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THE SEIA REPORT

Successful wealth management is the result of an ongoing collaboration between investor and advisor, built upon trust and maintained according to the highest standards of integrity and expertise.

THE RECIPE FOR A MATURING BULL MARKET

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FEAR: A five-year-old bull market can change people. Not that long ago, we were preaching to anyone who would listen the merits of stocks. But the conversation proved difficult as fear overwhelmed many investors. As recently as February 2011 we said, *"Even with our current bull market posting a near 100% gain…history suggests that this bull may still have room to run."* Our subsequent "Time to Get Patriotic" and "Relative Valuations" pieces suggested that U.S. equities offered value and were attractive on two fronts: 1) relative to history, *"the average P/E ratio for U.S. stocks over the last 100 years is 14 which equates to an earnings yield just over 7% (Earnings Yield = Earnings/Price, or the inverse of the more familiar Price/Earnings ratio). But today the earnings yield has increased to 9.5%...thus, relative to history stocks look attractive versus themselves;"* and 2) relative to other assets, *"historically, the average yield spread between (stocks and bonds) is 2.8%--and it has been extremely rare for that spread to rise above 6.0%. Today the spread stands at 7.4% (9.5% equity earnings yield - 2.1% Ten-Year Treasury bond) which is a level that is unprecedented over the last 30 years…if earnings hold and equity prices revert to the mean spread of 2.8%, then the S&P would trade north of 1600 from its current level now around 1200."* We then concluded that *"the time will soon be upon us when stocks again regain their status as king of the investment choices, if only because the opportunity cost of not buying stocks is so enormous."* Three years later, that time is now.

GREED: Investor's questions have morphed from "will stocks ever come back?" to "should I have more money in stocks?" In other words, the persistent fear of yesteryear is now waning and greed is taking its place. After five years of an equity bull market, certain signs of greed and froth are normal and unfortunately quite predictable. Investors have witnessed a bubble in *each* asset class over the last 15 years: tech/internet bubble in stocks, a housing bubble in land, a credit bubble in bond markets, as well as extremes in certain commodity prices (oil at $150 and gold at $1900). Although current overall stock valuations are elevated (from which a 10-15% pullback would be normal), fortunately it does not appear that we are in the later innings of another epic bubble that will wreak havoc across an *entire* asset class (perhaps today's bubble is the actual use of the word "bubble"). Rather, the signs of froth are limited to a handful of smaller market segments including some recent IPOs, smaller Biotech companies, multibillion-dollar private equity deals, and a basket of social media/internet stocks (not to mention the pure speculative action in Bitcoin, cannabis penny-stocks, alternative energy fuel cells, and the legal/political the fate of Freddie Mac/Fannie Mae). While dedicating a minute portion of a portfolio to speculative stocks is relatively harmless, investors should avoid devoting any material amount of a nest egg to assets that will not *systemically produce a reliable stream of investment returns.* Which begs the ques-

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THE RECIPE FOR A MATURING BULL MARKET

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tion, in the face of increasing greed, where should investors allocate capital to have the greatest chance of harvesting profits over the next three to five years? The answers to that $64,000 question may lie in two very different segments of the equity market.

EUROPE: Europe as an investment premise was first outlined here in the summer of 2013, but we still believe the continent remains an attractive option. In short, they offer a *"double whammy"* compared to U.S. stocks: they are projected to have higher earnings growth over the near-term yet are priced more attractively with lower valuations than their U.S. counterparts. In addition, tailwinds abound as their economy continues to improve (a Euro zone manufacturing index accelerated in April and marked the fastest pace of expansion in nearly three years) and consumer sentiment is catching up to reality (Euro zone consumer confidence climbed to a six-and-a-half year high in April). Consider the details...

