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DEIGHAN
WEALTH ADVISORS

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24 Years

Deighan Wealth Advisors
1994-2018

MARKET COMMENTARY

Let's say you're given a choice between ten dollars today and ten dollars tomorrow. Any rational person would choose ten dollars today. Why? Well, for a couple reasons:

First, if you have ten dollars in hand, then those ten dollars have utility. You can spend them immediately, meaning you don't need to forgo consumption by waiting until tomorrow. In finance, we call this time value. Time is perhaps the most precious resource that we, as humans, have. Most people inherently recognize this, and, if we are to forgo immediate gratification, then we expect to be compensated accordingly.

Second, there's no guarantee that you'd actually receive ten dollars tomorrow. The future is always uncertain, even the near future, and it's possible you'd never receive ten dollars if you were to wait until tomorrow. In finance, we call this default risk or risk of nonpayment.

A rational actor will only choose to forgo consumption or to risk nonpayment if she is to be compensated accordingly. But a choice between ten dollars today and ten dollars tomorrow provides no such compensation; there is no benefit to waiting. In other words, the interest rate, or growth rate, is zero. No rational actor will choose a zero interest rate in the absence of other benefits.

If the choice were modified – say a choice between ten dollars today and twelve dollars tomorrow – then the interest rate would turn positive and the decision would be less clear. In this revised scenario, there would be an incentive (a 20% premium) to defer consumption and to risk nonpayment. For some people, this would be enough incentive to wait until tomorrow. For others, it would not. Some people might require three or four dollars of additional compensation before they'd choose to wait the extra day. It all depends on A. how much they value spending ten dollars immediately (maybe they really want lunch!), and B. how much they fear not being paid at all.

This is the basis for interest rate theory. It's the reason why a long-term loan typically carries a higher interest rate than a short-term loan. It's the reason why a high-risk borrower, who is more likely to default, typically pays higher interest rates than a low-risk borrower. In addition to time value and default risk, a rational actor would also want to be compensated for inflation and liquidity risks. When you add all these things – time value, default risk, inflation, and liquidity risk – on top of a real risk-free rate of interest, you end up with what's called a "nominal" rate of interest.

Nominal interest rates are what we see when we go to the bank to take out a loan. They're what we see when we sign up for a credit card. They're what we see when we purchase a certificate of deposit, open a savings account, or purchase a bond. When we talk about "interest rates," we're typically talking about nominal rates – directly observable rates that account for time value, inflation, and a host of risks, such as default risk and liquidity risk.

> "Unemployment is historically low and there's a risk that, if rates don't rise, inflation could start to increase too quickly."

Now, imagine you're sitting on a floating dock at a saltwater marina, and it's currently low tide. You've brought some books with you to read, and they're stacked next to you on the dock. One is a treatise on economic theory with a particular focus on inflation. It's rather thick, and it sits on the bottom of the stack. The next is a collection of selected chapters from a finance textbook dealing with time value of money. It's a bit thin. The last is Too Big to Fail by Andrew Sorkin, a book chronicling the financial crisis and the fall of Lehman Brothers. It's modestly thick and serves as a reminder of what can happen when businesses default.

Picture in your mind this stack of books. Next, picture the tide coming in. As the water rises, so too will the height of the stack, even though the thickness of the stack will remain unchanged. As the tide comes in and goes out and comes back in again, the stack of books will go up and down and up.

Think of this book stack as all of the different premiums – time value, inflation, default risk, etc. – that a rational actor (maybe a bank or a bond investor) would consider when deciding

what interest rate to charge a borrower. Think of the top of the stack as the actual interest rate charged, the nominal rate. In our metaphor, this nominal interest rate would be the total distance between the top of the stack and the ocean floor. And the tide? Think of that as Federal Reserve monetary policy. There is a base rate, a real rate, on top of which all other interest rate premiums sit, and this base rate moves up and down as the Fed increases and decreases its policy rate. This causes all other interest rates (car loans, home mortgages, corporate bonds, Treasury bills, etc.) to rise and fall, much like our stack of books would rise and fall with the tide. Like the tide, Federal Reserve policy tends to be cyclical, because it is tied to the business cycle. Therefore, interest rates really do bob up and down and up again over time.

Right now, the tide is rising – interest rates are rising. They're rising, because we're reaching the end of the expansion phase of the business cycle. Unemployment is historically low and there's a risk that, if rates don't rise, inflation could start to increase too quickly. Because the Federal Reserve has a mandate to keep inflation contained, and because the Fed's other mandate – unemployment – is already at target, the Fed has embarked on a policy of increased rates.

