The Financial Navigator – March Newsletter

Happy St. Patrick's Day. As of last week it has been six years since the bear market caused by the Great Recession hit its low point on March 9th, 2009. Since then the US stock market has marched upwards with only minor corrections along the way; one of the longest bull markets in history. As a result many market watchers are forecasting a period of high, perhaps stomach churning, market volatility and possibly a drop in the US stock market of 10% or more. Two articles below, *Do Bull Markets End When Stocks are Fairly Valued?* and *When Diversification Fails* might provide some perspective if you have concerns about your investments given the current state of US stock market. In addition, some of the IRS rules governing IRA rollovers have changed as explained in *Rollover Rules – Beware This Tax Trap*. It is worth a read if you are contemplating moving an IRA.

You may know someone who has the same questions and concerns about the market and their portfolio. If you think it will help, feel free to forward this email and let me know if you have questions about a specific situation.

Sincerely,

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Rollover Rules – Beware This Tax Trap

One of the oddest things about tax law is the fact that often the rules and regulations are decided by the many court cases that are brought by taxpayers who didn't follow the rulebook. This happened once again in a recent tax court case, where the Tax Court decided that people can only do one IRA rollover in any one-year period, no matter how many other IRA accounts they happen to have. Never mind that the decision directly contradicted the IRS's own guidance in its Publication 590 and a number of private-letter rulings issued by the IRS.

Since the so-called *Bobrow* decision (which may be appealed), a common way to move money from one IRA account to another now has to be monitored closely. The ruling affects situations where an IRA owner takes a distribution from an IRA and then rolls those same funds over to another IRA within 60 days. So long as the same amount of money is put back into an IRA account within that time period, no taxes have to be paid on the distribution of funds (and no 10% additional penalty, if the IRA owner is under

age 59 1/2). But now you WILL have to pay taxes--and the penalty, if applicable--if you try to do this again with the same or other IRAs during the same 365-day period.

Fortunately, this rule doesn't apply to direct transfers, which is the way most professionals prefer to move money between IRA accounts. A direct transfer is exactly what it sounds like: the trustee of one IRA moves the money directly from that account into the hands of a trustee for another IRA account; that is, the money flows directly from one account to the other without the taxpayer ever touching it or putting it into his or her own checking account. Under current rules, even with the *Bobrow* decision, these kinds of transfers can be done all day long, all year long.

It has always been good advice to use only direct transfers to move IRA funds from one IRA to another. Now it's even more so.

Incidentally, this once-per-year IRA rollover rule doesn't apply to rollovers from an IRA to a Roth IRA (commonly known as a Roth IRA conversion). But most advisors prefer to handle those on a trustee-to-trustee basis anyway, to avoid confusion and potential problems with the 60-day rule. Mistakes on transfers can be costly from a tax standpoint, and the way things stand, they can't be fixed after the fact--unless you decide to take the case to court and hope to reverse the current rule of law, which is far more costly still.

Source: http://www.investmentnews.com/article/20140413/REG/304139996/irs-only-one-ira-rollover-per-year

Do Bull Markets End When Stocks are Fairly Valued?

Based on history, the answer appears to be no. Now that the S&P 500 has reached 2,000, the NASDAQ 5,000, albeit briefly, is the bull market over? Is there any way to spot the end of a bull market and the beginning of a long bear market decline?

Over the years, various market analysts have tried to put into words what everyone knows. The legendary mutual fund manager John Templeton once said: "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." Howard Marks said that there are three stages to a bull market: 1) when a few forward-looking people begin to believe that things will get better; 2) when most people realize improvement is actually underway; and 3) when everyone is convinced that things will keep getting better forever.

These are not exactly objective measurements, but they offer some insight into the psychology we normally encounter at the tail end of a bull market, just before the market is about to fall over a cliff. When the bear market is imminent, you will see virtually everybody feeling optimistic about the markets--a time when even the perma-

bears who are constantly predicting the end of the world finally get on-board with positive expectations.

By that measure, the fact that so many people are asking whether the bull market is over may be a clue that it isn't.

Aren't there more objective ways to evaluate the prospects of a bear market? One popular measure is the price-to-earnings (PE) ratio, which tells us, in a rough sort of what, what people will pay for a dollar's worth of earnings in the stock market.

The problem with the PE is that while we know the stock's price from the previous day's trading, we can never be very sure about earnings. We know last year's earnings, but will that number carry over into this year? We can take the average earnings over the past 10 years, but some companies are growing earnings while others are experiencing a retrenchment, and this measure doesn't capture the difference very well.

Looking at the past doesn't help much either. In 1982, at the beginning of the greatest bull market in U.S. history, PE multiples were under 10. When that bull market ended in 1999, the S&P 500 was trading at 27 times earnings. That generally tells you that stocks are probably due to rise if you can buy at a PE of 10 or under, and beware the bear if PEs climb up over 25.