- Price: European stock indices are still 20% below their 2007 peak; therefore, double-digit gains could be reaped if Europe merely catches up to the U.S.
- Earnings: Whereas the collective earnings of S&P 500 companies are at a new all-time peak, the earnings of European companies are still 23% below their 2007 peak (and 17% below their 2011 peak!). Earnings are ultimately the key driver of equity gains and stock prices should react as Europe recovers from their rare double dip recession.
- Valuations: European stocks have a collective Price/Earnings multiple around 14x compared to near 16x for the U.S. And this lower multiple is on depressed earnings (see previous Earnings bullet) compared to all-time high earnings for the U.S.
- Growth: According to Goldman Sachs, European earnings are projected to grow nearly 26% over the next two years, outpacing the U.S. Unlike the U.S., growth is not reliant on a large increase in sales. Small increases in revenue growth will have a major impact on earnings as their 6.2% profit margins have room to expand, in contrast to the historically high 9.8% level of profit margins stateside.
- Yields: European equities yield more than 3%--a level that is not only higher than European bonds (see Relative Valuations below), but is also 50% higher than the 2% dividend yield of the S&P 500.
- Relative Valuations: The themes outlined in the first paragraph of our 2011 "Relative Valuations" piece now can be applied to Europe. The European equity index has a 7% Earnings Yield, which when compared to the 1.5% yield of the German Bund (and a yield spread 5.5%) suggests equities are very attractive compared to other investable assets.
- Fiscal Policy: Like the U.S., the European fiscal drag is much smaller than recent years as austerity measures have been removed. All parties are in line to promote growth, which should provide a tailwind for stocks and corporate bonds (risk assets).
- Monetary Policy: The European Central Bank is hinting at starting a Quantitative Easing program, whereas Fed Chair Yellen is tapering and should eliminate the QE program by the end of the year. An accommodative Central Bank should provide a tailwind for risk assets.

As with any attractively priced asset, Europe does have its risks and investment gains are not guaranteed. The second option—outlined below—provides good diversification in case of an unforeseen event. This option at first blush is not as attractive as Europe (or the U.S.) as it not only exhibits lower earnings growth but also is priced at a higher valuation. It does not offer the "double whammy" investors usually desire, however, the beauty of this investment is in its earnings *stability*.

INFRASTRUCTURE: We have been investing in the alternative asset class Master Limited Partnerships (MLPs) for the better part of 10 years now. The asset class has not only outperformed global equities, but also has distributed much of that gain in a tax-advantaged income stream. We have written before how we were attracted to the asset class for its stability of cash flow as the MLP pipelines act as toll roads for the movement of oil around the country. Pipelines are relatively immune from the volatile price of oil, just as toll roads are indifferent to the price

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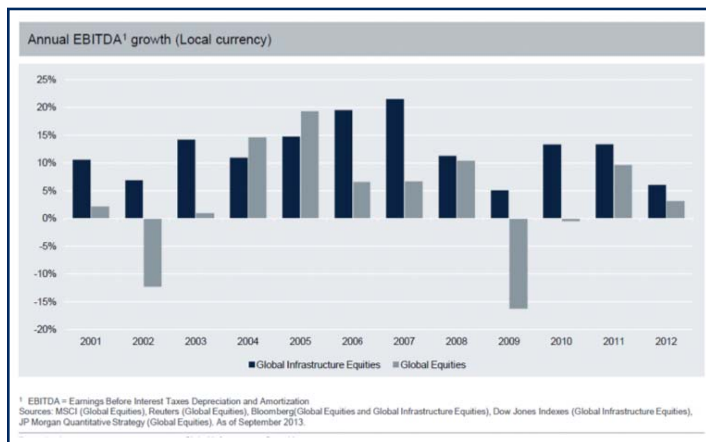
of the cars on its highways. Both rely on the quantity passing through its gates. Stable cash flows result as the quantity of oil consumed is relatively constant. And with the recent shale-oil 'fracking' revolution, more pipelines are needed to move the new found commodity to traditional refining markets, thus enhancing the growth runway and providing an additional tailwind to the asset class. MLP assets are the necessary *infrastructure* to move an essential entity or good—in this case oil. But oil is not the only essential good, and like MLPs, other infrastructure assets are required to transport other essential goods. The end result is a group of assets (collectively called Global Infrastructure) that provides efficient transportation of essential goods (i.e., commodities, people, or products).

