The Thoughtful Investor™

James W. Olsen, CFP® | Legacy Investment Strategies | Third Quarter 2013

Powerball is not a Retirement Plan and Other Paths to Financial Security

There have been enough articles that by now everyone probably knows that the baby boomer generation by and large is not financially prepared for retirement. If you count yourself among the unprepared boomers, there's still hope to retire rich, but some of the techniques may be a little challenging.

First…the easy stuff. Your best odds are to inherit your fortune from a parent, spouse or other relative. If you are short on wealthy relatives, you may be looking at Powerball or the lottery as your rich uncle. Not a good plan.

Yes, there are some people who have won the lottery more than once, and there are some people who have been hit by lightening more than once. But the odds are ugly at 175,000,000 to 1. Buy a ticket or two when the payoff is too good to not at least try, but the lottery is probably the worst retirement plan you could have.

Building a successful business has put more people on the billionaire list than any other approach. But it helps to have an original idea and/or

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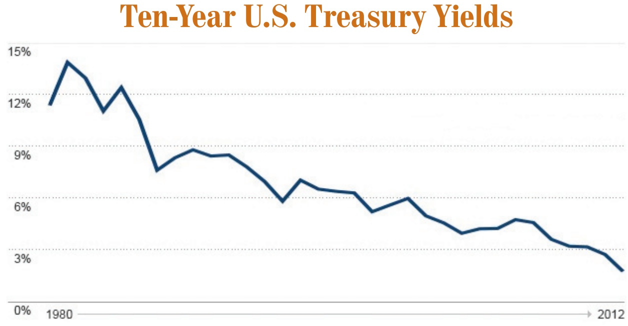
Impact of Interest Rates on Bond Values

Interest rates have been on the decline for more than 30 years and there's little if any room to fall farther. Which brings up the concern, what happens to bond values when interest rates rise?

Many analysts believe the resulting destruction of wealth will rival the dot com bust, in part because the bond market is considerably larger than technology stocks at their height. With that said, analysts have been predicting a bond market bust for years only to see their predictions fail.

Ten-Year U.S. Treasury Yields



With interest rates at historical lows, there's really only one direction for them to go and that's up. The million dollar question is when and how much money remains to be made in the asset class. Currently, interest

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Discretionary versus Non-Discretionary Management

Given market volatility, it is important for individuals to understand whether or not their financial adviser has the ability to limit drawdowns in a portfolio or to take advantage of market opportunities by repositioning assets. This typically depends on whether the adviser has discretionary or non-discretionary management authority.

In **Discretionary investment management**, the accountholder authorizes a portfolio manager to make buy-and-sell decisions without referring to the accountholder. These decisions must, however, be made within agreed upon limits. The client's investment policy statement governs the adviser's ability to act defensively or opportunistically. For example, if the policy statement does not permit hedging, the portfolio manager cannot use hedging in an attempt to limit losses or achieve gains.

Under **Non Discretionary investment management services**, the investment adviser can merely advise the client what may be good or bad for the portfolio. The client reserves full right to take his own decisions. While this gives the client the greatest control over his or her investments, it also places the responsibility for protecting a portfolio in market downturns squarely in the client's hands. Unless the adviser is authorized by the client, a more defensive or aggressive investment position cannot be taken.

Powerball is not a Retirement Plan and Other Paths to Retirement *— continued from page 1*

a strong work ethic. If you have yet to start a business, there may not be time to succeed and cash out by retirement.

Investing is a potential way to get wealthy, but it helps to start early and to find the right investment manager. Even small investments have the potential to become considerable nest eggs if they are in the right assets and have time to compound.

You might look for a challenge with a cash prize. The Clay Mathematics Institute of Cambridge, Massachusetts (CMI) will pay a $1 million prize to anyone who solves one of seven of the most difficult problems with which mathematicians are still grappling. Only one prize has been awarded to date. There are still six problems to solve and $6 million to award.

Keep an eye on Google for challenges with hefty prizes. 25 teams are competing for the Google Lunar X Prize, a $30 million reward "for the first privately funded team to send a robot to the moon, travel 500 meters and transmit video, images and data back to the Earth." They have until 2015 to win. Google also offers hacking awards to find security problems in Chrome as well as security issues that would affect users of all browsers.

