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Special Interest Articles:

Estimating Expected Returns in Your Portfolio

By Christopher W. Beale, CFP®

Before sounding like all other experts in the financial media, let me state the obvious. I don't know what your future returns will be. That's why the title of this essay is "estimating" expected returns. I will use forward-looking statements which by nature are predictive and will depend upon future events or conditions which may or may not occur. Actual events and results may differ materially from those expressed in these forward-looking statements due to unknown factors. I believe I have now satisfied all legal and compliance requirements.

Let me start by saying I am not predicting doom, although maybe I should be. Predicting doom is a great business to be in because our minds are wired to be spooked at the first sign of danger and eyes instantly attracted to warning signs. The real problem with doomsayers who have made dire predictions in the past is that they never actually have been right. Betting on the end of the world, or the end of the US economy, or the death of the stock market has never been a winning choice and I don't believe it is the right choice now.

Typically future return predictions start with actual historic returns. Most of the historic data referenced here has come from Professor Robert Shiller's (Yale University) research, Davis Advisors, the Federal Reserve, and the Bureau of Economic Analysis. Professor Shiller's research covers the last 140 years of the United States stock and bond markets. Since 1871 the annualized return of the US stock market is 9%. The annualized return of the US bond market is 5%. A diversified portfolio mix of 60% stocks and 40% bonds (historical asset allocation for pensions, foundations, and most retirees) would have provided a return of 7 to 8% annually. This 7 to 8% return assumption is used by many actuaries as an input to determine pension funding obligations.

In our office we have some concerns with using these returns in our forecasting. Our biggest concern is with the potential future return of the bond allocation.

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30 year Bull Market for Bonds – Is the Party Over?

By Christopher M. Lee, CFP®

The Barclays U.S. Aggregate Bond Index – (the broad U.S. debt index comprised largely of U.S. Treasuries) posted its first quarterly decline in seven years, slipping slightly (-.12% in the first three months of the year) as U.S. stocks rallied to unprecedented highs.

So what does this mean to you, the investor, and how does it affect you? What are we doing at New England Capital Financial Advisors, LLC going to do about it? This article will answer those questions for you. But first, let's take a quick review of what bonds are and why they may be in your portfolio.

Bonds, simply put, are IOU's. You loan $10,000 to a company (Coca Cola for example) and they promise to pay you back your $10,000 in 20 years. Along the way, they give you interest to make it worth your while. Based on current market rates, Coca Cola decides to pay you 4% interest (usually paid semi-annually or $200 every six months). Not too bad for you, the investor. You get $400/annually plus a promise to get your principal ($10,000) back in 20 years. Typically, bond holders are pretty secure as they are near the top of the totem pole if a company files for bankruptcy.

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Estimating Expected Returns in Your Portfolio

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The 10 year treasury as of today yields about 2% which is below the historic average and not the 6 1/2% it was yielding in 2000. Today if we hold the bond to maturity, the return we can expect is 2% coupon yield. If we sell the bond before maturity, we will receive the market price at the time of the sale. The main determinant of the market price of US bonds is the inverse relationship with prevailing interest rates. In other words, if interest rates rise after we purchase our bond, our bond price will fall. The Federal Reserve Chairman, Ben Bernacke has expressed a commitment to keep interest rates low through 2014, so this risk may not be significant this year. But, (here comes one of those forward-looking statements) if we think interest rates will rise over the next several years our bond prices will most likely decrease in value. The obvious difference between our current bond yield versus the historic bond yields cause us concern for future portfolio return expectations.

