CLIFFORD SWAN
The Investment Counselor
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Uncertainty and Change: Working with a Single-Digit World

By Randall L. Zaharia, CFA

"For time and the world do not stand still. Change is the law. And those who look only to the past or present are certain to miss the future."
— President John F. Kennedy, Frankfurt speech, June 1963

"There is nothing more certain and unchanging than uncertainty and change."
— Generally attributed to President Kennedy

Uncertainty and change are something we live with every day, and, as investors, we always have the current crises and global issues as the backdrop for decisions. Over Clifford Swan's nearly 100 years of existence our clients have experienced not only the assassination of President Kennedy, but two World Wars, the Great Depression, the Korean and Vietnam wars, the Cold War, numerous coups, oil shortages, double-digit inflation and interest rates, and more recently, the Great Recession of 2008/2009 and the global monetary response (massive quantitative easing) to that Recession. Change is a constant.

Evaluating change, uncertainty, and risk is an essential part of what we do. We analyze and weigh risks—current and future, global and domestic, macro- and micro-economic—against the potential for solid investment returns—the proverbial risk/return relationship. In our current environment many economists, financial analysts, and investors would agree that monetary policy—the zero interest rate policy and quantitative easing—has been the dominant influence on U.S. and global financial markets since the Great Recession. These untested tactics by the central banks have created a great deal of uncertainty about the future of the financial markets.

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The Federal Reserve has specifically stated that it wants to inflate asset values from depressed levels following the Great Recession, with the ultimate goal of boosting the U.S. economy and reducing unemployment. To some extent, investors have responded to the low interest rates, as well as to expectations of better economic growth going forward. Assets prices have appreciated. Equities, as measured by the S&P 500 Index, have increased from less than 700 in early 2009 to nearly 2,000 in July 2014—almost a tripling of valuation. From peak yield levels in 2007, the bond markets are at significantly lower yields and at higher bond prices. Housing prices, after declining in the 2008-2010 time period, have rebounded in many areas around the country. So, while the economic impact of monetary policies continues to be debated, there is no doubt that returns across a number of asset classes have been strong the last five years.

What is an investor to do now? Equity valuations generally appear to be fully or fairly valued. Some analysts might argue that stocks are overvalued, but few see them as generally "cheap." Bonds, which have largely appreciated over the last six or seven years, will probably deteriorate going forward. With the current 10-year U.S. Treasury rate at about 2.50% as of late July, and with expectations that rates will increase over the next several years, the returns on bonds will be more modest. Additionally, cash continues to earn little or no income. Within this context, Bill Gross, the CEO and Chief Investment Officer of PIMCO, a multi-trillion dollar investment manager

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in Newport Beach, CA, has posited the concept of "the New Neutral" (although, there are variations among other strategists). The "New Neutral" suggests that given the balance sheet recession in 2008/2009, massive debt loads and unfunded liabilities, and the U.S. economy's apparently elevated sensitivity to interest rates, that the Federal Reserve's monetary response (that is, increasing interest rates) would be measured and gradual. Ultimately, levels may be lower than the market's expectations. The New Neutral concept envisions lower real returns across a number of asset classes as a result of higher inflation and lower interest rates. It is from these assumptions that the investor sees a single-digit return world, at least over the intermediate term (about three to five years).

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With the current risk/return profiles less attractive than four or five years ago, we believe that we can add value by taking advantage of market fluctuations and better prices over the next several years. Liquidity and flexibility could be built through higher cash levels, short U.S. government and investment grade bonds, and a solid large capitalization stock portfolio. These stocks fall into two general categories: 1) mature, financially solid "blue chip" stocks, which typically represent traditionally stable industries with steady cash flows that pay good dividends, and 2) stocks from strong, secularly growing industries such as commercial aerospace, Internet-related, and healthcare/biotechnology. For some, even alternative assets such as commodities and/or precious metals may be an option. The key strategy is to be tactically and opportunistically nimble when markets are volatile.

A longer-term strategy would be to stay focused on the strengths of the U.S. economy. These opportunities were summed up by Gary Schilling, PhD, a noted economist and financial commentator, who stated in a recent *Bloomberg View* article:

> "I believe much of today's new technology—the Internet, biotechnology, semiconductors, wireless devices, robotics, and 3-D printers—is in its infancy. Collectively, they have the potential to rival the rapid growth and productivity-generating effect of the American industrial revolution and railroads in the late 1800's." (Schilling, 7/18/2014)

If these trends materialize, the next decade could see a very strong equity market and raise the specter of a potential third industrial revolution. We might also factor in the continuing energy renaissance as the result of modern drilling techniques in areas such as the Permian Basin in Texas and the oil fields of the Dakotas. The U.S. still knows how to be on the cutting edge of tomorrow's new products and technology. We just have to get past the modest returns of the next three to five years as we digest today's changing financial and economic environment. Ultimately, we do not want "to miss the future." ◆

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In the News

Clifford Swan is proud to have been recognized recently in several publications.

