April 2018

PINNACLE QUARTERLY

VOLATILITY AWAKENS

The Pinnacle Investment Team

Mental Accounting
Michael Kitces

How To Protect Your Child's Credit
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Why Your CPA Should Work With Your Advisor
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April 2018

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Mental Accounting: It's All In Your Perspective*

Michael Kitces, CFP®, MSFS, MTAX, CLU®, ChFC®, RHU®, REBC®, CASL®
Director of Wealth Management

One considerable (and common) challenge for clients is to focus on the goals they *ought* to focus on from a purely financial perspective, despite the psychological and behavioral biases which may direct their attention elsewhere. For instance, many households *overemphasize* accumulating assets (when they should be paying down debt), or *overemphasize* paying down debt (when they should be accumulating assets).

* This is a summary of an article by Derek Tharp, CFP®, Ph.D., that originally ran on **Kitces.com**.

To further complicate things, household preferences for accumulating assets versus paying down debt can sometimes shift in a seemingly confusing manner. However, an interesting new line of research points to one seemingly irrelevant factor which can be lurking in the background and influencing how clients perceive their wealth: whether their total net worth is positive or negative.

In this article, **Dr. Derek Tharp**—a Kitces.com Researcher, and a recent Ph.D. graduate from the financial planning program at Kansas State University—examines research on how our net worth may influence our perceptions of and preferences for holding assets and debt, and particularly the tendency to prefer having more assets when our net worth is negative, but less debt when our net worth is positive.

Mental accounting is a key concept of behavioral finance, which refers to the ways in which we mentally categorize assets, transactions, and other financial information in our heads. In theory, all of our resources should be fungible—dollars are dollars, regardless of what (liquid) account they're in—but in practice, this is not how we typically behave.

A study by Abigail Sussman and Eldar Shafir explores one particular form of mental accounting—the ways we tend to categorize assets and debt based on our net worth. By presenting participants with financial profiles that were equivalent in net worth but varying in the structure of their balance sheets, the researchers found that people tend to prefer having more assets when net worth is negative, but less debt when net worth is positive. For instance, despite the fact that net worth is actually the same —$100,000 in both scenarios, households tend to prefer having $100,000 in assets and $200,000 in debt over just $10,000 in assets and $110,000 in debt. However, if the assets and liabilities in the scenario above were reversed (i.e., net worth was positive $100,000 instead), then households would tend to prefer simply paying down their debt (even if it means having less in liquid assets)!

And this finding is notable, as it has several important implications from a financial planning perspective. For instance, it can help explain why people struggling with debt tend to accumulate assets and not pay down their debt, even if they're keeping cash in a 0.25%-yield savings accounts while compounding 22% credit card interest rates. Additionally, this may be why affluent clients who can afford lots of leverage still often want to pay down their mortgage. Which, ironically, may mean that the people who can afford to "prudently" use leverage tend to eschew it, while those who can least afford leverage tend to engage in high debt profile behaviors that may actually amplify financial fragility!

> **Researchers found that people tend to prefer having more assets when net worth is negative, but less debt when net worth is positive.**

Further, preferences may seem to shift suddenly, particularly as households pay down student debt and move into positive net worth territory, which may or may not align with what they should actually be focusing on. And for those who enter positive net worth territory quickly, there may be an overemphasis on paying down debt quickly (now that they 'can'), rather than saving into investment accounts which may grow at a higher rate in the long-run.

Ultimately, the key point is to acknowledge that seemingly irrelevant factors (such as a household's net

worth) can influence how households perceive their financial situation, the decisions they make as a result, and their willingness to keep accumulating assets (while not paying down the debt) versus liquidating assets to reduce their debt profile as well. In other words, it's important to understand the factors which may be lurking in the background and influencing our behavior, even if those factors should (in theory) be irrelevant.

[Michael's Note: This post was written by Dr. Derek Tharp, our Research Associate at **Kitces.com**. In addition to his work on our site, Derek assists clients through his RIA Conscious Capital. Derek is a Certified Financial Planner and earned his Ph.D. in Personal Financial Planning at Kansas State University. He can be reached at **derek@kitces.com**.]

