**2014 THE ROAD AHEAD** 

# {connecting}

the dots.

Taking stock of where things stand today is an important starting point as we begin to connect the dots between the capital markets, the economy, policy issues, and ultimately your portfolio.

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Each year, our Road Ahead commentary provides readers with an intellectual road map of our views for the coming years.

However, looking at where we've been is often a helpful exercise in order to provide insight into where we may be headed. While past twists and turns may not be repeated in the future, they are often similar. By plotting out the current state of the economy and capital markets, the topography of the road ahead becomes clearer. From peaks or valleys of capital markets showing signs of over or undervaluation, to evolving secular themes that could alter historical trends, we can begin to connect the dots to evaluate how those developments may ultimately impact you as an investor.

This year we'll discuss the major themes we view on the horizon, which are likely to impact client portfolios:

- Following a multi-decade period of falling interest rates, limited room remains for further yield compression. Given our expectation for rising interest rates over a secular time horizon, we evaluate the challenges facing fixed-income investors and how we've adjusted portfolios to manage against interest rate risk while taking advantage of tactical opportunities that may arise through flexible mandates.
- On the equity front, exceptionally accommodative global monetary policy has encouraged investors to assume risk in search of higher returns, pushing

U.S. equity markets to new highs. While we maintain a neutral outlook on stocks overall, we provide our thoughts on where valuations may indicate the potential for a relative value opportunity in some markets and comparative risk in others over the longer term.

- We revisit our strategic framework from which we construct efficient portfolios, and the role that alternatives play in a portfolio to enhance risk-adjusted returns over a long-term time horizon.
- Finally, we look at the tax changes that have impacted clients in 2013 and provide considerations for planning opportunities.

We recognize that accurately predicting the direction of capital markets or the economy over shorter time periods is impossible to do with consistency. However, we believe that there is value in identifying potential secular themes or cyclical drivers that could either create opportunity or act as a catalyst for excessive risk to build in the markets. But before we embark on the prognostications surrounding what may lie ahead, we believe taking stock of where things stand today is an important starting point as we begin to connect the dots between the capital markets, the economy, policy issues, and ultimately your portfolio.

### 2013:

### A brief look back

Historically, asset class leadership tends to change from year to year, as various areas of the capital markets rise up and fall down the list of top performers over time. They may have their moment in the sun, or perhaps what Andy Warhol referred to as their "fifteen minutes of fame," as investor interest waxes and wanes. Likewise, the major themes impacting the economy and capital markets also evolve over time. Sometimes, those changes are abrupt and chaotic, while other changes emerge slowly — almost imperceptibly — over time.

As we indicated in our Road Ahead commentary last year, we expected that policymakers would play a pivotal role in influencing economic and market outcomes in 2013, and that proved to be accurate. Whether it was dysfunction in Washington or uncertainty surrounding the potential for a course modification for monetary policy, the spotlight for much of the last year was on central bankers and fiscal wrangling in Washington. In fact, on the first business day of the year, the S&P 500 Index rallied over 2.5 percent when fiscal policymakers struck a deal to avert the full impact of the so-called fiscal cliff. By the latter half of the year, they returned to the headlines as a

result of the impasse surrounding the federal budget and debt ceiling.

Ultimately, their inability to strike a deal to extend funding forced the government to shut down for the first time in 17 years, leaving nonessential government employees on a 16-day furlough. While the full economic impact of the government shutdown is still unknown, economists have estimated that it may have trimmed fourth-quarter growth by 0.5 percent. That temporary setback contributed to the Fed's surprise decision to delay its anticipated tapering of bond purchases in September out of concern about fiscal uncertainty. Nonetheless, a December thaw between the parties in Washington led to a bipartisan two-year budget deal, a welcome development that should provide better fiscal clarity than has been present for some time.

The Federal Reserve initially announced its open-ended quantitative easing program in December 2012 and has remained on a steady program of \$85 billion in purchases of Treasury and mortgage bonds each month since that time. Although talk of tapering back these purchases led to a sharp upward move in long-term interest

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rates during the summer and anxiety for bond investors in particular, the FOMC announced that it was moving forward with its wind-down strategy coming out of its December meeting. As new Chairman Janet Yellen takes the leadership reins at the Fed, expectations point to a similar tone and a likely extension of the ultra-accommodative monetary policy of the Bernanke Fed for some time to come.

