Q3 2015 NEWSLETTER

Big Announcement for the Murphy's!

On September 21st my wife and I welcomed our first child into the world. Welcome Elise Marjorie Priest Murphy!

Clients have been very happy with the accuracy of results using the BizEquity tool for their business valuations.

Ashley Murphy named Adjunct Prof at GGU. As of the Spring 2016 Semester, I will be an Adjunct-Professor at Ageno School of Business, Golden Gate University.

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Wrap-Up of Q3 2015 Investment and Market Performance

The third quarter of 2015 was characterized by a sharp downturn, particularly in emerging and international markets, as well as a substantial loss in commodities. Though many factors were at play, we believe two main themes include:

1.The downturn of China's export-based economy and the subsequent effects it had on other countries.

Speaker panel at FPA in Minneapolis. In September I was featured on a panel of young, independent financial advisors discussing tips for working with Gen Y clients.

Australian CFP studies continue: I'm now several courses into my study for the Australian CFP. By the end of the next year, I'll be one of the few dually-qualified financial advisors to obtain the CFP qualification in both the USA and Australia.

Next Bay Area Visit:
December 9th - 12th

Upcoming: I'll be attending the Australian FPA conference November 17-19th.

2.The Federal Reserve's perhaps overly cautious approach to raising interest rates.

China

Developing economies reported a loss of -17.78% for the quarter. This number was brought down by China which suffered a -22% loss for the quarter. In July alone, Chinese stocks plunged by 15% on the back of a tremendous run-up in the first half of the year. July's losses frayed nerves that cascaded into August, greatly contributing to the turbulent month and quarter in global markets.

China, as the world's second largest economy and the largest importer of raw materials provided a knock on effect to other emerging commodity exporting countries such as Brazil. While that was a significant loss, we must not forget the astonishing 54% gain from the Shanghai Composite index achieved from the beginning of the year until June 12th.

The quarter began with frothy valuations leaving the markets vulnerable to a shock. That shock came in the form of an announcement by the Asian Development Bank that China's expected growth had slowed below 7%, the slowest rate since 2009.

Rising Interest Rates

The Fed stated their concerns that raising rates too soon could upset the economic recovery. Their rather pedestrian explanation was global market fragility, tame inflation data, along with an almost-interesting sidebar on decreasing starts in residential housing.

But on the other side of this coin lurks the possibility that failing to raise interest rates will create an over-stimulated economy that could lead to future inflation that would then need to be dealt with on a reactionary, perhaps panicked, front.

What is notable is the fact that the US economy continues to advance, even though there has been much resistance from a variety of global factors. For example, second quarter GDP increased by a strong 3.9%. This is possible in part due to the US' relative independence from foreign countries' economies; the reverse is far less true. This and many other factors lead the central bank to conclude that we are experiencing a stable economic growth environment, which is historically the primary condition under which policy tightening tends to occur. Because of this, it might not be unreasonable to expect that the Fed will raise interest rates in the coming months, as the central bank stated specifically that a hike would likely take place by the end

of the year. Nevertheless, it is also possible that the Fed may have missed its window with the soft economic data coming out of Europe and various emerging markets.

While it's arguable that the Fed has reason to justify their decision to hold rates, many investors are growing concerned that we're spending far too long in an artificial market environment, as it's been nearly a decade since we've had a rate hike. At this point, the central bank has waited so long that valuations are beginning to be dramatically skewed. Although rate hikes might very well increase volatility in the short-term, we must be vigilant in our efforts to create long-term, sustainable growth across the entire ebb-and-flow cycle of the market.

Marketplace Case Study: S&P 500 Index

Q3 2015 S&P 500

For the sake of historical perspective, the S&P 500 began the third quarter of 2015 with a value of 2,077.42 and closed the quarter at 1,923.82, resulting in the largest downturn since the credit downgrade of August 2011. The good news is that the index has already recovered substantially—127 points—from its lowest value of 1,867.61, which occurred on August 25th.

