Castling Financial Planning, Ltd.

Helping You Secure Your Future™

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Fall 2014 Newsletter:

Pardon Me While I Open the Bubbly... Wait, It's Kool-Aid?

"Don't drink the Kool-Aid" is a phrase often used as a negative response to comments or beliefs that are held without questioning, proper debate or scientific examination. It dates back to the horrific Jonestown mass murder/suicide in 1978[1]. We don't feel you should blindly believe what you are told, by anyone, including ***CastlingFP***. The ability to listen to various points of view, assess the evidence and only then make up your own mind before taking any action, will be to your long term benefit.

As we assess the current state of the financial markets and the economy, nearing the end of 2014, we see a mixed bag of both positive and negative points.

The economy is expanding, but we have still not seen year-over-year GDP growth at or above the 3% trend line that most commonly describes US economic performance. We need above trend line growth in order to get back on the trend line. So we would still not call this a recovery. It is definitely an expanding economy and we see no recession in 2015. But in no way, shape or form would we describe the current economy as being good or great. That would be drinking the Kool-Aid, in our view.

The stock market is usually described as being a leading indicator of the economy. But the market and the economy are two entirely different things. The stock market's ability to indicate major turns in the economy is well documented. The 2007-2009 bear market began as a sell-off in late 2007. The recession's start was later marked as December of that year. Later on, the upturn began in March 2009 and heralded an end to the recession. That was later confirmed as being June of that year.

So how is the market linked to the economy now and what signs, if any, is it showing us? For one, our ***CastlingFP*** valuation model is signaling that some overvaluation does currently exist. However, it is not a market timing indicator and we are not big fans of timing the market.

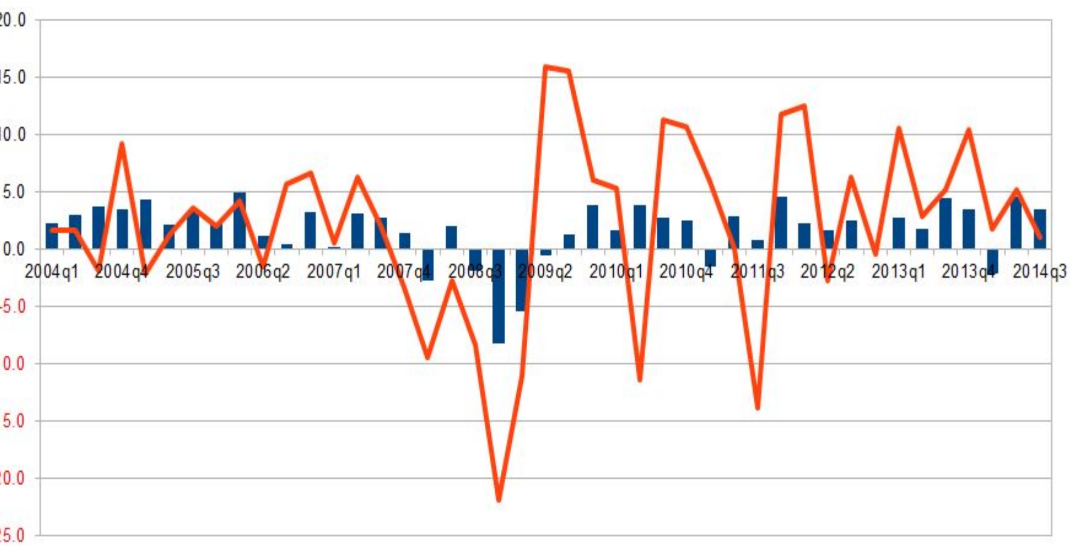
We expected to see a correction of 10% or more in 2014. It did not happen. We did see a drop approaching ten percent, but it fell short. Does it still count? Well, not if the comparison is to all other occurrences where there was a "real correction" of 10% or more in magnitude. We are not trying to be persnickety, but please...

On a more serious note, the yield on the US 10 Year Treasury Note started 2014 at 3.00%. The conventional wisdom was that it would increase (e.g. "begin to normalize") to somewhere in the range of 3.50%-4.00%. Had this occurred, we might have been saying, "OK, as expected. The economy is beginning to take off." Then a funny thing happened (as usually is the case), just *sans* the laughter.

Throughout the year, we saw it drop ever so slowly and then suddenly in October, to a level touching below 2%, albeit very briefly. Its current level, in the 2.2%-2.3% area, signifies weakness more than strength. The economic expansion in the US may be tepid, but in some other parts of the world, growth is downright pathetic, or not existent, as in Japan and much of the Euro-zone.[2]

Valid concerns have been raised that economic growth in the US simply will not take off, any time soon. Gridlock in Washington, DC does not appear to have been solved by the recent election results. Pro-growth, free market policy changes may still be some ways off.