Last year we suggested that the economy would likely maintain a similar pace of slower-trend growth. We expected corporate America to remain a source of relative strength given healthy balance sheets and robust profit margins, while we anticipated that consumer spending could be limited by higher taxes, still elevated unemployment levels, and modest income growth. As we look back, economic growth was indeed moderate throughout the year (a 2.6 percent growth rate through the third quarter), while corporate earnings grew at a subdued pace. Meanwhile, consumer spending did slow mid-year before accelerating in the third quarter, with spending growth on high-ticket items such as automobiles, furniture, and electronics acting as proof of improving confidence. We noted that the housing market

was also likely to be a bright spot for economic growth. That also proved correct, as residential construction posted double-digit growth in 2013.

Globally, we believed the stage was set last year for the potential for stronger but bifurcated international growth as bold policy action in 2012 significantly reduced the risk of negative outcomes. The continuation of unprecedented stimulus efforts abroad now appears to be pushing Japan and the Eurozone out of their economic malaise, but the path to stronger growth abroad is going to be a bumpy one. Expected growth rates in emerging markets have eased, but these countries continue to have favorable long-term dynamics including supportive demographic trends, rising integration into global trade, and the gradual reduction of obstacles preventing these countries from accessing global capital and adopting productivity-enhancing technology.

Within fixed-income markets, we believed that the challenges of recent years were unlikely to change. That held true as historically low yields and upward pressure on long-term interest rates limited returns for bond investors for the year.

Perhaps the most significant theme will once again be the central role that policymakers may play in defining the investment environment and investor confidence.

Perhaps the biggest surprise of the year was the strength of the global equity markets, particularly returns for U.S. stocks, which far exceeded expectations. Despite only moderate economic and earnings growth, investors piled into equities, driving broad U.S. stock indices to returns exceeding 30 percent.

Looking ahead, we believe some of these same themes are positioned to pave the way into 2014. Perhaps the most significant theme will once again be the central role that policymakers may play in defining

the investment environment and investor confidence. As we shift our focus from the past to the future, connecting the dots of today's backdrop to our insights of tomorrow, we remain cognizant of the risks that are present, but confident that opportunities for investors also exist. We believe that investors who maintain a long-term focus and appropriate diversification, within the context of their stated risk tolerance, can still meet their goals and achieve financial success. •

## Our strategic framework to portfolio design

Like many other areas within the world of finance, the asset allocation process has evolved over time. Harry Markowitz, the father of modern portfolio theory, illustrated to the world that the consideration of risk is just as important as attention to returns in the creation of efficient portfolios. He also championed diversification and asset allocation as core concepts necessary to optimize portfolio risk and return in a mathematical framework. Others have built upon this foundation to show that risk is not rewarded in a purely linear fashion, like Markowitz's efficient frontier would suggest. Simply put, they found that valuation matters. We believe that by connecting these two schools of thought together, investors unleash a powerful asset allocation approach that can be very effective in helping them to achieve their long-term financial goals.

Academic studies have shown that a portfolio's strategic asset allocation far surpasses individual manager selection or tactical asset allocation as the most important determinant of a portfolio's total return and variability in that return over time. Indeed, the foundation of our investment philosophy begins with the

generation of a set of strategic asset allocations, which, in addition to traditional stocks and bonds, includes various alternative investments. The development of these strategic allocations begins with a portfolio optimization process using independent capital market assumptions derived from both historical data and the current economic and capital markets backdrop.

Using the strategic allocations as an initial baseline, we seek to identify and exploit longer-term (secular) trends and tactical (cyclical) investment opportunities on a tax-adjusted, fee-adjusted, risk-adjusted basis. We believe that the recognition of these opportunities and their integration



#### **Strategic allocations**

A disciplined portfolio optimization process provides the framework for the development of our strategic asset allocation decisions. Strategic allocations serve as the anchor of our diversified, long-term investment approach.