Accolades by the *Financial Times*, the *Los Angeles Business Journal*, and *Financial Advisor* magazine were announced in June.

The *Financial Times* named Clifford Swan as one of the top 300 Registered Investment Advisors (RIA's) in the country. With more than 2,000 firms considered, RIA's were evaluated based on their standing in six primary areas: assets under management, asset growth, compliance record, years in existence, credentials, and accessibility.

The *Los Angeles Business Journal* named Clifford Swan to their annual list of the top 75 Money Management Firms in L.A. County.

In their ranking of fee-only registered investment advisory firms, *InvestmentNews* listed Clifford Swan as the 85th largest RIA in the nation and the 18th largest in California.

In July, *Financial Advisor* magazine's ninth annual ranking of independent advisory firms ranked Clifford Swan as the 87th largest RIA in the nation and 14th largest in California.

Please contact us if you would like a copy of any of these reports. ◆

Saving for College

By Carolyn S. Barber, CFA

Parents today are faced with the long-term challenge of funding their own retirement accounts and simultaneously saving for their children's college expenses. Given these two choices, funding retirement must be the priority, because you can borrow for college but you cannot borrow for retirement. The result is that more and more students are burdened with student loan debt upon graduation. Today over 70% of graduates receiving their bachelor's degree have borrowed to pay for their education, and the average debt load of these graduates is $33,000.

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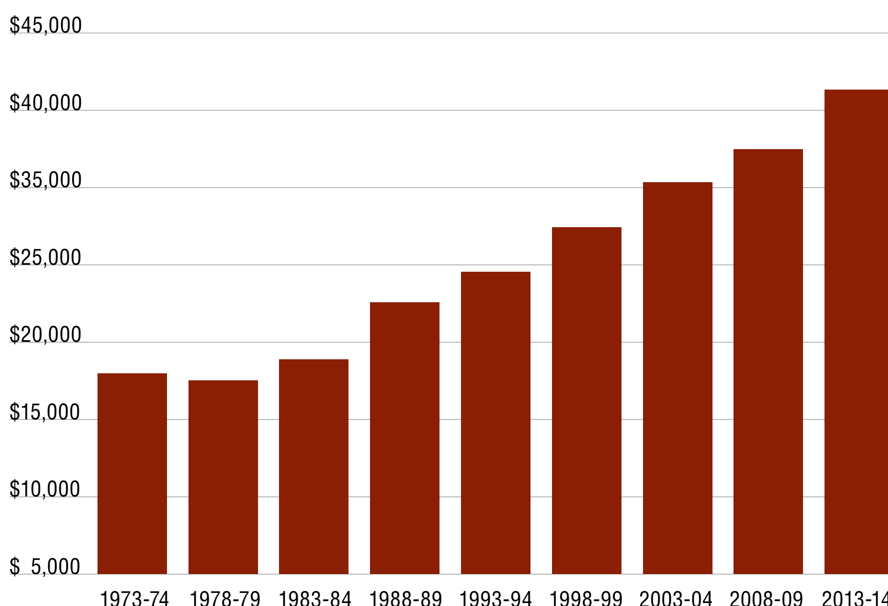
Grandparents can help by funding a college savings plan. Starting to save and invest for college expenses when a child is young means the account has years to grow before it needs to be tapped for education expenses. Paying for the costs of higher education is a way to pass assets along to heirs with the assurance that those assets are used productively. There are several types of college savings plans: Custodial Accounts (UGMA/UTMA), Coverdell Education Savings Accounts (ESA), and Section 529 College Savings Plans. Each type of plan has different rules.



SOURCE: THE COLLEGE BOARD, *TRENDS IN COLLEGE PRICING 2013*

College Savings Plans:

Custodial Accounts can be set up for a minor. The account is controlled by the custodian, usually the parent, until the minor comes of age (usually 18 or 21, but may be older, depending on the state). The assets must be used solely for the benefit of the minor, including, but not limited to, educational expenses. Custodial accounts may be funded using cash or other assets, such as stocks or mutual funds. There is no maximum amount that can be given, but funding is subject to the gift-tax rules. Once the assets are in the account, they become the property of the minor. The tax rules for the income earned in the account are a bit complex, but generally any income over $2,000 a year is taxed at the parents' tax rate. Because the assets belong to the minor, they may have an impact on the student's ability to receive financial aid. Another drawback to the custodial account is that the parent loses control over the assets once the minor comes of age. After age 18 or 21, the young person can spend the money in the account any way they want to.