So where does this leave us now? We tried to make some sense of our current conditions by comparing economic growth to actual stock market performance, by constructing the chart below.



The blue bars show the quarterly changes in GDP (inflation and seasonally adjusted).[3] The orange line overlay shows the quarterly total return for the Vanguard 500 Index fund.[4] This fund is one of the easiest ways to invest and after accounting for a tiny amount of expenses, the resulting return is essentially the same as the S&P 500 Index®.

We are looking at portions of two different market cycles, from the beginning of 2004 to the end of the third quarter, 2014. Here are a few observations:

1. The stock market and the economy seemed to be more closely aligned at the beginning, up until the recession began.
2. The market signaled coming problems by selling off in late 2007.
3. After a huge drop in overall value, the market came back strongly and was a leading indicator that economic conditions were about to change, in 2009.
4. Volatility in market returns seemed quite large coming out of the recession, but then seemed to quiet down (This past October was the exception).
5. We do not see much difference in the current GDP growth rate, versus growth right after the recession ended. 2014 will most probably not wind up being a 3% year. By contrast, 2009 Q4 through 2010 Q3 came in at 3%.
6. The stock market has continued on its merry way, seemingly unaware that its dance partner, the economy, is a few steps behind. Although subtle, this indication does show up on the right side of the diagram. In our view, stock prices have outpaced the economy somewhat, in the last couple years.

What could change this?

If the economy started performing above trend, with a minimum +4% GDP growth rate year-over-year, this would give us confidence that we will grow into the current market valuations, without much of a problem.

If we experienced a “pause that refreshes”. If the markets in 2015 put us all to sleep, but wound up largely unchanged, it could be a good thing in disguise. There will probably be a couple “buying on the dips” opportunities, in any case.

If we have a real correction (remember now, it's from 10-20% down from the current market high), this would erase a lot of investor complacency, inject some “useful fear” into the market and reset valuations to a more manageable level. However, this does not mean an end to the “secular” bull market cycle.

The Federal Reserve is expected to begin increasing the Federal Funds Rate (thus causing the Prime rate and other short-term rates to follow) beginning sometime in 2015. The first small increase at mid-year should already be “baked” into stock prices. It would be the major unexpected move, or perhaps no move at all, that would jolt the stock market down or up.

Or something worse? We are not projecting a bear market, but bad things sometimes happen. We would need to see some hard data that bolsters this position. So far, not much evidence supports a market meltdown scenario.

By contrast, the European Central Bank (ECB) and Bank of Japan (BOJ) have embarked on their own version of quantitative easing (QE). In our opinion, this has gone from the sublime to the silly. Do you honestly think that the Spanish 10 Year Bond (currently at 2.01%) is less risky than the US Treasury 10 Year Note[5]? If not, then it would not be selling for a higher price (yields move inversely to the bond's price) than the equivalent US Treasury security. The ECB and BOJ are printing money and buying up bonds in the process, at least temporarily inflating their bond prices.

If nothing of consequence changes, could 2015 basically be a repeat of 2014? Yes, we think so, although this is not our most desired scenario. Of course, the markets can stay silly longer than we can stay solvent. So our advice remains to follow your dollar cost averaging targets to your predetermined asset allocations. We will be on the lookout for more significant buying opportunities along the way.

If an economic breakout in 2015 is achieved, while we think it to be unlikely, this definitely would alter our market outlook. So stay tuned. In a future issue we will be writing about prospects for a real economic boom in the future, due mostly to the Millennial generation. We think that their impact will be massive, but has been delayed, due to the recession and subsequent weak “recovery”.

Mortality, Morbidity, Stupidity, Wha-ever! OK, Think Risk Management

(***CastlingFP*** has a somewhat different view of insurance, from that of most other financial planners, especially those who sell insurance based products. We also do not currently give advice on insurance as part of our advisory agreement, although we reserve the right to change this in the future.)

The uninformed may think this is an article about insurance. But it is much more basic than that and absolutely fundamental to financial planning.

Yes, you do need insurance. And you should be served by someone who is licensed, knowledgeable and experienced in the type of insurance you are considering. No problem there.

But since virtually all insurance agents are commission based product salespersons, there is no fiduciary standard of care requirement, to govern the interaction between you and him or her. That is our first caveat. Since ***CastlingFP*** acts as a fiduciary to all clients in all cases, we would like to let clients see the big picture first, before they dive into insurance products.

Insurance is a form of risk transfer. In exchange for paying a premium (a guaranteed small loss), you hopefully avoid a very uncertain, but potentially catastrophic, large loss.

