

# *Perspective*

July 2016 By Davis Riemer



**DHR Investment Counsel, Ltd.**  
*The Fine Art of Wealth Management*

We enter summer with this Perspective. *Twas brillig, and the slithy toves Did gyre and gimble in the wabe; All mimsy were the borogoves, And the mome raths outgrabe.* (Lewis Carroll, [Alice in Wonderland](#).) I am told that the meaning of this poem, “Jabberwocky”, is that, when one faces one’s fears, they are vanquished.

Our first section reviews capital market returns in a broad way for the second quarter of 2016. The next section pertains to Schwab’s money market funds and contains information resulting from a federal government decree that affects all of our clients. Louise discusses the pending changes that will result from it. We will handle them for you with Schwab; there will be transactions and confirmations, no cost and little difference in the nature of your holdings. In the next section, Davis adds to earlier discussions about bond investing. Throughout, just for fun, some quotes and cartoons. Last - comments on a piece of art – a politically timely piece of art, at that. We hope you enjoy this issue.

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*“It is never the demand for truth that determines whether memory recalls an action accurately or not. It is self-interest that does. Memory is pragmatic, it is sly and artful, but not in any hostile or malicious way; on the contrary it does everything it can to keep its host satisfied.”*

Karl Ove Knausgard

## Capital Markets Review

Volatility continued in the past quarter and its higher levels look like a permanent companion to investors. The decline in the first two months was one of the worst beginnings to a year we have seen in many years. We have recovered a lot of the loss. As of this writing, the domestic market has closed at an all-time high. Foreign markets have recovered somewhat from their lows, but still have not done well. The following charts tell a lot of the story, but call us if you want to discuss it.

### Q2 Market Summary Index Returns

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
2Q 2016	STOCKS				BONDS	
	2.63%	-1.05%	0.66%	4.48%	2.21%	3.11%
						
Since Jan. 2001						
Avg. Quarterly Return	1.7%	1.3%	2.9%	2.9%	1.3%	1.2%
Best Quarter	16.8% Q2 2009	25.9% Q2 2009	34.7% Q2 2009	32.3% Q3 2009	4.6% Q3 2001	5.5% Q4 2008
Worst Quarter	-22.8% Q4 2008	-21.2% Q4 2008	-27.6% Q4 2008	-36.1% Q4 2008	-2.4% Q2 2004	-3.2% Q2 2015

*“We make two mistakes. One – we assume that the averages don’t apply to us. Two – we assume that they do.”*

Bob McCrory

## Year to Date Market Index returns

Performance of Investment Market Indexes Over Periods Ending June 30, 2016  
Annualized Percent Performance of Asset Classes Ranked by Ten Year Total Return  
(2016 Year to Date Not Annualized)

	2016 YTD	One Year	Three Years	Five Years	Ten Years
S&P 500	3.84	3.99	11.66	12.10	7.42
Russell 3000	3.62	2.14	11.13	11.60	7.40
Dow Jones U.S. REITs	10.82	22.85	13.55	12.3	6.86
Russell 2000	2.22	-6.73	7.09	8.35	6.20
Russell 1000 Value	6.30	2.86	9.87	11.35	6.13
Russell 2000 Value	6.08	-2.58	6.36	8.15	5.15
Barclay's U.S. Aggregate Bond	5.31	6.00	4.06	3.76	5.13
MSCI Emerging Markets	6.41	-12.05	-1.56	-3.78	3.54
MSCI Developed Markets Small Cap	-0.69	-3.35	6.34	3.61	3.33
S&P Global REITs	10.02	7.25	6.96	5.91	3.31
MSCI Developed Markets Large Cap	-2.98	-9.84	1.88	1.23	1.63
MSCI Developed Markets Value	-4.68	-14.35	-0.24	-0.17	0.43



### Money Market Fund Rule Changes

By Louise Rothman-Riemer

“Great A, Little A  
Bouncing B.  
Cat’s in the cupboard  
And can’t see me.”