#### Secular outlook

Comprehensive research identifies long-term global investment themes, which may impact portfolio decision-making over a full market cycle.

#### **Tactical overlays**

Cyclical extremes create shorter-term opportunities.

... over the long term, fundamentals and valuations will trump momentum and ever-changing investor sentiment.

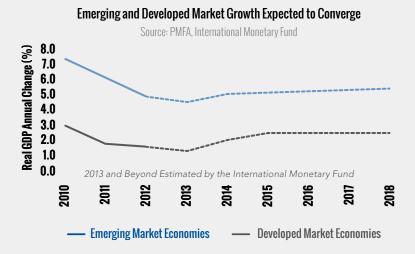
into a portfolio through overweight and underweight allocations can add value to portfolios, as forward-looking return expectations will change over time. These opportunities may become more apparent when a disconnect between fundamentals and valuation is recognized, or when a new cyclical or secular driver emerges. If prices are low and risks discounted, we believe that having greater exposure via an overweight allocation can add value to portfolios over the long term. Conversely, if prices are high and investors are not adequately compensated for risk, then an underweight allocation may be warranted. While these disconnects may persist for an extended period of time, sometimes spanning several years, valuations and fundamentals eventually converge. Put differently, over the long term, fundamentals and valuations will trump momentum and ever-changing investor sentiment. Sidestepping the extremes can seem counterintuitive when it seems that the markets are "all in" and prices are soaring, but recognizing that valuations matter can allow prudent investors to avoid falling prey to the emotions of fear and greed at market extremes.

What are some of these current opportunities, and how are they connected to our

clients' current portfolio positioning? On a cyclical basis, we see a number of reasons to be optimistic for growth prospects in the developed world over the near term. In the U.S., the negative drag from fiscal policy is expected to diminish in the year ahead, aided in part by the budget deal struck at the end of 2013. Elsewhere, stimulus efforts have also provided a temporary "shot in the arm" for Japan, the U.K., and the Eurozone. While economic growth in Japan is expected to remain positive in 2014, longer-term structural reforms may be needed to shift from a stimulus-led recovery to one that is more sustainable. The core countries in the Eurozone have also shown signs of growth, albeit at an uneven pace, amid a reduced emphasis on fiscal austerity. Still, peripheral Eurozone economies are likely to struggle to find their footing due to high levels of unemployment weighing on internal demand and with a relative lack of competitiveness also holding down external demand. It's not that all is well in the Eurozone — quite the contrary. However, change happens on the margin, and the continued improvement within the core of Europe as policymakers take action to steer the economy away from a worse outcome is a positive sign.

Unlike the developed world, growth prospects for the developing world appear to be slowing. While still expected to outpace their developed market counterparts over the long term, emerging economies remain in the midst of a difficult transitionary period. With the Chinese economy showing signs of stabilizing around a lower real growth rate compared to its recent past, commodity-exporting countries may be facing slower overall growth prospects, and commodity prices may remain dampened by diminished growth in global demand. In addition, emerging-market countries have recently been hindered by capital flows linked to developed market central bank policies. A normalization of these policies could negatively impact these economies, especially those dealing with high inflation and that are more dependent upon foreign capital. When accommodative monetary policy in the U.S. and other major economies is unwound, yields will rise, creating increased competition for capital.

While global growth expectations have been ratcheted up and tail risks have generally been diminished, investors



should continue to have a keen eye on monetary policy. The Fed's forward guidance, which accompanied its
December announcement to begin tapering the rate of asset purchases, has extended the timing for rate hikes out further into the future. The Fed has explicitly stated that it would allow a "considerable" amount of time to pass after stopping its asset purchases before it would begin to raise short-term rates.
As a result, liquidity is expected to remain ample over a cyclical time horizon, unless inflation, which has been held largely in check, increases unexpectedly.

... some relative value opportunities still exist within fixed income, equities, and alternatives.

