

March, 2014

# Lighthouse Monthly

The outlook for check the box investing

Central banks are still in control  
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Estate planning notes from the stars  
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# The outlook for check the box investing

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## Birth of a movement

Just about every investment advisor that started his career in the last 25 years was schooled in the ways of portfolio diversification via Modern Portfolio Theory (MPT). MPT was introduced by economist Harry Markowitz in a 1952 *Journal of Finance* article and again more broadly in Markowitz's 1959 book titled *Portfolio Selection*. MPT, as a financial theory, attempts to maximize portfolio expected return for a given amount of portfolio risk. For his research, Markowitz was awarded the Nobel Prize in Economics in 1990.

Shortly after Markowitz's Nobel prize award the financial services industry began to embrace MPT. It is easy to see how MPT was (is) attractive to the financial services industry. Who would not want to find the optimal portfolio for a set amount of risk? Once the optimal portfolio is found, all that is left is to monitor the health of the underlying investments and to rebalance periodically. Simple!

## Toward investing utopia

Along the way to experiencing investment utopia via MPT, a few significant changes happened in the

financial services industry. The first change was the birth of the company Morningstar. Morningstar started out as a mutual fund research company but has now become an investment research behemoth. It is not so much the arrival of Morningstar as it was the 1992 introduction of asset class style boxes that shook up the financial services industry. The birth of the Morningstar style boxes helped advisors to more accurately classify the size of the companies underlying a mutual fund, as well as the investing style whether it be value, growth or blended. In addition, Morningstar also created style boxes for bond mutual funds.

The second significant change was the widespread use and acceptance of index funds. Around the same time that Morningstar rolled out the style boxes, the acceptance and use of index funds exploded.

Lastly, in the mid 90's there came a plethora of companies releasing software to aid advisors in creating 'optimum' portfolios. Advisors could enter a mix of asset classes and tweak it to find the optimum portfolio for a set amount of 'risk' as measured by standard deviation (how far something varies from its mean.) ➔ [More](#)

Advisors could now easily classify their funds with Morningstar style boxes, gain inexpensive access to index funds and have software calculate optimum risk based portfolios. It appeared that investing was now turnkey.

Here at Lighthouse we dubbed the above process as 'check the box investing.' With this process, advisors needed to only ensure they had a fund in each box of the style boxes, check a few boxes in software and voila! - investing utopia. Or, so it was thought.

### **Reality hits home**

After nearly a decade of using MPT with success, the investing markets and advisors ran into the popping of the dot com bubble in 2000. It was in this time that advisors started to realize that there were some shortcomings to MPT and the 'check the box' or set-and-forget-it style of investing. In the popping of the dot com bubble advisers saw correlations of almost all asset classes converge. Said otherwise, most everything was losing money. Accordingly, some advisors began questioning MPT and the true value of diversification as a way to reduce portfolio risk.

### **And again**

For those advisors that did not start looking for alternative ways of mitigating risk, they were treated to another sharp rise in correlations and market drop in 2008. Once again, advisors had few places to hide as almost every asset class sold off. Even some money market funds lost money.

### **Different approach**

It was after the 2008 market drop that it became abundantly clear that mitigating risk was not as easy as checking the boxes. It was clear that more risks were surfacing that had not existed over the last 30-40 years.

At Lighthouse, we have moved away from building portfolios based solely on MPT. Much of the financial services industry still uses MPT as it has done for the last three decades. As we assess the world we live in, we see the new risks facing clients' wealth and how those risks have affected the old ways of portfolio construction. Today, we look at macroeconomic data, technical analysis of holdings, market fundamentals and more. For us, it is not enough to invest in asset classes because historically they may have performed in a certain pattern relative to other asset classes. Market dynamics as simple as interest rates warrant a deeper look at how we all invest.

### **Outlook**

We think the days of 'check the box' investing will be gone for some time. With the low interest rate environment and weak economy, any meaningful rise in interest rates will make almost every asset class move together once again. Therefore, buying and holding a diverse portfolio will not mitigate risk as it once did. Today, advisors must be more hands on with the fast moving, highly correlated markets.



