CLIFFORD SWAN
THE Investment Counselor
THIRD QUARTER 2016
WISDOM *for* GENERATIONS

NEGATIVE INTEREST RATES: THE IMAGINARY HAS BECOME REALITY

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In mathematics, the square root of -1 is equal to *1i*, an imaginary number. In finance and economics, negative interest rates were thought to be imaginary and impossible. In the last few years, the impossible has become reality.

WHAT ARE NEGATIVE INTEREST RATES?

Negative interest rates result in the investor or buyer of the bond paying interest *to* the issuer to purchase that bond. For example, assume that the Swiss government's 3-year bond rate is -1.0%. If an investor bought a Swiss bond at 100% of the face value (par), then the investor would receive approximately 97% of the face value at the end of three years. That represents a face value discount of approximately 3% (1% x three years).

Negative interest rates currently exist in many countries in the developed world, including Denmark, France, Germany, Ireland, Japan, and Switzerland. An article published on August 15, 2016 on *ZeroHedge.com*[1] noted that negative-yielding bonds (both government and corporate) now total $13.4 trillion dollars and are found in countries that account for 25% of global economic activity, as measured by Gross Domestic Product (GDP).

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HOW IS THIS POSSIBLE?

Most traditional economic books have no section on negative interest rates, as none of the well-known economic minds (e.g., Keynes, Hicks, Mankiw, and Friedman) thought it possible to produce negative interest rates. However, frictional transaction costs could allow central banks to charge negative interest rates. For example, there are storage and security costs to hold a large number of $100 U.S. bills, as well as 500 Euro and 500 Swiss franc notes. Estimates have placed these costs at up to 1% annually, which suggests that negative interest rates could decline to that 1% cost level. In addition, if investors expect deflation—that is, increasing purchasing power for future francs—then an investor would be willing to trade 100 Swiss francs today for 97 francs in three years, expecting those 97 francs to buy more in the way of goods and services in the future than 100 francs today. We experienced this deflationary phenomenon in the U.S. during the 1930s, as inflation rates declined and were negative.

HOW DID WE GET HERE?

The key motivations for central banks in creating negative interest rates were to support the fragile financial systems of their countries and to spur economic growth. There is an inverse relationship between interest rates and borrowing; theoretically, low rates will encourage borrowing, leading to spending and economic growth. During the Great Recession of 2008/2009, the global financial community suffered a massive meltdown as credit concerns and liquidity problems (think "bank run") led to a substantial recession with massive banking stresses worldwide. Sweden was the first country to realize negative interest rates, followed by Japan and

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several European Union (EU) countries. While not negative, U.S. interest rates have been low (at or below 2%) for several years.

Massive quantitative easings are ongoing in the EU countries and Japan, as the central banks continue to purchase government and corporate bonds. As a result, the worldwide monetary system has introduced a huge non-market driven distortion to the investment system with yields near or below zero. The bottom line is that, because of these distortions, many of the financial and investment models break down (see drawbacks described below).

WHAT ARE THE GOALS OF THE CENTRAL BANKS?

In their efforts to support the financial system, the central banks resorted to negative interest rates to motivate banks to lend and investors to step out on the risk spectrum to earn "reasonable" returns and yields. Cash holdings were meant to be discouraged. In fact, one of the stated goals of the central banks was to inflate financial assets to spur consumption. If wealth in general is increased, people will spend some of that new wealth. For example, if the value of one's house goes up 50%, then one could borrow against that new equity in the house and maybe do some remodeling or buy a boat.

While not widely acknowledged, another intended outcome was to devalue the country's currency in order to spur export growth. For example, if the Japanese yen devalues, the U.S. dollar would buy more yens and it would be cheaper for U.S. dealers to import Toyotas than before the devaluation. This spurs additional buying by U.S. dealers and increasing export growth in Japan.

WHY WOULD ANYONE ACCEPT A NEGATIVE INTEREST RATE?