More generally, the basic tools of risk management are:

1. Risk Avoidance
2. Risk Reduction
3. Risk Retention
4. Risk Transfer[6]

These are not really new to anyone. We quickly learn that some activities or situations are not "worth the risk" and choose to avoid them. Whereas Nick Wallenda may choose to walk a tightrope strung between two high rise buildings (and live to tell about it), we may decide not to drive in a snow storm or to neglect our basement's sump pump during a torrential rain storm.

We also take positive actions and purchase equipment that actively seeks to reduce the risk of accident or mishap.

But even with our best intentions and bravest actions, bad things occasionally happen. Our lives are full of risks and we cold make a strong case that risk taking built America. So knowing which risks to retain and which to transfer becomes the important issue. Beyond that, to what extent do we transfer a risk, when it does get transferred?

For example, what made you choose your automobile insurance deductible where you currently have it set? Do you like to purchase an extended warranty for every electronic product or appliance? (We sure hope not.)

So where are we going with this? From the very general, let's zero in on a process that could help you think of every risk related issue differently. Then let's tie it back to a ***CastlingFP*** principle.

In Emmett and Therese Vaughan's classic book, "Fundamentals of Risk and Insurance", the authors describe a six step process for risk management. We are merely paraphrasing here, with attribution:

1. Define the objectives
2. Identify risks
3. Evaluate each risk
4. Select which risk management tool(s) to use for each risk
5. Implement
6. Monitor and review[7]

Sometimes in practice, step one is overlooked. Instead, the client may allow the insurance professional to define the objectives. This is, in our opinion, the absolute wrong approach.

For the average, middle class American, there probably will never be enough time, money or other resources, to fully cover every potential problem with a risk transfer (e.g. insurance) based solution.

Identifying and quantifying risks are often left to the same insurance professional who has a vested interest in selling you certain products. Are your best interests being looked after? Let's explain what we mean by that.

Take mortality and morbidity, for example.

Mortality refers to the probability of death at a given age. One reason term life insurance is so inexpensive is because the probability of a young, healthy person dying prematurely (i.e. well before life expectancy) is very low. Low actual death rates translate into low annual premiums. However, these premiums do go up each year (Unless you lock in a longer term, such as 10, 20 or 30 years. But these will be at higher premiums than annually renewable term at the starting age).

Morbidity refers to the rate of illness and disability. Statistical tables displaying the incidence of morbidity are used to set the rates for disability income insurance. For most young and healthy people, the probability of untimely death is actually lower than of disability. So is the emphasis always placed on making sure these folks get the disability income insurance they need, even if life insurance needs to get de-prioritized, due to budget constraints?

No, not always. Perhaps seldom. Now let's go a step further.

A chronic illness may not result in death or disability, but it could still be a financial catastrophe, for a person without health insurance/healthcare plan. It is also more probable than either premature death or disability. Will it always get prioritized appropriately, especially if those priorities are being made by someone who has a financial interest in selling life insurance and not the other two?

Let's go another step further.

Now let's compare the probability of health issues versus career issues. Do you have a higher probability of contracting a chronic illness or of losing your job (or of having your career disintegrate, industry implode, or employer go bankrupt)? Do you know of an insurance policy that protects your career? We don't. For that reason, a six month emergency fund (including all necessary after tax fixed and variable expenses) is vital as a risk management tool.

Will the establishment and growth of your emergency fund be prioritized ahead of purchasing insurance products?

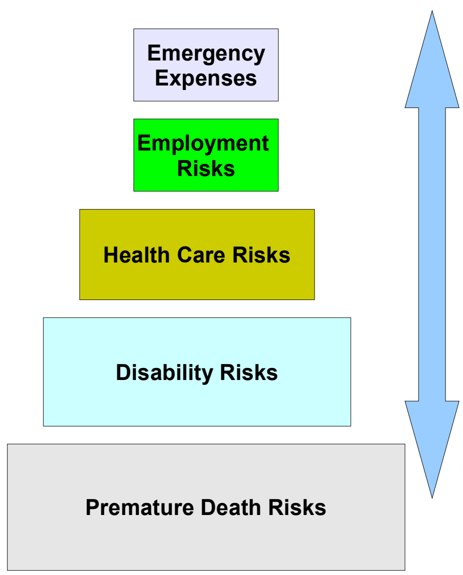
We are still not done.

What if some unexpected expense comes up? For example, an un-reimbursed healthcare expense, an unforeseen, but necessary and expensive home or auto repair, or one of a number of other emergencies that could make its way to your front door. Would you rather set up an adequate emergency fund now when all is quiet? Or do you listen to the commission based product salesperson who makes a seemingly convincing argument on why you need permanent life insurance now, because you may not be insurable in twenty years?

