April 2017

The Capstone Quarterly

Spring is upon us and California has finally gotten a decent amount of rain. While the drought is not officially over, we do have some breathing room and spring seems to be off to a good start as far as the rain is concerned. We hope your spring is off to a great start as well on a personal level with your careers or your retirement, your family and friends.

In this newsletter, we discuss our perspective on the current state of the US stock and bond markets. We also discuss the importance of beneficiary designations and the basic framework of what we think is a sound investment approach.

Bryce's Point of View

-By Bryce Pease, CFP®, Chief Investment Officer

In our last newsletter in January 2017, we wrote that we felt the US stock markets were "entering a sustainable trend to the upside."(1) So far, for the first quarter of 2017, this has proven to be the case as the broader US stock markets continued their move into positive territory. While of course no one can predict the future with a large degree of certainty, we do see continued demand for US stocks based on our research and indicators we follow.

In addition to our research and indicators, we also think there is a historical case to be made for a continued bull (up) market this year.

This is the second longest bull market in US history. It's only natural to wonder when this up trend will end. A bull market ends when we enter a bear market, which is generally defined as a 20 percent decline from the high point. All up markets cycle back down at some point. It's only a matter of time before this market heads back down too.

History suggests though this market may have some tailwinds this year. Since 1945, the US stock market, as measured by the S&P 500, has rose in value during the months of January and February 27 times. In other words, over the last 72 years, 27 of those years the market has been up the first two months of the year. In those years that the S&P 500 rose in value during the months of January and February, each one of those years recorded positive returns for the stock market.(2)

We can only speculate as to why the US stock market has had positive returns in the years when January and February are up. February is historically a difficult month in the markets and the fact that investors choose to keep bidding up prices as opposed to selling, suggests to us that investors are overall optimistic and "bullish" heading into the new year. Our feeling is that this historical tendency of the market being up in the years when January and February were positive may have something to do with investors not wanting to miss out on any potential gains and rather than selling during the historically difficult month of February, investors are buying, pushing prices up, creating momentum in the markets. Again, this is all just speculation, but we find it an interesting historical perspective. Just because this is the second longest running bull market doesn't mean it can't continue up. There is of course no guarantee that it will either, but there could be some tailwinds of momentum based on the stock market performance year to date.

We also discussed bonds in our last newsletter. In January we said, "Our research suggests that bonds are oversold and that interest rates may be leveling off for now…."(3) As of the writing of this newsletter, bond yields are right about where they were at the beginning of the year (after bouncing around a bit). We are continuing to monitor the bond markets closely. We don't really have a forecast for the bond markets other than to remind clients that interest rates are near historic lows and that someday interest rates will go back up again. If, and when, interest rates start to move back up (which would hurt current bond holders) owners of bonds and bond funds may want to look to limit losses by attempting to switch to less volatile bond funds or possibly cash for a short period of time.

We still have some serious concerns about the economy overall. In our opinion, though things have improved over the recent years coming out of the financial crisis of 2008, our country still faces a lot of challenges--entitlements we can't afford, underfunded pensions, the strain retiring baby boomers will put on the economy, the national debt, etc. At some point these issues will need to be addressed.

Just consider our national debt for instance. It is hard for us to imagine how the US can keep up with the interest payments over time (let alone pay down the debt!). In a recent book, author Danielle DiMartino Booth gives some perspective our country's current predicament with our interest payments on our national debt,

> "It is a statement of fact that the United States is paying less in interest than the average of the past half century. In 1995, the government shelled out $232 billion in net interest payments. In 2015, it had dropped to $223 billion.
>
> Is this a reflection of good behavior? Not hardly. According the CBOs [Congressional Budget Office] own math, if the yield on the ten-year treasury note rises to 4.1% over the next ten years, interest payments will swell to $893 billion. A nightmare."(4)

As we see it, problems like this are why we get downturns in markets and the economy every now and then. Markets cycle, economies cycle, the business cycle goes up and down. In our opinion, when markets cycle back down, we see it as a way for our markets and economy to reset the system and reset prices. Overall, we see it as a healthy process for our markets and economy. At some point the markets will cycle back down again. We don't think that's anything to be afraid of, but we do think it needs to be managed for investors.

Surprisingly, based on a recent survey done by the financial company Eaton Vance, most financial advisors don't seem to be concerned about downside losses. Eaton Vance asked 1008 advisors "what's your and your clients' approach toward market volatility?" Only 18% of the advisors surveyed said they would manage accounts to avoid losses.(5). Or another way to look at it, from our perspective, if Eaton Vance's sampling is at all indicative of advisors at large, 82% of advisors don't manage accounts to avoid losses.

We think that's crazy.

The perspective of the advisors of Capstone Pacific is that avoiding large losses is critical for building and maintaining wealth. We can't promise this or guarantee that we will do that, but we think it makes a ton of sense to avoid overbought sectors and funds, look to rotate out of sectors that are weakening and have an overall exit strategy for when things get bad. We are not making a prediction here, we just think it's prudent to be prepared for the inevitable downturns.