That is a good question. For one, as noted above, if an investor believed that deflation was occurring, then even the reduced proceeds at maturity may be desirable. For example, in a deflationary environment, a new car costing 30,000 Swiss francs might be purchased in three years for 24,000 (a 20% price decline). Using the example above, a decline from 100 francs to 97 francs in three years (a 3% decline) would be substantially more valuable relative to the price of that new car. It would take fewer francs to buy that car in three years, despite the decline to 97 francs from the negative rate investment. Secondly, we acknowledge that most people do not want to own bonds with negative rates. This is one of the reasons there has been a scramble to find any positive earning asset, whether it be a corporate bond, preferred stock, or high dividend stock. Those that are buying negatively yielding bonds are either required to purchase them (e.g., European and Japanese banks), or are dealers who buy them for a short term trade, buying at one (negative) price and selling at a higher (more negative) price. Finally, the key factor is that the central banks are buying large amounts of bonds, and are insensitive to the yields, resulting in governmental monetary policies distorting "normal" investment markets.

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WHAT ARE THE LONG TERM IMPACTS FROM LOW AND NEGATIVE INTEREST RATES?

We see a number of drawbacks. Modern portfolio theory and various investment valuation models rely on an assumption of what a sovereign country's bond yield is (also known as the "risk free" rate, assuming a minimal chance that the government defaults). With the current near-zero or negative interest rates, many of the financial models fall apart. Is a negative rate a realistic "risk free" rate? These are the unknowns being introduced into finance and economics.

In addition, negative interest rates and a modest 1-2% inflation rate suggest significant negative real rates of return. That is, if inflation is 1.5% and the actual 3-year interest rate is -1%, then the investor is losing 2.5% in real value annually (-1% interest rate and 1.5% inflation combine to a net -2.5% impact). Basically, 100 Swiss francs invested today return 97 francs in three years (see example above), but they are also worth about 5% less at the end of the period. In three years, this investment may be only worth 92 francs in today's value. That's negative real returns.

Another result is that liquidity traps have become real, as many people look to "put cash under the mattress" in various different ways rather than borrow to invest or to consume. In an article published on April 18, 2016 on *Bloomberg*,[2] Simon Kennedy noted that, "Japanese families seem to have a sudden affinity for home safes. According to the Tokyo-based manufacturer [of safes] Eiko, shipments have doubled since last fall. And in Germany, insurer Munich Re has stashed some 10 million Euros

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($11.4 million) worth of its own cash into vaults. . . .”

Low and negative interest rates are rewarding the borrower rather than the saver/investor. This is making the issuance of debt attractive to borrowers in certain cases. Many corporations have borrowed large amounts of debt to purchase outstanding stock of their company or to purchase other companies. Ultimately, this debt does not underpin assets that foster future growth, such as investing in factories or R&D. Instead, we observe financial engineering in many companies. Mergers and acquisitions are spurred by cheap money. It is natural that a European multi-national company, which can borrow 10-year money at less than 2%, might have an interest in a U.S. or another European company, and, additionally, they might be interested at a higher valuation level than would normally be expected. The low borrowing cost allows the company to invest in a company that may result in a much lower return than would be expected under more “normal” conditions.

In the end, the added economic benefit of low and negative rates in terms of growth may prove minimal or nonexistent. These are uncharted waters. Whatever the outcome, economists will be studying these times and events for decades to come.

HOW DO WE INVEST IN THIS KIND OF ENVIRONMENT?

We remain flexible and opportunistic in this previously unchartered environment. With real returns near zero or negative, absolute (total) returns may become more relevant. How can we beat an anticipated 2-3% inflation level going forward? Bonds may provide stability at approximately the current inflation level, but any real returns are likely to come from stocks and other assets. A diversified portfolio of stocks, bonds, and cash, along with possibly other alternatives, should provide flexibility and opportunity to buy a portfolio that produces positive real returns. We believe our fundamental investment approach, with bottom-up stock analyses focused on intrinsic values derived from cash flows and earnings, should serve well in the next five to ten years, and will hopefully produce returns in excess of inflation levels.