Although the S&P 500 seems to be getting a better foothold over the past few weeks, concerns over market volatility will continue to be front-and-center, as the value of the index hit both the lowest and the 2nd highest numbers of 2015, all within the span of about a month. And within just one week, from August 18th to the 25th, the value of the index plunged 230 points.

2000 - Q3 2015 S&P 500

Here are some other points of reference for the S&P 500 index:

- March 10, 2000 (climax of tech bubble) - **1,395.07**
- September 21, 2001 (lowest point following 9/11) - **965.80**
- March 9, 2009 (date recovery began) - **676.59**
- January 1, 2015 - **2,058.55**
- October 15, 2015 - **1,994.24**

Sector & Industry Performance

It would be easy to conclude that the last three months have also brought an overall decline in each sector's performance and that would've been accurate for all but one sector. Utilities saw a modest 2.56% (4.4% for Q3) rise for the quarter. Looking at longer term performances, we note that almost all sectors experienced tremendous growth over YTD, three-year, and five-year periods. Healthcare and Consumer Discretionary seem to be the front-runners of historical performance throughout the past five years.

In terms of a breakdown by industry, there were a few leaders that have had explosive growth YTD, as well as over the past three and five years. For example, the biotechnology and internet/catalog retail industries increased over 275% within the last five years, and gas utilities and health-care technology are both up nearly 200%. Also among the five-year performance leaders are health care providers/services at +165%, internet software/services at +160%, and building products at +155%.

Performance of Value versus Growth Stocks Since the Recovery Began

Since the Great Recession, we've seen a tremendous divergence between the performance of growth and value. Value investing had taken a backseat to growth due to the difficulty of identifying companies whose stock prices are underpriced when the markets have a severe downturn. In other words, it's hard

to find a diamond in the rough when everything is in the rough. It's been a much better bet to count on the growth prospects of companies who have observable track records.

Current Concerns & Risk Factors

As we move into the closing quarter of 2015, there are a few key risk factors that must be observed and monitored. These include geopolitical factors such as the enduring tensions with Russia, the Syrian crisis in the middle east, and the current status of US-China diplomacy.

One timely anecdote of the US-China tension was the warmth of hospitality displayed towards Chinese General Secretary Xi Jinping on his recent tour of the US compared with the UK in addition to the US sailing a destroyer within 12 miles of the reclaimed islands China has built in the South China Sea.

A Brief Commentary on the Enduring Bull Market

When you take a look at the last six and a half years since the recovery began on March 9th of 2009, you see a 158% increase in domestic equity indices and solid growth in global markets. The US has been the stand out performer internationally but with interest rates still at a zero-bound rate, may be likened to the least sick patient in the hospital waiting room.

The Schiller Cyclically Adjusted Price/Earnings (CAPE) ratio is standing well above its lifetime median of 16.01. At quarter end it stood at 25.79. It is likely these low interest rate conditions that have allowed price/earnings ratios to rise so high.

On Portfolio Diversification

It has been said many times that asset allocation is the only free lunch in the investment business. This recent spike in volatility reminds us of the pitfalls of an overly opportunistic stance on the market.

By exposing one's portfolio to a variety of different asset classes across a wide range of markets, investors can substantially improve the resilience of their portfolios.

We would be wise to accept volatility and build portfolios that can withstand the test of time. This is especially important as it takes a higher percentage of gains to offset respective losses. For example, if I'm trying to match an index and the performance of that index falls 10%, it will then require an 11.1% gain in order to net zero ($100-10%=$90 and you get 11.1% if you solve this equation: 90+90x=100.

Wrap-Up and Looking Ahead

The questions driving equity performance over the next six to twelve months are: Will the global economy improve? Will corporate earnings continue to advance? We say yes to both, and make the following points:

1. Equity bear markets typically occur when the economy falls into recession and corporate profits experience a pronounced decline. The odds of a global or recession are low, which means more upside potential than downside risk to the earnings outlook.