The Samsung Smart App Challenge 2013 offers up to $800,000 to the top 10 new applications utilizing its group communication function "Samsung Chord SDK."

Yuri Arcurs is the world's top selling stock photographer, selling an image online every 8 seconds, 24 hours a day (more than 4 million images each year). He's an extremely good and creative photographer, but who is to say you don't have sellable images as well.

In April of 2010, Amanda Hocking of Minnesota began self publishing her young-adult paranormal novels about trolls, vampires and zombies and 'supernatural teen romances,' selling them online for $2.99 or for as little as $.99. Today she makes more than $2 million a year from her e-book sales and has signed her first conventional publishing contract for four books.

If you are a lucky golfer, look for charity and guest tournaments that offer a $1 million hole-in-one competition. The hole-in-one prize is underwritten by an insurance contract, so you know the odds aren't in your favor, but they are still better than winning the lottery.

Go for the gold with a metal detector. Actually this may work best in areas where wars have been fought over the centuries, increasing the odds that someone buried a family treasure to protect it from raiders, only to die with the hiding place still hidden. Terry Herbert found 1,600 Anglo-Saxon gold and silver pieces valued at more than $5 million on a friend's farm in Staffordshire, England.

Find a treasure in your basement or at a yard sale. There are many stories of rare comic books, toys and collectibles that turn up in the family attic or basement. And, every so often, a yard sale offers an original masterpiece. The odds are pretty distant on this one as well, but you may find treasures to keep.

In the end, the most viable approach continues to be to save and invest your retirement funds with high quality money managers who understand the value of not only growing your portfolio, but also protecting it during down markets. Naturally, there can be no guarantee that an investment will be profitable. All investments have the potential for loss as well as gain. Past performance is not an indicator of future returns.

Ownership Forms and Their Impact

There are a number of different forms of ownership that can be used in titling your assets, from your home to investment and bank accounts. Which form is appropriate depends upon your circumstances… but here are some of your options with regards to your investment accounts:

Individual ownership – This is the simplest. One person controls the account. If that individual dies, the account becomes a part of his or her estate.

Individual Ownership with Payable on Death (POD) or Transfer on Death (TOD) – This form of ownership designates an entity(ies) to which the account automatically passes on the death of the account holder. A POD or TOD account bypasses the estate and probate, although the account value will still be counted in calculating estate taxes. U.S. savings bonds can also have a payable on death beneficiary.

Joint Ownership – Two or more entities own the account together. Upon the death of one member, assets are distributed equally among the surviving owners. If the joint account holders are spouses, the spousal exemption applies when calculating estate taxes. With joint ownership, the assets in the account are available to the surviving owners without waiting for the estate settlement.

Ownership in Common – This allows the proportion of the account held by one individual to pass on to his or her heir(s) or successor. Successors are typically determined by the individual's will and the assets are considered in the estate tax calculation. Assets held in common ownership are typically subject to probate.

Trusts – A legal relationship where ownership is held by one entity for the benefit of another – the beneficiary. Assets that have been transferred to an irrevocable trust more than three years prior to the death of the individual establishing the trust are not included in individual's gross estate for estate

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Impact of Interest Rates on Bond Values— *continued from page 1*

rates are being held artificially low by the Federal Reserve. Expectations are that the Fed will continue holding rates at their current lows through at least mid-2014. Only time will tell whether those expectations are correct and how effectively the Fed will be able to unwind its low rates.

