A Quarterly Newsletter Bringing you Financial Insights from the Leaders

June 2013
Volume 6, Issue 4

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.

WHEN SAFE BECOMES RISKY, TIME TO REBALANCE

Deron T. McCoy, CFA, CFP®, CAIA, AIF®
Director of Investment Strategy

Last quarter we suggested that although equity markets were approaching six-year highs, "higher yielding securities will continue to perform." That prognostication quickly proved true as investors' constant thirst for yield pushed income-oriented assets northwards as dividend securities (Utilities, Consumer Staples, Pharmaceutical Companies, Telecom, Master Limited Partnerships, etc.) enjoyed a rousing first quarter. But now with the S&P 500 at historic peaks, many are questioning whether the market can continue to advance or to heed the catchy rhyme of "Sell in May and go away."

Questioning the advance is reasonable as U.S. stocks have had a tremendous gain in the last six months. In fact, U.S. Large Caps have rallied 15% (200 points on the S&P 500, 2000 points on the Dow Jones Industrial Average) since Thanksgiving. While no one is predicting another 15% gain by the next turkey day, it is important to reassess the investment landscape and possibly reposition assets for the next double digit move. While we believe the equity market could advance as a whole (decent relative valuations, easy monetary policy, pent up demand stemming from recession, improving jobs market, improving housing market), tremendous value exists within certain sectors and now may be the time to take profits and rebalance. The question may not be whether the market can continue to advance, but rather in a world dominated by Global Central Banks and extreme monetary policy, where should investors bank their profits?

ARE ULTRA SAFE ASSETS NOW RISKY?

No one ever went broke taking a profit, but ZIRP (Zero Interest Rate Policy) and QE (Quantitative Easing) have changed the investment landscape. By pushing down yields to very low levels, the traditional norms of where to put profits are being challenged as historically "safe" options now hardly seem worth it.

- The Bank: Investors rotating gains into money markets, savings accounts, and CDs are not only earning a paltry yield but are also positioned to lose money after accounting for inflation and taxes.

- Government Bonds: While it is true that longer-dated government bonds yield more than savings accounts and default is unlikely, the asset is anything but "safe." Like savings accounts, the 10-year Treasury bond is also subject to negative real interest rates with a current 1.75% yield-to-maturity. Even longer dated 30-year bonds are not attractive as the 2.85% yield-to-maturity barely covers current inflation let alone any future rise (or spike) in the Consumer Price Index (CPI).

continued on page 2

SEIA

Signature Estate & Investment Advisors, LLC® (SEIA) is a Registered Investment Advisor firm offering Investment Supervision and Financial Planning Services tailored to meet the unique needs of affluent individuals and corporations. Fundamental experience and professionalism enable the financial advisors, with SEIA's research and support staff, to design a financial plan or investment portfolio to meet the client's goals.

TIME TO REBALANCE

continued from page 1

Thirty-year sovereign bonds may not be a wise investment at this point after considering historical CPI averages:

- 3.0% since 1926 (which includes the 1930's deflation),
- 4.3% since 1973 (which includes the 1970's inflation spike), and
- 2.9% since 1983 (the year *after* then Fed Chairman Volker declared victory on inflation).

Clearly these "ultra safe" "AAA" assets are not as attractive as their reputations would suggest. So what are investors to do? Should they shun "safe" assets (that now come with their own unique risks) for assets that are traditionally considered risky? It depends on how you define "risky."

ARE "SAFE" STOCKS BECOMING RISKY?

The monetary policy of Fed Chairman Ben Bernanke has pushed many investors out of CDs and into riskier fare in search of yield. Fortunately for investors, the strategy has paid off as domestic stocks have experienced a vibrant bull market. This market is unique, however, because low-growth defensive sectors (Consumer Staples, Utilities, Telecom, and Healthcare) have led the advance in part because these sectors are deemed safer due to their historically high dividend yields. Now more than ever, it is important to diversify income sources (MLPs, Covered Call strategies, Non-Agency Mortgages, etc.) as prices in the defensive names have risen and pushed valuations to historic extremes. Investors rotating profits into these "safe" stocks are buying assets that now have high valuations with low growth forecasts. (Sound familiar? Government bonds also are at extreme valuations but have zero growth potential). Although these prices should stay elevated for some time, it seems that "safe" areas of the capital markets are becoming less so.