Our point is that you should be focusing on the risks you have today, quantifying them in current dollars, assessing their likelihood and impact and then developing a plan for dealing with them. Now.

Leaving any of these risks unaddressed, while dwelling on risks you may have in ten or twenty years is, in our view, foolish.

We feel that anyone who sells you products, but does not adequately address your current overall risk management situation, is not doing you any favors. Consider the simple graphic below.



Premature death could be catastrophic to a young family, without adequate life insurance. But why emphasize permanent life insurance, when long duration term life insurance could cover this risk sufficiently and still leave ample funds in the family budget to cover all those other risks shown above? This question should always be asked.

The probability of each of these risks materializing is higher, the higher up we go in this pyramid. The dollar impact of a single occurrence may get smaller, though, but this is far from assured. Losing one's job is not as bad as contracting a terminal illness. But based on duration of unemployment statistics, not having an adequate emergency fund can turn the situation into one of desperation. During the last recession, some middle class folks needed to seek state sponsored food assistance after only a relatively short period of time.

A preoccupation with risks ten and twenty years into the future, while neglecting clear and present risks of today, is not in your best interests. Be certain that the financial advice you heed also takes this into consideration. Financial planning is about the allocation of limited resources in such a way that allows for you to best achieve your goals, given your budget.

Here is a ***CastlingFP*** principle as applied to risk management:

Insurance, however important it may be, is never an end in itself.
It is always a means to an end.
The end is always, always, always, Financial Independence.
So keep your eyes on the prize!

Social Insecurity, or How Not to Depend on the Government for Advice

In our Summer 2014 issue, we discussed how "stealth" taxes on Social Security benefits are trapping more and more Americans, simply because income parameters are not indexed to inflation. For example, as income surpasses the $44,000 threshold for a married couple filing jointly, up to 85% of Social Security benefits become taxable (at the Federal level).

Our focus in this article is to begin discussing the insecurity the general public feels, regarding Social Security. When it was first launched back in 1935 with the introduction of the Social Security Act, the program was viewed as social insurance. This meant that it was funded by premiums originating from the payroll (FICA) taxes paid in by participating employees and their employers[8,9]. This set it apart from a simple welfare program. Over the decades, both the payroll tax rates, as well as the maximum wage level subject to the tax, have increased significantly, even accounting for inflation. Added to this, the full retirement age (FRA) has increased from 65 to 67, depending upon year of birth.

Even with all of these changes and the taxes on benefits mentioned above, the long term solvency of the system has been called into question. The Social Security Administration reports that unless Congress takes action, the Social Security Trust Fund would be depleted by 2033. If this were to happen (although very unlikely), the program would depend solely on current payroll taxes and thus be able to pay out only about 77% of projected benefits[10].

The end result is public insecurity about Social Security. This has led many people to believe that the system will not provide future benefits to them, that are equivalent to those currently being paid out. The Employee Benefit Research Institute's (EBRI) annual Retirement Confidence Survey has been tracking public opinion on this matter for the last twenty years. In the latest survey, about two thirds of current workers polled responded that they are either "not too confident", or "not at all confident" that Social Security will provide future benefits of equal value to those currently paid. Interestingly, this was not the highest negative percentage response measured in the last twenty years and there is no discernible trend in public opinion over this time range[11].

To be totally honest, we have not been the biggest fans of Social Security over the years. It has been over hyped and used as a political football. Tax rates have increased , while the ratio of workers to retirees keeps shrinking. Decades ago, it was obvious to anyone listening to the program's actuaries, that demographic changes were going to cause problems. Politicians from both parties waited until near crisis conditions existed, before acting. But the changes made were relatively modest and increased the retirement age for full benefits from 65 to 67, among other things.

We think this type of change continues to be the fairest approach going forward. When the Social Security program first started, life expectancy was actually less than the age at which a recipient could claim benefits. So actuarially speaking, half of the folks died before receiving so called "old age social insurance" payments. With life expectancies rising, although lately at slower rates, it stands to reason that younger people should expect to receive benefits a little later on.

While many may be cynical of Social Security providing them anything, it is exactly these small changes, which implemented gradually over a period of time (just like the 65 to 67 shift for FRA) could be the best compromise solution that sees us through the next thirty years. So, let's get going on this!

So where does all this consternation leave those nearing retirement? If it means grasping for and clutching their benefits as soon as they can get their hot little hands on them, we think they may be making a big mistake.