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Coverdell Accounts were formerly known as the Education IRA. The assets in a Coverdell account must be used solely to pay qualified educational expenses for the designated beneficiary for all levels of schooling, not just college. The account must be funded with cash. Income and realized capital gains within the account are not taxed. The account is generally not treated as belonging to the student, which is helpful when applying for financial aid. Unfortunately, the maximum annual contribution to a Coverdell account is only $2,000 and that amount is subject to limitations based on the parents' adjusted gross income. The limited ability to fund the account sufficiently to meet the rising costs of a college education is the main reason that Coverdell accounts have fallen out of favor.

529 College Savings Plans have become a popular savings vehicle. First created in 1996, the 529 plans offer many advantages when compared to custodial or Coverdell accounts. All fifty states now offer a 529 plan and total assets held in 529 plans nationwide have grown to $213 billion as of 2013.

529 plans must be funded with cash and the assets within the plan grow tax free over time. Many states have no minimum and most plans allow for automatic contributions from a bank account on a monthly or quarterly basis, providing a means for participation from those with more modest finances to the most affluent. Funding 529 plans for grandchildren can also be used by more affluent grandparents as one tool within a comprehensive estate plan. Under the Internal Revenue Service five-year gift rule, a 529 plan can be funded quite generously without being subject to the gift tax rules. A married couple may contribute $140,000 per beneficiary in a single five-year period, so long as there are no further gifts to the beneficiary in the same period. There is no IRS-specified maximum dollar amount that can be contributed over the lifetime of the 529 plan, although the amount "cannot be more than the amount necessary to provide for the qualified education expenses of the beneficiary." Some state plans specify account maximums.

Like the Coverdell accounts, income and realized gains within the account are not taxed and 529 plans are not treated as belonging to the student, which is helpful when applying for financial aid. In addition, 529 plans have some unique advantages over the other two types of college savings plans.

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Unlike the other plans, there is no age limit either for making contributions or for withdrawing the funds for college expenses. Also, the beneficiary can be changed to another family member, such as a sibling, or even a parent. For example, if the oldest child doesn't use all of the assets in a 529 plan, the parent or grandparent who owns the account can change the beneficiary to a younger sibling. Or the beneficiary can be changed to the parent and used to pay educational expenses for a career change or for graduate school. Moreover, if the owners of the account find they need the assets for their own expenses, they can withdraw the funds, although they will owe taxes and a 10% penalty on the earnings in the account. This flexibility is one of the main reasons that 529 plans are so popular.

Another reason for their popularity is the ability to have the assets automatically invested in low-cost mutual funds and rebalanced on a set schedule based on the child's age. This is a distinct advantage over the other two types of college savings plans. However, not all states' 529 plans have good track records when it comes to the investments. Therefore, it is very important to research the plans, the investment options, and the fees before opening a 529 plan account. Some states, although not California, offer a state tax deduction for contributions by state residents to their plans.

Plans to be Wary of:
Some companies offer a life insurance policy for a child, which builds up cash value and can later be used to pay for college or any other expenses. The expenses on such policies can be high and returns may be capped. This is an expensive way to try to fund college expenses.

Some states offer pre-paid college tuition plans. Parents or grandparents can purchase college credits through the plan and use them later to pay tuition. These funds have become less viable as the cost of tuition has soared. In addition, these types of plans can only be used at specific schools and only to pay for tuition; other education-related expenses are excluded. As parents and grandparents have turned to 529 plans as a more attractive vehicle for college savings, the participation rate in pre-paid plans has dwindled. When the Colorado pre-paid tuition plan closed last November because it was no longer viable, only about 1,500 households were participating in the plan compared with 329,000 in its 529 plans. The contributions made to the Colorado plan were refunded, along with the returns, but the option to use the tuition credits ceased to exist.

Paying Tuition Directly:
Another thing to keep in mind is that grandparents (or anyone else) can pay tuition directly, without using any of

“...keep in mind that grandparents (or anyone else) can pay tuition directly, without using any of these college savings vehicles.”

these college saving vehicles. Tuition payments made directly to schools are not considered gifts, and so are not subject to the gift-tax limitations. This applies to all levels of education, not just college tuition. However, this exclusion from the gift tax rules does not apply for other types of educational expenses such as books, supplies, or room and board.