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# Estate planning notes from the stars

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It would be nice if some being could just beam down an estate plan without having to go through the uncomfortable decisions and attorney's fees. But, alas, the title of this article is not referring to extraterrestrial beings. In fact, we are pointing to the other stars that typically hail from or spend loads of time in Hollywood (which is a different place all its own).

Perhaps you have heard the stories of the Elvis Presley estate. At the time of Elvis' death, his estate was worth an estimated \$10 million (that was a lot of money in 1977). Unfortunately, once the dust settled on Elvis's estate, his heirs only received approximately \$2.3 million. The primary cause of the huge reduction was a lack of estate planning.

Stars, athletes and other celebrities, because of their notoriety, leave a lot of estate planning hints. People who do not show up in the headlines can glean a lot from such celebrities.

1. **Don't procrastinate** - There are far too many examples of relatively young celebrities to older celebrities that have died with no estate plan whatsoever. Unfortunately, no estate plan leaves

the fate of one's estate to decisions of governments.

2. **Don't do it yourself** - Legend has it that Elvis Presley wrote a check on a napkin that his bank honored. It is doubtful that a bank would do such today. It is equally doubtful that such estate planning documents would hold up in the current litigious world. There are so many intricate variables that must be considered in an estate plan. It is necessary that a professional draft and review estate plans.

3. **Create a trust** - In the case of Elvis Presley, if he would have had a trust, his family would have kept significantly more of his estate. A trust is a fiduciary arrangement where legal title of property is held and the property is managed by someone for the benefit of another. When a will goes into probate (the legal process of administering the estate of the deceased person) it becomes public record. However, if you create a living trust, you can avoid probate and keep your estate private. So, besides potential tax savings that comes with a trust, one can also keep her affairs private. ➤ [More](#)

4. **Where you live matters** - Changing states of residence is a large reason many people's estate plans become dated. It is important to remember that each state's rules, taxes and estate planning observations differ. Additionally, within the United States some states such as Louisiana, Texas, and California are community property states which have very different rules regarding property. Suffice it to say that a change in state of residence warrants prompt reviews of estate plans.
5. **Leave a note** - In today's world it is very easy for one to have multiple accounts from utilities to investments to cell phones. The management of such varied accounts typically happens online or at least on computers. To aid heirs in identifying and managing accounts, a note on location of

accounts, usernames and passwords is exceedingly helpful.

6. **Deploy the plan** - Far too many people create plans but do not deploy the plans. It is not enough to create an estate plan. Documents must be signed, accounts and property must be titled appropriately and documents must be accessible to heirs.

All of the tips above have been gleaned from reports in popular media regarding celebrity estates. The common thread in all of these tips is being prepared by personal effort and professional guidance.