2. Despite recent market volatility, forward earnings expectations for U.S. companies have held up remarkably well.

3. U.S. retail sales have been increasing, which should lead to improved corporate earnings in the coming quarters.

4. We expect energy sector weakness to diminish over time, but commodity-related sectors and markets should continue to be weak spots for earnings.

The main risk to this outlook is the possibility of deteriorating U.S. or global economic conditions, which could significantly dampen earnings expectations. We may see some downgrades in the near term, but we think the outlook for corporate earnings is generally positive.

As such, we continue to favor equities compared to bonds or cash. Volatility is likely to persist and equity markets may continue to struggle until we see more clarity around Fed policy. Over the long-term, however, we think it makes sense to adopt overweight positions in equities, with a particular emphasis on non-resource-related, domestic sources of revenues.

We must be careful in our fixed income allocation and selection in the current rising rate environment.

References

RETURNS	3Q15
Domestic Stock Indices	
Large Cap	
S&P 500	-6.44
S&P 500 Value	-8.25
S&P 500 Growth	-4.83
Small Cap	
Russell 2000	-11.92
Russell 2000 Value	-10.73
Russell 2000 Growth	-13.06
International Stock Indices	
MSCI EAFE	-10.19
MSCI Europe	-8.66
MSCI Japan	-11.7
MSCI China	-22.67
MSCI Emerging Markets	-17.78
Real Estate	
NAREIT Index	0.99
Commodities	
Bloomberg Commodity Total Return	-14.47
Bond Indices	
Barclays Aggregate	1.23
Barclays 1-10 Year Municipal	1.32
Barclays U.S. Treasury	1.76
Barclays TIPS	-1.15
Barclays Investment Grade Corporates	0.83
Barclays High Yield	-4.86
Citi WGBI non-USD	1.71

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Home Equity Loans Versus Lines of Credit: What's the Difference?

Thinking of tapping the equity in your home to do a renovation, buy a second home, or consolidate debt? Before you decide which borrowing option is right for you, it's important to understand the main differences between the two options.

Home Equity Loan	Home Equity Line of Credit (HELOC)
Fixed interest rate for the life of the loan	Variable interest rate over the life of the loan
Repayment in regular installments over a specific period of time	Option to re-borrow as loan is paid, up to approved credit limit
Typically used for single large purchase, such as a car	Typically used to fund ongoing expenses, such as home renovations, borrowing only as needed
Entire amount of loan received upon approval	Checks can be written at any time, up to approved limit

Comparison Shop

Both types of credit are sometimes referred to as "second mortgages," because, like your first mortgage, they are secured by your property.

Home equity loans are fixed, installment loans. They work more like a mortgage: you borrow a determined amount for a specific term with a fixed rate of interest. Regular installment payments are made each month for a set amount. Once you receive the lump sum check, you cannot borrow additional funds.

HELOCs are revolving, borrow-as you-go arrangements. They act more like a credit card in that you borrow as you need the money and pay off your balance according to the interest rate being charged, which is variable, and the amount of credit you have used. The term of the credit line is determined by the lender and may be extended/renewed at the lender's discretion. Once the term expires, the credit line must be paid in full.

Both home equity loans and HELOCs must be settled with the lender if and when you sell your home.

Match the Type of Loan to Your Need

Generally, the choice between the two types of credit depends on your intended use for the money and your time frame for repayment. For instance, if you have a set amount in mind for a specific expense (a

wedding, a new septic system or roof) and you have no further foreseeable expenses, then a fixed rate home equity loan makes sense. If, however, your needs are more open-ended, such as -- a major home renovation that will span a year or two, or to supplement a child's college tuition each year for the next four years -- then the more flexible HELOC could be the better option.