Connecting the dots, our current strategies mirror this cautious optimism and reflect a relatively neutral stance. Our asset class positioning in portfolios reflects the current balance between absolute and relative valuations, the seeming reduction in global economic and geopolitical risks, anticipation of better global economic growth ahead, and still supportive global monetary policy. While there appear to be very few undervalued areas of the capital markets, few asset classes appear to be grossly overvalued either. Yet, as we outline in the following sections, some relative value opportunities still exist within fixed income, equities, and

alternatives. For example, we continue to recommend that investors with some degree of risk aversion have significant exposure to absolute-return fixed-income strategies in lieu of a larger, benchmark-like core bond allocation. While overall equity exposure remains in neutral territory, we recommend that portfolios reflect an overweight positioning to international equities and a modest underweight to domestic stocks. Finally, within alternative investments, portfolios emphasize income-oriented hybrid investments while remaining underweight to commodities. •

## Preparing bond investors for various scenarios

Coming off a year of rising interest rates, we expect that the long-term trend will continue higher, but the near-term direction remains unclear. Rates could certainly rise further in the coming year, but fundamentals suggest that the near-term upside may be limited. Reasons for this include the expectation that the Fed policy rate will remain unchanged (anchoring short-term rates near zero) into 2015 or beyond, continued headwinds to more robust economic growth, and the resulting output gap that should help to keep inflation pressures largely at bay. At the same time, the downside for rates also appears limited by improving expectations for growth across much of the globe and the pursuit of reflationary policies. As a result of these opposing dynamics, we believe that rates could be range bound for some period, with seemingly few catalysts to drive rates sharply higher or lower. Nonetheless, within that range, volatility is likely to persist as the global economy continues down the road to health, and central bankers chart their exit strategy from their unprecedented policy measures.

The chart on page 10 illustrates changes in both short- and long-term rates over the past year. Despite the fed funds rate remaining virtually unchanged, the benchmark 10-year U.S. Treasury note was somewhat volatile in 2013, rising by over 100 basis points since the lows in May to end the year at just over 3 percent. This volatility created uneasiness among investors with some degree of risk aversion.

What can bond investors do to help manage interest-rate risk and the expectation of heightened rate volatility? There are many ways to help protect against downside events in bond portfolios. These include focusing on income, managing duration to limit interest rate sensitivity, increasing global diversification, or using flexible "absolute-return" fixed-income strategies.

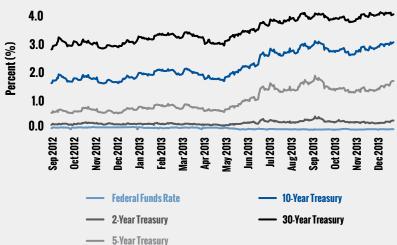
• First, a focus on higher-income opportunities versus the benchmark provides some direct protection against rising rates. When rates rise, as they did in 2013, an opportunity is created for bond managers to take advantage of higher yields by adding securities that increase the income

potential in their portfolios. The chart on page 11 shows the yield trend for mortgage-backed securities, investment-grade corporate bonds, high yield corporate bonds, and emerging markets' debt last year. Looking ahead, an emphasis on high-quality bonds that offer a yield advantage over U.S. Treasuries can provide a "buffer" against the negative effects of rising interest rates on portfolio performance.

- Second, bond portfolios may benefit from a reduction in duration a measure of the sensitivity of a bond or bond portfolio to changes in interest rates. By lowering a portfolio's duration relative to its benchmark, it would be expected to outperform that benchmark in a rising rate period, all else being equal. Other factors such as yield curve positioning and rate exposures to different countries will also impact bond portfolio performance, but duration management is a critical tool for protecting a portfolio when rates rise.
- Third, investing in global bonds and foreign currencies can provide







diversification in portfolios that are predominantly focused on domestic bonds. Managers with the ability to invest abroad can take advantage of opportunities to enhance returns or reduce the risk of being invested only in the United States.

• Lastly, "absolute-return" fixed-income strategies can add flexibility to a fixed-income portfolio. Such funds allow managers to be more opportunistic in response to changes in economic

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or market conditions than is typically possible for a core bond strategy. Managers are able to take advantage of strategic and tactical opportunities that arise from market volatility, including greatly reducing duration or even tactically taking short positions in this low real yield environment.