Besides MLPs, these assets include Airports, Sea Ports, Communication Towers, Rail, Water Systems, and actual Toll Roads. These long-lived hard assets have high barriers to entry—it's rather difficult for one to build a pipeline, much less an airport—and thus can command monopolistic pricing. Monopolistic pricing of an essential good creates an attractive and stable revenue stream, as demand is highly inelastic and not correlated to the booms and busts of the global economy. For example, while companies retrenched in the most recent recession, Global Infrastructure actually grew by over 5% in 2009 and nearly 14% in 2010. The downside? Earnings can lag in an expanding and booming global economy as they did in 2004 and 2005. But a properly diversified portfolio should also have exposure to markets entering an expansionary phase; Europe, perhaps? In the end, a portfolio should read like a recipe: *To your US equities and bonds, add one cup of infrastructure/MLPs, two cups of Europe, add Biotech to taste, and bake until desired results are achieved.*



[1] EBITDA = Earnings Before Interest Taxes Depreciation and Amortization
Sources: MSCI (Global Equities), Reuters (Global Equities), Bloomberg(Global Equities and Global Infrastructure Equities), Dow Jones Indexes (Global Infrastructure Equities), JP Morgan Quantitative Strategy (Global Equities). As of September 2013.

Same As It Ever Was...

By Kathleen Adams, CFP®
Senior Associate

"The Investor's Chief Problem—and even his worst enemy—is likely to be himself." –Benjamin Graham

I once overhead an investor make a comment about a Google price drop that happened the previous day: "I knew it; it was obvious that Google stock was going to drop. Next time I have a gut feeling like that I will sell!" This is a perfect example of the Behavioral Finance concept of Hindsight Bias. Once an event has elapsed, people tend to perceive that it was completely predictable rather than probable.

Behavioral biases in the investment world can make us do the wrong thing at the wrong time. Investing our capital inherently subjects it to risk. Risk includes price volatility, which can generate emotional reactions. Even though extreme volatility generates opportunity, the reality is most mistakes are made during those times. Below are other biases we see in investors.

Confirmation Bias—Investors seek out information that confirms pre-existing beliefs, while downplaying contradictory evidence. For example: employees or owners hold concentrated employer stock positions because of the bullish inside commentary, but ignore an alarming financial audit.

Self-attribution Bias—Investors' tendency to claim an irrational degree of credit for successes with an irrational denial of responsibility for failures. In this bias, good stock choices are due to talent and foresight, while poor choices are due to bad luck or timing. For example: people who knew very little about investing in the late 1990s quit their job to day-trade, made quick profits, then reinvested and traded in only one sector of the market until that sector crashed.

Availability Bias—Investors assume that readily available ideas or information represent unbiased, highly relevant data from which to make decisions. Familiarity from heavy advertising or reliance on "hot tips" can direct investment choices without proper due diligence. For example: purchasing "attention grabbing" stocks without disciplined research, or panic selling because an analyst says a market crash is eminent.

To help minimize irrational behavior that can destroy wealth, consider these three steps.

1. Utilize a thoughtfully crafted Investment Policy Statement to reference prior to making important investment decisions. Let professional advisors inject research, experience and objectivity into the process.

2. Buy the right amount of risk and rebalance to keep it. If your comfort level and goals suggest 65% of the portfolio in stocks but it grows to 80% in a bull market, rebalance to the correct allocation. Remain diversified.

3. Keep emergency reserves. If you are depending on investments for an income stream, have an appropriate amount of spending money in cash or cash equivalents to cover needs during a temporary decline.

Most of all, the next time markets go wild and you start to think, "this time is different," recognize we say that every time (1987, 2001, 2008…), and it never is.

Source: Behavioral Finance and Wealth Management: How to Build Investment Strategies That Account for Investor Biases, 2nd Edition; By Michael M. Pompian

IRS Announces New IRA Rollover Limitation
A tax court ruling raises eyebrows & may affect you.