Used for Debt Management

Perhaps one of the most popular reasons homeowners tap into the equity in their homes via a loan or a line of credit is to consolidate credit card debt. While recent conditions in the housing market may have deterred some from considering this option, home equity is GENERALLY SPEAKING one of the lowest cost loan options; and unlike credit card debt, the interest paid on home equity loans and HELOCs is tax deductible.

To learn more about tapping home equity, or to access current rate tables, visit a consumer-oriented website such as bankrate.com. To be put in touch with my recommended mortgage brokers, please feel free to contact me.

Of Market Bubbles and Busts: Learn to Spot Trouble in the Making

Recent stock market conditions in China present a classic illustration of the boom/bust cycle that periodically disrupts financial markets. While bubbles and subsequent busts occur in the investment world from time to time, there are typically some telltale signs to help investors recognize when there is trouble brewing.

When is a Bubble a Bubble?

Most investors now agree that the U.S. stock market boom of the late 1990s — particularly the boom in technology stocks — represented a classic bubble. That cycle saw the NASDAQ Composite index grow more than 200% between February 1997 and February 2000, and then fall 66% by August 2002.[1] But at what stage was it considered a bubble? In 1996, Alan Greenspan famously accused investors of "irrational exuberance," yet markets went on to score strong gains for three more years. Investors who heeded Greenspan's warning at the time would have missed out on one of the best performing periods in market history. But they also would have avoided the subsequent bust. The key, of course, is timing.

While even the experts cannot time markets, there are some warning signs that may point to a bubble in the making:

- **High valuations:** When valuations, measured by P/E ratios, rise significantly above their long-term averages, it should raise concern. Over the long term, valuations tend to revert to the mean.
- **Disconnect with fundamentals:** In general, a company's stock price is based on its sales, earnings, financial strength, and future prospects. When these fundamentals go in a different direction from prices, it should wave a red flag.
- **Hype:** Beware whenever you hear the words: "This time it's different." Those who lived through the tech bubble in the late 1990s may recall "the new paradigm" that was often cited by hawkers of overpriced stocks.

Of course recognizing a bubble in the making is the easy part. Determining when it is about to burst is a different story. For long-term investors, the important point is to put performance in perspective and know that sharp increases in prices, in aggregate, are generally not sustainable over longer periods of time. We will keep our eyes firmly trained on these fundamentals and provide our best effort to spot these bubbles in the making.

Source/Disclaimer:

[1] Wealth Management Systems Inc. and Yahoo! Finance Interactive Charts. For the periods indicated. The NASDAQ Composite Index is a broad-based, market-capitalization-weighted index that includes all domestic and international based common stocks listed on the NASDAQ Stock Market including many of the world's top technology and Internet stocks.

Do Alternative Asset Classes Belong in Your Portfolio?

'Alternative investments' are often defined not by what they are, but by what they are not. According to the academic literature, the only two core, traditional asset classes are stocks and bonds. Using this discourse, anything outside of these asset classes is considered alternative.

While some investors may equate alternative investments with the high-risk/high-return vehicles that garner the lion's share of media attention (especially when they fail), research suggests that adding carefully selected alternative investments to a diversified portfolio of traditional stocks and bonds may materially reduce the overall risk of that portfolio without materially affecting expected returns.[1]

What Is Considered Alternative?

Some broad categories of alternative investments are:

- Private real estate: real estate purchased directly through property pools, commingled real estate funds (CREFs), syndications, or separate accounts.
- Natural resources and commodities: investment strategies intended to track the value of raw materials such as oil and gas, timber, metals, minerals, and grains.[2]
- Hard Money Lending: higher risk/return loans offered for construction and development. Typically organized as a Limited Partnership.

General Benefits

One general benefit of alternative investments may be a low correlation to public stock and bond investments, hence their potential to enhance portfolio diversification and reduce risk. Another potential benefit is the access investors might gain to specialized management expertise. On the negative side of the equation are limited liquidity, limited transparency, and high fees.