On the stock side of the portfolio mix, Prof. Shiller in his book Irrational Exuberance, states that current stock prices affect future returns. While this sounds obvious it is current prices along with the investing public's expectation of future returns which can cause irrational investor behavior. The long-term trend of the US stock market shows a steady upward trend of wealth accumulation over time. Annual returns however are much more volatile. In the over 140 years of research, five years, 1917, 1931, 1937, 1974, and most recently 2008, have produced losses of over 30% which include stock market losses plus the loss due to inflation. We know even 10 year average returns can vary substantially. Both the decades of the 1980s and 1990s stock returns averaged over 14% annually. From 2000 to 2010 stock returns averaged 3.8%. Averages can be deceptive. If my right foot is in a bucket of 35° water and my left foot is in a bucket of 135° water, my feet are in water averaging 85°, but I'm still not comfortable. It is the non-average or outlier times of extreme exuberance or extreme fear which cause bad investor behavior (which subsequently causes poor investor returns).

Research by Davis Advisors cause me to be more hopeful about future stock market returns than bond market returns. Since 1926 there have been 5 ten year periods in the stock market that have produced less than 5% annualized returns, not counting the 2002 to 2011 ten year period. Each subsequent ten-year period has had very satisfactory performance ranging from 6.6% to 14.8% average annual return.

By most historic and current measures I believe the stock market is fairly valued. I also believe most markets including the stock market are driven by both short-term emotional forces and longer-term valuation forces. I am much better at predicting the longer-term investment valuations than I am at predicting how people are going to feel tomorrow. The former is a long-term analytical issue involving economics and valuation assumptions. The latter is a short-term behavioral issue which can be studied but very difficult to predict.

The research I cited include only analyzing two asset classes: the US stock and US bond markets. I believe we, at New England Capital, can add value by allocating your money over more asset classes such as small companies and international equities. We also invest in alternative asset classes such as emerging markets, real estate securities and natural resource funds. We can employ managers who use hedging strategies and we can invest in our own hedging strategies such as the one Chris Lee has discussed in this newsletter. Tactical rebalancing of portfolios adds value to your account by systematically buying low and selling high. I believe we have historically reduced volatility by not using leverage in our model portfolios. Even the methodology of how we distribute income from your accounts can add value and reduce volatility.

I have often said how we, at New England Capital manage your money will add no pizzazz to your cocktail party conversations. I personally find it very exciting to be boring. I know we are doing some very exciting things at New England Capital to keep your portfolio boring. I also know that you, at any time can find fault with our approach. A boring, well-balanced, properly allocated portfolio policy will typically underperform the all stock S&P 500 index in a bull market. In a bear market we will not hold up as well as an all cash bank account. My perfectionist self constantly fights my urge to always be right with my true desire to be correct over time. My hope is that your goals match mine.

"Courage is fear holding on a minute longer."

-George S. Patton, General, U. S. Army

"It is easy to make a buck; it is a lot tougher to make a difference."

- Tom Brokaw, Journalist, Author

30 year Bull Market for Bonds – Is the Party over?

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If assets of the company are sold, they are usually the first to get paid (after the attorneys of course). That is why bondholders of GM did not lose all of their money back on June 1st, of 2009, versus the stockholders that did. With that being the case, some people feel that bonds are safe, reliable, income-producing investments. If you hold the bonds until maturity, that is true, BUT not in the short term – let's fast forward one year from now (when you first bought that Coca Cola Bond for 4%).

Let's say that the economy slows down a bit and interest rates fall (the Federal Reserve lowers rates). Now, the current market rates for new bonds being issued are 3% or $300/annual interest. Your bond (at 4%) looks pretty attractive. If someone approaches you to buy your 4% bond from you, what will you say (knowing that you can only buy 3% bonds). Well, I hope your first response is "heck no". Then you think about it and offer to sell your $10,000 bond for $11,000 (making a $1,000 profit). You have given up that extra 1% in interest payments, but you just made a $1,000 profit. That is called selling your bond at a "premium". If the person that bought it from you for $11,000 holds it until maturity in 19 years, they will only get $10,000 in return and will have a $1,000 loss. The tradeoff is that they got the extra interest over the life of the loan.

With some fluctuations along the way, interest rates have basically been falling for the past 30 years and that's been great for bond investors. The yield on a 10-year Treasury has fallen from over 15% in 1981 to 1.86% recently.

