FIRST QUARTER
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DEIGHAN
WEALTH ADVISORS

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21 Years

Deighan Wealth Advisors
1994-2015

MARKET COMMENTARY

In the late 1960's I used to race home from school to watch my favorite show, the serial *Dark Shadows*. While it was a far cry from classy *Downton Abbey*, I loved it. It was a cheesy drama filled with constant surprise and impossible leaps of faith in plot. The screen writers must have had a ball coming up with the story line. Today, as testimony to its shallowness, I cannot recall even the barest detail of the storyline, but I do recall the excitement of wondering "What will happen next?" Sometimes as I report the quarterly goings on in the world markets, I wonder if clients and friends have the sense of watching a serial. While I know I can't compete with Downton Abbey, certainly there are enough twists and turns in the quarterly market story to keep us engaged.

In the spirit of a true serial, here is a brief re-cap of the previous episode. In 2014, we experienced plenty of market ups and downs, but overall, we hailed a recovering US economy as evidenced by solid returns for US stocks. At the same time, we cast worried eyes across the pond at negative market returns and continued economic strife in Europe. Wringing our hands we wondered, "Would the Eurozone woes and worldwide lethargy spread and derail our recovery?" We hoped not. Perhaps as a measure of our strength, the US dollar soared against most other currencies in 2014, but it hit our statements hard driving the returns of most foreign securities further into negative territory. On the fixed income side, despite record low interest rates, and a strong indication from the Fed that rates would be heading up, the ten-year US Treasury note defied gravity and delivered strong results for the year. This was a curious result since rising interest rates will mathematically result in lower bond prices. Apparently, this did not matter to investors worldwide as they plowed their funds into what appeared to be the safest place possible: US government securities, driving up bond prices. Meanwhile, back at the ranch, New Englanders were cheering the falling oil prices while the US western oil boom was under serious pressure due to oil price drops. How would this affect our US growth prospects in 2015? Would consumers find more discretionary income in their pockets due to lower gas and home heating fuel prices and spread the wealth? Or would the inevitable layoffs that must follow the dip in US energy firm revenues take a greater toll on the economy?

Let's fast forward to March 13, 2015! First, stock market volatility continued to provide alternate groans and gasps throughout most of the first quarter giving way to new trends for 2015. The chart below is a continuation of the chart shown in the 2014 year-end Market Commentary with a column added showing investment results for the first three months of 2015. Note the strong first quarter showing of Mid-cap and Small-cap US equities versus the larger US companies, many of which are large multinationals that have business holdings worldwide. Perhaps the balance sheets of those multinationals were negatively impacted by the strong US dollar. Further, note the strong comeback demonstrated by international stock indices. Remember, the first quarter 2015 results cover only a three month period compared to an entire year's

ASSET CLASS	REPRESENTATIVE INDEX	2014 RETURN	1Q 15 RETURN
US Large Cap Equities	S&P 500 Index	13.69%	0.95%
US Small and Mid-cap Equities	Wilshire 4500 Completion	7.94%	5.28%
Developed Int'l Equities	MSCI EAFE (Net)	-4.90%	4.88%
Emerging Int'l Equities	MSCI EM (Net)	-2.19%	2.24%
Alternative Equities	HFRX EH Eq Mkt Neutral Index	3.63%	1.69%
Hard Assets	Bloomberg Commodities	-17.01%	-5.94%
Broad Fixed Income	Barclays US Aggregate	5.97%	1.61%
Cash Equivalents	BOA/Merrill Lynch T-Bill 3-Mo	0.03%	0.00%

result. Furthermore, since these results are converted to dollars instead of reported in local currency, the international index results are stronger than they appear. The point is, markets move quickly and yesterday's underdog can become tomorrow's star, hence asset class diversification remains key.

So, what's next? Continued growth in the US stock market is generally considered likely, but given the energetic run up of 2014, US stock valuations are somewhat high. The MSCI US Composite shows a quarter-end normalized price to earnings (P/E) ratio of 23, far above the mean P/E ratio of 16.3 from 1969 to date. Thus, it is best to temper our expectations to slower growth in the US stock market. On the other hand, valuations of developed foreign equities excluding the UK were far less puffy with a P/E of 18.4 compared to a mean of 15.6, and the UK appeared even more approachable at 12.9 right on the mean P/E of 12.9 for the same time period.