Lessons in Liquidity

One of the most important factors investors need to consider before adding an allocation to alternative investments is the issue of illiquidity. Some alternatives require investors to commit their capital for an extended period (up to five-to-seven years or more).

For those who don't have the time or patience to wait out an investment for an extended period, there are alternative investments that can offer liquidity. For example, publicly-traded real estate investment trusts (REITs) provide a simple and transparent means to invest in real estate with daily pricing and trading options.[4] In addition, some exchange-traded funds specialize in energy and commodity investments rather than commonly listed stocks and bonds.[5]

Let's talk further if you're interested in learning more.

Source/Disclaimer:

[1] Past performance is no guarantee of future results. Investing in stocks involves risks, including loss of principal. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

[2] Exposure to the commodities market may subject investors to greater volatility as commodity-linked investments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity. Investing in the precious metals sector involves special risks, including those related to fluctuations in the price of precious metals and increased susceptibility to adverse economic and regulatory developments affecting the sector. It may also be subject to the risks of currency fluctuation and political uncertainty associated with foreign investing.

[3] Hedge funds often engage in speculative investment practices that may increase the risk of investment loss. Hedge funds can be highly illiquid; are not required to provide periodic pricing or valuation information to investors; may involve complex tax structures and delays in distributing important tax information; are not subject to the same regulatory requirements as mutual funds; and often charge high fees.

[4] The stock prices of companies in the real estate industry are typically sensitive to changes in real estate values; property taxes; interest rates; cash flow of underlying real estate assets; occupancy rates; government regulations affecting zoning, land use and rents; and the management skill and creditworthiness of the issuer. Companies in the real estate industry may also be subject to liabilities under environmental and hazardous waste laws which could negatively affect their value.

[5] Exchange-traded funds (ETFs) are subject to market risk, including the possible loss of principal. The value of the portfolio will fluctuate with the value of the underlying securities. ETFs trade like a stock, and there will be brokerage commissions associated with buying and selling ETFs unless trading occurs in a fee-based account. ETFs may trade for less than their net asset value. Additional risks of ETFs include lack of diversification, price volatility, competitive industry pressure, international political and economic developments, possible trading halts, and index tracking error.

Business Succession Issues: Understanding Buy-Sell Agreements

Running into financial troubles isn't the only reason that some closely held businesses fail to succeed. Their untimely demise may result from the lack of a formal plan regarding the orderly succession of management and ownership of the business. Such a plan frequently incorporates a buy-sell agreement as the tool for ensuring that the business will continue even after the departure, death, or disability of an owner.

To head off future problems, it pays to understand the uses and structures of these agreements. Although they can be adopted at any time, it is best to decide whether to put a buy-sell agreement in place as early as possible in the life of a business.

A buy-sell agreement is a legal document allowing the remaining owner(s) to acquire the interest of a withdrawing shareholder or partner due to a specified event. The agreement usually restricts an owner's ability to transfer his or her interest and sets out the terms under which another owner or the business entity may acquire the departing owner's interest.

A buy-sell agreement can anticipate situations that could imperil the business or be harmful to owners and key employees. For example, it can be used to prevent unwanted outsiders or heirs from obtaining an ownership interest. It can prevent the continued involvement of retired or inactive shareholders or partners. It can ensure the legal continuation of the entity should an owner become bankrupt or lose a required professional license.

Among its benefits, a buy-sell agreement creates a marketplace for the shares of a closely held business, helps ensure that departing owners will receive adequate compensation, and provides cash to pay estate taxes and settlement costs for surviving heirs, if applicable. In fact, fixing the value of a business or establishing a procedure for valuing it in the future addresses one of the most important issues facing a closely held business. An agreement can also help increase job stability for minority owners and non-owner employees critical to the success of the business.