How To Protect Your Child's Credit

Carrie Beren, CFP®
Wealth Manager

Last Fall, we wrote a blog post offering concrete steps to protect yourself from identity theft. (See "What To Do About The Equifax Hack," September 13, 2017.) But what about those in your care? How do you protect your minor children?

While it's unlikely that your children were affected by the Equifax breach, it's possible that their identities have been compromised in other ways. According to the *2012 Child Identity Theft Report* from Carnegie Mellon University's Security and Privacy Research Institute, children are *over 50 times* more likely to become the victims of identity theft than adults of the same security breach demographic.

Typically, the motivation for child identity theft is to pair up an unused Social Security number with a fictitious name and birthdate to obtain a false ID for employment, to engage in financial fraud, or (in perhaps the most distressing scenario) when a trusted family member or friend uses a child's identity to avoid the consequences of their own bad credit.

Often child identity theft is not discovered for years, perhaps not even until young adulthood when these 'children' are applying for their first loan. It can derail the best education planning if your college-bound teen tries to obtain a student loan only to be told that his or her credit was destroyed years ago with unpaid bills and maxed out credit cards.

How To Know If Your Child's Identity Was Compromised

Since an ounce of prevention is worth a pound of cure, you may wish to monitor and freeze your child's credit proactively. However, there are some red flags that warrant immediate action as these may indicate your child's identity has already been compromised.

- Has your child received any mail in his or her name for pre-approved credit card offers?
- Has an actual credit card bill, collection notice, or a jury summons been mailed to your child?
- Have you received a letter from the IRS saying your child owes income taxes?
- Do you get collection calls or bills from unfamiliar vendors?
- Was your teen driver notified of citations or unpaid parking tickets when applying for a driver's license for the first time?

It's a good idea to check a child's credit well before they have to apply for a job, a loan, or to rent an apartment, so that you have time to correct any errors due to fraud or misuse. Currently laws allowing parents and guardians to freeze credit reports for minors are on a state-by-state basis, although there is proposed federal legislation to address the issue.

How To Protect Your Child's Credit

The first step is to reach out to each of the four major credit bureaus—Equifax, Experian, TransUnion, and Innovis—and request a manual search for any items associated with your child's name or Social Security number. Make sure to keep good records of dates you contact the credit bureaus, representatives you speak with, a summary of what was discussed during the call, and copies of any documents mailed.

If any erroneous or fraudulent items are found, follow the Federal Trade Commission's process to report and repair the damage (to get started, visit: **https://www.identitytheft.gov**).

Hopefully nothing will be found, signifying that your child's credit has not been compromised. To keep your child's credit secure, parents can request that each bureau create a credit file for the minor which is then immediately frozen. (The bureaus may charge a fee for the freeze based on your state.)

Activating your child's credit report and then freezing it is somewhat more difficult than freezing our own credit. It can't usually be done online and there is more documentation needed to verify a minor's identity and your authority to monitor their credit. The Federal Trade Commission has created a handy Uniform Minor Status Declaration to help streamline the process (visit **https://goo.gl/N1aWJy**).

The following documentation is usually required to be mailed to the credit bureaus along with your request:

- A copy of your minor child's birth certificate
- A copy of your minor child's Social Security card
- Proof of your identity / residency

And here are the links to the Minor Child Credit Freeze process for each bureau:

- Equifax (**https://goo.gl/uGRiiz**)
- Experian (**https://tinyurl.com/y8tejxxt**)
- Transunion (**https://goo.gl/G1iMlj**)
- Innovis (**https://goo.gl/R3uhZv**)

In addition to going through the credit freeze process on behalf of your child, limit sharing your child's Social Security number as much as possible. Don't be afraid to ask your child's school or doctor's office if the use of your child's Social Security number is mandatory or if another identifier can be used, and make sure to talk to your child about safeguarding his or her information.

