COLORADO FINANCIAL MANAGEMENT®

THE INFORMED WAY TO INVEST™

*July 2016*

SUMMARY
S&P 500 is expecting to earn $113 operating earnings per share, according to Standard & Poors.

After the "Brexit" vote, Prime Minister David Cameron stepped down and Theresa May stepped up. The vote will likely slow the global economy.

Bond rates continue to fall to historic lows, while the stock market is at historic highs.

There have been large swings and fluctuations in the US job market between the months of April through June.

## In This Letter



Dear Clients and Friends,

It has been six months since the merger of Sargent Bickham Lagudis and Colorado Financial Management. One of the significant benefits to come from this combination is that we have two portfolio management focuses to build off of: SBL's strategic model which tends to produce purposeful and incremental portfolio adjustments based on intentions to maintain positions for a year or longer, and CFM's tactical model which is designed to pivot at least monthly based on economic metrics and a variety of statistical signals about the markets and economy. Being able to offer these two approaches allows us to be responsive to our clients' individual investment objectives in a way that we believe just isn't matched by other investment advisors. Starting with this newsletter, we will provide updates on both the strategic and tactical portfolio management approaches.

## Market Commentary and Review

*by Brad Bickham,* CFA, CFP®

"Flat is the new up. The S&P 500 started the year at 2044, immediately fell 11% to 1829, rallied 16% to 2119, fell 5% after the Brexit vote to 2001, and rebounded to close mid-year at 2099 for a YTD gain of 2.7%. Our year-end target remains 2100, reflecting a potential 6 month return of 0.1%."

| Returns as of June 30, 2016 | 2nd Qtr 2016 | Year to Date |
|---|---|---|
| World Stock Index (ACWI) | 1.1% | 1.4% |
| Large Cap U.S. Stocks | 2.5% | 3.8% |
| Small/Mid Cap U.S. Stocks | 4.1% | 4.0% |
| Foreign Stocks – ACWI ex-U.S. | -0.6% | -1.0% |
| Foreign Stocks - Emerging | 0.7% | 6.4% |
| U.S. Bonds – Taxable | 2.2% | 5.3% |
| Hedge Fund Index | 0.6% | -2.6% |
| 60/40 Balanced World Index | 1.5% | 2.9% |

That is a sobering prediction from one of the world's leading investment banks. We tend to agree with the sentiment, although we do not have the hubris to predict a specific number for the market's year ending close or return. We have been arguing, however, that this year would be another year of consolidation. Let us review the reasons and our strategy, but first we will briefly summarize what Brexit means and its implications.

[1] *From a 7/1/16 Goldman Sachs report on portfolio strategy*

Britain has voted to leave the European Union (EU). The EU is an economic and political arrangement between most of the European countries that allows for the free movement of goods and services, and of people. You can think of it as a United States of Europe, although it is a lot more complicated than that. With its choice to leave the EU, Britain now has to renegotiate contracts and treaties; and people will eventually have to show their passports when crossing borders, and be subject to immigration rules. Just designing the exit process could take two years or more to finish, and the truth is that nobody knows how it will play out and what affect it will have. At a minimum, Brexit will slow economic growth in England for a few years. But there are more pessimistic views suggesting that this is just the first domino in the breakup of the European Union, which has been in place for over 60 years.

With the uncertainty this creates, how do we navigate these volatile markets? Once again we will use our six investment pillars to guide our analysis.

**Economy.** The U.S. economy grew at a 1.1% annual rate in the first quarter, and probably at 2.0 to 2.5% in the second and third quarters according to forecasts by the Federal Reserve. This is the same pace at which we have been growing for several years and could be considered a 'goldilocks' rate of growth; neither too hot nor too cold. The Brexit vote is likely to slow global economic growth, but will only shave one or two tenths of a percent from U.S. growth.

**The Fed, Inflation, & Interest Rates.** Inflation is tame regardless of the measure used. The Fed's favored measure, core PCE is running at an annual rate of 1.6%, below the Fed's target of 2% and not likely to increase meaningfully any time soon. Combined with the new worries about slowing growth due to Brexit, the Fed is expected to remain on hold for longer than previously assumed. There is some risk that longer term rates could rise from their extremely low levels, but would probably only rise to the levels at which they began the year.

