BCM Financial Literacy Collection

2017 and 2018

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April is Financial Literacy Month and for good reason. A lack of financial preparedness has huge individual and societal costs, especially as our country ages into retirement. Regardless if it is April or not, we at BCM know how valuable your financial well-being is and the importance of "starting early" to attain it. If you have not felt secure with your personal situation and hope to achieve financial literacy and understanding for yourself or your clients, educate yourself on the dedicated Financial Literacy series topics below:

Glossary of Financial Terms

By David Haviland

April is Financial Literacy Month and for good reason. A lack of financial preparedness has huge individual and societal costs, especially as our country ages into retirement. Regardless if it is April or not, we at BCM know how valuable your financial well-being is and the importance of "starting early" to attain it. If you have not felt secure with your personal situation and hope to achieve financial literacy and understanding for yourself or your clients, look out for our dedicated Financial Literacy series posts throughout the next four weeks.

Now start with us on step one: understanding common terms and financial concepts in our industry. Below, see what we deem to be most commonly used terms you may come across today. While there may be overlap from our 2017 Glossary of Terms, we received feedback that both individual investors and financial advisors found it to be a very useful tool. So we thought we would kick this year off with a refresher of these terms! You also can refresh yourself and view our Financial Literacy posts from last year.

Glossary of Financial Terms:

- **Active Management** can be thought of as any strategy that uses human discretion to decide what the portfolio should own. The manager(s) generally employs some combination of fundamental, quantitative, or technical research in conjunction with their experience, knowledge and judgement to try to find opportunities greater than the market. The fees are typically higher than passive as you are paying the managers for their work

- **Passive Management** is often synonymous with index investing. By simply investing in the holdings of the index the strategy follows, the buy and sell decisions are not discretionary but rather based on the rules of the index. If an index fund that you invest in enters a period of failure, then your portfolio will also succumb to the market failure. Costs are typically low as there is little management of the portfolio.

- **Tactical Management** is a type of active portfolio strategy that shifts the percentage of assets held in various asset classes, sectors or individual investments to take advantage of opportunities as they present themselves. Tactical is also unique in that in times of market duress, Tactical managers seek to protect the assets by raising cash, shifting into other asset classes or geographies, or using other types of defensive mechanisms to avoid large losses.

- **Closet Indexing** is a strategy used to describe funds that claim to actively purchase investments, but wind up with a portfolio not much different from the benchmark. By doing this, portfolio managers are able to achieve returns similar to an underlying benchmark, like the S&P 500®, without exactly replicating the index.

- **Drawdown** is the measurement of an investment's total decline from its previous peak for a particular period of time. Drawdown is a useful tool to help determine an individual's risk tolerance. This statistic can help investors gauge their risk appetite as previous large drawdowns, or peak to trough declines, may repeat in the future. Since most investors' primary worry is how much they can lose in a bear market, this is often a good measure of an investment's appropriateness to each investor. How large of a drawdown can your client handle before they begin to panic or react with emotion?

- **Alpha** is a measure of excess return, usually expressed as a percentage. A positive excess return means that for the risk taken, the reward received was greater than expected. In the industry, it is commonly accepted that a manager with positive Alpha has added value beyond what was available to a passive investor.

- **Beta** is used to determine the risk-reward profile of an investment relative to the market as a whole. If the beta is greater than one, then the investment is deemed riskier than the market as a whole as and if less than 1 than it is less risky than the market. A beta of 1.2 implies that if the index goes up or down 10%, the investment in question can be expected to go up or down 12%.

- **Standard Deviation** (Volatility) is a measure of the dispersion of a set of data from its mean. It is calculated as the square root of variance by determining the variation between each data point relative to the mean. If the data points are further from the mean, there is higher deviation within the data set.

- **Sectors** (Sector Investing) sectors are areas of the economy in which businesses share the same or a related product or service. There are eleven sectors of the stock market which include areas such as Financials, Utilities, Healthcare, and Energy. Sector investing is a strategy based on moving investments across these sectors to take advantage of cyclical trends in the overall economy.

- **Smart Beta** is often synonymous with Factor Investing. Smart Beta funds typically follow a passive index yet the index is built to own securities with certain investment attributes or factors. Factors generally seek to do one of two things: exploit market inefficiencies to create alpha, or harvest a risk premia to realize higher returns through the targeted beta in one or more factors. In short, these factors have the ability to add alpha to portfolio returns.

  By itself, may not be so smart. While the factor exposure can lend 1-3% of excess returns over time, unfortunately smart beta funds act too similar to the broad markets when they falter. The 6 most common factor ETFs (Dividend, Momentum, Quality, Size, Volatility and value), if held in equal weights, declined the same amount as the S&P 500 in the 2007-2009 drawdown.

- **Single Factor** investing includes funds that focus on a single factor, like value or momentum, when creating an index.

- **Multi-Factor** investing includes funds focus on multiple different factors when organizing the weights of a given index.

- **Rules-Based** is a term often used to describe a Tactical Manager's ongoing process. Most Tactical processes have been created using quantitative and/or technical research. This research is then used to derive rules for managing money. The rules and process of the various strategies will vary, sometime wildly, but the point is that rules have been created as part of system to manage assets in a non-emotional, methodical manner.

