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On the [MONEY]

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From the Grapevine...

Congratulations to Todd Perry for being named a Five Star Wealth Manager in the Detroit area for the first time this year. The Five Star Professional designation has been presented to less than 7% of local advisors each year since 2011. Frank Moore was named again for the fifth time and Joe Henderson was named for the second time.

Frank Moore took on the role of Chairman of the national board of directors for NAPFA at the beginning of September. He'll kick off his one year term with a media tour in New York City and a meeting of the Financial Planning Coalition in Washington DC. The Financial Planning Coalition includes NAPFA, the Financial Planning Association and the CFP Board. Frank has been involved with the Coalition over the past few months in supporting the Department of Labor's proposed new rule that would require financial advisors to act as fiduciaries (in the best interest of clients) when giving advice on IRAs. The major Wall Street firms and insurance companies have been vehemently opposed to the consumer friendly rule.

SOCIAL SECURITY TURNS 80—WILL IT LIVE TO 100?

The Social Security Act marks its 80th anniversary in 2015. Each year the Social Security Board of Trustees releases its annual report to Congress on the financial status of the Social Security trust fund. The trust fund consists of two parts, the Old Age and Survivors Insurance (OASI) fund, mainly for retirement benefits, and the Disability Insurance (DI) fund.

When considered together, the combined funds are projected to run out of reserves in 2034, one year longer than last year's estimate. A change in the future assumptions, including wage growth, is the main reason for the better result.

Individually, the Disability Insurance fund is still projected to deplete reserves in late 2016. Income collected from taxes afterwards will only pay about 81 cents on the dollar of the scheduled benefits. It is likely that funds will be shifted from the Old Age and Survivors Insurance fund to cover the shortfall.

After 2034, Social Security benefits would need to be cut by about 25% if Congress doesn't act. Payroll taxes could be increased by about a third to fund the full benefits or there could be some combination of reduced benefits and higher taxes. For more, see the July 23 Social Security blog post at blog.socialsecurity.gov

WHAT DOES FED RATE HIKE MEAN TO YOU?

For years now, investors have been speculating on when the Federal Reserve would begin to increase the Fed Funds rate back to a more normal level. While the first increase from today's near zero level hasn't happened yet, Janet Yellen, the Fed Chair, has made it clear that she expects an increase by year-end. So what impact will an increase in the Fed Funds rate mean to you?

Home Equity Credit Lines

The most immediate impact may be to the interest rate on your home equity line of credit, if you have one. These rates are usually tied to the Prime Rate and Prime often moves in lock step with changes in the Fed Funds rate. The Prime Rate is a rate set by banks and the Wall Street Journal publishes the rate used by at least seven of the top ten largest banks. It's been stuck at 3.25% since late 2008 when the Fed made its last cut in interest rates. Typically, it is 3 percent higher than the Fed Funds rate. The first Fed rate increase may only be 0.25% to 0.5% so your home equity line interest rate won't jump a lot, but the Fed typically will increase rates steadily over a period of months or years if the economy is strong. In the last increase of Fed Funds rates, the rate went from 1.0% to 5.25% from the summer of 2004 to the summer of 2006. Given today's low inflation and slow economic growth, it's unlikely that the Fed will increase rates that quickly or steeply in the next couple years.

Bonds

Many investors assume that when the Fed increases the short term Fed Funds rate that bond interest rates will rise as well. That's not a given. While the Fed can control short term rates, longer term bond rates are set by the markets. (In reaction to the Credit Crisis of 2008-09, the Fed did attempt to reduce bond and mortgage rates by buying bonds in their "Quantitative Easing", but they stopped that program in 2014). Bond investors are mainly concerned with inflation that eats away at their principal over time so they often will cheer an increase in short term rates to keep inflation at bay. It's possible that bond rates will increase as the Fed begins tightening (raising rates), but the longer term bond rates probably won't increase as much as the short rates, at least initially. If bond interest rates do rise, then their prices will fall, leading to poor or even negative total returns for the higher quality corporate, municipal and government bonds.