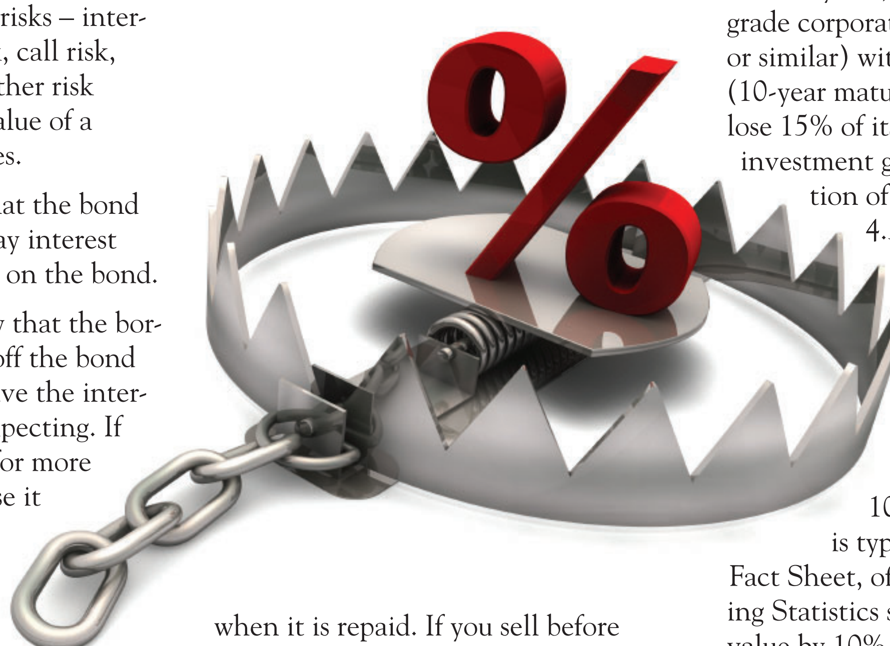
Bonds have four basic risks – interest rate risk, inflation risk, call risk, and default risk. While other risk factors may impact the value of a bond, these are the biggies.

Default risk is the risk that the bond issuer will be unable to pay interest and principal and default on the bond.

Call risk is the possibility that the borrower will decide to pay off the bond early, and you will not have the interest payments you were expecting. If you purchased the bond for more than its face value because it offered a higher interest rate, you could also lose a portion of your investment. Calls are more likely to happen when interest rates are declining.

Inflation risk is the risk that the interest you earn on your bond will be less than the rate of inflation, resulting in a loss in purchasing power.

Interest rate risk is the big risk in today's market. When interest rates rise, bond values fall. How much a bond's value falls depends upon a number of factors including (1) years to maturity, (2) the financial stability of the bond issuer, and (3) selling pressure. If you hold a bond to maturity, barring default or call, you can expect to receive the face value of the bond



when it is repaid. If you sell before maturity, the prevailing interest rates and ***duration*** will determine the value of the bond. If you own bonds through a bond fund or ETF, the value of your position will be determined by the duration of the bond portfolio.

Duration is a measure of how sensitive the price of a bond investment might be to a 1% change in interest rates. Duration is calculated based on time to maturity, call features, yield, credit quality and changes in credit quality. The higher a bond's duration, the greater its sensitivity to interest rates changes.

For instance, if interest rates were to rise by 2%, a medium investment grade corporate bond (BBB, Baa rated or similar) with a duration of 8.4 (10-year maturity, 3.5% coupon) could lose 15% of its market value. A similar investment grade bond with a duration of 14.5 (30-year maturity, 4.5% coupon) might experience a loss in value of 26%.[1] For a simplistic calculation of bond values, visit http://tipscalc.investinginbonds.com/.

A bond fund with 10-year duration (duration is typically found in the fund's Fact Sheet, often in the Bond Holding Statistics section) will decrease in value by 10% if interest rates rise 1%. If a fund's duration is two years, then a 1% rise in interest rates will result in a 2% decline in the bond fund's value.

Math aside, selling pressure can also reduce the value of a bond beyond that indicated by duration. An estimated $38 trillion is invested in the U.S. bond market. When interest rates increase, the possibility that investors will rush to sell could further depress bond values. Rising interest rates could also put pressure on corporate and government issuers reducing credit quality, again affecting bond values.

Unless your intent is to buy and hold a bond until maturity (and even then your investment is not guaranteed against loss), today's bond market demands some level of risk management.

[1] Fitch Ratings, Macro Credit Research Report, The Bond "Bubble": Risks and Mitigants, 2012

Ownership Forms and Their Impact

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tax purposes. Gift taxes may have to be paid at the time of the original transfer to the trust. Trusts file their own tax returns and as of the 2013 tax law revisions, are subject to taxes at the highest income brackets on gains retained in the trust and not paid to the beneficiary.