- **Quantitative Research** uses mathematical and statistical methods, often aided by computers, to objectively analyze data for the purpose of making quantifiable favorable investments. If the research is not directly actionable, it may be further refined into rules and models for implementation. The advantage of quantitative research, if completed without bias, is that the system should be devoid of emotion and not subject to human interpretation.

- **Fundamental Research** is a research method of evaluating an investment in an attempt to measure its intrinsic value, by examining related economic, financial and other qualitative and quantitative factors. The end goal is to use real, public data including macro and micro economic factors, like the overall economy and company management, respectively to decide if the investment is over or undervalued.

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Investment Acronyms: Say What?! CNBC Slang Finally Decoded

By David Haviland, Managing Partner and Portfolio Manager

Popular sites such as Investopedia and The Financial Dictionary have over 1,885 financial acronyms housed in their shared glossaries. I would challenge you to find anyone — let alone a typical investor — list-off and define the most fundamental acronyms common to our industry.

In honor of April being Financial Literacy Month, we have compiled a guide to the terms you should know that we here at Beaumont Capital Management (BCM) use and converse in everyday conversation. Plus, our guide contains a Retirement specific list that will help demystify the confusing realm of retirement plans whether you are an advisor or an investor!

As a supplement to this Quick Guide to Investment Acronyms, educate yourself on important financial terms with our Glossary of Financial Terms.

General Investing & Wealth Management:

- **ACWI:** (All Country World Index) captures large and mid-cap representation across 23 Developed Markets and 24 Emerging Markets countries. With 2,495 constituents, the index covers approximately 85% of global investable equity.
- **BD**: (Broker Dealer), a person or firm in the business of buying and selling securities, operating as both a broker and a dealer, depending on the transaction.
- **CFA** (Chartered Financial Analyst), is the designation attained by a person who has successfully completed all three phases of the Chartered Financial Analyst program. To have the CFA designation, an individual must first have a bachelor's degree and three years of practical experience in the investment industry. The CFA designation focuses on developing professionals who can do financial analysis and manage large sums of money.
- **CFP**: (Certified Financial Planner™), is the designation awarded to individuals who successfully completed the Certified Financial Planner Board of Standards, Inc initial and ongoing requirements. The focus of CFP is to create professionals who can advise individuals on managing their personal portfolio and financial planning. CFP advise people on many areas, such as investment management, estate and retirement planning, tax planning, personal cash flows and insurance.
- **CPI** (Consumer Price Index): expresses the current prices of a basket of goods and services in terms of the prices during the same period in a previous year, to show effect of inflation on purchasing power.
- **DOW** (Dow Jones Industrial Average or DIJA), is a stock market index that shows how 30 large, significant publicly traded companies based in the United States have traded during a standard trading session in the stock market. When you read in the paper or hear on TV that "the markets are up today", often they are referring to the DOW and was created to serve as a proxy for the stock market as a whole.
- **ECB**: (European Central Bank), is the central bank for the euro and administers monetary policy of the eurozone, which consists of 19 EU member states and is one of the largest currency areas in the world.
- **EFT**: (Electronic Funds Transfer), is the electronic transfer of money from one bank account to another, either within a single financial institution or across multiple institutions, via computer-based systems, without the direct intervention of bank staff. An everyday example of this is direct deposit.
- **ETF** (Exchange Traded Fund), is a basket of securities you buy or sell on a stock exchange. ETFs are offered on virtually all asset classes ranging from traditional investments to alternative assets like commodities or currencies. They are similar to a mutual fund in that it is a vehicle to invest pooled assets; but the wrapper is very different in that it trades on an exchange, has high daily liquidity and lower fees than a mutual fund.

- **FED**: (Federal Reserve), is the central bank of the United States. The Federal Reserve performs five general functions: conducting the nation's monetary policy, regulating banking institutions, monitoring and protecting the credit rights of consumers, maintaining the stability of the financial system, and providing financial services to the U.S. government. Most recently you would have read or heard about the Fed in regards to rising interest rates and unwinding of Quantitative Easing (QE).

- **FINRA**: (Financial Industry Regulatory Authority) is the single largest independent regulatory body for securities firms operating in the United States. FINRA primarily regulates BDs and RRs.

- **GDP:** (Gross Domestic Product), is a monetary measure of the market value of all final goods and services produced in a period (quarterly or yearly) of time. This is used as a measure to assess the growth of individual country's economies. This is used as a measure to assess the growth of individual country's economies.

- **GIPS®**: (Global Investing Performance Standards), are ethical standards to be used by investment managers for creating performance presentations that ensure fair representation and full disclosure of investment performance results. When evaluating an investment manager's performance, you can ask to see the "GIPS® presentations" which are prepared by an independent third party after verifying the performance. Many firms can claim compliance with GIPS but that does not mean they have been verified by a third party.

- **IAR**: (Investment Advisory Representative) is a professional who works for an RIA and provides advice to others about investments for a fee and are required by most states to become licensed to do so.

- **K-1**: is a tax document used to report the incomes, losses and dividends of a partnership.

- **LIBOR**: (London interbank offered rate), is a benchmark rate that some of the world's leading banks charge each other for short-term loans.

- **MLP**: (Master Limited Partnership) a limited partnership that is publicly traded, it combines the tax benefit of a limited partnership with the liquidity of publicly traded security.