The global disinflation triggered by the immense drop in oil prices in 2014 will continue to cut two ways. Importing countries such as China and the US will benefit from reduced energy costs for consumers and businesses. Exporting countries such as Russia, Brazil, and Venezuela are negatively impacted. Similarly, the strong dollar has winners and losers. The US consumer has more international buying power, but large multinational companies will continue to see downward currency adjustments on their foreign operations.

We've seen a dramatic decrease in US Treasury yields with the ten-year Treasury Note dropping from 2.73% to 1.94% from March 2014 to March 2015. US Corporate bond yields dropped from 3.10% to 2.91% while US high-yield (lower grade) bonds inched up from 5.23% to 6.18% over the same time frame. Meanwhile, the Fed has wrapped up the first part of their pledge to return to interest rate normalcy (a faint memory in the distant past), and has stopped the quantitative easing program. An active increase in the Fed Funds rate is in the forecast for this year. While the Fed has promised to be patient and to avoid raising rates until they believe the US economy can stand it, we will likely see a rate hike in June or September of this year.

The recent disappointing jobs report was an interesting exercise in market reaction to the push pull of news. When the report became public, the stock market dipped several hundred points. Foreign markets followed suit as they worried we may be slipping out of our recovery mode. Then, over the Easter weekend, the news was digested and calmer views prevailed. The lower numbers could have been the effect of the brutal Northeast winter, the likes of which we are all hoping we will not see again for a while! However, the bad jobs number could have been the effect of lower oil prices causing layoffs in the mid-western and western energy companies. Whatever the reason or combination of reasons for the bad jobs number, the Monday market rebound was swift. Apparently the perceived silver lining of the bad jobs report that caused the rebound was a consensus that the Fed would now delay a rate hike until September. Eventually, higher rates will prevail, and we must be prepared for it.

As I look back over this market commentary, it occurs to me that some might ask, "Wait, is this a re-run?" In some respects it may appear to be as the over-arching themes relative to investing remain constant: diversification, rebalancing to maintain diversification, valuation analysis for security selection, avoidance of market timing, expecting volatility, and holding firm over the rough patches. Truly, there is nothing new under the sun. However, the timing of the predominant themes is difficult to predict, and thus we remain engaged as the stories unfold. And so dear reader, that's the way it is... until next time!

RETIREMENT INCOME: SEARCHING FOR CERTAINTY IN AN UNCERTAIN WORLD

When we started the firm in 1994, Peter Lynch of Fidelity Investments was writing interesting investment books, and one of his most charming lines was, "Is it true that bonds have more fun?" It was a giggle then and may still be to most of retirement age because it was hard to envision staid, safe, income generating bonds with the sex appeal that the old Clairol ad implied for blondes. Bonds have traditionally been the defensive side of an investment portfolio. Of course, bonds had no fun, but quality bonds of intermediate duration delivered yields of 4.5%-5.5% back then. So, at least they produced steady, reliable income, and that was a sterling quality. We would "ladder bonds" in portfolios. That is, purchase bonds maturing in different years so we would only need to replace a few bonds annually as they matured. Thus, interest rate swings had minimal impact on the income generating ability of the bond side of the portfolio. Those were glory times.

The former sterling quality of bond income reliability has tarnished considerably. Interest rates have dropped to such low levels that quality US bonds don't deliver meaningful income. At quarter-end, a 3 year Treasury note had a current yield of 0.87%, 5 year: 1.37%, and 10 year 1.94%. Even the 30 year Treasury note yield was low at 2.54%. This is not sustainable income generation. So, what is an investor to do?

First, investors need to face the fact that they must accept some risks on the defensive side of the portfolio. Second, they need to understand the risks and how we manage them. The first risk to consider when evaluating bonds is credit risk. Although interest rates are uniformly down for all types of bonds, US corporate bonds backed by a single company will generally pay higher interest rates than US Treasuries backed by the full faith and credit of the US Government. Quality corporate yields compare favorably at 2.91% for the average investment grade 10 year bond. Moving up the risk ladder, high-yield corporate bonds (below investment grade) are reporting yields of 6.18%. But wait! High-yield bonds can contain significant risk that the issuer will default on its obligation to bond holders. Although there are some diamonds among the junk, it takes careful credit analysis to find the gems - analysis more akin to equity analysis. It is crucial to be careful and appreciate credit risk. We have employed limited amounts of credit risk to the benefit of client fixed income results, but only by using skilled managers, and typically by holding no more than a 5% allocation in client portfolios to any one particular issuer or bond fund.