The nursery rhyme stated above may be familiar to many of you. Below I have re-purposed it to introduce a conversation about money market funds and changes that are coming.

“Great C, Little c  
Bouncing C,  
Cash is in the bank,  
But what’ll it be?”

A dollar is a dollar unless it is not. During the financial crisis of 2007-2009 some money market funds “broke the buck”. In other words a dollar in these funds was no longer worth a dollar. It was worth something less. Most financial institutions covered the difference so their investors were made whole. But the fact that it happened raised significant concerns.

Beginning in October 2016 there will be two basic kinds of money market funds under the new regulatory definition: one “retail” and one “institutional” fund. (By the way, a money market fund is really an ultra-short-term bond fund.)

Retail money market funds, according to Schwab, are those funds described as having policies and procedures that limit beneficial ownership to those investors deemed as “natural persons”. These

money market funds will remain stable and will have a constant net asset value (NAV) and will maintain their dollar value.

Institutional money market funds on the other hand will fluctuate if the market becomes volatile, as it did during the financial crisis. Therefore the value of a dollar in an institutional money market fund may not be valued at a dollar. It will be valued at “the market”. These money market funds are subject to review by the custodian to see if they have maintained the ability to meet shareholder redemptions, stated as a percent of the total money market fund assets calculated over duration of several business days. At Schwab, starting in October, if the assets in an institutional money market fund fall below 30%, a liquidity fee would be imposed on all redemptions. In some extreme instances redemptions from these money market funds would temporarily be prohibited.

So how will you know if your money market account is a “Big C” retail money market fund or a “small c” money market fund? If your investment account has a social security number attached to it, meaning that the account is owned by an individual, then it will be “Big C” retail money market fund and will retain the dollar value. If your cash asset funds are not in an account that has an individual social security number attached to it it will have a “small c” institutional money market fund account value and it will be subject to fluctuation. An example of such an institutional money market account is likely to be found in a retirement plan in which the money in it is in a pooled account and does not have an individual

investor’s social security number attached to it.

In such a situation, money that is contributed to such an account is pooled with money from other participants in the Plan when it is invested and the account holds the funds in the name of the Plan not the name of any individual investor.

Importantly, an individual participant’s contributions and investment growth (or loss) in each fund the participant has selected, including the money market fund, is strictly accounted for by the Plan’s Third Party Administrator.

*“The public cannot be too curious concerning the characters of public men.”*

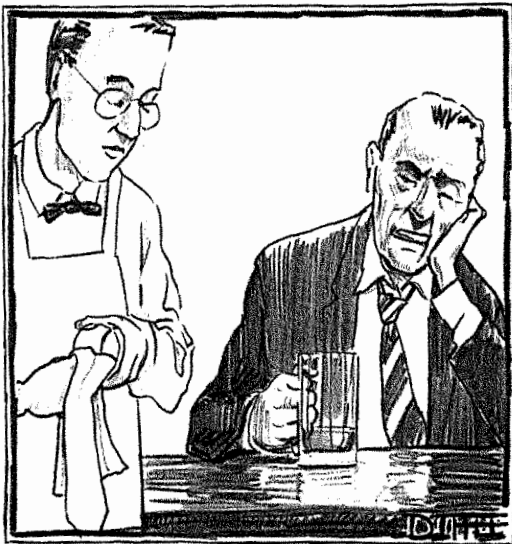
Samual Adams

Most DHR clients will see no change in their money market fund or will its value fluctuate. Charles Schwab, where many DHR client assets are held, has already determined that all Schwab Prime and Municipal Money Market Funds and will qualify as “retail” money market funds by October 2016. Effective in April 2016 the same was true for all Schwab Government Money Market Funds. That said, for most clients the “sweep” money market funds, those we have been using for several years, have been grandfathered in and you will notice no difference. For new accounts the money market fund will likely be purchased, just like a mutual fund. We already purchase money market funds such as the Schwab Value Advantage Money Market Fund.