- **NAV**: (Net Asset Value), is the value of a fund's asset less the value of its liabilities per unit. In other words, its the value per share of a mutual fund or ETF on a specific date or time and helps an investor determine if the fund is overvalued or undervalued. NAV differs from market price in that it does not include sales loads or fees.

- **NASDAQ** (National Association of Securities Dealers Automated Quotations): Nasdaq is a global electronic marketplace for buying and selling securities, as well as the benchmark index for U.S. technology stocks.
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- **NYSE**: (New York Stock Exchange), is considered the largest equities-based exchange in the world based on total market capitalization of its listed securities.

- **OECD:** (Organization for Economic Cooperation and Development): is a group of member countries that discuss and develop economic and social policy. OECD members are democratic countries that support free market economies.

- **P/E:** (Price to Earnings Ratio), is a valuation ratio where a company's current share price is divided by its per-share earnings. In general, a high P/E suggests that investors are expecting higher earnings growth in the future compared to companies with a lower P/E.

- **PM**: (Portfolio Manager), is a person or group of people responsible for investing a mutual, exchange-traded or closed-end fund's assets, implementing its investment strategy and managing day-to-day portfolio trading.

- **PPI:** (Producer Price Index), focuses on the whole output of producers in the United States. This index is very broad, including not only the goods and services purchased by producers as inputs in their own operations or as investment, but also goods and services bought by consumers from retail sellers and directly from the producer.

- **QE** (Quantitative Easing): is when a central bank purchases government securities from the market in order to lower interest rates and increase the money supply. To simplify, QE in the U.S. involved the Fed buying trillions of U.S. Treasuries and Mortgage Backed Securities.
- **REIT:** (Real Estate Investment Trust), are companies that own or finance income-producing real estate in a range of property sectors such as office and apartment buildings, to hospitals. REITs are intended to allow individual, retail investors the opportunity to acquire ownership in commercial real estate, which they wouldn't otherwise have the means to do.
- **RIA:** (Registered Investment Advisor), is an advisor or firm engaged in the investment advisory business and registered either with the Securities and Exchange Commission (SEC) or state securities authorities.
- **RM**: (Relationship Manager), is a professional who works to improve a firm's relationships with both partner firms and customers.
- **ROE**: (Return on Equity), is the amount of net income returned as a percentage of shareholders equity.
- **ROI**: (Return on Investment), measures the gain or loss generated on an investment relative to the amount of money invested.
- **RR**: (Registered Representative) is a professional who works for a BD and provides advice to others about investments. RRs are compensated by commissions on products they sell to clients.
- **SEC**: (Securities and Exchange Commission), is the federal agency responsible for the oversight and enforcement of laws pertaining to the securities industry to help protect investors. The SEC primarily regulates RIAs and IARs although this agency oversees FINRA and the industry as a whole.
- **SMA**: (separately managed account) is a portfolio of individual securities managed on your behalf by a professional asset management firm.
- **S&P**: (Standard & Poors), is a financial market intelligence corporation. It provides credit ratings on bonds, countries and other investments. It calculates more than one million stock market indices. The most well-known is the S&P 500® Index.
- **UMA:** (unified managed account) is a professionally managed private investment account that can include multiple types of investments all in a single account. Unified managed accounts are often rebalanced on a specified schedule.
- **VIX®**: (CBOE Volatility Index), (The Chicago Board Options Exchange Volatility Index), is used by stock and options traders to gauge the market's "anxiety" or "fear" level. It is a mathematical measure of how much the market thinks the S&P 500 Index option, or SPX, will fluctuate over the next 12 months, based upon an analysis of the difference between current SPX put and call option prices.
- **W2**: (Form W-2) the form that an employer must send to an employee and the Internal Revenue Service (IRS) at the end of the year. The W-2 form reports an employee's annual wages and the amount of taxes withheld from their paycheck.
- **WTO**: (World Trade Organization) is the only international institution that oversees the global rules of trade between nations. The main function of the organization is to help producers of goods and services, exporters and importers protect and manage their businesses - without resulting to major violence or war.

Retirement:

- **3(21):** (3(21) investment advisor) is a co-fiduciary role. An advisor provides advice to an employer with respect to funds on a 401(k) investment menu, but the employer retains the discretion to accept or reject the advice.
- **3(38)**: (3(38) investment advisor) has the discretion to make fund decisions. The plan sponsor has less liability in this relationship, because they offload fiduciary risk for investments to the advisor.
- **3(16)**: (3(16) investment advisor) is the plan administrator with ERISA reporting and disclosure duties.

