Investment Update

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Saltmarsh
Financial Advisors, LLC
AN AFFILIATE OF SALTMARSH, CLEAVELAND & GUND

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Investment Insight

"Pundits forecast not because they know, but because they are asked."

-John Kenneth Galbraith

Join us for ***The Evolution of Investing*** with Dr. Apollo Lupescu of Dimensional Fund Advisors.

Pensacola
Saltmarsh Office
January 11th
8:00 - 9:30 a.m.

Tallahassee
Governors Club
January 12th
12:00 - 1:30 p.m.

For details, please visit saltmarshfa.com

Prediction Season

The close of each calendar year brings with it the holidays as well as a chance to look forward to the year ahead. In the coming weeks, investors are likely to be bombarded with predictions about what the future, and specifically the next year, may hold for their portfolios. These outlooks are typically accompanied by recommended investment strategies and actions that are aimed at trying to avoid the next crisis or missing out on the next "great" opportunity. When faced with recommendations of this sort, it would be wise to remember that investors are better served by sticking with a long-term plan rather than changing course in reaction to predictions and short-term calls.

Predictions and Portfolios

One doesn't typically see a forecast that says: "Capital markets are expected to continue to function normally," or "It's unclear how unknown future events will impact prices." Predictions about future price movements come in all shapes and sizes, but most of them tempt the investor into playing a game of outguessing the market. Examples of predictions like this might include: "We don't like energy stocks in 2017," or "We expect the interest rate environment to remain challenging in the coming year." Bold predictions may pique interest, but their usefulness in application to an investment plan is less clear. Steve Forbes, the publisher of Forbes Magazine, once remarked, "You make more money selling advice than following it. It's one of the things we count on in the magazine business—along with the short memory of our readers."[1] Definitive recommendations attempting to identify value not currently reflected in market prices may provide investors with a sense of confidence about the future, but how accurate do these predictions have to be in order to be useful?

Consider a simple example where an investor hears a prediction that equities are currently priced "too high," and now is a better time to hold cash. If we say that the prediction has a 50% chance of being accurate (equities underperform cash over some period of time), does that mean the investor has a 50% chance of being better off? What is crucial to remember is that any market-timing decision is actually two decisions. If the investor decides to change their allocation, selling equities in this case,

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Prediction Season

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Exhibit 1: Percentage of US Equity Funds That Underperformed a Benchmark

Fund Category	Comparison Index	One Year (%)	Five Year (%)	10 Year (%)
All Large Cap Funds	S&P 500	84.62	91.91	85.36
All Mid Cap Funds	S&P MidCap 400	87.89	87.87	91.27
All Small Cap Funds	S&P SmallCap 600	88.77	97.58	90.75

Source: SPIVA US Scorecard, "Percentage of US Equity Funds Outperformed by Benchmarks." Data as of June 30, 2016.

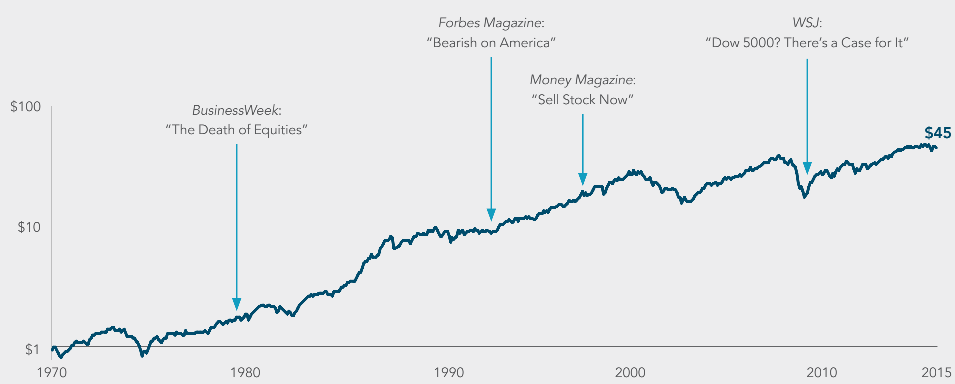
Past performance is no guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. The S&P data is provided by Standard & Poor's Index Services Group.