These changes to money market funds have been in the works for some time. The first regulations changed in 2010. More changes came in 2014 and now in October of this year the changes detailed above will take effect. If you have specific questions about the money market fund in your account please give us a call or send us an email.

Great C, Little c,  
Bouncing c,  
Cash in in your account  
And you'll know what it will be.

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*"I feel like a man trapped in a woman's salary."*

## Investing in Bonds: Strategy

When one invests in securities, one needs a strategy. Presumably, one wants to buy "what looks good" for future outcomes. But how can one accurately predict future outcomes? Investors have spent anxious years trying (usually unsuccessfully) to predict market outcomes after the expected rate increases from the Federal Reserve. A recent research report from the Vanguard Group illustrates this problem well. The research started with the question: Over the last thirty years, how have various asset classes behaved during periods of rising interest rates (increases prompted by the Federal Reserve Bank). If the results show a reliable pattern of behaviors after the fact of interest rate increases, then that could be used to fashion a good strategy before the fact. In their research on the period of rising rates, the Vanguard team compared price movements in the broad U.S. equity market and the international equity markets, along with those of a number of sectors - value and growth, small and large cap and REITs. They also compared the price movements of the broad U.S. bond market with its sub-asset classes of corporate investment grade, high-yield and Treasury bonds. They found no predictable pattern of price behavior in those sectors that outpaced the general equity or bond markets. In other words, they discovered nothing in the last thirty years that would suggest that one could divine a reliable strategy today that would increase profit in times of increasing rates tomorrow better than simply holding the market in a diversified way. Still - one can guess....

Many investors do guess (although they might not call it that) and then adopt strategies to defend bond portfolio values against potential losses. However, in the end, those strategies are often more costly than beneficial. For example, money market funds and short duration bonds offer some protection, but at the cost of low yields. After holding them for a period of time, when rates do rise, the accumulated amount of interest not received can surpass the decline in price of those longer bonds one avoided. Furthermore, in a diversified bond portfolio, the price decline of the longer bonds will eventually be recouped and the higher interest will have been received throughout.

As you know, we believe that the securities markets are efficient. To the extent that this is true, it is not possible, reliably and over time, to profit from under or over valuation (mispricing) of shares, or other inefficiencies. Nor is it reliably possible to time price movements. One portfolio answer to the problem of selection is to “buy them all.” However, there are many, many bonds out there - far more than stocks – which makes it impossible to “buy them all.” So, one must select. What, then, to do?

*“The other day I was looking for crime novels in my local independent bookstore. I approached the bookseller behind the counter and asked, “Where are mysteries?” He smiled beatifically and replied, “All around us.”*

Anonymous

The following text comes from research done by David Plecha, the Chief Investment Officer for Fixed Income (Bonds) at DFA. (Much of it too technical for this publication, but if you want to see it, let us know). Here is some explanation of a few terms in the text – “term premium,” “credit premium” and “term spreads.” The word “premium” refers to the extra return that has historically been earned and is expected to be earned from investing in a security that bears more risk. Investors who bear risk expect to be paid for it. The expected extra amount or return is the “premium.”

The “term” of a bond is the time remaining to the maturity of the bond, e.g. 2 years, 10 years, 30, years, etc. A maturity of 30 years presents substantially more risk to the investor than one of 2 years. The extra interest paid by the 30 year bond is the “term premium.”

The “credit premium” refers to the financial quality of the company or municipality that issued the bond. Essentially, one wants to know: “What is the chance that the issuer will go broke and default?” Poor financial quality leads to high credit risk, for example “junk bonds.” Investment in bonds with top grades represents less risk, so they will pay less interest than those with lower grades, creating the “credit premium” for lower ratings.