- **403(b)**: plan is a retirement plan for specific employees of public schools, tax-exempt organizations and certain ministers. These plans can invest in either annuities or mutual funds.
- **401(k)**: plan is a qualified employer-established plan to which eligible employees may make salary deferral (salary reduction) contributions on a post-tax and/or pretax basis.
- **CIF/CIT**: (Collective Investment Fund/ Collective Investment Trust) is an institutional investment vehicle sponsored by banks or trust companies that pool retirement plan assets into a single portfolio. This includes possible investments in a wide range of vehicles like mutual funds, Exchanged Traded Funds (ETFs) and asset classes like equities and fixed income.
- **DB**: (Defined Benefit), is a type of retirement plan that an employer sponsors, where employee benefits are computed using a formula that considers factors, such as length of employment and salary history.
- **DC**: (Defined Contribution), is a type of retirement plan in which the employer, employee or both make contributions on a regular basis. A 401(k) plan is a defined contribution plan.
- **ERISA**: (Employee Retirement Income Security Act), Employee Retirement Income Security Act of 1974 (ERISA) protects the retirement assets of Americans by implementing rules that qualified plans must follow to ensure plan fiduciaries do not misuse plan assets.
- **IRA**: (Individual Retirement Account), An individual retirement account is an investing tool used by individuals to earn and earmark funds for retirement savings. There are several types of IRAs as such as Traditional IRAs, Roth IRAs, SIMPLE IRAs and SEP IRAs.
- **PSP**: (Profit Sharing Plan), is a plan that gives employees a share in the profits of a company.
- **QDIA**: (Qualified Default Investment Alternative), is a type of investment account that provides plan sponsors with a safe harbor from fiduciary liability for investment decisions made by participants in their 401k accounts.
- **TDF**: (Target Date Fund), an investment vehicle that is professionally managed using an asset allocation strategy that takes into consideration risk tolerance over time.
- **TPA**: (Third Party Administrator), is an organization that handles certain administrative responsibilities for other organizations. TPAs typically take on claims administration, loss control, risk management, and retirement plan administration.

For more insights like these, visit BCM's blog at blog.investbcm.com.

Disclosures:

Sources: Fidelity, Investopedia, Financial Dictionary, VIX, MSCI, DOL, ERISA

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The Good, the Bad, and the Ugly: What No One Tells You About Debt

By David Haviland, Managing Partner and Portfolio Manager

The average age Americans learn how to balance a checkbook is 28[1]. Age 28! If Americans are not taught about basic finance in high school or college, then how can they possibly be ready to evaluate what debt is necessary, budget for it, and have a plan to pay it off without impairing and impeding their financial future? If we don't educate our clients and their children about the benefits and pitfalls with debt, then we are failing them.

Most Americans are introduced to the concept of taking on debt from those who peddle it. You get student loan offers in order to help pay for college. You get credit card offers while in college despite having no meaningful (or any!) income. Then, there is your first car purchase or lease, and eventually many go on to purchase a home, and so on. How can we ask our children to make informed choices when the only information fed to them about debt is from lenders? Is this not the ultimate "fox guarding the hen house" scenario? Well, let's change that starting now.

The Good

Good debt has a purpose and should benefit you now and in the future. Borrowing money in a good way simply means you are buying a capital asset with both a present and future value, and you are financing that purchase with a loan. The best examples would be buying a home or a car. I can even make a case for reasonably sized student loans, but I will discuss that in more detail below.

Another example of good debt can be found in local, state and federal government. If a government builds a school, a bridge, a hospital or a dam, then they are spreading the cost of that capital asset out over time while the benefits should continue well after the debt (bonds) are paid off. Society gets an asset that can be used today, tomorrow and well into the future, as well as indirect benefits such as home appreciation in that community. Good debt invests in the future and builds equity for an individual or a society alike.

The Bad

For individuals, bad debt occurs out of unawareness, lack of discipline or misfortune. Let's leave aside misfortune as it is out of your control. Most bad debt occurs when you finance a want versus a need. Put another way, any time you spend more than you can afford, you are acquiring bad debt. Bad debt typically gets you into debt trouble slowly and without you even realizing it. You take on credit card debt in college with no context around how hard it is to pay off debt with a 15.99% interest rate (or higher). That one nice item of clothing, the quick weekend getaway and the "oh let's just grab a bite"—it adds up, and suddenly the lenders have "gotcha" because you can't pay the full balance each month. Banks and auto companies love to lend you money because they make handsome profits. You can read more in depth about the effects of compound interest and leasing versus buying a car in previous pieces on the BCM blog.

In government, bad debt occurs when a government entity spends beyond its means just to provide current services. If tax revenue is $100, and the operating budget is $110, $10 must be financed. This means future tax payers must pay the interest and principal for previous spending they have not benefitted from. Societally, it is the most selfish thing we can do for our future neighbors, friends and family. Why do we do it? Some decisions are hard to make. Politicians are known to defer tough choices and "kick the can down the road", and won't commit to any definitive long-term solutions if it makes them unpopular while they're in office.

The Ugly

Overall, bad debt sacrifices the future in that we ask the future to pay for today's fun without any long-term benefit. A fancy vacation now may be fun and "amazing", but if you spend beyond your means, that vacation could become a burden that prevents you from realizing other, more important goals. At best, it could delay a future car or home purchase. Perhaps that vacation means the difference between a beater car and a new one. Perhaps due to your debt, you can only afford a home in a lesser school district for your kids...or no home at all. Or the burden of this debt, including any late or missed payments, harms your credit score so lenders will not grant you good debt at reasonable rates. Yes, this may be harsh to read...but sometimes the truth is hard to hear. Bad debt creates nothing but a burden on your future self and your future lifestyle.