Given the unknowns of today’s zero-and-negative-rate environment, the old adage of “risk vs. return” becomes even more relevant. The central banks are forcing investors to take on additional risk per degree of return. Our job is to determine whether the risk/return relationship makes sense given the specific situation each of our clients face. Over the past century, Clifford Swan has served clients through all market scenarios, and we continue to manage through the current financial environment. ◆

1 Durden, Tyler. “‘It’s Surreal’—Negative Yielding Debt Rises to Record $13.4 Trillion.” *ZeroHedge.com* 15 Aug. 2016.

2 Kennedy, Simon. “The Sub-Zero Club: Getting Used to the Upside-Down World Economy,” *Bloomberg.com* 18 April 2016.

MAKING WITHDRAWALS FROM IRA ACCOUNTS

By Carolyn S. Barber
CFA, CIPM, CIC

The purpose of this article is to describe IRA withdrawals for a typical retiree. It is not meant to be a comprehensive review of the subject, or to offer tax advice. Space does not permit us to discuss every type of IRA, nor do we claim to have the expertise to address every situation. We recommend that you consult your tax professional when planning for your IRA withdrawals. However, some of our clients have asked us general questions about IRA withdrawals, and this article is a response to their inquiries.

WHAT ARE IRA ACCOUNTS?

Many of our clients have retirement savings held in Individual Retirement Arrangements (IRAs). IRAs are tax-advantaged accounts that allow individuals to accumulate assets meant to be used in retirement. The two main types of IRAs are what the Internal Revenue Service (IRS) calls Traditional IRAs and Roth IRAs. Traditional IRAs include Contributory IRAs and IRA Rollover accounts.

Traditional IRAs are the oldest form of IRA account, created by legislation in 1974. In a Traditional IRA, you generally contribute cash on a pre-tax basis. In other words, you make additions from your wages and you are able to deduct the amount you contributed from your taxable income. The income and gains on the investments in your IRA are not taxed. There are limits to how much you can contribute, and the tax deduction is phased out for higher earners. IRA Rollover accounts are usually the result of transferring assets from another retirement account, such as a 401(k) or 403(b). IRA Rollover accounts may be a substantial part of a person’s retirement assets.

Roth IRAs were created by legislation in 1997. Roth IRAs differ from Traditional IRAs in a significant way. Contributions are made to a Roth on an after-tax basis. You don’t get a tax-

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deduction for the contributions to a Roth. As with a Traditional IRA, the income and gains in your Roth are not taxed. There are also contribution limits, and restrictions on contributions for higher earners.

WHAT ARE REQUIRED MINIMUM DISTRIBUTIONS (RMDS)?

The IRS warns, "You cannot keep funds in a Traditional IRA . . . indefinitely"

> "You must start making withdrawals from your Traditional IRA when you reach a certain age."

(IRS Publication 509-B). You must start making withdrawals from your Traditional IRA when you reach a certain age. The minimum amount you must take each year is calculated based on the value of your IRA account divided by a life expectancy figure from an IRS table. This amount is called your Required Minimum Distribution (RMD). There are severe penalties for not taking your RMD. You may have to pay a 50% excise tax on any amount that should have been distributed, but was not.

The magic age is 70 ½. You must take your first RMD by April 1st of the year after you turn that age. The value of your IRA on December 31st is used to determine the RMD. For most people, the life expectancy figure is taken from the Uniform Lifetime table. However, if your spouse is more than 10 years younger than you, and is the sole beneficiary of your IRA, a different table is used. It is the Joint Life and Last Survivor Expectancy table, which results in a lower RMD. The intention is to help the assets in the IRA last for both the IRA owner's lifetime and the lifetime of the younger spouse.

Required Minimum Distribution Illustration

Example	December 31st Value	Uniform Lifetime Table	Joint Life and Last Survivor Expectancy Table	Required Minimum Distribution
A	$1,000,000	27.4	NA	$36,496
B	$1,000,000	NA	35.1	$28,490

The above table shows two examples. The IRA owner is 70 ½ in both examples. In Example A, the IRA owner is single or the IRA owner's spouse is not more than 10 years younger. In Example B, the IRA owner's spouse is 50 years old.

The good news is that if an RMD is required, your IRA custodian "must either report the amount of the RMD to you or offer to calculate it for you" (IRS Publication 590-B). Also, you may withdraw more than the RMD without penalty after age 70 ½ if you wish to. The RMD is the minimum amount you must take.

> ". . . you may withdraw more than the RMD without penalty after age 70 ½ if you wish to."

HOW ARE RMD'S TAXED?

If all of the contributions to a Traditional IRA were made on a pre-tax basis, then the full amount of the RMD and any additional amount you withdraw are taxed as ordinary income. This is the case for most IRA owners. However, some IRA owners may have a combination of pre-tax and after-tax contributions. When that is the case, the RMD is taxed differently, and we recommend you consult with your tax professional to determine the tax treatment.