they have decided to get out of the market, but they also must determine when to get back in. If we assign a 50% probability of the investor getting each decision right, that would give them a one-in-four chance of being better off overall. We can increase the chances of the investor being right to 70% for each decision, and the odds of them being better off are still shy of 50%. Still no better than a coin flip. You can apply this same logic to decisions within asset classes, such as whether to currently be invested in stocks only in your home market vs. those abroad. The lesson here is that the only guarantee for investors making market-timing decisions is that they will incur additional transactions costs due to frequent buying and selling.

The track record of professional money managers attempting to profit from mispricing also suggests that making frequent investment changes based on market calls may be more harmful than helpful. **Exhibit 1**, which shows S&P's SPIVA Scorecard from midyear 2016, highlights how managers have fared against a comparative S&P benchmark. The results illustrate that the majority of managers have underperformed over both short and longer horizons.

Exhibit 2: Markets Have Rewarded Discipline

Growth of a dollar—MSCI World Index (net dividends), 1970–2015



In US dollars. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results. MSCI data © MSCI 2016, all rights reserved.

Rather than relying on forecasts that attempt to outguess market prices, investors can instead rely on the power of the market as an effective information processing machine to help structure their investment portfolios. Financial markets involve the interaction of millions of willing buyers and sellers. The prices they set provide positive expected returns every day. While realized returns may end up being different than expected returns, any such difference is unknown and unpredictable in advance.

Over a long-term horizon, the case for trusting in markets and for discipline in being able to stay invested is clear. **Exhibit 2** shows the growth of a US dollar invested in the equity markets from 1970 through 2015 and highlights a sample of several bearish headlines over the same period. Had one reacted negatively to these headlines, they would have potentially missed out on substantial growth over the coming decades.

Conclusion

As the end of the year approaches, it is natural to reflect on what has gone well this year and what one may want to improve upon next year. Within the context of an investment plan, it is important to remember that investors are likely better served by trusting the plan they have put in place and focusing on what they can control, such as diversifying broadly, minimizing taxes, and reducing costs and turnover. Those who make changes to a long-term investment strategy based on short-term noise and predictions may be disappointed by the outcome. In the end, the only certain prediction about markets is that the future will remain full of uncertainty. History has shown us, however, that through this uncertainty, markets have rewarded long-term investors who are able to stay the course.

1. Excerpt from presentation at the Anderson School of Management, University of California, Los Angeles, April 15, 2003.

8 Questions for RMD Season

By Christine Benz

It's a high-class problem for a retiree: A large tax-deferred portfolio and no immediate need for spending money. But even though you would rather leave the money in its place, allowing it to compound on a tax-deferred basis for your heirs, the government won't let you take advantage of retirement-savings tax breaks forever. At some point, you are required to start pulling the money out and paying the tax collector.

Enter required minimum distributions, or RMDs—mandatory withdrawals that must commence from tax-deferred accounts such as 401(k)s and Traditional IRAs once a retiree passes age 70 1/2. (Investors in other situations, such as those who inherit IRAs, are also required to take RMDs, but for the purpose of this article, I'll focus on RMDs from one's own retirement accounts.)

For many retirees, RMDs are a nonissue; they're already taking more from their retirement accounts than the government requires them to do. But for affluent retirees who have enough cash on hand from other sources, RMDs can be a headache, saddling them with higher tax bills than they would otherwise have.

I've received many questions about RMDs over the years; what follows are some of the most common ones.

Is there any way to reduce the tax impact of RMDs?
To a large extent, RMD-related taxes are what they are: You'll pay ordinary income tax on your withdrawals from your IRAs and company retirement accounts, to the extent that those monies haven't been taxed yet. (Any money you contributed to your account that consisted of after tax dollars will not be taxed again.)