Bad debt usually is accompanied by disproportionate ramifications. Americans today have ~$1.03 trillion in credit card debt, with an average of $15,654 per household![2] While banks are currently paying you less than 1% on your cash held with them, the credit cards typically charge you 12%-18%. This debt is typically unsecured by any asset and thus the rates charged are higher than any debt that is secured by an asset, such as a house. If you go over your limit or miss a payment, your rate will quickly leap, sometimes to over 30%—not to mention the damage to your credit score. So those who struggle or get into trouble end up getting charged the most! If you pay just the minimum amount due, we have seen situations when the repayment of that debt would take over 30 years. And don't forget the teasers...Borrow $1,000 for some furniture interest free for a year. This is a great strategy if you execute a plan to pay it off on time, but if not, that 30% interest rate means your furniture just went from $1,000 to 1,300 and will go much higher if you don't pay it off! Could you use this money elsewhere in your life? If you'd like to see how long it will take to pay off a balance or how much interest you'll have to pay over the course of your loan please click below:

www.creditkarma.com/calculators/debtrepayment

So here are some suggestions for overcoming bad debt. You only need two credit cards, i.e. an American Express® and either Visa or Mastercard®. These are accepted virtually everywhere a credit or debit cards are accepted. Shop for a card that gives you benefits you can use (cash back, points towards travel, free merchandise, etc.) Cut up and close any store cards or other cards if you have more than two, especially if you carry a balance. Store cards typically have much higher interest rates and you are being taken advantage of under the guise of convenience or some teaser discount. Don't fall for it. Pay your full credit card balance off each month, don't just make the minimum payment. Don't finance smaller items like furniture or an appliance unless absolutely necessary. Save until you can pay up front or the lenders will bilk you with the rates noted above.

If you do have credit card debt, the fastest way to get out is this: pay the minimum on every card except the card with the highest rate. Put all available cash towards this card. When it is paid off, switch the payments to the card with the next highest rate and proceed until your balance is $0. Another trick for those with superb discipline: find a card with no interest due for the first year and transfer your balance to this card, taking advantage of the zero interest while you pay off the entire balance. Just remember to do so before the year is up to avoid the interest returning to your statement and nullifying the advantages of the balance transfer process altogether.

Think about it this way—investing in stocks like those in the S&P 500® Index has historically given you returns around 10% over most timeframes. If you avoid paying a bank this amount in interest, it saves you the same as you could potentially earn from investing in stocks over the long term!

The Ugliest—Student Loan Debt

I saved this for last and afforded it an entire segment of this piece because student loan debt is a different beast. As I mentioned earlier, depending on the size of the loan, I could argue either way whether a student's loans are good debt or bad debt. So let's dig a little deeper into this.

Today Americans have over $1.5 trillion in student loan debt.[3] Societally, we are burdening a generation with so much debt, so early, that we are stifling economic growth and dooming millions to relative poverty...poverty they think they are avoiding by earning their degree(s) in the first place. The average student spends $25,290/year for a four year in-state public undergraduate degree and $50,900/year on a private four year degree.[4] Depending on the degree and university, graduate degrees can cost over $60,000/year![5] Beyond scholarships and grants, today's excessive educational costs can ruin a student's future. Again, without impartial information or education provided to students on debt, with no explanation as to the costs of the debt and how long it will take to repay it, we let the lenders, including our own government, take advantage of us.

Please understand that student loan debt is secured by you and all your future income. If you cannot pay off your student loan debt, it never goes away, even if you declare bankruptcy. Student loan lenders can garnish your Social Security payments to recover the debt from you. Did they tell you this when you were applying? Did they tell you this when you were deciding your major, probable career path, and potential future earnings?

At what point does student loan debt turn from good to bad? The answer is simple math after you research what you can expect to earn with your degree.

Let me use an extreme example with a medical degree. In 2017-2018, the average cost of attendance for medical school was $60,543/year.[6] With 6% inflation over four years, this will total ~$272,000. Let's assume no undergraduate or other debt, $272,000 at 6% interest over 15 years will cost ~$27,400/year in principal and interest. The Doctor will have to pay ordinary income taxes on their salary before putting any money towards their loans. Using a state tax rate of 5% and an estimated Federal effective tax rate of 35% as a proxy, this means that ~$45,700 of that Doctor's annual income will be required to pay off the loan. If a pediatrician can be expected to earn $202,000 per year[7], then is this student loan debt worth the expense? Perhaps if the aspiring doctor learned this information up front and could choose a higher-paying discipline, such as becoming an orthopedic surgeon, it would make more sense.

If you are an undergraduate and you plan to take on a career that might pay you $50,000/year to start (the average starting salary of a 2017 college graduate[8]), does taking on $100,000 of debt make sense? How about $200,000? College students today are facing ridiculously high college costs, and must be informed to decide in advance if their degree has the potential to afford them a better lifestyle. In many cases, it could actually subjugate them to a future of relative poverty and indebtedness. How will your student loan debt affect your future? When you need to buy that car to get you to work, will you be able to afford both payments? If you want to borrow $500,000, at 4%, to buy a house, will you be able to afford it? Will the bank even grant you a loan at a reasonable rate if you have a large amount of student loan debt, let alone a car loan and/or credit card balance?

While consumerism drives much of the U.S. economy, we must, like everything else, use debt in moderation and with purpose. We must also ensure that we all know the difference between good debt and bad debt, and that we all have full knowledge of the ramifications of debt on our future lives. At the end of the day, distinguishing good debt from bad debt and evaluating the growth potential of each purchase you make is crucial to securing your financial future. What if, instead of acquiring bad debt by purchasing things you want but don't need, you invested at least some of your hard earned money (plus the money saved by avoiding interest and fees) instead? Imagine the possibilities!