Let's go back to the original bond purchase of 4%, but this time instead of rates dropping, interest rise a little bit. The economy starts to heat up and inflation creeps in. The Federal Reserve (in order to temper the economy) raises interest rates. Now, current market rates for bonds are 5% or $500 annually on a $10,000 investment. You have a bond paying 4% interest. You really want that 5%, so what do you need to do to sell it? You have to sell the bond for $9,000 (taking a $1,000 loss) which is called a "discount". You now have a higher interest rate paying bond, but you took a loss on selling your bond.

Now you can see the inverse relationship: when interest rates rise bond prices fall. Vice versa, when interest rates fall, bond prices rise.

Buying a bond at today's low rates is, in a sense, a bet that the economy won't grow very quickly between now and when that bond matures. Even the relatively modest 3% GDP (Gross Domestic Product) growth forecast by economists in the latest Wall Street Journal survey would boost interest rates enough to cause today's low-rate bonds to lose value.

With that being the case, what are you to do (the investor) if you own bonds? That is where New England Capital comes in. Our investment committee (that meets quarterly and in-between if warranted) has been looking for ways to reduce/mitigate your risk. One way is to lower the duration (A measure of the sensitivity of the price (the value of principal) of bond to a change in interest rates) of the bonds that you hold, which is what we have been doing. Other ways that we are trying to protect your bond portfolio is investing in foreign bonds, floating rate funds, TIPS (treasury inflation protection bonds), adding more dividend paying equities, and finally an inverse bond ETF that we will be adding to some of the portfolios over the next quarter.

Even with the above mentioned techniques, we cannot guarantee that your bond portfolio will not lose money going into the future. No one knows when (not "if") interest rates will rise. It could be 6 months to 2 years or more. All we can do is try to prepare (and be proactive – not reactive) at this point.

Lastly, the best compliment we can receive at New England Capital is a referral from you. If you have a family member, friend, or co-worker that may need guidance with their hard earned money in these volatile times please give us a call.

"Most of the important things in the world have been accomplished by people who have kept on trying when there seemed to be no hope at all."

-Dale Carnegie, American writer, lecturer and developer of famous courses in self-improvement

NEW INCREASES TO PLANS!
2013 IRA and Retirement Plan Contribution Limits

Roth IRA & Traditional IRA 2013 Limits	
AGE 49 & BELOW	**AGE 50 & ABOVE**
$5,500	$6,500

401(k), 403(b), and 457 Contribution Limits	
AGE 49 & BELOW	**AGE 50 & ABOVE**
$17,500	$23,000

Simple IRA Limits	
AGE 49 & BELOW	**AGE 50 & ABOVE**
$12,000	$14,500

SEP IRA Limits	
Max Dollar Allocation	**Max Considered Compensation**
$51,000	$255,000

NECFA News!

We are in the process of transitioning all of our mailings/reporting to our *Client Access* on our website www.newenglandcapital.com. Effective **December 31st 2013 we will no longer be mailing (via USPS) out our "quarterly summaries"**. Unless you have specifically asked us, they will now only be available through our secure website. If you are not already on our *Client Access*, we will need to set you up.

If you are not signed up you will need to get set up with your own specific User ID and password. We will need to send you a "Welcome Email" with instructions. To get set up on this, please contact Michelle at our office at (203) 935-0265 or email her at michelleacanfora@newenglandcapital.com and let her know that you want Client Access.

What is "Client Access" - This was our new addition to the website last year! This link gives you access to your own personal on-line storage folders. You can store your key documents online including your employer retirement plans, insurance policies, wills, tax returns, and trust documents. This new *Client Access* (or client vault) offers extraordinary security. Files are encrypted while they are uploaded or downloaded and they are stored using high encryption (encryption is the process of transforming information using an algorithm to make it unreadable to anyone except those possessing special knowledge, usually referred to as a key).

We will also be able to upload documents from our office right to your personal folder (so you can easily retrieve them), including meeting notes, applications, summaries of your accounts, and important tax documents.

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