Lassus Wherley
Building Better Futures
...a View from the Top

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It Is All About Greece— Or Is It?

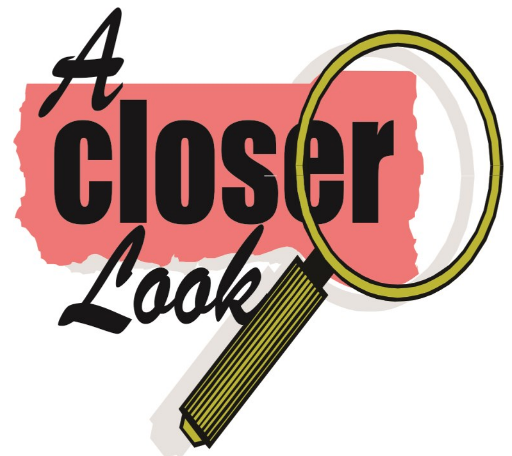
Here are our thoughts around Greece, China, Puerto Rico and the financial markets. We also answer some important questions concerning IRAs and market performance for the last 12 months.

The story in Greece has pretty much dominated the headlines lately even if there are many other important stories to be told. Greek voters said "no" to austerity, but the recent agreement seems to have settled the financial markets for now. We haven't yet heard the details of the deal between the Greek government and the euro zone leaders. There are still many questions remaining in terms of what the agreement will mean for Greece, Europe and the rest of the investment world, but for now everyone is breathing a sigh of relief.

But it isn't all about Greece. China also has many challenges and Puerto Rico is dealing with their own financial crisis.

Puerto Rican bonds have been popular with investors because of their "triple-tax-free" status. This means the interest paid by these bonds is exempt from federal, state and local income taxes. However, they are having major issues with their very large accumulated bond debt and are at risk of a default. Many investors have some level of exposure to these bonds through mutual funds.

This situation is complicated by the fact that Puerto Rico is a territory of the US and not a sovereign nation. This means that they cannot seek assistance through the International Monetary Fund (IMF). Another part of the challenge is because they are a territory and not a state, they cannot resolve their debts through Chapter 9 of the US Bankruptcy Code, as public utilities located in US states are able to do. Although we do not hold mutual



funds with exposure to these bonds, we are still concerned about how this will be resolved.

What happens in China could be more important than what is happening in Greece or Puerto Rico. The Chinese stock market is unique compared to other major

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investable countries due to the regulatory controls around their stock exchanges. The first and oldest stock exchange is in Hong Kong and is widely accessible by local and foreign investors. This is the market most emerging market stock funds are invested in.

The second, more regulated market, is in Shanghai. This market is comprised mostly of Chinese companies and is much less accessible to foreign investors. The recent headlines around the Chinese market are mostly related to the Shanghai exchange.

What happens in China could be more important than what is happening in Greece or Puerto Rico. The Chinese stock market is unique compared to other major investable countries due to the regulatory controls around their stock exchanges.

The Shanghai Stock Exchange Composite index (SSEC) is the most widely used benchmark of the Chinese stock market. Over the last 12 months ending June 30th, the SSEC was up an unbelievable 109%, even when including the final two weeks of June which saw a 24% decline. Selling has continued into July, with an additional 19% of value being lost from the index. Despite the impressive 12-month performance, the speed and magnitude of the current sell-off has stirred investor concern and has heightened volatility among Chinese stocks and the emerging markets as a category.

There are many reasons for the strong performance over the past year, but the bottom line is that this market was driven by massive capital inflows from Chinese retail investors. In fact, 85% of the Chinese market is comprised of retail investors. As we know from our experiences with other markets, the retail investor component is typically the most volatile. This is due to their lack of experience, access to information and the role psychology plays in their investment decisions. Institutional and professional money managers tend to have a longer term focus and do not generate the level of volatility we typically see from the retail market.

Over the last year many of the retail investors borrowed money on margin to increase their stock holdings. As the value of their investments has dropped, they've experienced margin calls which necessitate adding cash as collateral to their investment accounts. If the investor does not have sufficient outside cash to replenish the accounts, assets must be sold to cover the margin requirements. This is one of the major contributors to the speed of selling and recent market declines. Outstanding margin levels are still exceptionally high in China.