For more insights like these, visit BCM's blog at blog.investBCM.com.

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Lease vs. Buying: What Every Car Dealer Doesn't Want You to Know

By David Haviland, Managing Partner and Portfolio Manager

Let's face it, buying a car is usually one of the most strenuous and, dare I say it, unpleasant experiences. When you are approached by the salesperson the conversation is typically steered towards the "buy or lease" question.

Now I admit I am biased, and there are sometimes good reasons to lease, but let's go through why leases are so sought after by the dealers and manufacturers.

1.) What do you pay?

Most vehicle purchases can be negotiated down from the MSRP, often 10%-20% or more off the cars MSRP. The last client we helped was able to negotiate $5,000 off their $30,000 car. Leases do not allow negotiation of purchase price...the lease and your payments are based on MSRP and thus in this example, you are behind $5,000 right out of the gate.

2) Imbedded interest rates.

When you buy a car today, the interest rate is around 0.9% to 1.9% for someone with at least decent credit. The imbedded capitalization cost (the lease's interest rate) is typically 7.9% to 11.9%. When combined with point #1 above, you often have very similar payments on a 4 or 5 year purchase versus a 2 or 3 year lease.

3) Mileage.

If you own your car and drive it more than expected, it probably has no affect. But if you lease and drive more than the negotiated allotment of miles, you pay big time with a per mile over the limit charge. These overage charges are as high as $0.50 per mile...so if, as an example, you were to drive 5,000 miles over the lease's limit you would owe $2,500 at lease end!

4) Residual value.

The dealer gets to pre-determine the value of your car when the lease expires. This means that if you want to buy it out when the lease is over (perhaps because you drove over the mileage limit) then you may end up paying more than the car's fair market value... and this price is rarely negotiable.

5) Ordinary wear and tear.

When the lease is over the dealer can charge you for items like dings in the door and stains in the carpet. These charges can add up quickly!

6) Many leases require thousands of dollars in up front.

These are called "capital reduction costs" in the form of cash or a trade to help defray the cost of paying commissions and/or to lower the monthly payments. If you are offered a lease with this provision, calculate the monthly payments including the monthly share of the all of the up-front expenses.

7) Equity.

If you purchase a car, when the term is up you own your car and hopefully can drive it for years to come. Now you have an asset that you can sell or trade in. You have equity! At the end of a lease you have nothing other than the need for another car.

As mentioned above, there are certain circumstances where leases make sense. But if you have an option, we hope the above will help you make an informed car acquisition decision.

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Compound Interest: The Eighth Wonder Of The World

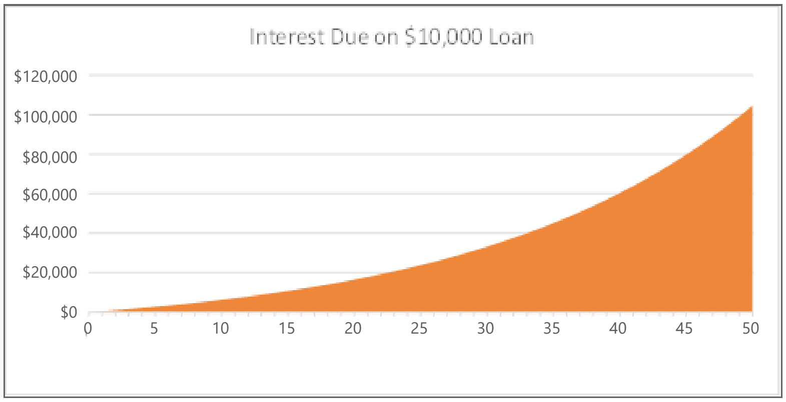
By David Haviland, Managing Partner and Portfolio Manager

"Compound interest is the eighth wonder of the world. He who understands it, earns it ... he who doesn't ... pays it."
- Albert Einstein

What is compound interest, why is it so important, and is that THE Albert Einstein? The answer to the third question is yes. In addition to contemplating the laws of the universe, the world's most famous theoretical physicist was also keenly aware of the most powerful force in the financial world.

When you borrow money the amount you borrow is called principal and you pay an interest rate to compensate the lender for providing the loan. Interest rates are generally presented as an annual percentage rate. As a result, multiple factors affect how much interest you will ultimately pay. The primary factors are the interest rate, the amount of principal, the length of the loan, and how frequently the interest is compounded. The first two factors, the interest rate and principal amount, are generally out of your control; you know how much you need to borrow and the lender sets the interest rate. Therefore, we'll focus on the latter two: the length of the loan and the compounding frequency.

Let's imagine a 10-year $10,000 loan with a 5% interest rate compounded annually. To put the "compound" in compound interest, and for the sake of keeping the math simple, we'll assume that you aren't required to make any payments until the loan is due. Instead the interest is added to the principal at the end of every year and this new amount is used to calculate the interest for the next year. In 10 years the lender will ask for $16,288.95; repayment of the original $10,000 as well as $6,288.95 in interest. What if we extend this same loan out to 20 years? Although the length of the loan doubled, the amount of interest owed nearly triples to $16,532.98.