WILL YOUR RMD AFFECT YOUR MEDICARE PREMIUMS?

Medicare Part B Premiums are based on your Modified Adjusted Gross Income (MAGI). This includes all of your taxable income, such as pension income, dividends, interest, realized capital gains and your RMD. For calculating the MAGI, any non-taxable income, such as tax-free municipal bond interest, is added to your taxable income.

If your RMD is substantial, it may increase your MAGI enough that it results in higher Medicare premiums. The table below shows the current MAGI levels that impact 2016 monthly premiums, based on income (as reported on your tax return two years ago).

If you have a year when your RMD may have a material effect on your future Medicare premiums, we recommend that you talk with your tax professional about the issue.

YOU MAY MAKE A CHARITABLE CONTRIBUTION FROM YOUR IRA TO SATISFY THE RMD

One possible solution to avoid a high MAGI and high income related deduc-

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Monthly Medicare Premiums

Your Annual Income		2016 Premium Amount
Individual Tax Return	Joint Tax Return	You Pay
$85,000 or less	$170,000 or less	$121.80
$85,001 up to $107,000	$170,001 up to $214,000	$170.50
$107,001 up to $160,000	$214,001 up to $320,000	$243.60

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tion phase-outs would be to make a charitable contribution from your Traditional IRA. Assuming you are older than 70 ½, you may contribute up to $100,000 to a qualified charity. The contribution must go directly from your IRA to the charity. The contribution is counted as part (or all) of your RMD and is not included in your taxable income. However, you will not receive a charitable deduction for the gift. If you are considering making a charitable contribution from your IRA, please discuss the pros and cons with your tax professional.

YOU MAY TAKE WITHDRAWALS FROM YOUR IRA BEFORE AGE 70 ½

You may take withdrawals from your Traditional IRA without penalty if you are 59 ½ years old or older. The withdrawals are generally taxed as ordinary income. If you are younger than 59 ½ and take withdrawals, you will usually have to pay a 10% penalty on the amount withdrawn, in addition to the income taxes due.

There are a few exceptions that would allow you to take withdrawals without penalty even if you are not yet 59 ½. The general categories of exceptions are for first-time home buyers and to pay for qualified educational expenses, medical expenses and qualified reservist distributions. You may also take "substantially equal payments" over a period of years, based on certain criteria and not be subject to the 10% penalty. The rules for each exemption are quite specific. We urge you to consult your tax professional before making any IRA withdrawals if you are not yet 59 ½, in order to avoid the tax penalty.

HOW ARE WITHDRAWALS FROM ROTH IRAS DIFFERENT?

There are no RMDs for Roth IRAs. You may leave your assets in a Roth IRA indefinitely. If you choose to take withdrawals from your Roth, they are not taxed. However, there are the same penalties (and possible exemptions) for taking withdrawals before age 59 ½. In addition, there are special rules for taking withdrawals from a Roth IRA that was created by converting a Traditional IRA. The assets have to be held in the Roth for at least five years, and if there was more than one conversion there will be more than one five-year holding period. Please consult your tax professional before taking any withdrawals from a Roth IRA.

"There are no RMDs for Roth IRAs."

THERE ARE OTHER TYPES OF IRAS

In this article we did not address withdrawals from Inherited IRAs, SEP IRAs or Simple IRAs. Nor did we discuss withdrawals from a Traditional IRA held as an annuity. Each of these IRAs has its own withdrawal rules and penalties for non-compliance. Please consult your tax professional about withdrawals if you own one of these types of IRAs.

THE IRS HAS IRA RESOURCES

For those of you with an inclination toward doing your own tax research (you know who you are!), the IRS has several comprehensive publications on the topic of IRAs, which can be downloaded from their website, www.irs.gov.

- Publication 590-A "Contributions to Individual Retirement Arrangements (IRAs)"
- Publication 590-B "Distributions from Individual Retirement Arrangements (IRAs)"
- Publication 560 "Retirement Plans for Small Businesses (SEP, SIMPLE, and Qualified Plans)" ◆

FAMILY WEALTH: MENTORING THE NEXT GENERATION

By Linda Davis Taylor

Famous people often credit mentors with helping them succeed. For Oprah Winfrey, it was Mrs. Duncan, her fourth grade teacher. For Bill Clinton, it was his grandmother. For Mark Zuckerberg, it was Steve Jobs. For Warren Buffett, it was Benjamin Graham, another great investor and Buffet's university professor.