**Earnings**. According to Standard & Poors, the S&P 500 companies are expected to earn $114 operating earnings per share this year. That would be a 14% increase versus last year but only equal to the twelve months ended September 30, 2014. Since we believe stock prices largely follow earnings, it is easy to see why the stock market has been trending sideways for the last year and a half.

**Valuation.** It depends on what your earnings assumptions are! The S&P 500 is trading at about 2100. Based on trailing earnings of $100 the PE is 21x, which is at the high end of the historical range. Based on $114 of

earnings it would be 18.4x, and based on the estimate 12 months forward of $125 it would be 16.8x. We believe this backdrop is not overly attractive from a valuation perspective.

**Financial Stress.** We believe the risk of a banking crisis is low. You can see from the St. Louis Fed Financial Stress Index that we are well below the high risk zone. However, considering the *Alice in Wonderland and Through the Looking Glass* world we live in, with negative interest rates all around the world, and at least a small risk of the breakup of one of the world's largest currencies, we would call the risks elevated despite the chart below.

**Politics.** We conclude the risks from the political front are elevated. Following the Brexit vote, the Prime Minister of Great Britain resigned and now has been replaced by Theresa May. In the U.S. we have the two least popular Presidential candidates ever, and a Congress that will accomplish nothing this year, nor tackle any of the difficult issues facing our country.

In sum, we believe the "muddle through" scenario continues for a while longer. The biggest surprise to us is how resilient the market is to all the bad news. This indicates a market that wants to go higher. We are evaluating possible adjustments to our allocation strategies, but in general believe that our portfolios are positioned appropriately.

## Update on Our Tactical Portfolio Management Approach

*By David Eads,* CFP®

*(as of 6/20/16, recommendations subject to change at any time)*

Our models produce many analytical signals, of which we focus on about 200 with monthly analysis, monitoring two dozen on a daily basis. Our investment committee interprets those signals and develops conclusions upon which we base our portfolio allocation choices.

The Weight-of-the-Evidence observations at present are:

- The average of our signals suggests a moderately bullish stance on stocks

- Waiting for more pessimism to creep into the market before increasing equity exposure, allowing us to buy at a lower price
- Corporate profits need to grow, otherwise we are likely to hit a valuation cap in the stock market in 2016 and 2017

Based on the various signals and discussions we have had, our conclusions relating to the positioning of our portfolios are to continue to mildly overweight stocks relative to bonds and cash. This moderately bullish strategy has paid off year to date, as our tactical performance is ahead of the benchmarks.

For those clients who track some of the detail behind this approach, here are our "Eight Monthly Investment Decisions":

**Bond vs. Stock Allocation:**

- Lightly overweight stocks vs. bonds in the tactical portion of each portfolio
- +14 on a scale of -100 to +100 (-100 = max bonds, +100 = max stocks)

**Regional Stock Allocation**

(relative to MSCI All Country World Index NR):

- Overweight: U.S. Markets
- Marketweight: Emerging Markets
- Underweight: International Developed Markets

**Growth vs. Value:**

- Mild Overweight: Value
- Mild Underweight: Growth

**Large Cap vs. Small Cap:**

- Mild Overweight: Small-Cap
- Mild Underweight: Large-Cap

**ETF - Stock Selection:**

- Monitor current ETFs vs. other Schwab OneSource ETF options

**ETF - Bond Selection:**

- Monitor current ETFs vs. other Schwab OneSource ETF options

**Mutual Fund – Core Stock Selection:**

- Possibly reduce PIMCO International US Dollar Hedged mutual fund exposure with proceeds going to the Artisan International fund