Stocks

The big question many investors have is whether the rise in the Fed Funds rate will cause the stock market to drop. As always, there are differing views of what will happen to the stock market. Typically, the reason that the Fed increases their rates is that the economy is growing nicely and they want to forestall an overheated economy that could drive inflation higher. Inflation has held stubbornly low, at 2% or less for the last three years, so the Fed will have a hard time raising rates very much unless inflation picks up. If they communicate their moves well and don't raise rates very quickly or by very much, then there may be little negative impact on the stock market. The concern investors have is that higher borrowing costs and a slowdown in the economy would impact corporate earnings. At Vintage, we're not too concerned about the Fed's impact on stock prices in the near term.

Savings Accounts

Savers will be helped by an increase in the Fed Funds rate as most short term, cash-like vehicles like money market funds and bank CDs should see rate increases. Money market funds have struggled to survive over the past few years with interest rates near zero. As rates increase, many will be able to regain a profit margin so their rates may not jump as much as the initial rate hikes.

LOWER COSTS = HIGHER RETURNS, RIGHT?

Many investors are concerned about how much they are paying for investment management, financial advice, and transactions in their portfolios. It's logical to think that finding a stock mutual fund with a lower cost may result in savings and thus higher net investment returns, but that's not necessarily the case.

Let's look at one of the most popular and lowest cost mutual funds, the Vanguard 500 fund that mimics the S&P 500 index. Since the fund simply tries to match the holdings and performance of the index, there's no need for investment research and that helps reduce costs. Also the fund is huge, thus giving it very good economies of scale. As a result, the fund costs are extremely low. With the Admiral class shares, the annual expense ratio is only 0.05%, over 1% less than the average, actively managed stock fund.

Morningstar reports on the performance of the fund and also on how the average investor in the fund has done over the years. You would think that the figures would be the same, but investors tend to buy and sell shares over time instead of simply holding them for a 10 or 15 year period. Morningstar has calculated the investor return for the Vanguard 500 fund Investor share class. Over the fifteen year period through 7/31/15, the fund return, very close to the index return, was 4.49% annually. The investor return, however, only averaged 1.60%, or 2.89% per year less than the fund earned.

The difference in returns can be attributed to investors that generally bought at higher prices and sold at lower ones. It was a tough fifteen year period for the stock market, but investors that tried to save costs, often by bypassing an advisor, ended up with awful returns and a lot of volatility. Over that time period, the fund dropped about 50% twice. While most stocks funds struggled to produce good returns over that period, the investors in the Vanguard 500 fund earned returns in the 68th percentile. In other words, over two thirds of stock fund investors outperformed them!

As we outlined in a previous article in this newsletter, Vanguard did a study that indicated that, on average, financial advisors could add "about 3%" each year in better returns to investors over the years. Of course, advisors cost money, but if you can pay 1% to get 3%, that's a pretty good investment.

At Vintage, we do look for low cost funds for our clients and often use very low cost institutional shares, but there's much more to getting a good, net return than the fund expenses.

NO COLA FOR SOCIAL SECURITY IN 2016?

It looks like there will not be a Social Security cost of living increase for 2016, and many high income retirees may see a net reduction due to higher Medicare premiums. Social Security will make the official announcement in October, but based on the formula and recent inflation figures, don't plan on an increase. This would be the third year of no increases since 2010 and follows the last three years when the increases were 1.7% or less.

The Social Security trustees project a 52% increase in Medicare Part B premiums for 2016. Currently the premium is $104.90, which is deducted from your Social Security benefit, but higher income retirees are subject to surcharges. Most retirees will escape having their monthly benefit reduced due to the Medicare increase, but high income earners may see a reduction. Future retirees will also be subject to the much higher Medicare premiums to come.

VINTAGE FINANCIAL SERVICES OFFERS

Fee only investment management, financial planning,
and tax preparation.
Minimum portfolio $500,000
(401(k) balance may count toward minimum).

For a no charge, no obligation initial interview please call our office at (734) 668-4040 or (800) 666-9237 or e-mail:

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