The best way to reduce RMD-related taxes is to reduce the amount of your retirement assets that are subject to them. That means accumulating assets in taxable and Roth accounts in addition to traditional tax-deferred wrappers. For retirees, that ship has already sailed, but the post-working, pre-RMD years may be a good time to draw upon traditional IRAs and 401(k)s for living expenses, to skinny down the balances that will be subject to RMDs later on. Additionally, converting traditional IRAs to Roth can be appropriate in some situations; check with a tax advisor for guidance on whether that's a sensible maneuver for you.

Finally, retirees may have some leeway to tinker with other parts of their plans to help reduce the taxes they owe in high-RMD years—bunching deductions together in a single year to get more bang from itemized deductions, for example, or using a qualified charitable distribution to reduce RMD-related taxes.

What's a qualified charitable distribution?
A qualified charitable distribution is a way for retirees to steer a portion of their RMDs to a qualified charity; because retirees never put their hands on the money, that portion of the RMD doesn't increase their modified adjusted gross income, which is a key determinant of an individual's tax bill.

Can I reinvest my RMD in an IRA?
Once you've taken an RMD, you can't put that money back into a traditional IRA. You can, however, invest in a Roth IRA in the same year you take an RMD, provided you or your spouse have enough earned income—that is, income from working rather than portfolio or Social Security income—to cover your contribution amount. (I've met several retirees who have told me they have picked up part-time work for this very reason.) Roth IRAs don't carry RMD requirements. If that all sounds like too much of a bother, you can reinvest any RMDs you don't need in a taxable brokerage account, with an eye toward tax-efficient investments.

If I delayed my first RMD, when should I take the second one?
You often hear that RMDs commence once you turn age 70 1/2, but you actually have until April 1 of the year following the year in which you turn age 70 1/2 to take your first RMD. Let's say, for example, that you turned 70 in September 2015, and 70 1/2 in March 2016. You'd have until April 1, 2017—the year after the year in which you turned 70 1/2—to take your first RMD. You'd then need to take your next RMD by Dec. 31, 2017, however, so postponing the first RMD isn't always worth it, despite the usual admonishment to defer your tax bill for as long as you can.

My RMD is going to take me over my planned withdrawal amount. What should I do?
The government says you need to start taking your money out of your tax-deferred accounts post-age 70 1/2, but there's

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8 Questions for RMD Season

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nothing saying that you have to spend it. Thus, if your planned withdrawal rate is 3% but your RMD is over 5% of your total portfolio, you can reinvest that money. As noted above, you can reinvest the proceeds in a Roth IRA, provided you or your spouse have earned income and the contribution doesn't exceed $6,500. Or you can reinvest in a taxable account. Employing tax-efficient investments, you can actually do a pretty good job of reducing the drag of taxes on the taxable account on an ongoing basis, similar to what you had in your tax-deferred account.

Do I need to pull RMDs from all of my IRA holdings?

No. To calculate your RMDs, look back to the balance for each of your accounts as of the previous year-end. To calculate the RMD that you'll take out by Dec. 31, 2016, for example, you'll find your balances as of Dec. 31, 2015. If you own three separate traditional IRAs—one with an RMD of $4,000 at the end of 2015, one with a $1,000 RMD, and one with a $3,500 RMD—you'd need to take $8,500 in total, but it wouldn't matter which IRA you took it from. Because you can pick and choose where you pull them from, RMDs can be an effective way to help improve your portfolio's positioning, as discussed in this article.

Note that you can't combine RMDs from different account types—for example, if you have IRA assets as well as 401(k) that you're pulling from, you'd need to take separate RMDs. Nor can spouses combine RMDs, pulling from one spouse's account while leaving the other RMD-subject spouse's account alone; because the accounts are owned individually, the RMDs apply on an individual basis, too.

I've heard that I may be able to delay RMDs if I'm still working after age 70 1/2. True?

Yes and no. If you have IRA assets, you still have to take RMDs from those accounts post-age 70 1/2, even if you're working. But if you're still working and have assets in a company retirement plan, you can delay withdrawals from those accounts until April 1 of the year after you retire. The exception to this rule is for employees who own more than 5% of the company where they're working and participating in the plan; they must begin taking their RMDs at age 70 1/2.