There is no question that the environment remains challenging for bond investors. Nonetheless, bonds remain an integral component of portfolios for investors with some degree of risk aversion or liquidity need. We continue to emphasize the important role of bonds in portfolios as a source of income and diversifier against riskier assets, particularly in flight to quality scenarios. Short-term mark-to-market price declines are sometimes difficult to accept, but investors should remain mindful of the role of bonds within an

#### **Spread Sectors Offer Relative Value** Source: PMFA, JPMorgan, Federal Reserve Economic Data 7.0 6.0 5.0 Percent (%) 4.0 3.0 2.0 1.0 0.0 JPM Developed Market High Yield (YTW) **EMBI Global Index (YTM)** FNMA 30yr Current Coupon (Yield) Non-Agency MBS Prime Index (Yield) B of A ML US Corporate Master (Yield)

asset allocation framework and maintain their focus on their long-term goals amid short-term volatility on the path to reaching their investment objectives. •

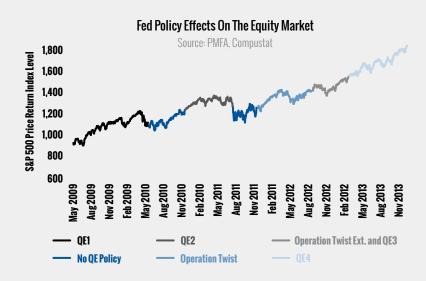
## Equities climb the wall of worry

Throughout 2013, the proverbial wall of worry — including the fiscal cliff, tensions in the Middle East, elections in Europe and potential resulting changes to policy therein, slowing growth in China, lack of clarity around Federal Reserve policy, and the Congressional budget and debt ceiling standoff — was no match for one of the more resilient equity rallies seen in recent history. Ongoing, unprecedented, easy monetary policy continued to act as a buffer against any material decline in equity prices. In fact, U.S. equities have not experienced a market correction of 10 percent or more since August 2011. In the face of many sources of uncertainty, the multi-year surge in stocks has been impressive.

Beyond the U.S., global central banks also maintained easy monetary policies and stood ready to provide additional support as needed. Nonetheless, international equity markets were more volatile throughout the year, most notably the Japanese and emerging market indices.

Domestic equities returned 32.4 percent during 2013, as measured by the S&P 500 Index, with most of that performance derived from price to earnings (P/E) multiple expansion, rather than strong earnings growth. For the year, earnings

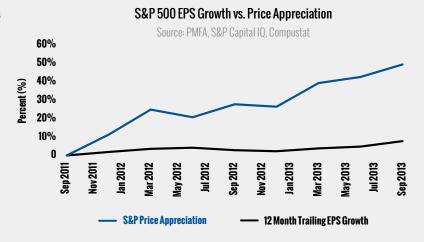
grew modestly, in the mid-single digits. Although analysts are forecasting double-digit earnings growth for 2014, those projections may be optimistic given current expectations for economic growth and already lofty profit margins. The trend in recent years has been for initial earnings estimates to be high and revised consistently downward. We have little reason to believe that trend will not continue in 2014. However, if the global economic expansion remains on track as expected or even exceeds expectations, corporate profit growth could also pick up, providing critical support for equities. A continuation of improving global growth driving corporate earnings and supportive



monetary policy will likely be key ingredients for the current rally to continue into 2014.

Broadly speaking, U.S. equities appear to be fairly valued – but with some areas of the market at least bordering on expensive territory. That doesn't mean that those richly valued stocks can't move higher still, however, or that the current bull market couldn't extend further.

As mentioned above, we believe the path for equities in 2014 will depend greatly on economic growth and the continued support of monetary policy. Revenues would need to break out of their pattern of low single-digit growth to support stock returns exceeding mid-single digits, unless P/E ratios or profit margins were to expand further. If GDP growth remains in a muddling sub-3 percent range, sales growth will likely languish; however, if GDP growth accelerates to 3-4 percent, revenues would benefit, and likely flow positively through to better corporate earnings growth. While a sharp, sustained upturn in economic growth is seemingly positive, it could also prompt the Fed to tap the brakes on policy more quickly, which could be a negative development for stocks. As such, the best case scenario for equity markets would seem to require a "Goldilocks" economy: not too hot, but not too cold.