Some investors may be tempted to seek a higher rate by purchasing a longer maturity bond. Caveat Emptor! Purchasing longer term bonds to get a higher rate means assuming interest rate risk, and history has shown that taking on interest rate risk can deliver painful results. For example, imagine purchasing $100,000 worth of a

10 year Treasury with a 2% coupon rate right now. Each year, this investment will dutifully pay you $2,000 until it matures in year ten when it will return the $100,000 invested. What will that bond be worth a year from now? It will depend upon the then prevailing interest rates. Let's take a look at historical rates of the 10 year Treasury note. In 1962, the 10 year Treasury had a 4% yield. By November of 1979, the yield had crept up to 10%. Then, in the early 1980's, during the Jimmy Carter stagflation years, 10 year rates spiked to 16%. Rates remained volatile and generally high throughout the 1980's. They started to drift down in the 1990's, but generally the 10 year note stayed around 6%. In the 2000's, the 10 year note was pushed down by the Fed in response to the "Dot.com Crisis" and drifted lower to the 4% range where it remained until the "Financial Crisis" of 2008 when the Fed truly aggressively lowered rates. Now, the Fed is clearly signaling that it intends to increase rates. So! Let's assume a new 10 year bond will deliver a 4% current yield a year from now. A purchaser of a new $100,000 bond a year from now could expect an annual payout of $4,000, twice the income of the 10 year bond purchased the year before! In this environment, the price of the first bond will plummet dramatically, and if sold, the loss would be significant.

In 1980, I managed a trust department. The trust department had a high quality bond fund mostly comprised of US Treasuries that had a 10 year average maturity and the yield to maturity was close to 10%. I keenly recall the "10-10" theme. When rates spiked to the 16% range, because bond prices have an inverse relationship to yields, the price of the bonds in the fund dropped so dramatically that redemption resulted in a price of 65 cents on the dollar. In other words, a $100,000 investor would get only $65,000 back if he sold his investment. That was a dramatic example of interest rate risk. Yes, the bonds eventually came back, but it took several years. I can easily say that this was the most unpleasant investment experience in my life so far because bonds are supposed to comprise the defensive side of the portfolio where safety of principal is the main objective.

Now let's look at another concern - liquidity risk. Assume that rates start going up and bond prices go down. Investors open their monthly statements and panic. Some bond fund investors demand their money back. Managers of bond funds and exchange traded funds (ETF's) are forced to sell securities, potentially at significant losses, to satisfy customer redemptions. Liquidity risk in this context is the risk that panicked investors sell their holdings at any price, causing wide spreads in bid-ask prices, and large price declines. In other words, fund managers are forced to sell assets at depressed prices to meet investor redemptions.

Finally, inflation risk is a problem with bonds and annuities. Bonds don't typically see growth of principal outside of price fluctuations due to changing interest rates. Fixed annuities don't see growth of principal at all. Purchasing fixed annuities during this time of record low rates exposes investors to significant inflation risk. It's tempting because annuities promise an appealing constant cash flow over the annuitant's lifetime. However, the reason it looks appealing is because some of the investor's original principal is included with each payment. Think of the Shel Silverstein book, "The Giving Tree". The little boy was not content to just eat the apples from the tree. He had to have the branches, then the trunk, then the tree was gone. "No worries!" says the insurance company issuing the annuity, "We guarantee the payments for life!" Please! It is important to remember that not only is the original principal included in each payment, the guarantee is only as solid as the insurance company - and they do fail. Insurance behemoth, American International Group almost failed in the 2008 financial crisis and would have if the government had not stepped in to rescue it. I witnessed two clients experience failing annuity guarantors in the 1990 banking crisis. When the state stepped in to cover investors, they reduced investor payouts and made contract adjustments. If you are determined that an annuity is right for you, at least wait a few years as the likelihood of higher interest rates means that you good stand a chance of collecting higher payments. Remember that the insurance company is faced with the same investment menu you have - including the same risks. They must invest your money at a higher rate than they are paying you just to stay in business.