What was once allowed is now prohibited. In 2008, an affluent New York City couple made a series of withdrawals and transfers among contributory IRAs, rollover IRAs, and non-IRA investment accounts, all according to long-established 60-day deadlines for tax-free IRA rollovers. As esteemed tax attorney Alvan Bobrow and his wife withdrew and rolled over a series of five-figure sums within a six-month period, they assumed their actions were permissible under the Internal Revenue Code. In January 2014, a U.S. Tax Court judge ruled otherwise.[1]

This Tax Court opinion has prompted the IRS to tighten the IRA rollover rules. Some clever taxpayers have effectively treated themselves to interest-free loans from their IRA funds by using multiple IRA accounts to sequence multiple 60-day rollover periods. In the court's view, the Bobrows were exploiting this loophole, and the IRS is closing it.[1,2]

Starting in 2015, you are allowed *one* IRA-to-IRA rollover per 365 days. Publication 590 has long stated that a taxpayer can generally only make one tax-free rollover of any part of a distribution from a single IRA to another IRA during a 12-month period. That didn't preclude a taxpayer from making multiple IRA-to-IRA rollovers using multiple IRAs during such a timeframe.[1,4]

In response to *Bobrow v. Commissioner, T.C. Memo 2014-21,* the IRS issued Announcement 2014-15. Effective January 1, 2015, the once-a-year rollover restriction applies to all IRAs maintained by a taxpayer. So the tactic of making multiple IRA-to-IRA tax-free rollovers during a 12-month period is kaput.[3,4]

Don't grumble just yet. The new IRS rule change doesn't apply to every type of IRA "rollover." The term "IRA rollovers" may refer to IRA-to-IRA rollovers, distributions from a workplace retirement plan going into an IRA, or a trustee-to-trustee transfer of IRA assets between financial firms in which the taxpayer never handles the money.

Here's the good news. IRS Announcement 2014-15 states: "These actions by the IRS will not affect the ability of an IRA owner to transfer funds from one IRA trustee directly to another, because such a transfer is not a rollover and, therefore, is not subject to the one-rollover-per-year limitation of § 408(d)(3)(B)."[3]

In other words ... the new restriction does not apply to trustee-to-trustee transfers. The IRS has clearly defined in the above language that it does not regard these transfers as rollovers. For additional transition relief, the IRS also won't apply the new limitation to any rollover involving an IRA distribution that happens prior to January 1, 2015.[4]

Important questions beg for answers. As Bloomberg BNA notes, the new limitation actually muddies the waters a bit. Some taxpayers own both traditional and Roth IRAs—will they be allowed to take one distribution from their traditional IRA with the intention of a tax-free rollover and another distribution from their Roth IRA pursuant to a tax-free rollover within the same 12-month period? Could a succession of linked IRA distributions pursuant to a single outcome substantively amount to a single distribution, citing the step transaction doctrine in defense?[4]

It is possible that further guidance from the IRS may emerge. Regardless, IRA-to-IRA rollovers are going to be scrutinized more closely.

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Citations.
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What Method Should I Use to Rebalance My Portfolio?

By Mark Copeland, CFP®, AIF®
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It is almost impossible to remain focused on your portfolio objectives unless you continually review and rebalance the distribution of your investments across and within asset classes. The importance of rebalancing cannot be understated, particularly when markets are as volatile as they are today. The next issue, then, is determining the best way to rebalance.

For various reasons, including marketplace forces that are beyond control, your portfolio can deviate from your key investment objectives. But whether that deviation is sudden or gradual, not rebalancing to reflect those marketplace changes can lead to overexpose, risk, and underperformance.

For example, in 2013 the markets were complacent as the continued growth of equity markets challenged the perceived need for portfolio rebalancing. But by late January 2014, the equity markets were down six percent and bonds were up 1.5 percent. In just one month, many portfolios had become over-weighted in stocks while fixed-income investments suddenly made sense. This illustrates the need to review and rebalance assets to manage effective asset allocation.