"RISKY" STOCKS: ATTRACTIVE VALUATIONS *AND* HIGHER GROWTH

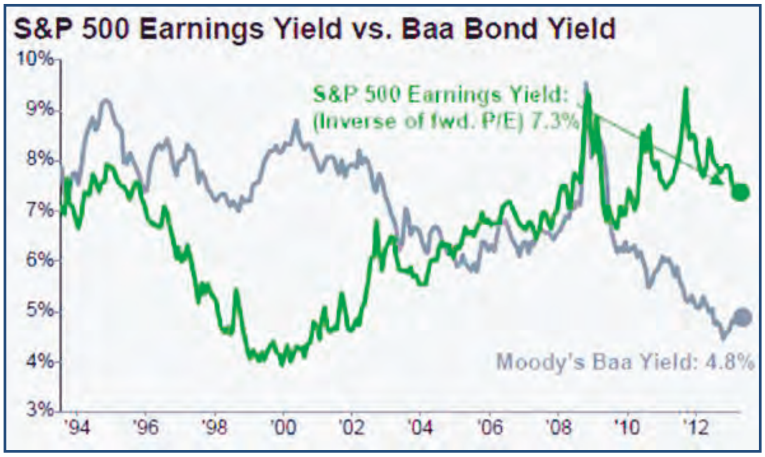
To be clear, not every risky asset is cheap; High Yield bonds are a prime example. Due to ZIRP driving investors to reach for yield, High Yield (junk) bonds have set all-time records this quarter, reaching a record-low average yield near 5%. As the bull market has pushed up prices in High Yield bonds and defensive equity sectors, many in the traditional "offensive" sectors have been left behind, namely Cyclical stocks and Emerging Markets. In fact, Cyclicals (Industrials, Materials, Consumer Discretionary, Financials and parts of Energy/Technology) are currently more undervalued relative to Defensives than at any time in the past 15 years (ex: Staples, Utilities, and Telecom trade at a 17-19 Price/Earnings multiple whereas Financials and Industrials trade around a 12-13 P/E). According to Goldman Sachs, the relative P/E valuation discount for Cyclicals versus Defensives stands one Standard Deviation below the 30-year average.

Not only are "offensive" sectors cheaper, they have better growth profiles as well—especially if U.S. GDP and global growth gains momentum. Normally, investors pay a higher price (valuation) for assets with greater growth prospects. The lower valuation for higher growth is unlikely to persist indefinitely and the disparity between Cyclicals and Defensives should narrow.

Additionally, investors should not dismiss investments overseas, as valuations in Europe and Emerging Markets are very attractive. The S&P 500 trades at a 14 P/E versus an 11 P/E for the U.K., Germany, and France and a 10 P/E for Emerging Markets. Emerging Markets also have the added benefit of higher GDP growth and fiscal *surpluses.*

TAKEAWAY AND CONCLUSION

In 1999, risky stocks were deemed "safe" as many thought the world had changed. In hindsight, the world did not change and it was a great time to rebalance. Now may be a similar time. You may not know it yet, but we are living (and investing) in an upside-down world where Global Central Banks have distorted traditional asset classes. In this New Normal, being too conservative is actually being too aggressive as the definition of "safe" has morphed and these assets may not hold true to their name. While we are not ringing the alarm bell just yet, now may be a great time to take profits, rebalance, and reposition assets with high valuations and low growth forecasts (or no growth forecasts in the case of Treasuries) for those with low valuations and higher growth forecasts. Shorten duration and increase Alternatives. Rotate equities into sectors that are cheaper than their historical averages. Maybe the old adage is spot on—it just needs a minor adjustment: *"Sell Treasuries in May and go away."*



Standard & Poor's, J.P. Morgan Asset Management

Why is the mantra 'Let's just tax the rich…' not valid?