The term “premium spreads” represents the difference at any moment in time in premiums, or promised interest, between bonds of varying maturity and quality. One who believes in market efficiency will regard the current pricing of bonds

in the market, created by the aggregate of all investors, to be fair pricing. Therefore, except for differentiation by risk category, that leads to a disinclination to believe that there are “bargains” out there on anything like a reliable basis. Term and credit, maturity and quality make up the risk dimensions. They create the expectation of premium return – higher for higher risk, not for “a lucky find.” This has been confirmed by decades of rigorous academic research. The challenge for investors is deciding how to structure their allocation to fixed income securities to target the credit and term premiums in a cost-efficient way that adds value.

The difference in expected returns between two bonds depends on differences in yields, probabilities of default, and recovery rates between them. This implies that current credit spreads have information about future credit premiums (expected returns) and one can use that information to create portfolios that dynamically change the credit exposure according to when it is likely to be rewarded. This approach does not require forecasting changes in the yield curve; instead, it uses current information in the yield curve to determine expected premiums. For instance, within certain limits, one can overweight or underweight allocation to corporate bonds relative to the market or some benchmark of government and corporate bonds based on the magnitude of yield spreads between government and corporate bonds. If spreads are wider than a given threshold, it would cause an increase in the allocation to corporate bonds; if they are narrower, it would cause an increase in the allocation to government bonds.

*A reliable relationship exists between current credit yield spreads and future return differences.* Investors can use the information in current credit yields to design fixed income strategies that seek higher expected returns by dynamically varying the credit exposure— investing more in lower quality bonds when credit spreads are wider and the expected credit premium is larger, and investing less in lower quality bonds when credit spreads are narrower and the expected credit premium is smaller.

DFA uses the information contained in market prices to determine how much credit or term exposure one should take. *This is using the market – not individual judgment – to make these allocation decisions.* Market data provide the information needed to structure diversified fixed income strategies that dynamically vary the exposure to the credit and term premiums, depending on whether they are expected to be high or low, to seek higher expected returns in a systematic and transparent way.

When we create bond portfolios at DHR, we typically use mutual funds and separate them primarily by “term,” so our reports contain labels of “short” or “intermediate,” referring to the remaining term to maturity of the bonds held in the fund. We restrict our “credit” buying to the highest grades, so there is not a lot of differentiation by quality risk in our portfolios. DHR invests in bond funds created primarily by Vanguard and DFA, both of whom approach the market “passively” with respect to timing and selection. Vanguard uses the “buy the market” index approach and

DFA uses the system discussed above. For clients whose income tax brackets warrant investment in tax-exempt issues, we usually build portfolios of individually selected municipal bonds, so we control the maturity and credit risk.

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### Investing in Bonds: Negative Interest Rates

You might remember Click and Clack, the Tappet Brothers, hosts of National Public Radio's "Car Talk." I love this line, from them: "We are going to start an investment company – *AND* – *We guarantee* to give you half your money back!" An idea that could fly? The day might come when, if you lend money to the Federal Government (buy a bond or bill from them) you might be *guaranteed* that you will get back less than you invested. Not as little as half, for sure, but nevertheless, a "guaranteed negative yield." So – as modern parlance goes: "What's up with that?"

In recent media reports, Janet Yellen, Chair of our Federal Reserve Bank, is quoted as saying that the Fed is "considering" negative interest rates. It will probably not happen soon, and might not happen at all, but it is a cloud on the horizon and people want to know about it.

*"In theory, there is no difference between theory and practice. But in practice, there is."*

Yogi Berra

As in other economies with similar structure, the most basic rate in our domestic economy is the rate commercial banks pay each other for the simplest, shortest loan – an overnight loan of electronic cash. However, these loans are not direct. Since our commercial banks use the Federal Reserve Bank as their bank, these loans move money from one bank's Fed account to another's. The funds in these Fed accounts are called reserves. The Fed can charge interest on the loan it made to the first bank, and it can pay interest on the deposit it is taking from the second bank. Central banks are usually tasked with keeping inflation at some target—around 2% for the United Kingdom, the Euro Zone, and the United States. When inflation falls below target, usually because the economy is running below full capacity, central banks will typically lower their reserve rate to encourage firms and households to borrow and spend money.