Conclusion:
Parents and grandparents who want to help with saving for future college costs have several options. 529 plans are currently the most attractive type of account, due to their flexibility and easy maintenance. Before opening a 529 account, talk with your investment counselor, who can help you choose the appropriate savings plan. You may also wish to consult your accountant and/or attorney about the tax and estate-planning aspects, especially if you are contemplating making large contributions to the 529 plan. ◆

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CFA Society of Los Angeles Presents Roger Gewecke, Jr. with Prestigious Governor’s Award

CFA Society of Los Angeles Vice President, Kerry Gawne Rapanot, CFA, presents the Governor’s Award to Roger Gewecke, Jr., CFA.

At the 83rd annual Meeting of the Members on July 9, 2014, the CFA Society of Los Angeles presented Roger Gewecke, Jr. with the Governor’s Award for Outstanding Lifetime Contributions. This recognition is awarded when merited by the CFALA Board of Governors to individuals whose contributions to the Society have been so substantial and exemplary that they are deemed to be members for life in the CFA Society of Los Angeles.

The Society’s highest honor, the Governor’s Award has been presented to only ten individuals over the last 38 years, making Roger the eleventh member of the esteemed group.

A. Mark Harbour, the current president of the Society, said of Roger:

> “Roger Gewecke began his volunteer service to CFALA as a coordinator with the USC/CFALA CFA review program and has been the lead coordinator for Level III since 2007. He is an instructor in the Review Program as well, teaching Behavioral Finance at Level III. Roger has spent 8 years on the CFALA board including being president from 2012-2013. He has represented the Society at various CFA Institute Leadership Conferences from Hong Kong to Newport Beach and has always been an advocate for CFALA and its members. All of us at CFALA have benefited from his selfless service.”

Roger’s involvement with the Society is a family tradition. His father, Roger Gewecke, Sr., who passed away in June, was remembered at the meeting for his 43 years in the investment industry and active volunteerism with what was then called the Los Angeles Society of Financial Analysts, serving as its president from 1971-1972 and as membership chairman for 20 years. ◆

Internship Program Benefits both Clifford Swan and Interns

Clifford Swan instituted a summer internship program in 2014 and hired Katherine Goree and Anuj Mongia, who were selected from over 160 applicants from universities throughout California. In the nine-week program, Katherine and Anuj were exposed to the key aspects of work at Clifford Swan, including equity and fixed income research, marketing, compliance, and performance evaluation.

Katherine Goree is a rising junior at Scripps College, where she majors in Mathematical Economics. She is an active member of the Scripps College student investment fund, where she will serve as vice-president this year. Katherine will spend her fall semester studying abroad in London, England. She is a native of Iowa City, Iowa.

Anuj Mongia has completed his first year at Claremont Graduate University in the Masters of Financial Engineering Program. He graduated from the Birla Institute of Technology in Mesra, India in 2012. Anuj has held internships with both IBM in India and the Bahrain Islamic Bank in Dubai. Additionally, he was a participant in the CFA (Chartered Financial Analyst) Investment Research Challenge, a competitive event where college students from local universities present research reports on public companies.

Clifford Swan's goals in launching this new program were to provide talented young people who have demonstrated interest in the investment and wealth management business a substantive educational experience in each element of our work. We consulted with other firms across the country that had conducted successful internship programs and were able to learn from their experience as we planned our program.

The intern program was led by Roger Gewecke, who, along with Linda Davis Taylor, conducted the interviews and selected the successful candidates. The interns worked directly with Clifford Swan colleagues who served as their teachers and mentors as they delved into their projects.

"We were very pleased with Katherine's and Anuj's contributions this summer," said Roger Gewecke, who coordinated the internship program. "Their work was consistently excellent and their youthful enthusiasm really rubbed off on our 'seasoned' investment professionals. It was especially gratifying to have so many of our partners working so closely with these outstanding young people. Although one of our goals in this endeavor was to help young people, I think all of us who work at Clifford Swan benefitted more than they did." ◆

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The information contained in this publication is for educational purposes and should not be considered a recommendation or investment advice. If you have any questions, please contact your investment counselor.

Mark Your Calendar!

Clifford Swan is pleased to announce a conference call for clients and friends of the firm on Thursday, October 16th at two o'clock in the afternoon, Pacific Standard Time.

Titled "Why Investors Don't Earn the Returns They Should," the discussion will be led by investment counselors Roger Gewecke and Kevin Cavanaugh. They will explore the behavioral tendencies that explain why investors consistently fail to earn the returns available in the market. Call participants will have the opportunity to pre-submit questions for a Question and Answer session at the end of the call.

Further details will be provided closer to the date, but if you would like to be added to the list now, please email Jennifer Loesch at jloesch@cliffordswan.com or call at (626) 792-2228. ◆