**Mutual Fund – Core Bond Selection:**

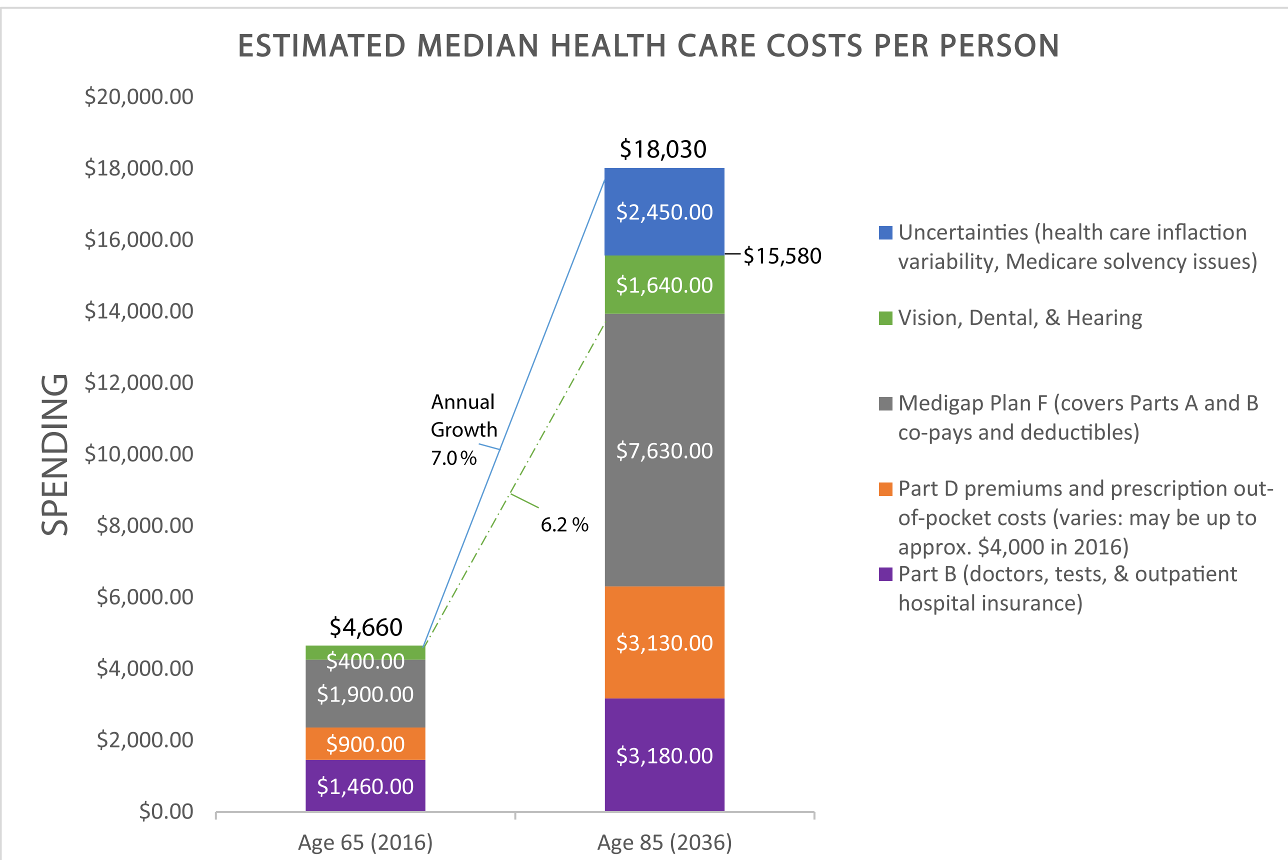
- No change

## Financial Planning Update

*By Gary Powell, Director of Financial Planning*

One financial planning variable that we spend a good deal of time discussing relates to the spending plans of a client after retirement. Not only is the absolute level of spending important, but the growth of that spending (caused by inflation) can present significant challenges in later years. Conventional thinking is that an individual or couple may continue to spend at about the same rate for a few years after retiring, taking advantage of opportunities to travel and so forth. Then spending will decline to a more stable level and be sustained there for some time. Predicting inflation becomes one of our big challenges.

Given the significance and variability of health care costs, it may be prudent to assume a separate inflation




[1] *The basis for this analysis is Employee Benefit Research Institute, SelectQuote data as of December 31, 2015 and J.P. Morgan analysis.*

rate for this category of spending. We are using an inflation rate of 7%, which suggests one may need growth as well as current income from a portfolio in retirement.