Like an increase in the tide, the Fed's goal is to increase rates at a measured, predictable pace. At its September meeting, the Federal Open Market Committee (FOMC) raised the federal funds rate, the base rate (the tide), by 0.25%. It now sits at 2.25% on the upper bound after eight such hikes in the past three years. Seven of those hikes occurred in the past eight quarters, meaning that we've seen roughly one rate hike of 0.25% per quarter for the past two years – a measured and predictable series of increases. According to recent comments from Fed Chairman Jerome Powell, the Fed expects to transition from an accommodative monetary policy to a neutral monetary policy over the next year. A neutral policy would see the base rate rise to around 3.00%, implying three more rate hikes in the next twelve months.

Rising interest rates pose both challenges and opportunities for investors. On the upside, a return to more normal interest rates after a decade of historically low rates means that savers, defined as low-risk investors investing primarily in fixed income securities, should finally be able to earn a positive return above inflation. For a long time, bond yields have been so low that they haven't kept up with inflation, meaning that savers have seen a reduction in real wealth. To keep up with inflation and to earn a reasonable return, low-risk investors have needed to increase stock allocations and take more investment risk. Now that bond yields are increasing and normalizing, this should allow low-risk investors to "right-size" their asset allocations, reducing stock exposure while still achieving a reasonable return. This is a good thing.

At the same time, however, fixed income investors need to be wary of the impact of rising rates on existing bond holdings. A bond's price moves inversely with interest rates. In other words, if an investor owns a bond and interest rates increase, then the value of that bond will go down, at least for a while. This effect is lessened for short-term bonds and magnified for long-term bonds.

> "Despite uncertainty around tariffs, financial markets remain resilient."

To protect clients from this phenomenon as much as possible, we've chosen to invest primarily in short-term and intermediate-term bonds. This is intuitive; if a bond comes due in just a few years rather than in many years, then we will be able to reinvest it sooner at higher rates. Therefore, such a bond shouldn't decrease in price as much, because it has less opportunity cost.

We've also been conscious of bond funds within client portfolios. While they invest in bonds, bond funds don't exactly act like bonds. They don't have a set maturity date, and so they are more adversely affected by interest rate increases. To counteract this effect, we've chosen short-term and floating rate bond funds for client portfolios, and, when possible, we've reduced or eliminated the use of bond funds.

Rising rates can also impact stock portfolios. As rates rise, costs rise for consumers, meaning reduced consumer spending and lower corporate revenues. Costs also rise for businesses, meaning a reduction in expenditures and a reduction in profitability. Therefore, it is typical for earnings growth to slow as the economy starts to slow, meaning slower growing stock prices or even decreasing stock prices. Additionally, interest rates are discount rates. A stock's price, mathematically speaking, is nothing more than the present value of a company's future earnings. Thus, as interest rates rise, future earnings become more heavily discounted, resulting in lower stock prices.

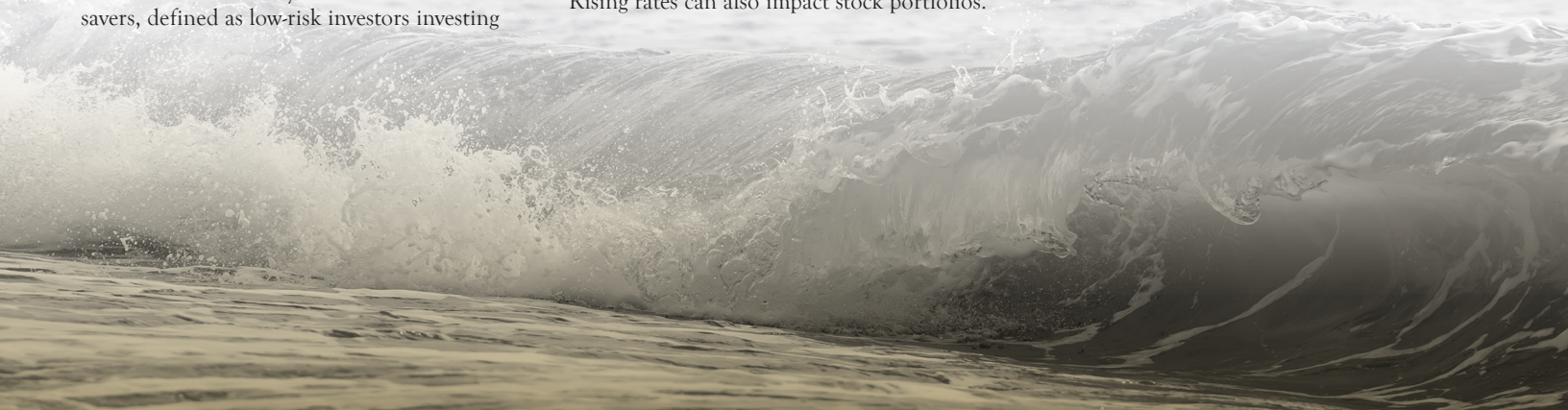
Despite all this, the stock market has shown little sign of giving up. The S&P 500 Index, for example, returned 7.71% in the third quarter and was up 10.56% on the year through the end of September. But at some point, the business cycle will turn and stock prices will come down. Like the tide, it's cyclical, and it will happen. It's a natural event, and investors need to start mentally preparing for it. While we see no evidence of this occurring immediately, we remain vigilant. We will start to take proactive steps to reduce risk in equity portfolios as events warrant them. For now, however, we are holding the course and enjoying the ride.