Custodial Account – This account type allows a custodian to invest on behalf of a minor child and may be called a Uniform Gifts to Minors Act Account (UGMA) or Uniform Transfers to Minors Act Account (UTMA)

Business Accounts – Account ownership may also be held by legal corporations, professional associations, or professional corporations. These accounts use the business tax identification number and ownership of assets is determined by ownership of the business.

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It Really Is Different This Time

Good investing, we believe, is the process of making informed decisions about the market's current direction. Typically, decisions rely to some extent on the past because in the past are often found patterns that repeat. The financial market is the product of human behavior and human behavior has historically followed cyclical trends.

Every market cycle throws a few new elements into the mix, however. Whether or not those elements twist the pattern will be seen only in hindsight. It is rarely the known issues that trigger a reverse in market direction, but the unknown, the black swan. When a black swan occurs, existing market stresses can compound reactions. Thus, knowing about a problem is, in a way, a means of blunting its impact on the financial market.

There are a number of factors that are different this time…

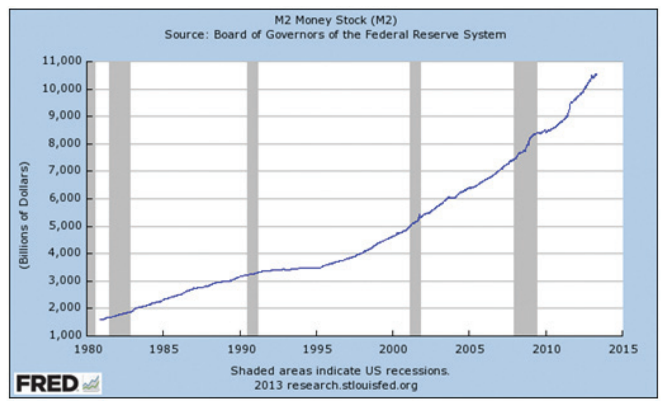
(1) The growth of index funds, spurred in part by the proliferation of Exchange Traded Funds.

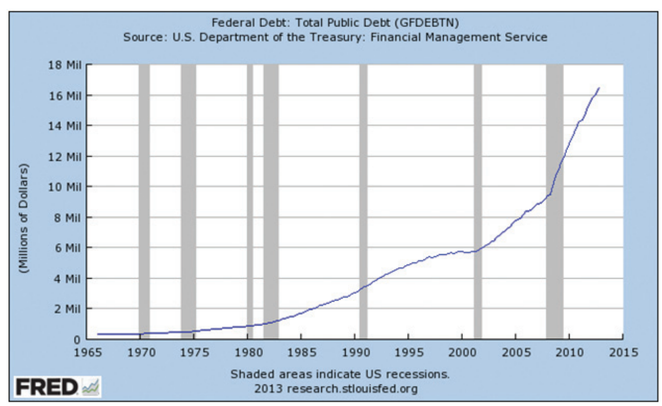
The *Financial Times* reported in 2012 that institutional indexing of U.S. equities could increase its market share to 50% as early as the end of 2014.

Why does that profoundly change the nature of the financial market? Because with indexing, investments are no longer selected based on a good business model, or whether a company makes good or bad products. It doesn't matter if the management team is working for the shareholders or for personal benefit. Even the profitability and financial health of the company no longer matter. Indexing eliminates judgment as to the essential value of the company. Instead, value is driven by demand for the index.

(2) Concentration of an expanding Money Supply.

The U.S. money stock has expanded at an unprecedented rate over the last five years. At the same time, average household wealth and income has declined. Increasingly, the new money is concentrating at the top of the food chain.





(3) Government Debt.

Even more intimidating than the amount of Public Debt is its growth rate. There are no *good* solutions ahead.

These three trends alone are enough to make us very wary of the direction of the U.S. financial markets. What will create the tipping point and when will it come? We don't have the answer but one conclusion is clear. This is not the time to follow a buy-and-hold investment approach.