The original mentor was a character in Homer's epic poem, the *Odyssey*. When Odysseus, the king of Ithaca, went to fight in the Trojan War, he entrusted the care and teaching of his son, Telemachus, to Mentor. Since the days of ancient Greece, the role of a mentor has been to impart spiritual, social, and personal values to the young. For families, sharing knowledge with the next generation is just as important now as it was centuries ago.

The terms "coach" and "mentor" are often used interchangeably, but the two have different responsibilities. Coaching is about improving performance in a specific area by developing certain skills. It's short-term and focused. Mentoring helps someone prepare to take on new responsibilities, work in a new environment, or build confidence to continue to learn and grow. Mentoring looks further down the road. There's a place for both coaching and mentoring in families.

Noted family advisor James E. Hughes brings the concepts close to the context of family in his writings on the subject. "Mentoring is about asking questions not about giving answers.

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A mentor's questions should guide us to the deepest possible learning about ourselves. Successful mentoring is a dialogue where both parties learn something essential." This suggests a genuine partnership is formed. When looking for a mentor, it's smart to look within your family.

Families are awash in potential mentors. Parents, uncles, aunts, grandparents, cousins, or siblings can emerge at different times as the ideal wise counselor or teacher to guide a family member through an important phase. A mentor's role is crucial, but it isn't meant to be a permanent crutch. When the time is right, the mentee steps up to the new challenge.

Grandparents often have a head start on the job. They are eager to spend time with their grandchildren, and the younger set is inclined to listen. Mentoring between them can be as simple as offering to help with homework. Sharing family stories of earlier times can bring a routine history lesson to life in a new way.

If investing is a favorite topic, talking about companies and how stocks work can build money skills better than just handing over a check on every birthday. Grandkids might be surprised to know that their wise grandparents probably made a few bad calls along the way. There's nothing like the voice of experience.

Elders can continue to be mentors long after the basic lessons are mastered. The value of sound advice has no statute of limitations. Given the twists and turns and unpredictability of today's careers, hearing loving but firm words of counsel is valuable to family members of any age.

Our millennial generation is ready and eager to learn. Despite growing up with more connectivity than ever, today's generation between the ages of 18 and 33 is more isolated than the preceding one. Social networking platforms encourage quantity over quality where success, self-image, and relationships are concerned. It's all too easy to see life as a picture of happiness, even if the image is false. It takes more than editing one's profile page to make genuine progress.

If the members of the next generation need more advice and support as they make the transition to full independence, family members can be ideal resources. What makes the mentoring relationship so well suited to a family is that it's a process of mutual sharing. The mentor and the mentee learn together. And because members of the family have different needs at different times, the natural web of family is a fertile ground for both becoming a wise counselor and finding one.

Families provide many benefits. They offer love, sympathy, teaching and learning. Financial advice is a gift that money alone can't buy. *Save for a rainy day. A penny saved is a penny earned. The early bird catches the worm.* Often it's family members who pass on such pearls of wisdom. Translated into financial lessons, these "intergenerational communications" help build habits that defer gratification, build capital, encourage hard work, and instill a sense of appreciation for what has been earned and learned.

Trusted advice from a family mentor is a gift that money can't buy. Those are always the best kind.

Excerpted from the book, "The Business of Family" published in 2015 by Linda Davis Taylor. ◆

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WISDOM *for* GENERATIONS

MARK YOUR CALENDAR!

Clifford Swan Investment Counselors is pleased to announce a conference call for clients and friends of the firm on Thursday, November 3rd at 10 o'clock in the morning, Pacific Daylight Time.

Titled "Investment Manager Research and Due Diligence," the discussion will be led by investment counselors Max Pray and Lloyd Wong. They will talk about how we at Clifford Swan conduct due diligence and select outside managers for client portfolios in which third-party investments are appropriate. Call participants are invited to pre-submit questions for a Question and Answer session at the end of the call.

While further details will be provided closer to the date, please email Jennifer Loesch at jloesch@cliffordswan.com or call 626.792.2228 if you would like to be added to the attendee list now. ◆