How and when you claim your Social Security benefits will be one of the major financial decisions of your lifetime. Guess what? Not only is there no one in government who is going to provide specific advice to you on this issue, in fact, they are prohibited from doing so.

We will continue covering Social Security matters in future issues of our Newsletter. This article is meant to introduce the concept of claiming strategies as part of your overall financial planning. We have also updated our Financial Engineering Your Retirement diagram (thoroughly described in our Spring, 2014 issue; please contact us if you would like a free copy), as shown below.

Consider these points before making any Social Security decision:

1. Those already receiving benefits or very close to retirement have previously seen either no impact or very minor impact, to their benefits. So rushing to get benefits at the earliest opportunity, out of fear, does not seem warranted.
2. Delaying benefits until at least FRA should be analyzed, taking into consideration our on-going discussion and other sources of information you may have.
3. Maximizing your cumulative benefits received during your lifetime is not your only goal. Think about longevity risk. Instead of merely worrying about "what if I die before I receive much back in benefits?", you need to balance this with "what if I live a very long time and spend down almost all my assets?".

4. Taking Social Security benefits early, in conjunction with other retirement accounts and pensions, may mean a more comfortable life for a while, but at the price of higher taxes. Consider the taxes on up to 85% of your benefits, as mentioned earlier. Delaying benefits means delaying and possibly minimizing taxes on those benefits.
5. The regular monthly benefit at FRA is called the Primary Insurance Amount (PIA).
6. For any age before FRA, benefits claimed are permanently reduced. If FRA is 66 years, taking early benefits at 62 means that only 75% of the PIA will be paid. Similarly, if FRA is 67, benefits at 62 are only 70% of PIA[12].
7. Delaying benefits until after FRA, results in earning extra retirement credits. This only accrues until age 70. So if FRA is 66, benefits at 70 would be 132% of PIA. If FRA is 67, benefits at 70 would be 124% of PIA.
8. When factoring taxes on Social Security benefits which are added on top of pension and retirement account distributions, try to offset some of this taxable income with distributions from after tax savings or Roth IRAs.
9. We are not trying to push people into working longer, if that is not their desire. We are, however, making the point that how you “prepare and mix together” your various income sources will determine how you can maintain your desired standard of living at the lowest level of income tax liability and with the greatest chance of not outliving your assets.

Let's finish with a practical example of a 62 year old single female. She is divorced, but was married less than ten years and therefore, cannot receive benefits based upon her ex-husband's earnings record. She is analyzing what to do, based upon her own earnings history. Her PIA is $2,000. She has no one who is dependent on her income.

She has decided to retire from her employment, in order to devote time to her passion, which is art. She is concerned that she may not have enough income to make this dream a reality.

(Of course, her first great move was to seek out an hourly, fee-only financial planner who does not sell products or charge asset management fees. She did this a few year back and now feels much more confident in making her retirement decision!)

She carefully reviews her Social Security statement with her adviser and finds that her full retirement age is 66. She qualifies for reduced benefits at 62 of: 75% of $2,000, or only $1,500. But if she delays taking benefits until age 70, she would receive the inflation adjusted amount of: 132% of $2,000, or $2,640.

Creating a budget with her adviser's help several years before retirement, has allowed her to emphasize saving and investing. She enters retirement needing only $4,100 of gross income per month. She will start taking her employer's pension immediately at 62, but it amounts to only $1,300 per month and is not inflation adjusted.

Based on seeing the current age 70 projection of Social Security benefits and knowing that taking them now would mean more in income taxes, she decides to wait. However, she is somewhat nervous at seeing more of her IRA being used up each month, until Social Security benefits kick in later on.

At Age 62, Monthly:	
Gross Income Needed	$4,100
Employer Pension	$1,300
IRA Distribution	$2,800
Remaining Shortfall	$0

Let's assume that her "personal" inflation rate averages 3%, but that the cost of living adjustments on Social Security (COLAs) are not as great (which oftentimes appears to be the case) and her benefits go up by only 2% each year (this is on top of her delayed retirement credits, which totaled $2,640 from above).

Monthly at Age 70:	
Gross Income Needed	$5,194
Employer Pension	$1,300
Projected Social Security	$3,093
IRA Distribution	$801
Remaining Shortfall	$0

Notice how eight years later, the "burn rate" on her IRA (the monthly distribution needed to maintain her standard of living) is much less than in the first eight years.

But what if she took Social Security at the earliest age possible of 62? How different would her budget look?

Monthly at Age 62:	
Gross Income Needed	$4,100
Employer Pension	$1,300
Projected Social Security	$1,500
IRA Distribution	$1,300
Remaining Shortfall	$0

The burn rate on her IRA seems light, so her remaining assets can grow. She has apparently sufficient income and ample assets. What could possibly go wrong? So let's fast forward eight years.