At year end, profit margins remained near historic high levels at over 9 percent for the S&P 500 Index — well above their 40-year average of 6 percent. Since margins have tended to revert toward their historical norms over time, one must question how long they can stay at these elevated levels before reverting back to the mean. If margins contract, earnings will almost certainly follow, and combined, it would put pressure on equity returns.

Nonetheless, if the economy persists in this "not too hot, not too cold" growth range and monetary policy remains loose, stocks and other risk assets could be set up for an extension of the current bull market. How long could that last? It's impossible to say with certainty, but history does provide some clues. First, we know that even expensive stocks can further

Across traditional equities, we continue to see greater opportunity within international markets, where nominal earnings levels have not yet eclipsed their highs from \( \) 2008 and profit margins remain comparatively low.

increase in value as retail investors pile in and momentum drives prices even higher. Secondly, over the long term, valuations will revert to normal levels, suggesting that investors should seek value, but need to be patient and allow sufficient time for the market momentum to subside and for that value to be recognized.

With the Fed's reduction of the pace of bond purchases slated to begin in January 2014, interest rates could rise further, but the market reaction to that news was muted, suggesting that the taper may already be largely priced in. As already noted, we believe rates are likely to remain range bound for some time. While rising interest rates are directly linked to bond performance, equities are almost certain to be impacted by a sustained upward move in interest rates. If rates remain steady or rise gradually as a byproduct of robust economic growth, equities could benefit. However, if rates rise too rapidly, or move higher specifically because inflation is slipping out of control, investors could become unnerved, believing that monetary policy is behind the curve, and stocks would likely suffer. Moreover, some equity sectors tend to be more sensitive to rate movements than others,

specifically the higher yielding sectors such as telecommunications and utilities. Other industries (like banking), on the other hand, may actually benefit from rising rates as net interest margin expansion could boost their profitability.

Across traditional equities, we continue to see greater opportunity within international markets, where nominal earnings levels have not yet eclipsed their highs from 2008 and profit margins remain comparatively low. Additionally, on a relative P/E and price to book (P/B) basis, international equities also appear more attractive than their U.S. counterparts. Consistent with this, we recommend that long-term portfolios hold an overweight to international equities offset by a moderate underweight to domestic equities, looking to capitalize on the relative attractiveness of non-U.S. stocks over a secular timeframe.

As always, we remain vigilant in evaluating cyclical risks and opportunities, and believe the long-term outlook for stocks is still attractive relative to bonds or cash. Thus, for investors with a long-term time horizon, we continue to believe adequate equity exposure, consistent with one's tolerance for risk, is an important component of an investment portfolio to drive wealth creation and increase purchasing power.

## Diversification expanding beyond stocks and bonds

While stocks and bonds are cornerstones of a traditional investment portfolio, we believe that alternative investments also play an important strategic part in a well-diversified portfolio. In the past, we've discussed the roles that specific alternative assets can play within a portfolio, and how the use of different alternative investments may vary depending upon prevailing valuations and market conditions over the course of the business cycle. According to modern portfolio theory, the inclusion of alternative investments, which are not perfectly correlated to traditional equity and fixed-income assets, can increase the efficiency of an investment portfolio by lowering the amount of risk per unit of return. This diversification effect is the primary reason that strategic allocations to alternative asset classes benefit investors over long-term investment time horizons. Beyond these diversification benefits, tactical opportunities within alternatives may also arise throughout a market cycle, providing attractive risk/reward opportunities relative to traditional asset classes.