In the current low inflation environment, health care costs appear to have an uncontrollable upward momentum that needs to be specifically addressed when analyzing future retirement costs. Using traditional Medicare premiums as a proxy for estimating future health care costs can provide an insight into estimating future costs. [1]

As illustrated in the graph, at age 65 (2016) the estimated median health costs per person are as follows:

- Part B – doctors, test, & outpatient hospital insurance costs - $1,460
- Part D – premiums and prescriptions out-of-pocket costs (varies; may be up to approximately $4,000 in 2016) costs - $400
- Medigap Plan F – covers Parts A and B co-pays and deductibles costs - $1,900
- Additional medical costs not covered by Medicare premiums:
    - o Vision, dental & hearing costs - $400
      Thus, in today's dollars, total costs in 2016 - $4,660.

Applying a 6.2% inflation rate to the estimated median cost of $4,660 results in a total of $15,580 per person at age 85 (2036) ($31,160 for a couple).

You will need to adjust your Medicare premium cost for the 2016 additional premium per person based on your "Modified Adjusted Gross Income (MAGI) which is generally your Adjusted Gross Income on your tax return. For example, assuming your MAGI is between $170,000 and $214,000, you would have an additional premium of $737 for a total median cost of $5,397 for one person – a married couple's total cost would be $10,794 in 2016.
Now for the wild cards that are in play: health care inflation variability, Medicare solvency issues, etc. Many health insurance companies are resisting paying for revolutionary expensive drugs. Additionally, each individual has or will have additional health issues with age that may propel their personal health care costs above the medical health care costs illustrated above.

We believe it prudent to adjust upward the "uncertainty figure of $2,450" to make allowance for your personal health situation. We have incorporated a 7% inflation rate in our financial planning process. This is approximately 4.5 times the current inflation rate on other living expenses.

Your mindset about future health care costs and retirement portfolios should reflect future rising costs of healthcare.

**2016 Additional Premium per person for Modified Adjusted Growth Incomes (MAGI) of:**

| Filing Single | Married Filing Jointly | Additional Premium | Total Median Costs |
|---|---|---|---|
| >$85,000 - $107,000 | >$170,000-$214,000 | $737 | $5,397 |
| >$107,000 - $160,000 | >$214,000 - $320,000 | $1,855 | $6,515 |
| >$160,000 - 214,000 | >$320,000 - $428,000 | $2,972 | $7,632 |
| >$214,000 | >$428,000 | $4,091 | $8,751 |

## The Last Word

*By Rick Lawrence, CEO*

I am writing this the day after the Bastille Day tragedy, barely a week after the Dallas shootings. Great Britain has decided to exit the European Union, and chosen a new Prime Minister. Our Presidential candidates are about to announce their VP picks, and then we proceed to an election for a new President. And, our stock market is at an all-time high level, with interest rates are at historic lows. Not typical, and certainly not a stable setup.

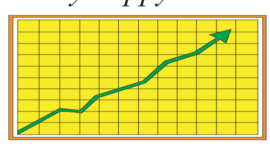
This quarter's newsletter really shows the value of having an investment advisor in your corner. Brad and Dave's pieces provide insight into the thinking that is going on here about your money, and how best to position it in the context of today's complex and somewhat conflicting investing climate. And different portfolio strategies yield different results. The merger of our two firms allows us to compare notes with one another every week, and apply insights into one another's analysis. We think both approaches will benefit over time.

Gary's section gives you a taste of the comprehensive and thoughtful approach we are taking on the other side of our business, If you happen to have a financial plan which was prepared by some other company or advisor, check it and see if they have applied the care we do in terms of thinking about your future spending and ability to afford healthcare for your family. Next time you talk to your CFM advisor, please ask about whether it is time to update your plan. We have new tools, very up to date thinking, and eight certified planners on our staff. We believe a sound financial plan builds a strong foundation for a sound investment plan.

We mentioned at the beginning of the newsletter that we have six months of experience working with the combination of Sargent Bickham Lagudis and the original Colorado Financial Management. Even with the merger of two small companies like ours, it is amazing to see the synergies that can be achieved, and the benefit of new thinking that accrues to both sides of the marriage.

Thank you to all the clients, of both companies, for your business and your loyalty.

*Many happy returns,*



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