In summary, this uptrend in the stock markets can't last forever. Near term we are optimistic about the stock markets. Longer term we have our concerns. On the more conservative side of the spectrum, bond yields have stabilized but are uncertain. In all asset classes, we still maintain that a downside strategy is critical for wealth building.

Casey's Corner

-By Casey Morris, CFP®

When it comes to basic financial planning, one common area often overlooked is beneficiary designation. For most people the choice of beneficiaries is simple: Spouse first, then children. For others it may not be that simple—or not stay that simple.

The most common cases requiring beneficiary designation are on wills and trusts, and on financial accounts like qualified retirement plans (401(k), 403b, 457), IRAs, annuities, life insurance policies, etc. Some accounts provide for "transfer on death," which accomplishes essentially the same thing. Most people assume that if they die without designating a beneficiary, assets automatically go to their spouse, and then to their children. This may prove true, but the determination can require a costly, sometimes unnecessary probate process, tying up money in court for many months. It's better to avoid that result if possible.

Events like divorce and remarriage, and having children from two or more marriages can complicate beneficiary designations. If you remarry, do you want all your assets to go to the new spouse, and then to the spouse's children—perhaps some of them biologically yours, others not—rather than or in addition to your children from the previous marriage? Do you want to include stepchildren? If you have not remarried, do you want to include your ex-spouse?

One rule of thumb: if you can't remember who you've designated as a beneficiary, it's been too long and you need to review your accounts. If you have questions on beneficiary designations, please feel free to contact me.

The Planning Perspective

-By Jon Teran, CFP®

This month I celebrate my 19th wedding anniversary. 19 years ago is also about the time when I decided I needed a "real job" and started working in the financial services industry. I've learned a lot over the last nearly two decades about investing (and about life!). One of the biggest lessons I've learned about investing, is that it is more important to focus on your investment process than it is to just chase outcomes.

When I entered the financial services world in the late nineties, the internet "dot-com" era was just beginning to take off. It seemed like every party and social event I went to, I would always meet and talk with people who were chasing the next big winner or hot idea in internet stocks. While I mostly just listened and refrained from giving my opinion (who wants to talk about work at a party afterall?) I definitey did not get the sense in the internet bubble that folks were making investent decisions based on a sound process—they were just chasing outcomes.

We all know how the dot.com bubble ended. It was a disaster. And a lot of people got hurt.

At Capstone we believe that when it comes to investing you have to understand the process that led to your outcome to have the best chance at having consistent results and outcomes.   A process by no means guarantees you won't incur losses or are guaranteed to make money in your investements. We just believe that having a process is a much better way to go than flying by the seat of your pants and picking out investments based merely on recent returns.

Investor and author Jim O'Shaughnessey who has done a lot of research on varoius investment strategies has found that, "Outcomes are important, but it's much more important to study and understand the underlying process that led to the outcome, be it good or bad. If you only focus on outcomes, you have no idea if the process that generated it is superior or inferior. This leads to performance chasing and relying far too much on recent outcomes to be of any practical use."(6)

We have a process that tracks and goes through trends in the investment markets and helps us prioritize which investments and sectors to focus on and when to make changes. We don't always get it right, but we are always reviewing our process with the intent of improving our process as conditions change and new information dictates.

It's only a matter of time before we hit more market turbulence. We are convinced that a sound process for buying, selling and making changes is foundational for investing success.

Finally…

We have been honored to have the opportunity to speak at the US Forest Service in Sacramento, educating new hires on financial planning and investing. Jon and Casey have been making trips to Sacramento to put their public speaking skills to work with a very lively and engaging audience.

We always welcome the opportunity to speak and educate. Please don't hesitate to pass our name along if your organization is looking for educational workshops on topics related to financial planning, savings and investing.

We hope you have a wonderful spring and we look forward to our next meeting or conversation with you.

Sincerely,

The Team at Capstone Pacific

P.S. If you ever run across anyone who could use our services, we always appreciate it when you pass on our name.

(1) *Capstone Quarterly*, January 2017
(2) Sam Stovall, "Market Mazurka" *Sam Stovall's Sector Watch: Standard and Poor's Equity Research*, March 7, 2017.
(3) Capstone Quarterly, January 2017
(4) *Danielle DiMartino Booth, Fed Up: An Insider's Take on Why the Federal Reserve is Bad for America*, Feb. 14, 2017, p. 253.
(5) "Advisors Top-of Mind Index Insights," Eaton Vance Investment Managers, Q1 2017.
(6) Jim O'Shaughnessy, "Successful Active Stock Investing is Hard: Here are Seven Traits that I Believe are Required for Active Investors to Win in the Long Run," *What Works on Wall Street: Yahoo Finance*, March 13, 2017.