We've long maintained a strategic position in commodities, and over the long term we believe that "real assets" like commodities can provide diversification benefits and

protection from unexpected inflation. However, weak commodity futures fundamentals and slow global growth provided support for an underweight position to commodities in portfolios throughout 2013. This proved to be beneficial, as the asset class underperformed other risk assets. The opportunity set for commodities seemingly improved in the later stages of 2013, as an improving global growth outlook appears poised to support demand for commodities, at a time when the supply of some major commodities globally is tightening, and demand fundamentals continue to improve. Still, the global climate for commodities remains somewhat lackluster and pricing dynamics in the futures market do not suggest that commodities are a relative bargain. As such, we will continue to evaluate both the fundamental attractiveness of commodities and other real asset strategies against the risk of inflation and more attractive opportunities elsewhere in the capital markets.

From a tactical view, the current underweight to commodities is offset by an overweight exposure to hybrid investments, which exhibit risk/reward characteristics that generally fall between Today, income producing hybrids such as high yield bonds, multi-sector bonds, and global bonds provide a comparatively steady return through income and actual cash flow to the investor, without reliance upon capital appreciation.

those of high-quality bonds and global equities. Current valuations across much of the capital market spectrum suggest that price appreciation may be more limited moving forward than in the past several years in the aftermath of the financial crisis and accompanying bear market.

Today, income producing hybrids such as high yield bonds, multi-sector bonds, andglobal bonds provide a comparatively steady return through income and actual cash flow to the investor, without reliance upon capital appreciation. While return expectations for hybrids have been reduced over the past few years, they remain a viable alternative to augment the returns of a high-quality core bond portfolio.

Moreover, we continue to evaluate other hybrid strategies that may provide better return potential over the next phase of the market cycle.

Meanwhile, the environment for hedged strategies has improved. Intra-stock





attractiveness of the active hedged strategy opportunity set, have begun to stabilize at lower levels after an extended period of elevation. That "rising tide that lifted all boats" environment in equities has given way to greater disparity in returns across the equity markets, creating greater opportunity for long/short equity managers to add value. Given those changing conditions, we believe that hedged equity strategies can produce good risk-adjusted performance while providing diversification

to traditional equity investments. •

correlations, a measure of the

## Nothing's certain but death and taxes

Many taxpayers enter 2014 with work left undone from 2013. The need to reevaluate the tax efficiency of investments and business structures should be a high priority in light of the increases in tax liabilities in 2013. While tax rates begin 2014 unchanged from 2013 levels, many taxpayers only recently realized the full impact of the 2013 tax hikes.

In 2013, the maximum ordinary income rates went from 35 percent to 39.6 percent; maximum capital gains and qualified dividend rates went from 15 percent to 20 percent and investment income was subject to a new 3.8 percent Medicare surtax. Add it all up, and the maximum federal rate on ordinary investment income went from 35 percent to 43.4 percent, a 24 percent increase, and the maximum federal rate on long-term capital gains and qualified dividends went from 15 percent to 23.8 percent, a 58.67 percent increase.

Connecting the tax dots in 2014 will not, however, be as simple as learning from experiences of the prior year. The recent bipartisan, two-year budget accord will be followed by the detailed appropriations process and a new round of debt ceiling negotiations. Significant tax reform appears to be unlikely in the near term, but these battles inevitably involve changes to the

tax code. This means that while income tax planning for 2014 should address lingering issues from 2013, it should also be flexible enough to adjust to potential tax law changes that have not yet been identified.

The critical elements for successful planning in 2014 are to begin early and take a long-term, multi-year approach. Changes to investments and business structures only impact taxes arising after the date of the change, so waiting until the end of the year will result in the loss of a year of opportunity. •

Maximum ordinary income rates

4.6%

Maximum capital gains and qualified dividend rates

**45**.0% +3.8%

Investment income

Maximum federal rate on ordinary investment income

Maximum federal rate on long-term capital gains and qualified dividends



## Connecting the final dots

As we close the book on the past year and look toward 2014, we are mindful that this year's Road Ahead also represents a bit of a milestone as it's the tenth year in which we have prepared this annual outlook for our clients. In the first Road Ahead in 2005, the capital markets were coming off of a solid year for stocks. The technology stock bubble was still deflating, and the Price/Earnings ratio for the Russell 1000 Index had been cut in half from its March 2000 peak of over 40 times earnings. Interestingly, valuations for both larger cap and smaller cap stocks today aren't meaningfully different from where they were at the time. Bond market conditions were quite different, however, as both short-term and long-term yields were higher than they are today. Investors were still dealing with the lingering effects of the euphoria that drove stocks to prices beyond anything justifiable by fundamentals, and valuation multiples would decline further back toward more reasonable levels. Nonetheless, 10 years later, broad equity indices are much higher.