Monthly at Age 70:	
Gross Income Needed	$5,194
Employer Pension	$1,300
Projected Social Security	$1,757
IRA Distribution	$2,137
Remaining Shortfall	$0

Notice how the IRA distribution above, at age 70, has increased significantly since age 62. The budget looks progressively worse, year by year, if we continue the analysis. Let's do one more round and look at the situation at age 80. Once again, we assume a 3% personal inflation rate, but only a 2% Social Security COLA.

Here is how it may look at age 80, if she took the age 62 option:

Monthly at Age 80:	
Gross Income Needed	$6,980
Employer Pension	$1,300
Projected Social Security	$2,142
IRA Distribution	$3,538
Remaining Shortfall	$0

The monthly amount needed to distribute from her IRA is now 172% higher than when she started eighteen years earlier ($3,538 instead of $1,300). Will her IRA last as long as she does? One could argue that she could live on less, but we are simply assuming that she maintains her standard of living and keeps her budget in balance (i.e. no new debt).

Each subsequent year, she is burning through more of her IRA wealth. This is to be expected. <u>The issue is really about how quickly it occurs and what this might eventually do to her standard of living</u>. <u>This is an example of longevity risk.</u>

By contrast, here are the results, at age 80, of having waited until age 70 to take benefits.

Monthly at Age 80:	
Gross Income Needed	$6,980
Employer Pension	$1,300
Projected Social Security	$3,770
IRA Distribution	$1,910
Remaining Shortfall	$0

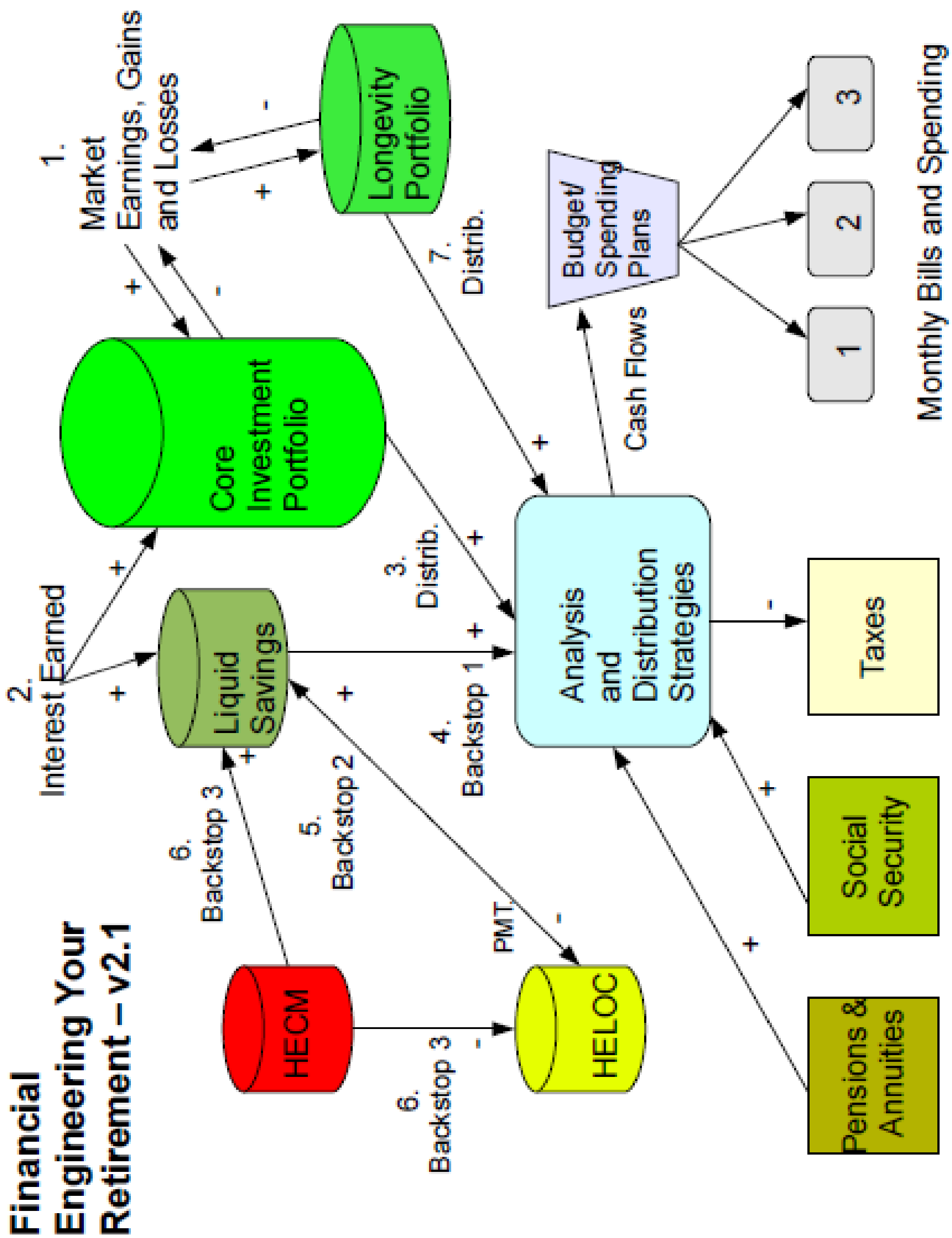
The monthly IRA draw is only 54% as much ($1,910 versus $3,538).