The graph above illustrates the power of compound interest. The relationship between time and the total amount of interest due is exponential because as time goes on, interest is charged on the original principal AND any unpaid interest! Lenders are well aware of this relationship and long ago discovered that charging interest more frequently would result in more profit. How frequently the interest is calculated is called the compounding frequency of the loan. Most home mortgages, car loans, and other personal loans will compound monthly (12 times a year) but an ambitious lender can compound continuously (daily) if you agree to it. If you ask and see that your interest is calculated continuously, perhaps you should seek a new lender!

	Annually	Semi-Annually	Monthly	Continuously
Principal Due	$10,000.00	$10,000.00	$10,000.00	$10,000.00
Interest Due	$6,288.95	$6,386.16	$6,470.09	$6,487.21
Total	$16,288.95	$16,386.16	$16,470.09	$16,487.21

At this point you should have a good understanding of the power of compound interest. Now you can use this knowledge in your favor to minimize the amount of interest that you pay over the life of any loan. Here are some simple, effective tricks:

Make one extra mortgage payment each January. This alone will turn a 30-year mortgage (at a 5% interest rate) into a 25-year mortgage! If you are paying more than 5% interest, making an extra payment would shorten the mortgage further.
Round up your payment to the nearest $100 or more if you can swing it. These small extra principal payments add up over time and can significantly lower the interest charges.
Pay your mortgage bi-weekly if the lender allows it. By paying half the amount 2 weeks early, the interest charges over the term of the loan will be reduced significantly.

The above examples use a mortgage loan as an example because prepayment penalties on mortgages are rare in the U.S. We recommend seeking loans with no prepayment penalties if possible, and contacting your lender prior to making prepayments on any existing loans. As you formulate a strategy for reducing debt, remember that every little bit counts. Any payments in excess of the interest due is credited to the principal and will reduce the amount of interest that accrues in the future. If you can't swing one of the above, or need to take a break due to a tight budget, don't sweat it…just do what you can whenever you can.

A final note: Compounding can work for you as well. To the critical reader this article not only presented important debt management concepts but illustrated how lucrative being a lender can be!

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Why Own an Umbrella When it's Sunny Every Day?

By David Haviland, Managing Partner and Portfolio Manager

Why would you buy an umbrella when it's been sunny every day? Let's not forget the original use for an umbrella was actually as a sunshade, not for rain, but I digress. Seriously, why would you keep an umbrella in your car, at home or in your golf bag? To state the obvious, it's one thing to get caught in a light shower, but quite another when a squall line or worse moves in. You don't want to get soaked!

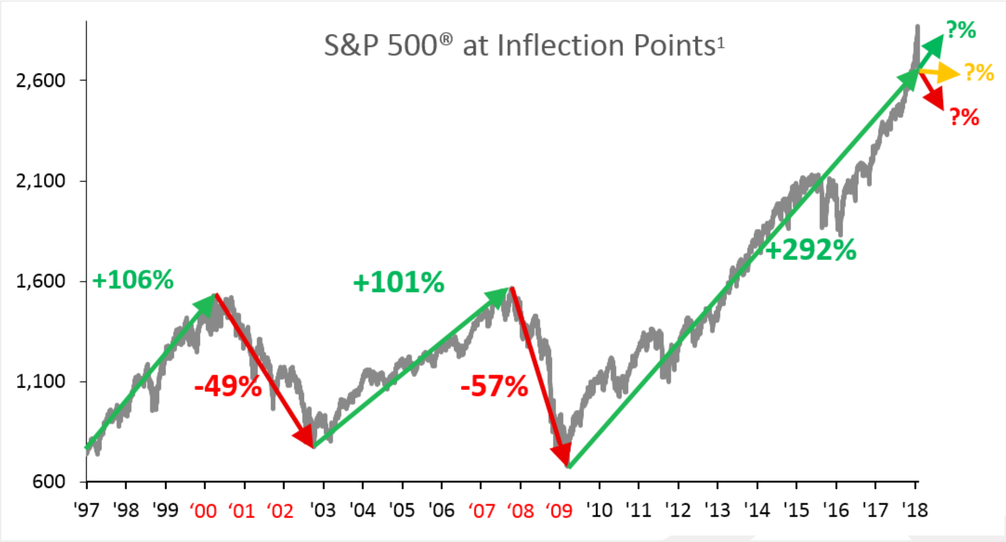
Why do you wear a seatbelt? Why do you wear a life preserver when boating or fishing? Why does a fighter pilot put on a parachute for a routine training mission? We take all of these actions because we are trying to prevent an unforeseen disaster from ruining our future.

Why do you buy insurance? To protect yourself financially if your home, car, income, or other assets were subject to a catastrophic event.

Every day, without thinking about it, we seek to protect ourselves by taking actions or creating a "plan B" in order to avoid or prevent an undesired result. What about your investment portfolio? What actions are you taking to mitigate or prevent a catastrophic bear market from ruining your future financial life?

Ah. You have diversified. Perhaps you have invested some of your portfolio in an annuity or a CD as an anchor to windward. Good, but what about the rest of your portfolio? Do you really mean to have all of it exposed to unlimited loss? What if there was another way?