Five years later, the picture had changed considerably. The world was in the midst of the most severe recession and financial crisis since the 1930s, and investors were

feeling the impact. The S&P 500 Index closed 2008 at 903, but would fall more than another 200 points before bottoming in early March. At its nadir of 667, the index was at about one third of its level of 1848 to close out 2013. With the benefit of hindsight for long-term investors, it was a good time to invest, despite the historically high volatility, the exceptional uncertainty, and the extreme degree of fear gripping the market.

A year ago, we laid forth our outlook for the economy and capital markets, with mixed results. Our expectations for the economy, the impact of fiscal and monetary policy, and challenges for bond markets were largely accurate. However, like most market observers and investors, we did not anticipate the type of returns that the equity markets provided in the past year. From an investment perspective, we expressed a view that "the next few years will continue to be characterized by a lower return/higher volatility environment." It's worth noting that, although we publish our thoughts annually, we don't think about the future in terms of individual calendar years. It's the same reason that we break from some of our peers within the industry by not providing an expected target level for the

#### "You can never plan the future by the past."

Edmund Burke, Irish Statesman

S&P 500 to end the year. It can make for interesting conversation, but we don't believe it's meaningful, largely because we don't believe that we — or anyone else for that matter — can predict the future with such precision.

Over the past 10 years, much has transpired that we couldn't have foreseen. In many regards, the outlook today is very different from what it was a decade ago. Certainly, the passage of time brings with it new opportunities and, of course, new challenges. But there are things that haven't changed — and shouldn't. At its core, investing is still a process that requires discipline and patience. In that 2005 edition of the Road Ahead, we closed with the following:

"We remain vigilant in our efforts to identify opportunities to find uncommon value through constrained tactical reallocation between sub-asset classes while maintaining our resolute commitment to strategic bond and stock allocations. When conditions look less than optimal for a given segment of the market, maintaining that delicate balance can present challenges for even sophisticated investors. Volatility and the risk of loss are

always present in the market, especially over short periods. Irrational decisions that sometimes drive short-term market momentum and unforeseen market shocks can wreak havoc with investor expectations and portfolio results. Such events cannot be reliably predicted, nor can the direction of market volatility over even multi-year time frames. Risk will always be present, whether or not the investor looks down from the tightrope. Our goal is to reduce the potential for risk by positioning client portfolios in a manner that mitigates those risks and emphasizes strategies that afford a higher probability for success."

Looking forward from here, it's impossible to say what the next 10 years will hold. Undoubtedly, there will be challenges that we can all prepare for, and there will be those for which no one can. There will be opportunities as well, as advances in medicine, technology, and energy among other industries have the potential to improve our standard of living, drive economic growth, and provide opportunities for investors willing to take risk. As Edmund Burke noted, "You can never plan the future by the past." Change is inevitable. However, we know from the past that no matter how great

... we remain steeped in our commitment to putting our clients' interests first, listening to your goals and needs, and helping you to craft a plan that will allow you to reach those goals.

the challenge and the fear that may accompany it, the human spirit will rise to that challenge. It's true in a very broad sense, and it's true in the more narrow sense for investors. Investors are still wise to remain focused on the long term, while not allowing oneself to be caught up in the moment and be either excessively deterred by fear or blindly emboldened by greed.

That was at the core of our philosophy in 2005, and it remains at the core today. Certainly, we have adapted to change, but always with the same core principles built on a foundation of strategic asset allocation, the search for opportunities and awareness of risk, and maintaining an appropriate focus on the long term. Most importantly, we remain steeped in our commitment to putting our clients' interests first, listening to your goals and needs, and helping you to craft a plan that will allow you to reach those goals. That remains our promise and commitment to you as we travel with you on the Road Ahead.

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