That said, clients are likely to see trades in equity portfolios as we near the end of the calendar year. As we do every year, we look through portfolios to identify losses so we can offset gains and reduce tax bills. We may be in touch with you or your accountant, as we work through this process.

Heading into the final quarter of the year, we remain cautiously optimistic. Despite uncertainty around tariffs, financial markets remain resilient. We're surely in for a heated election season this fall, which might contribute to some increased volatility. But, by and large, the near-term outlook remains positive.

As always, we're happy to discuss our outlook with you. Simply give us a call or drop us an email to schedule a time to chat. Until next time, best wishes for an enjoyable holiday season filled with family and friends.

– Deighan Wealth Advisors



PLANNING CORNER

Thank you to our guest columnist, Jennifer Eastman, Esq. Ms. Eastman is a partner at Rudman Winchell in Bangor, Maine, who concentrates her practice on estate planning and administration, and elder law. She is a member of the Maine State Bar Association and served as Chair of the Elder Law Section from 2013-2016. Jen is also a member of the American Bar Association and the National Academy of Elder Law Attorneys.

Estate Planning Considerations

Estate Planning is an often overlooked, yet vital, element of financial wellness. True financial wellness requires thorough and thoughtful analysis of needs, goals, and plans, with a mission to change your life, and potentially the lives of generations to come. A solid estate plan is an essential part of ensuring that goals for financial well-being are realized during our life and after death.

The term "estate planning" often overwhelms clients before they can even begin to think about the process. Most people do not think of themselves as having "an estate," a word that recalls castles and vast realms. The truth is that everyone has an estate. Your assets ~ from your home, to retirement accounts and cash, to beloved family heirlooms ~ make up your estate. An estate plan ensures that your financial, medical, and personal needs are met during your life, and that your intent for disposition of those assets is fulfilled after your death. A basic estate plan is generally comprised of four documents: (1) a Durable Financial Power of Attorney; (2) an Advance Health Care Directive, (3) a Last Will and Testament, and often, (4) a trust.

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A Durable Financial Power of Attorney appoints an agent to make financial decisions for you and manage your assets if you are incapacitated or unable to handle your financial matters. An Advance Health Care Directive appoints an agent to make medical decisions for you if you are unable to do so. A thoughtful planner will include provisions that outline more specific authorities, such as whether your agent can make gifts of your assets, including maintaining your customary charitable giving; create trusts for your benefit or work with an elder law attorney to preserve assets should you have long term care needs; detail your end of life care; direct care for your pets; and provide direction on your funeral and burial plans.

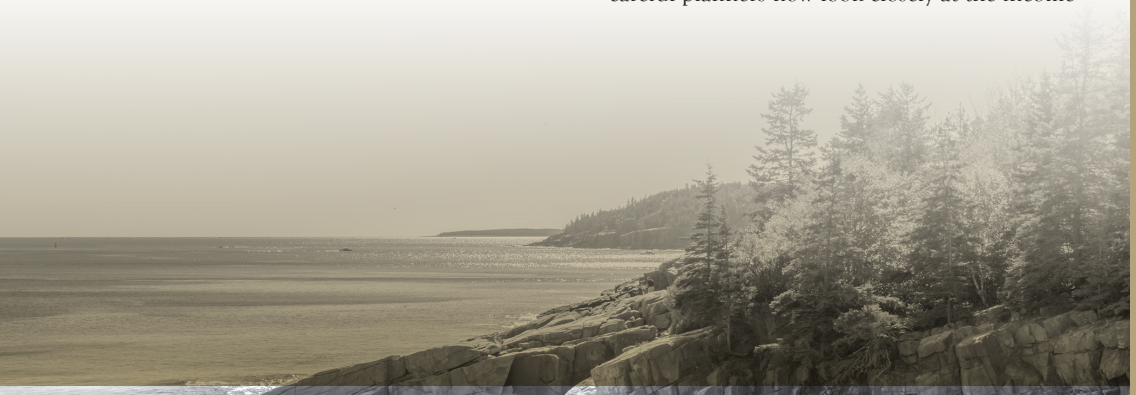
Your Last Will and Testament controls the disposition of your probate assets upon your death. This important document may be relatively simple as well, leaving all your assets to your spouse or descendants, and naming guardians for minor children. If you intend to control the distribution of those assets over time, or with certain restrictions, a testamentary trust incorporated into your will may be most appropriate. In other situations, a separate revocable trust may be more suitable, particularly in second marriages, if you own real estate in multiple states, or wish to avoid probate.