All of the examples above hopefully describe situations that will never occur or at least do so on an infrequent basis. Yet we take actions to counter them not because they are frequent, but because they are extreme. In the investment world, stocks have historically spent most of their time increasing in value. However, as the chart below shows, there are periods of time when potentially catastrophic losses significantly impact your goals, aspirations and future well-being. What if there was the potential to avoid most of them?



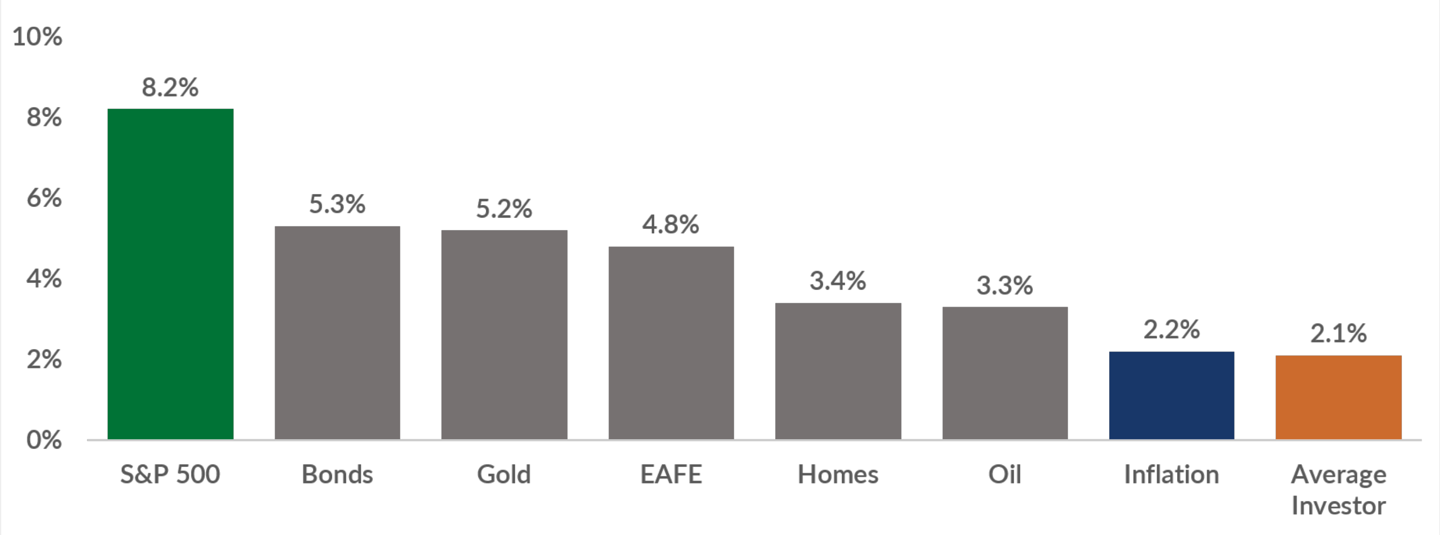
Now let's talk about timing.

Do you close the barn door after the horse has escaped? Do you buckle your seatbelt after you've hit a pole? Do you insure your home after it has burned down? Of course not! We take all of these actions beforehand in order to protect ourselves from the extreme unforeseen event. So why are you treating your portfolio any differently? Why have you ignored your financial well-being so completely? Why do you expose the majority of your portfolio to the whims and the risks of the financial markets without even thinking about mitigating large losses?

Welcome to tactical management. First, tactical management is not insurance in any way, shape or form, but the objective is the same: to prevent a large, catastrophic loss from ruining your (financial) life. Like insurance with a deductible, it will not protect you from all loss, but it can, as part of an integrated portfolio, help reduce loss and smooth your overall investment experience. The time to incorporate tactical management is not during or after a bear market, but rather now after we have enjoyed the nine years of growth under the second-longest bull market in the stock market's history. Look at the chart again. What does your intuition say is likely to happen soon? How will you react when the next bear arrives? Be honest, how did you react in 2000-2002 and/or 2007-2009?

Most investors who have not sought any means of protecting their portfolio find themselves not only exposed to the peaks and troughs of the markets movements, but also to their emotional reactions to them. As the DALBAR study below so poignantly outlines, the typical American investor succumbs to their emotions and ends up making one or more poorly timed decisions which have been shown to devastate their investment results over time.

20-Year Annualized Returns by Asset Class[2]



If you would like to see how incorporating a tactical portfolio might help, please click to see a short paper on how to build a portfolio with diversified management styles. There is no magic elixir. No strategy is bulletproof. Yet similar to a seatbelt, parachute or life preserver, a tactical portfolio may not get you out unharmed, but if it works as designed, it will improve the likelihood of achieving your life's aspirations and goals. Why would you ignore a device that can offer such important defensive attributes? Why would you wait to use it until after it's too late?

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[1]Bloomberg. Data as of 2/14/18. The returns shown in the chart are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. The Standard & Poor's (S&P) 500® Index is an unmanaged index that tracks the performance of 500 widely held, large-capitalization U.S. stocks. Indices are not managed and do not incur fees or expenses. "S&P 500®" is a registered trademark of Standard & Poor's, Inc., a division of S&P Global Inc.

[2]DALBAR, Inc. "Quantitative Analysis of Investor Behavior, 2016", www.dalbar.com

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