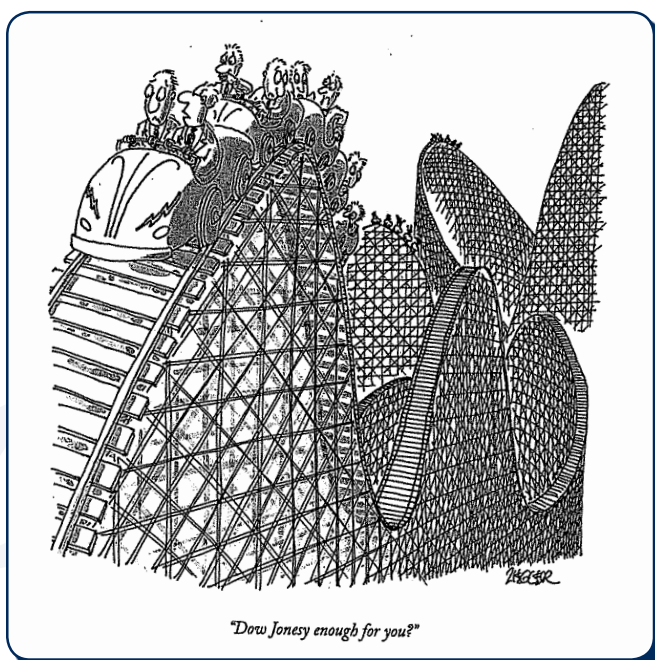
How does the Fed actually impose a negative rate on deposit accounts? Answer: It shrinks the electronic balances in those accounts. Today's rate is approximately 40 basis points (four-tenths of one-percentage point) though it changes. If 40, then a deposit of \$10,000 at the Fed today will return \$9,496 tomorrow. Who would make that deposit? What is the point of that – to agree to deposit money in a shrinking account?

The point of it, from the Fed's perspective, is to push down rates across the economy and thereby stimulate economic activity. They figure to accomplish that because, indeed, who would make that deposit? If you're a bank, better to make other loans – commercial, real estate, personal and



the like. Those loans are more likely to support or to stimulate other economic activity – which is the point. The longer range goal, accomplished with greater economic activity, is an increase in inflation. Higher demand boosts growth, which puts upward pressure on wages and prices, helping inflation return to target.

A low and falling rate of inflation worries governments because it can lead to deflation – a much bigger problem. More buying is supposed to lead to higher prices – inflation. Whether the “supposed to” will actually eventuate – we do not know. The actual effect of negative rates on economic activity will depend to a large extent on how these rates are passed on to firms and households through borrowing and lending rates by banks. There is some evidence that this pass-through mechanism hits a roadblock at negative rates because banks are reluctant to charge negative deposit rates to customers. They are correspondingly less likely to cut borrowing rates.



When investors buy a bond (i.e. lend money) that has negative yield, then they, like banks, are paying for the privilege of lending. A bond with a negative yield means that the interest and principal payments the investor collects when the bond matures are collectively less than the price of the bond when it was purchased. This is not a highly motivating strategy for investment, so again, what’s the point? When the Fed lowers its rate, loan costs throughout the economy will also decrease (in theory). The Fed and many others want us, as economic actors, to buy more “stuff.” Not only retailers, but also the stock market responds favorably to higher consumer purchase rates. The Fed figures that, if lending earns so little – even costs us a “negative yield” - then we will use our money some other way – perhaps to acquire or to hire.

All that having been said, perhaps the most direct way that negative rates affect inflation is by weakening the currency. There is some evidence that negative rates have caused the euro to weaken, for example. But of course, if lots of central banks use this policy at the same time, this competitive devaluation becomes counterproductive.

What about bonds in an investment portfolio? How would they be affected?