Of course, this is true only if you believe the numbers. The most pessimistic PE calculation among analysts, the Shiller cyclically-adjusted PE ratio, whose mathematics tracked the S&P 500 as trading over 40 times its definition of earnings at the bottom of the market in 2009. Today, this less-than-bullish indicator says that the PE ratio is 27.85, which is above the historical mean of approximately 17. That, of course, tells us that stocks are trading at a premium right now. But if you look at the data over the long-term one can see that this current level, measured in this way, is not generating any screaming warning signals.

What can we conclude from this? If you're not feeling especially bullish, and if you're detecting some degree of caution from analysts, from news reports and from your friends and neighbors, then it's possible the bull market will grow on skepticism--with inevitable periodic setbacks, of course--for a bit longer. When it starts to feel as if the market will roar upwards forever, and you find yourself talking about stocks with your cab driver and barber, and especially if people are paying $25 or more for a dollar of corporate earnings, you might have reason to worry.

Except that the history of market psychology tells us that you probably WON'T worry then. So you might as well relax and enjoy the ride.

Sources: http://www.multpl.com/

http://www.washingtonpost.com/business/how-to-know-whether-stocks-are-cheap-or-pricey/2014/03/20/ec105d54-ae2c-11e3-9627-c65021d6d572_story.html

When Diversification Fails

Having different asset classes may not always protect you from market downturns.

Correlation coefficients are one of the most complicated areas of the asset management world, but the idea behind them is pretty simple--or, at least, most of us thought it was until the 2008-2009 meltdown. The basic idea is that you study the price movements of, say, the stocks of large companies (represented by the S&P 500), and then look at the price movements of, say, stocks in the NAREIT (real estate) index. You find that, on average, they tend to march to different drummers; when one goes up, the other goes up less, or it may go down. When the other goes down, the first asset may go up or stay the same. They have, in the parlance of experts, a low correlation.

These correlations between various flavors of stocks and real estate, commodities, bonds and other assets are expressed mathematically, and is one of the factors that professional investment advisors take into account when they build portfolios. Whenever one kind of asset is going down, ideally you want something else in the portfolio to be going up, responding to different influences.

But all of these carefully-crafted models and all the higher mathematics went seriously awry during the 2008-2009 downturn, when every risk asset--from commodities to real estate to stocks--went down in concert as if the correlation coefficients had suddenly decided to converge at exactly the wrong time. How could this happen?

At a recent investment conference, the outlines of a possible explanation began to emerge. It was noted that all of those risk assets had one thing in common: they were financed or owned by the same small number of investment banking and brokerage institutions. When Lehman Brothers went bankrupt and Bear Stearns was essentially folded into J.P. Morgan, when Citigroup and Merrill Lynch and Goldman Sachs suddenly had to rebuild their balance sheets, they all needed to sell assets to raise money. The result: the world's largest owners of risk assets were all desperate sellers at the same time. Suddenly, all those assets, no matter how different their underlying economics, were in the same boat: they had to be sold so that companies could meet their net capital requirements and stave off bankruptcy.

And, of course, this caused those assets to have something else in common: they were dropping in value so fast that the average investor was scared out of his wits. Instead of

a run on the banks, as we saw in the 1930s, there was a run on the markets, fueled by the same kind of panic: will I be able to get my money out before it disappears?

This explains how the normal historical correlations failed to protect even the best-diversified portfolios. The discussion then turned to: is there anything we can do about this going forward? The solutions under discussion ranged from buying expensive hedges (which, of course, become dramatically more expensive during a panic), to selling into the teeth of the storm (and locking in significant losses), and, in general, the answers weren't very satisfying. The consensus was twofold: first, these kinds of panics don't happen very often. Interestingly, the mathematics of modern portfolio theory suggest that a 2008-like downturn should happen every 65-80 years, and that happens to be just about how long it was between the Great Depression and the Great Recession.

Second: these panics seem, in retrospect, to be great times to buy risk-based securities. When others are selling in a panic, you can almost name your price, and to the extent that you don't believe that civilization is coming to an end, you trust that sooner or later the stocks you bought cheaply will, when the panic subsides, rediscover their true value. The trouble, as one advisor put it, is: how are you going to tell your frightened clients, in the height of a storm, that this is a great time to put more money into the market? Is anybody going to listen to that advice when the largest global investing organizations are trying to unload those same assets at any price they can get?

The bottom line here is that professional investors are finally getting a handle on why well-diversified portfolios didn’t protect against the 2008 downturn. But the fact remains that the people who can control their panic seem to be the only ones who will be protected the next time there’s a panic run for the exits. Until we invent a cure for the human tendency to flee with the herd, investment portfolios are likely to go down the next time we experience a serious market downturn. Let’s hope we’ll have to wait 60-80 years.