By Brian D. Holmes, MS, CFP®, AIF®

"Tax the rich" was one of the campaign themes of the 2012 election. The assertion was that our country's deficit problems were the result of the rich not paying their "fair share."

But with the election behind us, we should examine the tax revenue numbers behind the federal budget. The truth is, the federal government takes in less revenue than it spends; it has done so at an alarming rate for decades. Since 1960 average federal receipts (revenue) have averaged 17.9 percent of GDP annually, while average outlays (spending) have been 20.5 percent. So solving the annual deficit should be as simple as closing that 2.6 percent revenue/ spending gap. The problem, however, is that this cumulative yearly 2.6 percent gap now annually accounts for one-third of the $3.6 trillion annual federal budget, in the form of interest payments.

Historically, personal income tax revenue has accounted for nearly one-third of federal budget financing. But now, virtually 100 percent of all personal income tax revenue goes to paying the annual interest payments on the national debt.

If the "rich" are the top 5 percent of wage earners, they account for 32 percent of all income, yet they already pay over 58 percent of income taxes! The "rich," then, are already shouldering their fair share by paying the majority portion of income taxes, while earning less than a third of total income.

Even if "the rich" were taxed at a 100 percent rate in 2012, leaving zero spendable income, the annual federal deficit would still be nearly half a trillion dollars.

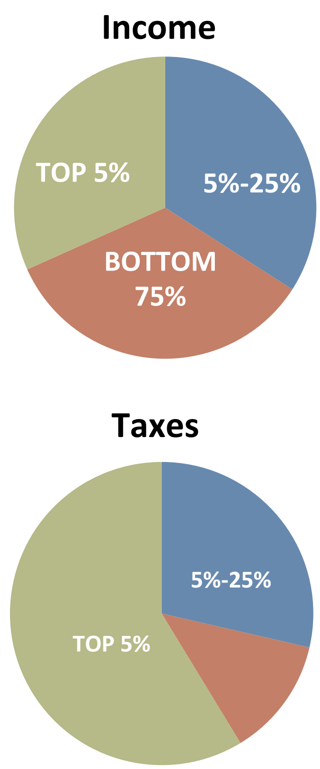
The fiscal impact of the recent 24 percent tax hike on the rich (35 percent to 39.6 plus 3.8 percent) barely put a dent in the annual deficit, accounting for less than 4 percent of the federal budget.

It is simple math: The tax rates from the other 95 percent of taxpaying Americans will likely have to rise. Additionally, at least some of the 47 percent of Americans paying no federal income tax must also pay their "fair share."

Clearly, Washington has to make meaningful cuts in spending. Selling austerity will not be easy for politicians, especially since 54 percent of the $3.6 trillion budget is spent on defense, social security and Medicare/Medicaid.

President Obama's 2012 campaign included the battle cry of the rich needing to pay their "fair share." President Reagan's 1979 campaign slogan was that "The problem is not that people are taxed too little; the problem is that government spends too much." The answer lies somewhere in the middle.

Share of Federal Income Taxes



*Tax rates based on maximum U.S. individual income tax. Wage income tax rates include employer and employee contributions to the Medicare tax. Includes recently enacted healthcare tax of 3.8%. *Based on AGI and Federal Taxes in 2009 IRS, J.P. Morgan Asset Management. Data are as of 12/31/12.*

SEIA

SIGNATURE ESTATE & INVESTMENT ADVISORS, LLC®
www.SEIA.com

What is the best investment strategy in a rising interest rate environment?

By Paul Taghibagi, MS, CFP®, ChFC, AIF®

As the economy continues to improve, interest rates will likely begin to rise from their historic lows of recent years. In planning proactively for this type of inevitability, it is imperative to review your portfolio mix, paying particular attention to bond holdings.