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SOUNDBYTES

Jean Deighan attended the **IAA Investment Advisor Compliance Conference** in Washington, DC, a two-day program designed to provide the most current information available on the ever-changing regulatory environment.

Jenifer Wilson attended the **Inside ETFs** annual conference in February, where she had the opportunity to hear from financial industry thought leaders. Later that month, she attended a three-day educational seminar at **Tamarac University** to hone her skills with our portfolio reporting software.

Congratulations to Lucie Estabrook for a job well done as Chair of the **Bangor Symphony Orchestra's *Symphony Soiree*** committee. The annual fundraiser was a resounding success, raising nearly $50,000 for this wonderful organization – the oldest continuously operating symphony in the United States.

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Just recently a client contemplating retirement wistfully asked, "Do you ever think we will see a 5% CD or Treasury note again?" I said, "Yes I think so." We've heard it countless times in investment discussions, "Everything reverts to the mean." Investment academic Jeremy Siegel describes "mean reversion" in the context of a financial time series in which, "returns can be very unstable in the short run but very stable in the long run." In other words, investment returns and interest rates tend to revert to their long-term mean or average return. This is a time to be very careful. If you are considering retiring soon, please call and make an appointment to sit down with us and develop a retirement cash flow plan that you understand and are comfortable with. We are here to help you.

INVESTMENT CHANGES ADDED

Dodge & Cox International (DODFX)

This mid-to-large-cap international stock fund takes a long-term view to investing with one of the lowest portfolio turnover rates in its peer group. DODFX's disciplined security selection process has led not only to strong relative performance, but earned the company "Fund Managers of the year for 2014" by mutual fund rating company, Morningstar. Where appropriate, DODFX joins Mutual European fund as a core actively managed developed international stock component of client portfolios.

Schwab Intermediate-Term US Treasury ETF (SCHR)

Schwab Short-Term US Treasury ETF (SCHO)

These two exchange-traded funds (ETFs) seek to track the performance before fees and expenses, of Barclays Capital US 3-10 year Treasury Bond Index, and the Barclays Capital US 1-3 year Treasury Bond Index respectively. They invest in US Treasuries within their respective maturity ranges, which are rated investment grade, and have a minimum of $250 million of outstanding value. An ETF tracks a market, sector or index, but can be traded like a stock. We've added these low-cost ETFs as a passive component in the bond portion of client portfolios.

TCW Core Fixed-Income (TGFNX)

While the bond ETFs that we've recently added provide passive bond index exposure in client portfolios, TGFNX adds active bond management. This intermediate-term bond fund has a similar risk profile to its peer group, but has seen above average long-term results thanks to thoughtful sector and security selection. We now hold both TGFNX and PIMCO Total Return fund in the core active bond manager space.

REMOVED

Vanguard Total International Bond ETF (BNDX)

iShares Core US Aggregate Bond ETF (AGG)

Both of these bond ETFs were purchased primarily in taxable client portfolios at year-end 2014 to replace funds that were sold to realize capital losses in order to offset taxable realized capital gains. Rather than stay completely out of the bond market for 31-days to avoid IRS "wash sale" rules, we chose to replace the sold mutual funds with these two bond index ETFs while we performed our due diligence work on the funds and ETFs that would eventually replace those that were sold. Once identified, the actively managed funds and passive bond index ETFs were purchased and these two placeholder ETFs were sold.

Oppenheimer Floating Rate (OOSAX)

We chose to sell OOSAX in client portfolios and keep only one floating rate holding, Ridgeworth Seix Floating Rate Fund (SAMBX). The two funds had experienced almost identical long-term returns, but OOSAX has taken more risk and has a higher expense ratio than SAMBX. In an effort to simplify holdings in the floating rate category, we eliminated the higher cost, higher risk offering.

Oppenheimer International Bond (OIBAX)

Our investment committee chose to sell OIBAX after careful consideration of cost versus diversification benefit. We've found that the higher cost of foreign bond funds and ETFs generally erases the diversification benefit, and that the actively managed bond funds that we continue to hold contain an adequate proportion of foreign bond exposure to satisfy the allocation levels that we wish to employ for clients at this time.

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