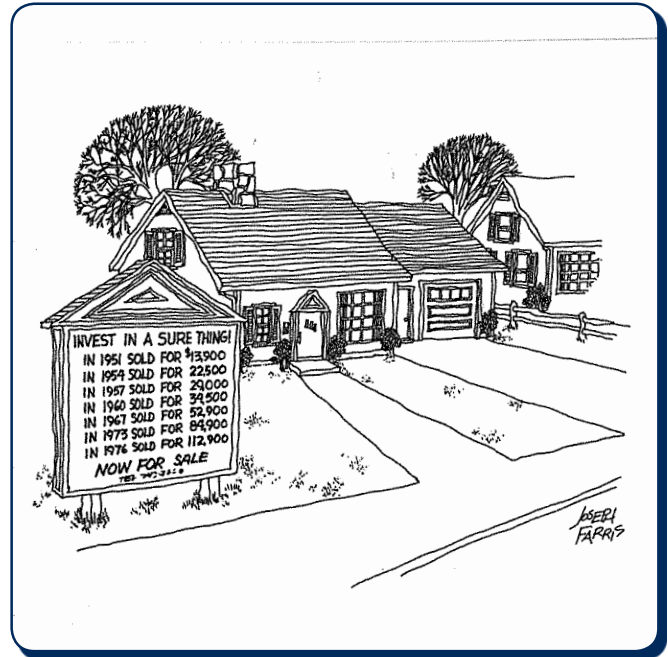
One strategy available to investors – of all sizes - is to exit the bond market and put that money in cash. After all, we would not expect anyone to hold an asset with a negative yield if they can also hold a bank account, as an alternative - even a zero-yielding deposit account. A physical cash yield of zero would seem to be superior to any

negative yield. However, for larger sums – those owned by institutions, for example, even the return on physical cash is negative, because it is inconvenient to hold large amounts of cash - think of storage costs, tracking and transfer costs and risk of theft. These factors help explain why it is possible for reserve interest rates to move into negative territory, but there is a limit on how far into negative territory yields can go. If rates were to go too negative, the incentive to move to cash would take over.

What should an investor do? The first step is to breathe deeply. Despite its historical uniqueness (for us) this should not cause “panicky reactions.” Here are some reasons: we do not yet have negative rates; we do not know whether we will; if the Fed sets negative rate, we don’t know whether banks will follow; if short rates do go down, into negative territory, then long rates might also, or do something entirely different. Long rates, set by the market’s participants in their buying and selling, reflect inflation expectations as much as anything else.

*“Democracy is a device that insures we shall be governed no better than we deserve.”*

George Bernard Shaw



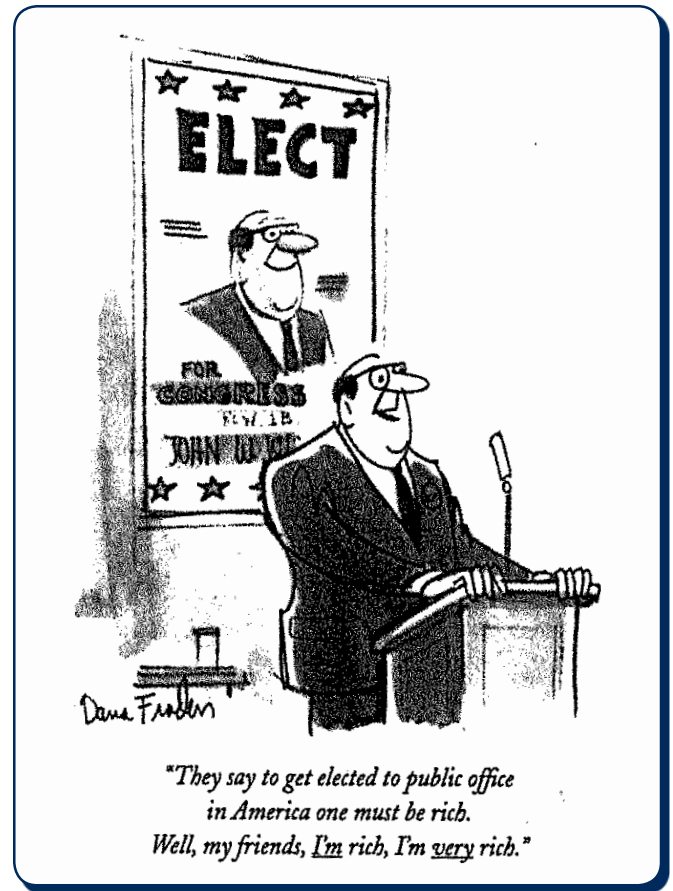
What are the actual effects on a portfolio of bond funds, which owns both government and corporate bonds? Part of the answer can be seen in the experience of the Japanese bond market. Japan has had a sluggish economy for a number of years and its interest rates have moved to negative levels. As the shorter maturity yields went negative, buyers moved their capital to longer maturities, in order to capture a positive yield. That collective action drove prices up in the longer maturities. As absolute bond prices rose, relative yields fell in percentage terms, and eventually went negative. This process kept repeating and extending further out on the yield curve. Now, the Japanese bond market has negative yields out to fifteen years on the curve.