When it comes to investing, most people think of a conservative portfolio as one that has a high allocation to bonds, but this is not necessarily true in a rising interest rate environment. Remember, it is a mathematical certainty that bonds and interest rates have an inverse relationship, meaning that, as interest rates rise, the principal value of bonds declines.

So in a rising interest rate environment, if you have a heavy allocation to bonds there are a number of protective steps to consider when it comes to adjusting your portfolio.

1. Reduce the proportion of fixed rate bonds and in-crease the proportion to stocks. If your current allocation is 20 percent stocks/80 percent bonds, consider adjusting to 35 percent stocks/65 percent bonds. If you are already at 35/65, look at 50 percent stocks /50 percent bonds. And if you are 100 percent bonds, consider allocating 25 percent to stocks. When selecting stocks to replace bonds, focus on dividend paying stocks. While dividend paying stock values can go up and down, they tend to be less volatile than non-dividend paying stocks.

2. Reduce the bond maturities in your portfolio since longer maturity bonds are harder hit when rates rise than are those with shorter maturity.

3. Increase your allocation to floating rate bonds whose rate fluctuates in step with market interest rates, making them less susceptible to rising interest rates. And while rated lower than government bonds, they have a senior, secured position in the capital structure and are highly liquid.

Also consider these strategies:

4. Use foreign bonds, especially in countries where the rates are higher than in the U.S. Foreign bond securities tend to have lower sensitivity to U.S. interest rates and typically deliver a higher return. Additionally, many foreign countries are behind the rising interest rate curve compared to that of the U.S.

5. Make an allocation to alter-native investments such as commodities, oil and gold as well as real estate investment trusts (REITS). REITS are listed securities that trade on stock exchanges, and not only offer a liquid way to invest in real estate, but tend to deliver high yields.

6. Buy Treasury inflation-protected securities (TIPS) whose value increases as inflation increases and decreases with deflation. It is very common to have increasing inflation during times of rising interest rates.

In sum, remember that each phase of the economy favors a different asset class. Make sure that your portfolio is properly allocated for the current market environment.

2121 Avenue of the Stars, Suite 1600
Los Angeles, California 90067
telephone 310.712.2323
facsimile 310.712.2345

2010 Main Street, Suite 220
Irvine, California 92614
telephone 949.705.5188
facsimile 949.705.5199

3452 East Foothill Blvd., Suite 1140
Pasadena, California 91107
telephone 626.795.2944
facsimile 626.795.2994

1815 Via El Prado, Suite 100
Redondo Beach, California 90277
telephone 310.712.2322
facsimile 310.712.2377

8607 Westwood Center Dr., 3rd Floor
Vienna, Virginia 22182
telephone 877.301.7342
facsimile 703.564.0153

Would you prefer to receive our quarterly newsletter electronically? Do you have friends or family that you would like to add to our quarterly distribution list? E-mail us at: contactus@seia.com.

SEIA is excited to welcome Kathleen Adams to the Redondo Beach office

Kathleen Adams, CFP® has been a Financial Advisor for over 12 years and is a Certified Financial Planner® certificant from the Certified Financial Board of standards. Kathleen also completed the Personal Financial Planning (PFP) designation program at UCLA Extension and received her Bachelor of Science degree from Loyola University in Chicago, graduating Magna Cum Laude. Her focus has always been on the integration of financial planning with wealth management, especially in conjunction with exit and succession plans.

Kathleen brings her dedicated team of David Swift and Katie O'Neill along with her practice to the Redondo Beach office. David's chief role is to help develop sound financial advice for the Adams' team clients. His focus is in investment analysis and financial planning strategy. Katie joined the Kathleen Adams team in the summer of 2009 and her focus is primarily on business development; including client communications, marketing, and managing client events.

"We are thrilled to have Kathleen and her team join our office in the South Bay", says Vince DiLeva, Senior Partner of Redondo Beach. "Her experience and commitment to her practice and SEIA makes this a perfect fit in our growing office."

Davis Swift, Kathleen Adams, Katie O'Neill