The Satellite strategy comprises about 40% of the portfolio and uses sophisticated quantitative analysis that leverages value and momentum data as it rotates equity sectors, bonds, and cash to balance growth and risk.

Our proprietary quantitative model evaluates current market conditions based on a set of valuation and technical indicators, and rotates the allocation between ten U.S. equity sectors and bonds or cash. This portfolio will appeal to clients who are looking for a heavily rules-based approach to investing and are willing to make aggressive allocation changes depending on market conditions.

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