Of course, the <u>constraint is that our client would need to have saved and invested enough to be able to see her through the eight year period from age 62 to 70, without relying on Social Security</u>. Then again, she pays no income taxes on a benefit that she does not yet collect on.

While we teach children that delaying gratification can be a good thing, we may have difficulty practicing what we preach. Obviously, not everyone can wait that long. But the benefit is clear once the much larger Social Security payment is added in. <u>While we did not explicitly factor income taxes into this analysis, it would only make the comparison worse, for taking the age 62 option</u>.

Beyond introducing the subject and presenting the two polar opposite choices, the major conclusion from this example is that not only will delayed retirement credits fatten up your eventual Social Security benefit, but <u>the annual cost of living adjustments that compound on top of the larger original benefit means that your other assets will be drawn down more slowly as you get older, thus decreasing longevity risk</u>.

Since there is no one size fits all financial planning, this is once again another reason for the affordable, hourly approach of ***CastlingFP***.


Financial Engineering Your Retirement – v2.1
1. Market Earnings, Gains and Losses
Longevity Portfolio
Core Investment Portfolio
2. Interest Earned
Liquid Savings
3. Distrib.
7. Distrib.
4. Backstop 1
5. Backstop 2
6. Backstop 3
6. Backstop 3
PMT
HECM
HELOC
Analysis and Distribution Strategies
Budget/ Spending Plans
Cash Flows
1
2
3
Monthly Bills and Spending
Taxes
Social Security
Pensions & Annuities

Grossed Out! Lessons to Take from Bill Gross's Departure at PIMCO

Do you know who Bill Gross is? Do you care? For many readers and clients, the names of mutual fund managers are not synonymous with rock stars and movie actors. They may invest based on their adviser's recommendations, the fund choices available in their employer's plan or by reading commentary from a third party service such as ***Morningstar®,*** or a magazine such as ***Kiplinger's Personal Finance***. Who arrives and who departs are mostly just obscure personnel changes.

But we think that Bill Gross's recent high profile departure from the Pacific Investment Management Company (PIMCO), that he co-founded back in 1971, is illustrative of some of the problems encountered when: funds become too big, parent companies obsess over growing assets, active managers have too much cash to invest, thus diluting their good ideas and internal personality clashes always seem to magnify the problems, when performance results start moving in the wrong direction.

This article is not meant to be a negative portrayal of Bill Gross, in the least. He stands as one of the most knowledgeable and skilled bond investors ever. He built a large organization from scratch and ran the most successful bond fund, PIMCO Total Return, since its founding back in 1987 and into what was once, the largest mutual fund in the world (based on assets). For those who do not know, there are many share classes of PIMCO Total Return, ranging from the load based Class A shares (ticker symbol PTTAX) to institutional class shares (ticker symbol PTTRX).

CastlingFP has never seen a need to recommend front or back end loaded mutual funds to our clients and this fund is no exception. We have always found alternatives that serve our clients' best interests, without adding sales loads and commissions (which add needless cost). However, <u>share classes without loads were often available to participants in employer based plans, such as 401(k)s</u>. As a result, the no load version of this fund was sometimes recommended to certain clients.

This fund is of course, actively managed. But the expense ratio for the institutional class shares has been at or below the 0.50% benchmark we talk about with our clients. Can the active manager deliver a better return, adjusting for the risk taken and after all expenses are subtracted? That remains the difficult hurdle. Most actively managed funds fall short. As a result, we often do recommend and use index funds.

<u>It should be kept in mind that index funds represent low cost investing with style "purity", but this is not synonymous with "safety"</u>. It does mean that the management of

a US large cap index fund is not about to throw in shares of a foreign, small cap gold mining company, just to spice things up.