Like many forms of modern identity theft, child identity theft is usually a crime of opportunity and you can minimize the risk through a few proactive measures. Hopefully, this will help our children one day avoid the hardship and hassle of restoring their stolen identities.

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Why Your CPA Should Work With Your Advisor

I have been a financial advisor for more than 30 years. During that time, I have worked with clients who have prepared their own taxes, those who work with CPAs I have never spoken to or worked with, and those who work with CPAs with whom I have a professional relationship. My preference is to develop a working relationship with the client's CPA because I find it to be the most beneficial for the client.

One area of planning that seems to benefit most from a team approach is tax planning. If I can work with a client's CPA during the year, we can plan proactively which options are the most meaningful, most effective, and most beneficial.

Here are some examples of information that is shared throughout the year:

• Dividend and interest income. Updates regarding interest and dividend income allow for more accurate estimated tax payments, if applicable.

• Capital gains and / or losses. Again, updates regarding capital gains and / or losses allow for more accurate estimated tax payments, if applicable.

• IRA distribution. To withhold or not to withhold, that is the question; and then, of course, how much?

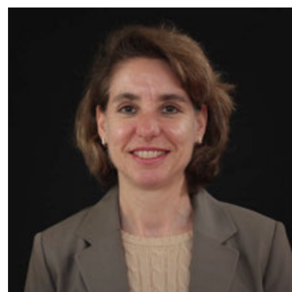
• Retirement accounts for the self-employed. More of a planning / cash flow / affordability issue, but letting

the CPA know which plan has been selected can help them be more proactive.

• Charitable contributions. A client wanted to make a significant donation and coordination with the CPA in terms of the "right" amount to donate relative to the client's income tax situation was quite helpful.

• Roth conversions. A client's unique situation in a given year may allow for Roth conversions in a low income tax bracket. Coordinating with the CPA to provide as much information as possible about the client's tax situation can create opportunities.

Each client's situation, of course, is unique, but what is not unique is that coordinating and sharing information with the CPA can provide opportunities and benefits for all.



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MARKET REVIEW

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The beginning of the first quarter was serene and pleasurable, as equity markets levitated on the back of increasing earnings expectations and solid world economic underpinnings. But the market euphoria didn't last long. February saw volatility awaken from its slumber with a jolt, kicking off a long-anticipated correction that reminded investors there is never a free lunch in the world of investing. As the quarter progressed and the correction intensified, investors were forced to endure an emotional roller coaster as markets swung wildly. By the end of the quarter, most developed markets had chewed through early year gains and returns fell mildly into the red.

As we start the second quarter, investors are left to wonder if the market is turning from bull to bear, or just correcting from an overbought and highly complacent condition.

Catalyst 1: Inflationary Transition

The start of the volatility flare up was largely predicated on an inflation scare resulting from details within the January employment report indicating that long-stagnant wages were finally beginning to rise. This catalyst appeared to align with the idea that the economy is transitioning towards the late phase of the cycle, causing markets to begin to discount the possibility that the disinflationary backdrop that has characterized the environment ever since the financial crisis is gradually turning more inflationary.

While inflation has been dormant for many years, there are several reasons to believe that inflationary green shoots are beginning to develop in the U.S. economy. From a cyclical perspective, actual GDP growth rates are starting to outstrip potential growth, meaning that aggregate demand has reached the point where it is starting to outstrip supply which typically causes prices to rise. One part of the economy where this seems evident is in the labor market, where the unemployment rate has already fallen below the equilibrium level that usually signals a pickup in wage levels. Other cyclical inflationary catalysts include a weak dollar and commodity prices that are steadily rising.

To compound the cyclical backdrop, the current administration's stance on trade and immigration also suggests a more structural foundation for inflation is building as the pendulum appears to be swinging from peak globalization towards protectionism. As this gradual transition from disinflation to inflation takes place, it's perfectly normal for markets to undergo a volatile adjustment phase, but it's also premature for a slow normalization of inflation and interest rates to end the economic cycle just yet.