China has attempted to implement controls to better contain the magnitude of market declines. The Chinese state-backed margin finance company, with the backing of the Chinese Central bank, has organized a group of professional investors to buy $19.3 billion worth of mainland-listed stocks to support the market. State-backed insurance companies along with the China Mutual Fund Association have also

piled in tens of billions of yuan into index funds in an attempt to boost prices and slow the pace of selling. New share issuance in the form of Initial Public Offerings (IPOs) has been halted, with more than 38 companies suspending their scheduled IPOs. In addition to these controls, approximately 25% of the market has halted trading in their shares until volatility has been reduced.

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China is the world's second largest economy and is a major component of global and emerging market stock indices. Of stock indices available to US investors, it represents 2.5% of the global investable universe and 29% of the emerging market universe. However, much of this exposure does not include the Shanghai stock index since the restrictions to foreign investors are high. The Hong Kong market, which is a better representation of what we currently own in portfolios, has had much calmer performance and volatility. Over the 12-month period ending June 30th, the index returned approximately 11%, with the final two weeks in June losing 4%, which is tame when compared to the Shanghai index.

Anytime a market doubles over a short period of time, it is not unusual to see some level of correction, bringing prices back to more reasonable levels. We expect to see continued volatility in Chinese markets as the government attempts to control capital flows. Given the exceptional recent performance, the typical behavior of the leveraged retail investor and the dynamics of a state-controlled market, we believe this will persist for some time. However, the longer term story still holds for both Hong Kong and main-land-listed stocks as China's economy continues to grow faster than almost every other investable market. At present, our direct exposure to stocks listed on the Shanghai index is zero with our core Chinese exposure coming from the Hong Kong market.

The US economy is continuing along the path of slow growth, and inflation readings remain muted. The manufacturing sector does remain a soft spot for the economy for the most part, as the effect of the stronger dollar on US exports continues to be present in recent reports. However, we are seeing several positive signs from recent economic reports. The jobs market has been showing steady improvement for some time, despite June's mixed employment report showing that growth in private payrolls was lower than expected. The unemployment rate is now at 5.3%, jobless claims continue to hover around 15-year lows, and we are seeing solid growth in both retail jobs and professional and business service jobs recently. Housing also showed improvement heading into the spring, and that trend has continued as of

late with existing and new home sales both showing solid growth in the latest report for May, as well as a strong advance in April in the case of new home sales. We are also starting to see consumer spending increase alongside increases in personal income, as well as stronger retail sales reports. These are positive signs since we know what an important driver consumer spending is for the overall economy.

We expect GDP growth to bounce back in the 2nd quarter after a slightly negative 1st quarter, and to come in at the 2-3% range for 2015. Our prognosis for US equity markets continues to be for modest single-digit returns for the year, with continued volatility and divergence in returns between international and domestic equity markets.

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Here are a couple of great questions from some of our clients. Let us know if you have one you would like included.

Question: *What happens to an IRA when a person dies and what are some things to consider?*

Answer: Individual Retirement Accounts (IRAs) are assets that can pass to heirs outside of the will, thus avoiding the probate process. The role of the beneficiary designation allows the account owner, during their lifetime, to provide instruction on how the IRA assets should transfer at death.

Upon death of the IRA owner, the assets will pass to the individual(s) or entities named as the primary beneficiary. If the primary beneficiary has predeceased the IRA owner, the assets will transfer to the listed contingent beneficiary. If no living beneficiaries remain, or no assignments have been made, the assets will transfer based upon the instructions of the will. If no will exists, state law will dictate the transfer of assets. This is an important reason why we suggest naming both a primary and contingent beneficiary as well as reviewing your designations periodically. It is critical that the correct beneficiaries are listed on your accounts. Generally, it is also important to avoid naming your estate as a beneficiary. By naming your estate, the IRA assets get pulled into the probate process with the distribution of assets determined by the will or state law. This effectively negates the intended role of the beneficiary designation and could increase the administrative costs of settling your estate. It also means that the IRA assets lose their qualified status and become income taxable.

When the assets are transferred, the

beneficiary will receive the assets in IRA form. The rules for inheriting IRA assets depend on the individual's relationship to the original IRA owner. If the beneficiary is a spouse, the IRA can be rolled into the surviving spouse's IRA. The characteristics of the surviving spouse's IRA will not change and distributions will not be required until age 70 ½. If the surviving spouse is already taking the required minimum distribution, the distribution amount will increase to reflect the increased value of the IRA. Contributions can still be made into the account as long as the surviving spouse is younger than 70 ½ and has earned income. It is important for the surviving spouse to revisit his or her beneficiary elections to ensure they are up to date.

When the beneficiary is not a spouse, an inherited IRA will need to be opened to receive the assets. The account maintains its tax-deferred status, but the rules for required minimum distributions are different than a typical IRA.