To us domestic investors, an interesting feature of negative yields in foreign nations is that they can show a profit to us. Many of our clients own DFA’s global bond funds. DFA hedges away the

currency risk in its global bond funds, which has the effect of converting the foreign negative yield to a positive yield for a U.S. investor. However, because our yield curve is among the most positive in the world, currently the two “global” bond funds managed by DFA hold over 90% of their assets in U.S. bonds.

If this event – negative yields – does arrive in our bond market, then as with any other kind of market movement, the best strategy might well be to sit still. We have no idea what might be the timing, depth, persistence or total cost of this yield experiment. For most investors it will still be appropriate to hold a diversified portfolio, which might include negative-yielding bonds. What one does about that will remain the central question. Negative rates on new issues and depressed yields in the secondary bond market, while frustrating and costly, present issues in investment decision-making that we have faced before. It is also important to remember that, when rates fall, bond prices tend to increase. If / when the Fed sets a negative rate, then the prices of all the bonds our clients own should rise in price.

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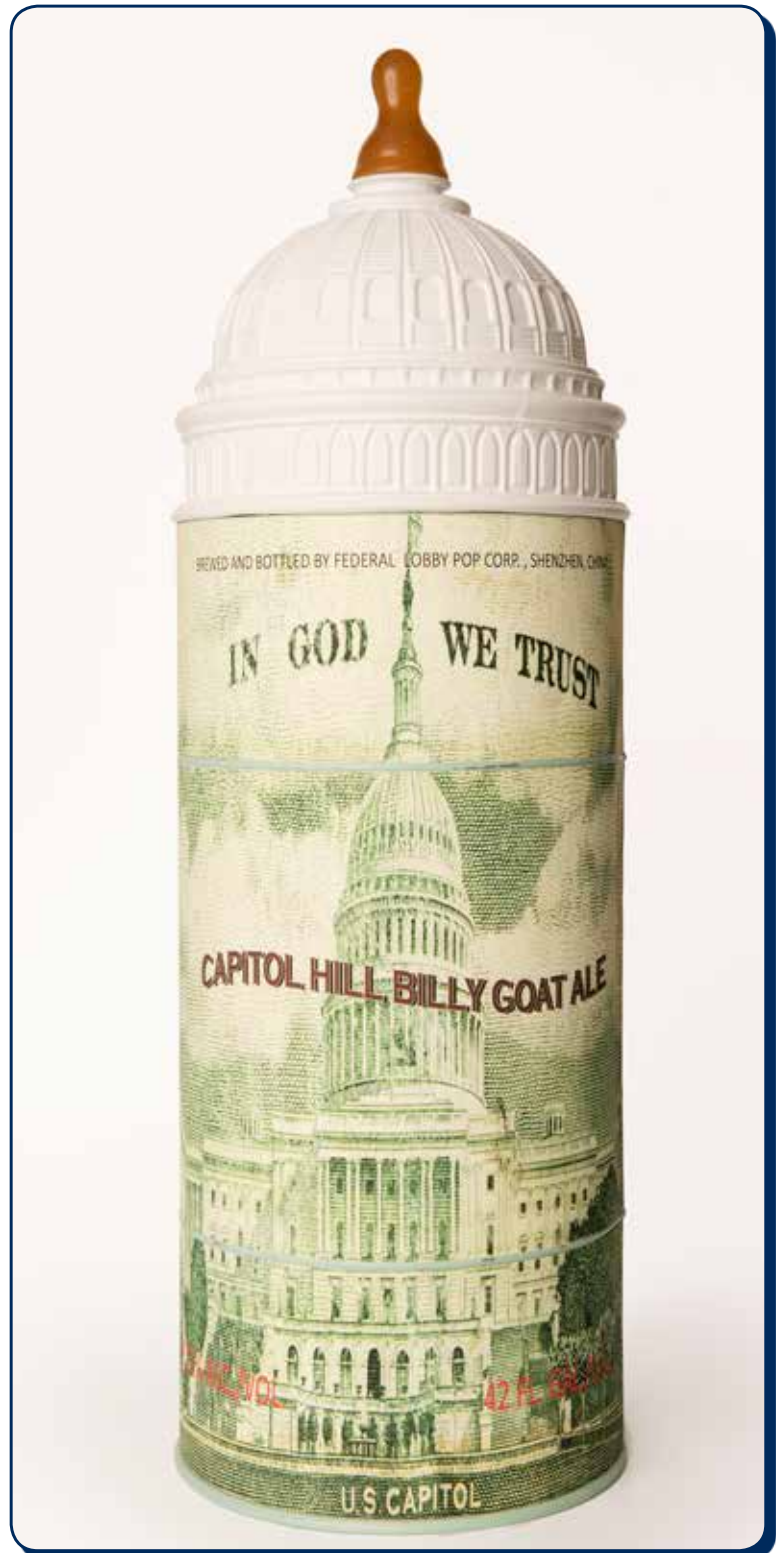


### “Capitol Hill Billy Goat Ale”

This piece seems particularly relevant for the season and appealed to us as soon as we saw it. A visual comment on money and corruption in political life, it reminded me of the saying: “Money is the ‘Mother’s Milk’ of politics.” Whether it comes from a wealthy constituent, an interest group, a block of voters, or from lobbyists - elected