While these documents serve as the foundation for a solid estate plan, a comprehensive plan requires much more attention to detail. Issues to review include:

Confirmation of beneficiary designations on non-probate assets, such as life insurance, retirement assets, and payable on death accounts. Non-probate assets are not controlled by provisions of your Last Will and Testament; these accounts will pass directly to the named beneficiaries. If the estate is named as the beneficiary, care should be taken to ensure the assets pass to the individual or trust intended.

Review of joint accounts. Property owned jointly with right of survivorship will pass automatically to the surviving joint owner. Joint owners are often added to accounts for ease of access by a caretaker child, or to pay for immediate after-death expenses. Be aware that there is no obligation of the joint owner to use the funds for estate or funeral expenses, or to share the proceeds with other beneficiaries. The remaining funds will presumptively belong to the surviving owner.

Analysis of income tax consequences. With the dramatic rise in the estate tax exemption, careful planners now look closely at the income



SOUNDBYTES

Jean Deighan, Lucie Estabrook, and **Jenifer Butler** attended the 2018 Insider's Forum at the Hotel del Coronado in San Diego, California in September. This three-day seminar provides a unique opportunity for fiduciary professionals to learn essential information for better serving clients, as well as valuable opportunities for networking with industry thought leaders.

Jenifer Butler attended the Maine Investment Adviser Cybersecurity Seminar hosted by the Maine Office of Securities for important information about maintaining policies and procedures to protect client accounts and personal financial information.

Another fine Maine summer has passed. Let us know if there is anything we can do to assist with your year-end financial house keeping!

tax effects of the transfer of assets. While inheritance is generally not taxable income, retirement assets can incur severe income tax consequences if not treated properly. Beneficiaries usually have options to stretch distributions over time, or to liquidate a qualified asset in a lump sum, which will be taxable, not only incurring a significant tax liability, but potentially bumping the beneficiary into a higher tax bracket. If you are concerned that beneficiaries will make poor choices regarding taxable assets, specialized trusts can be established to avoid lump sum distributions and stretch the tax liability out over the lifetime of the beneficiary.

Protection for disabled beneficiaries. If an intended beneficiary receives disability benefits, well-meaning inheritance could interrupt that individual's eligibility for government benefits. A Special Needs Trust may be necessary to preserve eligibility, while providing funds to maximize quality of life for a disabled loved one.

Location of, and access to, important information. If an emergency happened who knows where to find important information? Are your documents and account information not only in a safe place, but where they can be located? If you store information in a safe deposit box, does someone else have access to it if you cannot be present? If the documents are locked in a home safe, or information securely stored in the Cloud, who knows how to access the files in a crisis?

Changes in life and in law. While having an estate plan in place can provide peace of mind, it is imperative to review your plan every five to ten years. Not only do families and family dynamics change over time, laws change regularly, affecting the implementation of your documents. For example, power of attorney laws changed substantially in Maine in 2010. Documents signed prior to the new law are still effective, but it may take a financial institution much longer to review the document, determine the law in effect at the time it was signed, and whether the power is effective under the old law. This delay could significantly hamper an agent who needed access to funds in an emergency.

> "An estate plan is much more than one-size-fits-all, fill-in-the-blank forms."

Clients often ask for an estate plan that is impervious to legal challenge and family conflict. The best way to avoid family conflicts in elder care and estates is through communication and transparency. Fiduciaries have legal obligations to provide certain information to principals and beneficiaries. Your documents can require more. It may be wise to appoint co-fiduciaries, two people to serve together, and to keep an eye on each other. Large transfers by agents under power of attorney can require approval by a majority of the children, or by the principal's attorney. Regular accounting and reporting obligations can be added to a trustee's responsibilities. While any aggrieved party can bring a claim challenging a fiduciary's actions or contesting a Will, thorough and detailed documents can reduce the likelihood of a lawsuit, and make it quite difficult for such a claim to succeed.

An estate plan is much more than one-size-fits-all, fill-in-the-blank forms. Estate planning is an opportunity to combine your unique financial goals with your personal goals, for end of life care and for generations to come. A comprehensive plan should involve your team of professionals-- your financial advisor, attorney, and accountant -- collaborating to ensure that all the details are considered and the needs met, giving you peace of mind, and the freedom to enjoy the financial well-being you have worked so hard to retain.

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