Catalyst 2: Tariffs & Trade Wars

In 2017, a major theme of ours was that a post-election "roadmap" was developing that would shape investment markets over coming years. The roadmap had three components. The first was that fiscal policy was set to pick up, and it has through the recent tax reform that was enacted. The second component was that the administration would focus on deregulation, and they have been addressing that as well. In 2018 these market friendly forces are still with us, but they have now been joined by the third element of the roadmap, which is a turn towards protectionist trade policy.

Unlike the first two components, which tend to be supportive of growth, earnings and markets, this last component is not generally considered a positive for the stock market. The administration's protectionist policies started modestly, but they have been escalating steadily this year, with the most recent policy measures threatening to apply tariffs on a wide range of Chinese-made goods. The market is understandably jittery about the prospects for an all-out trade war, as history has shown that although tariffs may help support certain industries, they also usually end up creating significant headwinds for the economy as a whole. While the risk of a trade war is higher than it was coming into the year, there are still reasons to believe that the threat of tariffs is being used as a high pressure negotiating tactic, and that both sides should ultimately realize that it is in their best interests to come to an agreement rather than risking a full-blown trade war that would likely damage the global economic backdrop.

> **While inflation has been dormant for many years, there are several reasons to believe that inflationary green shoots are beginning to develop in the U.S. economy.**

Catalyst 3: Bitten by the FAANG

The latest bull market has been particularly kind to a subset of stocks that has come to be known as the FAANGs. FAANG is an acronym that stands for Facebook, Amazon, Apple, Netflix and Google, which have been some of the market darlings during the current bull market run. Believe it or not, these names

have been responsible for approximately 25% of the entire market's gains since the 2016 market bottom. Recently, some of these leaders have come under fire for a variety of reasons. Facebook finds itself in the middle of a crisis of confidence, Amazon is being attacked by the White House, and the entire technology sector appears vulnerable to rising trade tensions between the U.S. and China.

Some analysts are concerned that the recent underperformance of these stocks is signaling that the broader market may be losing a major area of market leadership, and one that exerts a hefty influence on the behavior of the major indices due to the lofty weightings of some of the stocks included in the cohort. The good news for technology is that it should be the beneficiary of an increase in business spending this year, and setting aside some of the bigger companies, the sector still sports a very reasonable valuation in a market that is overvalued. Also, despite the latest news headlines surrounding some of these companies, the relative performance of the sector is holding up very well even in the face of trade spats and some idiosyncratic problems in select names. So, it may be too early to give up on technology at this juncture.

Base Case: Still A Correction, Not A Bear

The market has clearly been on a roller coaster ride and the correction appears to be wearing on investors' nerves as markets swing wildly from headline to headline. The exaggerated nature and speed of the moves only adds to the confusion and serves to create a feeling that something major has changed in markets. We do think the market has entered the late cycle, which is inherently more inflationary and tends to carry a higher level of volatility, but that hasn't yet altered our current base case that the market is simply undergoing a much-needed correction rather than turning towards a cyclical bear market. Some of the recent market moves have certainly been unnerving, but the weight of the evidence continues to point towards positive developments happening beneath the surface of increasingly noisy headlines.

Stimulus And Tax Cuts Still Support Economy And Earnings

Despite a policy backdrop that has created some new risks, it's important to remember that tax and deregulation policies already enacted are starting to flow through economic data and along with record amounts of share buybacks, should help to put a floor under markets for the remainder of the cycle. It helps that the fundamentals of the global economy are still healthy as well.

The U.S. economy still appears to be growing at a firm level, and so far, there has been no deceleration in leading indicators that would warn that this expansion is coming to an end. Consumers may be held back somewhat due to a low savings rate, but business spending seems ripe to rise at a brisk pace given the combination of elevated confidence, tax cuts, and the front loading of business expenditures that was part of the 2017 tax legislation.

Outside of the U.S., there has been a leveling off in economic activity in various economies around the world, but for now this appears be just a deceleration in forward momentum following last year's robust synchronized upswing and not another downturn. On balance the global economy remains healthy, which should continue to support risk assets whenever this volatile digestion phase settles down.