When the beneficiary is not a spouse, an inherited IRA will need to be opened to receive the assets. The account maintains its tax-deferred status, but the rules for required minimum distributions are different than a typical IRA. Generally, distributions must begin by December 31st of the year following the original IRA owner's death regardless of the new owner's age. Distributions cannot be deferred until age 70 ½. If the original IRA owner was younger than 70 ½ at death, the owner of the inherited IRA can elect to take distributions spread out over their lifetime, over a 5- year period or as a lump sum. If the original owner was older than 70 ½ at death, the Inherited IRA owner does not have the option of distributing the IRA over a 5- year period. Distributions must begin by December 31st of the year following death. The ongoing required minimum distribution schedule can be spread out over their lifetime or made as a single lump sum. In either scenario, distributions in excess of the required minimum distribution are permitted.

Inherited Roth IRAs do not avoid the required minimum distribution rules; however, monies coming out of the inherited Roth IRA are not taxable to the account owner. Another caveat regarding inherited IRAs for non- spouse beneficiaries is that the account owner cannot make contributions into the account. Ongoing contributions should be made into a separate IRA.

There are implications for failing to make the required minimum distributions from an inherited IRA. Generally, a 50% penalty is applied to the value of a missed distribution. When an IRA is inherited from an original account owner younger than 70 ½, there is some flexibility in the distribution schedule during the first 5 years. For example, even if no distributions were made for 4 years, as long as the IRA is fully distributed by the end of the 5th year, no penalties will apply. However, if more than 5 years have passed and no distributions have been made, the account owner may be subject to pen-

alties on the aggregate of the missed distributions. As mentioned previously, if the original IRA owner was older than 70 ½, required minimum distributions must begin the year after death. For large IRAs, the penalties for failing to take the required minimum distributions can be significant. Because of the complicated rules and potential penalties associated with inherited IRAs, it is important to make us or your tax advisor aware if you have received inherited IRA assets.

The trade-off of utilizing a broadly diversified portfolio is that we will not have 100% exposure to the asset class that performs best in any given year. However, we will not have 100% exposure to the asset class that performs the worst either.

Question: *I see that the US markets have done well, but my portfolio performance has lagged over the last year. What is going on?*

Answer: Over the last 12 months ending June 30th, the US stock markets have performed exceptionally well relative to other investable asset classes. The S&P 500 and Russell 2000 indices, which represent the large- and small -cap market segments, returned 7.42% and 6.49% respectively. Other asset class performance has not been as strong, with the majority of categories used in a globally diversified portfolio experiencing low or negative returns. The international developed and emerging markets equity indices, represented by the MSCI EAFE (Europe Australasia and the Far East) and MSCI EM (Emerging Markets) returned -4.22% and -5.12% respectively. Broad domestic bond indices returned between 1-3% while international bond indices were flat to negative. A combination of these asset classes resulted in a portfolio that underperformed the US stock market over the last year.

A primary goal of our asset management process is to create a diversified portfolio that offers favorable risk and return attributes when compared to each asset class on a standalone basis. In order to do this, we establish targets to asset classes across the global investable opportunity set. The exact targets to each asset class are client specific and heavily influence the portfolio's risk and return expectations. At present, our portfolios contain targets to as many as nine distinct asset classes.

The trade-off of utilizing a broadly diversified portfolio is that we will not have 100% exposure to the asset class that performs best in any given year. However, we will not have 100% exposure to the asset class that performs the worst either. Since returns among asset classes fluctuate from year to year, we believe it is prudent to have specific and managed targets to major asset classes throughout market cycles. By reducing the dependence on any one asset class and the corresponding volatility of returns each year, the diversified portfolio will outperform many of its individual components over the long term.

For example, for the 15 years ending June 30, 2015, a globally diversified

portfolio experiencing no withdrawals may have achieved an annual rate of return in the range of 5-6% while the S&P 500 would have returned approximately 4%. A key point is that these higher returns were achieved with lower risk, which is the primary benefit of diversification among assets.

We expect international and emerging markets to be a major source of portfolio returns in the long term even if they do have their challenges in the short term. Bonds and cash still play a vital role in creating the stable base to which higher risk and return exposures can be added. While the timing and sequence of investment returns are unknown, we do know it is critical to have exposures across each of these markets in a well balanced asset allocation.

Keep in touch and remember that you are a long-term investor regardless of what happens in the financial markets in the short term.

Enjoy the Summer.

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