Bill Gross, while at PIMCO, was an active manager of what is typically viewed as an intermediate term, investment grade bond fund (meaning it would buy the bonds of both corporations as well as sovereign governments). He would search for investments throughout the world, use derivatives and also leverage. Over his entire tenure at PIMCO Total Return, he significantly outperformed his comparable indexes.

But as often happens, smooth sailing sails into a few storms, eventually. Even for someone like Bill Gross. He made a few predictions on the direction of interest rates and the economy that were less than stellar, over the past several years. This led to investment policy decisions that caused the fund to under perform its peers. Some investors began pulling their money and these outflows have continued for a couple years.

By digging through some reports and data on the Morningstar® Website, we were able to determine the Total Return fund's asset base has dropped from over $250 billion in September, 2013, to less than $171 billion currently[13]. And it keeps dropping. We have since heard multiple reports of the fund being dropped as a choice from employer sponsored plans, ever since Mr. Gross's departure on September 26th.

We should point out that this does not imply that shareholders are in any immediate danger. The fund currently has about a +4% year-to-date return and this is roughly in line with its category. The long term Gross-less future, however, is far less certain, although PIMCO management will be trying their best to get the fund back on track.

One other important fact to point out is that PIMCO was acquired by the large German insurance and financial services company, Allianz SE, back in 2000. It is commonly thought that the firm runs pretty much as an autonomous subsidiary of the parent company[14].

Now here is our take. Size matters in mutual funds. The fees that are generated are enormous. Index funds minimize the bite, although the Total Return fund was not expensive, from most any point of view. But there is a problem with asset growth in actively managed funds. While index funds would take cash inflows and continue to invest by replicating their benchmark index, an actively managed fund is committed to make other choices, based upon its stated investment policy and management team's ability to find new, promising investments.

But what happens when performance is great, but more cash comes in than can be deployed effectively? For any large corporation, holding a lot of cash may be seen as a sign of weakness in management. The CEO and his team would be expected to either find promising projects to expand the business, invest in R&D, or simply, buy back shares or pay a hefty dividend back to the shareholders. Sitting on loads of cash earning essentially no return is not something a CEO is supposed to be doing (for long).

In the mutual fund universe, outperforming your benchmark is the standard of comparison for any active manager. Since the annual returns in the bond arena are quite smaller than for stocks, every basis point (one hundredth of one percent) of return is vital when it comes to showing your year end performance.

But what if your best investment ideas are not an endless parade, but a finite set of dwindling choices? Buying more of the same investments will increase their prices and decrease their expected returns. Or it could cause the active manager to seek out less than stellar investments, which turn sour. Or it could cause him to design more risky scenarios involving financial derivatives and leverage. Or it could simply cause him to hold more cash. Two or more of these situations in combination could easily cause the fund's returns to trail their benchmark, net of fees and expenses.

The solution? It's quite simple. <u>A fund's managers or the fund family's management can make the fateful decision to close the fund to new investors, before reaching the point where they can no longer handle the asset level the way they did before</u>. Such an action is in the best interests of the existing shareholders. An example of this is Vanguard's Wellington Fund. This is also an actively managed fund, but it follows the classical 60/40 equity to bond asset allocation. When management felt that the fund had gotten too big, Vanguard made the decision to close it to new investors. This closure is not permanent and can be reversed at any time, without notice.

Of course closing a fund to new investors means that most of the subsequent growth in assets would have to be due to an increasing net asset value (i.e. the investments would be worth more in the markets).

In the case of PIMCO Total Return, would the situation have been different if the fund had closed to new investors at the end of 2012, when it finished with a sterling 10.35% total return and in the top quartile of its peer group? It went on to lose 1.92% in 2013 and as this happened, outflows started increasing and increasing.

This must have led to growing tensions at the firm, which ultimately led to Gross leaving, for Janus Capital Group, Inc. In an interview published in ***Investment News***, Gross was asked a question regarding how much easier or more difficult it will be to manage a much smaller fund (his new one: Janus Unconstrained Bond Fund: JUCTX) versus the previous huge fund.

His response was very telling and so we think it instructive to print part of the quote here:

"...a Martian would know that a smaller amount of money can be moved more nimbly than a much larger size of money...at least at the beginning, the amount of money will be much more manageable from the standpoint of strategy"[15].

We wish Mr. Gross the best of luck in running his new fund. We have not yet formed an opinion of it and it has zero real track record. It does appears that a lot of cash is chasing him from PIMCO to Janus, although we are not a big fan of trying to chase performance, especially chasing the "cult of personality" of a rock star fund manager. <u>We do think that paying attention to whether a fund is getting too big to manage, is important. And if the fund's management is not going to pay enough attention to this issue, then we will step in and make sure we do, on behalf of our clients</u>.

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