Primary Trends Supportive, Sentiment Starting To Clear, Bottoming In Play

Despite some short-term technical damage, longer-term trends in markets are still supportive of a bull market, and sentiment that was overly complacent just a few months ago is returning to a healthier level of skepticism. While recent price activity is testing investors' nerves, the good news is that the declines toward the February lows are showing characteristics of a market that is entering the later stages of a bottoming process. It would be encouraging to see a good dose of buying enthusiasm that would help to confirm that the corrective process is ending and the bull market is resuming. Of course, there's no guarantee that this will occur, so it will be critical to pay close attention for signs of any negative divergences during rallies. For instance, a rally back to the recent high with waning participation might be a warning sign that the foundation of the market is weakening. For the moment, the message from the indicators is that a bottom is close at hand, but it will be important to remain vigilant as this process continues to play out.

Hedging Our Bets

Despite our current assessment that fundamentals are still healthy, and that this correction is not likely to turn into a bear market, it's also apparent that risks continue to build, which makes it prudent to carry some portfolio hedges to defend against a variety of risks that could prematurely end the business cycle and bring on a bear market in risk assets. The list of risks has grown recently, but perhaps the most significant for equities is a policy mistake out of Washington. If the administration accidentally miscalculates and pushes trade negotiations too far resulting in a full-blown trade war, it would very likely be a game changer for any economic or market outlook. Indeed, in the event of a trade war, economic growth globally would suffer—possibly leading to a premature recession—and it would surely rattle financial markets.

While the risk of that actually happening still appears to be low for now, there is no doubt that it has been steadily rising this year. Currently, we hold an optimistic view that cooler heads will ultimately prevail since it's in both the U.S. and China's best interest to dial things back, but the administration has frequently taken an unorthodox approach to addressing issues like trade and is creating uncertainties that are hard to quantify for markets. In this type of environment, it seems sensible to hold a variety of hedges in case something causes volatility to erupt again on short notice.

Diversifying Hedges More Important

Determining what hedges to use in portfolios is more complicated than it used to be. For decades, U.S. government bonds were the go-to safety trade in times of turmoil for investors. But recent dynamics are in flux for the bond market, and it's harder to trust that asset class these days. Bonds risks are heightened due to the transition to a more inflationary world, an increasing supply from Federal Reserve balance sheet reduction, and Chinese policymakers that are threatening to use treasuries as a weapon if trade tensions escalate. In today's environment, investors can't be as sure that treasury bonds can be relied upon to dampen portfolio volatility like they used to.

For the time being, we believe the best strategy is to carry a variety of hedges that may work if the worst

comes to fruition. One of the most attractive hedges in a policy mistake scenario is gold, and we have been building positions back in the shiny metal to defend against the increasing risk of that occurring. But gold is volatile and has its own risks, so it also makes sense to carry other hedges like extra cash-like holdings as a form of dry powder, and a small percentage of long-term treasury bonds in the portfolio in case growth is cut off prematurely. In short, we are currently navigating a very tricky environment that demands some diversification in the portfolio hedges that are being used.

Conclusion

The first quarter of 2018 produced an awakening in market volatility that was overdue after the serene run in markets over the previous four quarters. This market correction has clearly been a violent and gut-wrenching affair, with numerous reasons to give the bears hope that the market cycle is finally turning south. However, looking beyond the headlines and hysteria, we still think there are solid reasons to believe that this bull cycle is not finished yet. World fundamentals still look solid and should remain supportive, and investors are arguably beginning to focus more on what could go wrong than what might go right.

Our base case is still constructive, and we believe that stocks are getting closer to the end of a bottoming process that should set up markets for a more positive bias over coming quarters. But we also acknowledge that there are some risks building that must be hedged and monitored closely. The tail end of a bull market can often be whippy, but there is usually enough upside remaining to be worth the risks. For the time being, we choose to use the awakening in volatility in an opportunistic fashion, but we will continue to monitor the evidence and remain ready and willing to materially dampen portfolio risk should the weight of the evidence signal that it is time to go into principal protection mode.

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, adjusting 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 (through 12/31/2016). 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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