Two Styles of Asset Allocation Management: Strategic and Tactical

Strategic asset allocation is more formal and involves reviews of asset distribution at consistent intervals—quarterly, biannually, and sometimes annually. Investors who favor this approach tend to like a more traditional buy-and-hold approach. Even an annual review and rebalance, however, can reflect changes in objectives or the marketplace.

In contrast, tactical asset allocation is a less formal, more active management style. Reviews are not scheduled but ongoing, creating a more opportunistic approach. Rebalancing takes advantage of real-time changes in asset classes that make them more or less attractive as investments. Allocations are shifted away or toward an asset class based on its potential to achieve the portfolio's overall objectives.

For example, with a tactical asset allocation approach, portfolios that were loaded with equities throughout 2013 and ended with an imbalance early in 2014 would quickly rebalance away from equities and toward fixed income to reflect the market change. In contrast, in a strategic asset allocation, a quarterly review in March 2014 could have initiated a rebalance or maintained a hold on those equities until the market tilted their way again.

The best approach, however, is to avoid asset imbalances in the first place. For example, when stocks are hot, do not sell off your high-quality bonds, because they are inversely correlated to the stock market. That is, when stocks go down, bonds go up. Limiting correlated investments within asset classes can avoid another type of imbalance.

Let's say a portfolio's stock allocation in 2014 includes several automotive companies because 2013 was a banner year for car sales. If that category softens in 2014, the portfolio's auto stocks will drop at the same time. If the imbalance were in social media (or software, solar, etc.), it would pose the same risk. To avoid this kind of exposure, strive for a non-correlated stock or bond mix. Maintain investments in a variety of categories so that a stumble in one category has a minimal negative impact on the overall portfolio.

Nonetheless, whatever allocation method you prefer, the most important thing is to rebalance when your asset allocation deviates from achieving your overall objectives.

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SIGNATURE FUND *for* GIVING

By Marshall Smith
Operations & Project Manager

Our Signature Fund for Giving was created in 2011 to support local youth in Southern California. Through partnerships with A Place Called Home, Toberman Neighborhood Center, and Children's Hospital of Orange County, we have raised over $150k for both local and national nonprofits since the fund's inception.

This issue of "The SEIA Report" highlights the Toberman Neighborhood Center.

Toberman Neighborhood Center is proud to be among the oldest charitable organizations in the city of Los Angeles. Founded in 1903 by the six-term mayor of Los Angeles, James Toberman, and his wife, Emma, Toberman Neighborhood Center provided services for widows, invalids, and orphans. In 1937, the organization moved from Echo Park to the Los Angeles Harbor town of San Pedro. Today, this non-profit community-based organization is committed to assisting Harbor Area families and individuals by delivering life-changing services that encourage, inform, educate, and empower them to live healthy and purposeful lives.

Toberman Neighborhood Center enriches lives by providing three key community programs: 1) Children, Youth, and Family Services; 2) Family Source Center; and 3) Gang Intervention Services. Each program addresses the root causes of poverty and is an integral part of the everyday lives of the individuals and families in the community.

For more information on how you can get involved with Toberman Neighborhood Center, please visit http://www.toberman.org/support-toberman/.

For questions regarding our Signature Fund for Giving please contact Marshall Smith at 310-712-2323 or msmith@seia.com.

Thank you all for your continued support—we could not achieve such growth and make this impact without you.

Toberman Upcoming Events

Summer Academy

When: 6 weeks starting June 12th

What: Over 100 kids participate all week in math, writing, and reading lab. They also have several field trips and community service projects.

Healthy Start: Back to School & Food Fest

When: Saturday, August 2, 2014 6pm

What: An event at Toberman serving nearly 1,000 families. They provide a backpack full of school supplies, and services designed to help children get the right start at school - including haircuts, health, eye, hearing, and medical check-ups. The focus is also on providing nutritious food. Over 60 vendors are setup at our 30,000 sq. ft. campus to provide a multitude of free services to families.