A buy-sell agreement can be triggered by a variety of events. In addition to the death, disability, or retirement of an owner, other possible triggers may include an attempt to dissolve the entity, an irresolvable conflict among owners, or an owner's desire to sell his interest.

There are generally two basic types of buy-sell agreements:

> **Cross-purchase:** Each owner enters into an agreement with every other owner. This approach becomes cumbersome if more than three or four individuals are involved. For example, 64 separate agreements would be required for eight owners.
>
> **Entity-redemption:** The business itself enters into an agreement with each owner and is obligated to buy the shares of a departing owner.
>
> A third type, or so-called Hybrid plan, is essentially a combination of the cross-purchase and entity purchase. This approach allows the entity and its owners to delay a purchase decision until a triggering event occurs. The entity typically has the first right of refusal for purchasing the shares of a departing owner.

Life insurance is the most popular funding mechanism for buy-sell agreements. Life insurance is unique in that it creates immediate funding in the event of death, while allowing tax-deferred cash to build up over time. In a cross-purchase plan, each owner buys and maintains a policy on every other owner in an

amount sufficient to cover the insured's ownership interest. In an entity arrangement, the business purchases the insurance policy on each owner and the business is the beneficiary.

Besides life insurance, other less popular but potentially effective funding mechanisms include cash flow, asset sales, loans, promissory notes, sinking funds, and reserves.

Tax and Estate Planning Considerations

Tax consequences are an essential consideration in determining whether to utilize a buy-sell agreement and how to structure one. This process involves evaluating the benefits and drawbacks of each type of arrangement in relation to the specific situation. For example, a cross-purchase agreement offers shareholders a stepped-up basis on stock acquired in a buyout, and there are no alternative minimum tax (AMT) consequences if the business has C corporation status.

On the other hand, the cash value of any life insurance owned by the decedent that insures the life of another owner under a buy-sell agreement is includable in the decedent's estate, which may affect estate taxes. Secondly, federal law precludes using a buy-sell agreement as a discounted giving technique.

Moreover, buy-sell agreements may be problematic for individuals looking to pass their business on to other family members if the agreement sets a price that is less than the fair market value of a deceased owner's stock. If that were the case, then not all of the stock passed on to the surviving spouse may qualify for the marital deduction. In addition, a child named in a buy-sell agreement who elects not to purchase a deceased parent's shares may subject the surviving parent to gift taxes for the shares the child did not purchase.

An entity purchase plan has tax ramifications for the business itself. While death benefits are received tax free, life insurance cash values and death proceeds may result in corporate AMT. Also, insurance premiums are not a deductible business expense nor is a step-up in basis provided to the surviving partners who buy the deceased’s shares.

As this overview suggests, buy-sell agreements have many potential advantages. Among others, they can reduce conflicts, create a marketplace for shareholdings, and assure customers, suppliers, and employees that the business will continue. However, their complexities must be assessed, and agreements must be carefully crafted to address needs of the business, its owners, and their heirs. Input from qualified insurance, legal, and tax professionals is essential before entering into a buy-sell agreement.

Points to Remember:

- A buy-sell agreement spells out what will be done with — and funds the transfer of — the ownership interest in a closely held business in the event of the death, disability, or withdrawal of an owner or partner.
- A buy-sell agreement can reduce disputes among those involved in a closely held business, as well as ensure the continuity of the business, by providing a fair process that protects departing owners, remaining owners, and the business itself.

- A buy-sell agreement may be structured as a cross-purchase, entity purchase, or hybrid purchase plan. The choice of structure depends on the number of owners involved, as well as tax, estate planning, and other concerns specific to each situation.
- Life insurance is the most popular mechanism for funding a buy-sell agreement. The structure of the agreement determines whether individual owners or the business entity purchase the policies and receive their proceeds.
- Legal, tax, estate planning, and insurance professionals familiar with buy-sell agreements need to be consulted before deciding whether to employ an agreement and which structure it should use.

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