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# Market Review

## Central banks are still in control

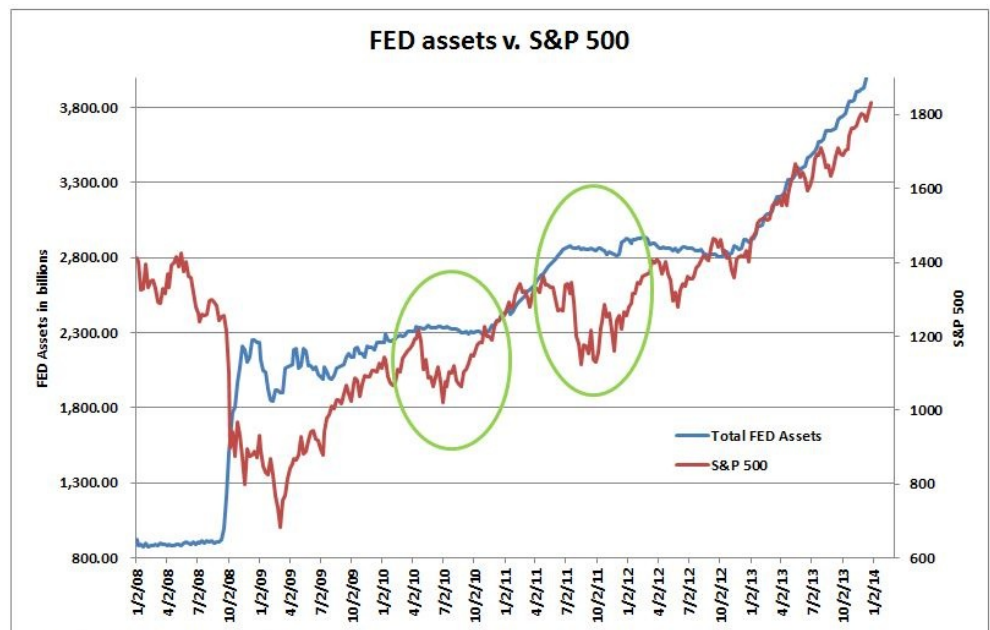
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As we move through the beginning of 2014, we are continuing to see global market sensitivity to central bank policies. In December 2013, the US Federal Reserve (Fed) announced the beginning of its 'tapering' of bond purchases. For 2013, the Fed was purchasing \$85 billion per month in US government and mortgage-backed bonds. At the time of writing this update, the Fed has reduced its bond purchase target to \$65 billion per month.

Since the financial crisis market bottom in March 2009, the correlation between the Fed's balance sheet expansion and the S&P 500 Index stands at approximately 89% (chart). So, while the Fed is not expanding the balance sheet at the same rate, it is still expanding the balance sheet at a fair clip.

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Source US Fed

The reduction from \$85 billion a month to \$65 billion a month in bond purchases leaves a lot of liquidity continuing to be pumped into the market. However, similar to a fire fighter dialing down water pressure on a fire hose, there is still water to fight fires; the water just does not reach as far.

It is important to keep in mind that since the Fed started pumping heavy doses of liquidity into the global financial system (via quantitative easing) the flows of money into emerging markets exploded. With much of the developed world sitting at low interest rates, money traveled to emerging nations through the currency, bond and equity markets. Now, with the Fed liquidity tide receding, the reverse is happening as the 'hot' money that pushed emerging markets up is flowing out.

The famed investor Warren Buffett once quipped, *"Only when the tide goes out do you discover who's been swimming naked."* In the case of the Fed's liquidity tide, we are seeing trouble with the investments most exposed to a tapering. Those exposed investments are the riskiest assets that investors took on as the low interest rate environment sent investors in search of returns.

It stands to reason that as the low interest rate, heavy liquidity environment changes the periphery investments that benefited from such policies will be the first to show cracks. It also stands to reason that one of the investments closest to the liquidity fire hose (US Stocks) have fared much better than foreign stocks in the last 18 months.

Recent history suggests that when the balance sheet of the Fed stops expanding, the US stock market is likely to slow as well. In the chart on the previous page, we see that there were two periods which are highlighted in circles (Between QE 1 & 2 and between QE 2 & 3) which show that when the Fed stopped buying bonds, the stock market sagged.

The Fed's recent decision to begin tapering bond purchases appears to be more about its actions' impact on investing markets rather than its impact on the economy. The fact that the US economy is still very weak and that interest rates are still being held to the floor by the Fed does not point to less bond purchases to help the economy. Actually, it is the opposite. Therefore, the rationale for lowering the bond purchases looks to be to stem potential negative impacts to investing markets. The trillion dollar question is did the taper come too late? Time will tell.

Logic tells us to watch the periphery such as emerging markets, real estate and currencies for some clues as to how the global economy is digesting the Fed's attempts to unwind its previous actions. Common sense tells us that unwinding such extraordinary measures will not come without consequences. Investors would be wise to maintain a cautiously optimistic outlook as the global economy looks to regain some normalcy and less central planning.



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