representatives are drawn to money like babies to bottles. Of course, it is not only money that flows from these sources to the elected representative – it is also prescriptions for government policy agendas and preferences - even the actual language for legislative bills being sponsored by the representative, all “fed” to the representative in a manner reminiscent of feeding with a bottle.

Walter’s piece stands 32 inches tall and its creation was filled with inventiveness. Walter first scanned a \$50 bill. Then, with Photoshop, he created in small scale the images and text that wrap the piece. He then took the file to a master printer, who brought it up to full size. The dome at the top was made from a mold taken from a glass cover for a cake dish. The nipple is correspondingly large, and has an interesting history. It wasn’t available in the appropriate size from the local pharmacy, (Paul Bunyan disappeared 100 years ago in the North Woods of Wisconsin) so, in order to get the right size, Walter used a lathe to carve a nipple out of wood. Then, using the wood model, he made a plaster mold, which he then used to make the rubber nipple. Walter made two renditions of this piece – the single one we have and a full six-pack of them (same size), which he considered calling “Super Pac.”

Walter has done two pieces in our collection. They differ markedly. The one not shown is a fantastic piece of carving – a hand, from the wrist down, gripping the top of a large sack, all done in deep toned wood, about 15” high, except for the carved and gold painted “\$” on the front. The hand and fingers are stunning. Called “Ransom,” it’s a great piece. We invite you to come see and enjoy these and other pieces in our College Avenue offices.



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