FAIRPORT ASSET MANAGEMENT
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The Compass
Wealth management tips, trends and articles that provide confident navigation for high net worth clients.

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Mid-Quarter Outlook
By John M. Silvis, CFA
Chief Investment Officer

As we hit the halfway mark on the second quarter of 2014, the international equities markets have fared better than the U.S. markets year-to-date. The MSCI ACWI Index, a global equity benchmark, has a current return of 2.33%, slightly outpacing the S&P 500 Index, which returned 2.02% so far this year. Like riding a new rollercoaster at Cedar Point, there have been more than a few surprising dips along the way. As we mentioned at the beginning of the year, we thought volatility would rear its ugly head again in 2014 after taking the last two years off. Even with the market swings, the S&P 500 Index has reached new highs nine times so far in 2014, with the most recent happening this week as it pierced 1,900. Strap in and stay focused – we are just getting started.

The U.S. economy was dealt a blow by the weather in the first quarter of 2014, with the initial reading of Gross Domestic Product (GDP) coming in well below the consensus at 0.1%. When all is said and done, growth in the first quarter may be revised down further (we will get a revised number on the 29th of the month), showing a contracting economy to start out the year.

Focusing on the future, all indications are pointing to a stronger second quarter, with the average growth forecast of 3.3% from Bloomberg's survey of economists. The current forecast is being driven by better economic activity, which could, in part, have been pushed forward due to the bad weather. The employment picture is definitely getting better, as 288,000 jobs were created in April and the unemployment rate dropped to 6.3%, the lowest in several years. Another encouraging sign over the last six weeks has been the decline in the Initial Unemployment Claims (the number of new people who sign up for unemployment for the first time) which dropped below 300,000 for the first time since November of 2007.

Industrial production is also ramping up as the year goes on with both higher capacity utilization numbers and a rising Purchasing Managers Index (PMI) in the past two months. After a slow start due to the weather (I know it is redundant), auto sales rebounded in April with an annualized rate of over 16 million cars. With an aging fleet on the road, we should see more improvement in auto sales as the year unfolds. Leading economic indicators are pointing to better prospects ahead and further improvement from a dismal first quarter.

Monetary policy remains accommodative under Fed Chair Yellen, as the Federal Reserve continues to taper their bond purchases, lowering it to $45 billion at the last meeting. Any talk of interest rate hikes is likely premature, as the Fed will pause for several months after ending the current quantitative easing program later this year. The fiscal health of the country continues to improve, as the current budget deficit will decline from last year and likely finish below $500 billion (that sounds like a big number, but it was over $1.5 trillion a few years ago).

The bottom line is, the consumer's net worth has increased to new highs due to rising home values and an increase in retirement account values due to the equity markets over the last few years. This has caused consumer confidence to rise and should help lift our economy (approximately 70% of GDP is consumer driven) in the coming quarters. Employment is at an all-time high and banks are lending again, pointing to better prospects ahead.

Fairport Large Cap
Even as the markets reach new highs, there has been a battle taking place within the Large Cap space between the cyclically based sectors of the market (Technology, Industrials and Consumer Discretionary) and the less volatile defensive sectors (Utilities, Healthcare, Consumer Staples and Telecom). While the defensive names, with their higher dividends, have had the upper hand, as rates decline and investors search for yield, we could see a new risk-on environment take shape in the coming weeks. Better economic data tends to benefit the more cyclical sectors of the market. As earning season winds down, companies within the S&P 500 have seen earnings rise nearly 6% over last year, beating analyst estimates over 60% of the time. We continue to see better earnings in the quarters ahead, which should drive M&A activity for the remainder of the year. The research firm ISI Group recently calculated over 165 deals already this year, totaling almost $1.5 trillion.

If there has been a weak spot this year in the domestic equity markets, it would be the poor performance of Small and Mid-Cap equities. The Russell 2000 Index, a small cap benchmark, has seen a negative return of -5.40% so far this year. A lot of the underperformance can be attributed to the pullback in momentum stocks like biotech and internet companies. We would maintain an allocation to both asset classes.

Fairport Global Asset Allocation
Across the pond, Europe continues to produce less than stellar economic growth while it wrestles with the escalating conflict in the Ukraine. There is a fear that a prolonged dispute could have ripple effects on their already anemic growth. ECB President Draghi has indicated that further monetary stimulus may be needed and would likely take place in the coming months. This should help support their equity markets over the short term, while fundamentals within Europe improve with companies in much better shape than a few years ago. Japan, on the other hand, saw their economy grow at 5.9% in the first quarter, far outpacing the estimate of 4% by most economists. Much of the growth can be credited to shoppers getting out and spending before an increase in the value-added tax took effect in April. The long term effects of the increase could see slower growth going forward. We remain cautious on Japan.

On the emerging market front, all eyes are on China and their official GDP growth target of 7.5%. It is likely that the economy will come up short of its goal and officials will need to lower estimates in the coming months. That should have a negative effect on commodity prices, as well as those countries that provide materials to China. Both India and Brazil are holding elections this year (India's will conclude this week) which will affect the direction of their equity markets. Brazil is struggling to contain inflation while ramping up for the World Cup and the 2016 Summer Olympics. Some are starting to question if they can pull it off and not harm one of the world's biggest economies. The MSCI Emerging Market Index has recovered from a slow start this year, with a return of 3.37% year-to-date. We are waiting for confirmation that the emerging equity markets are forecasting better growth ahead before we add new resources to the asset class.

Fixed Income Commentary
U.S. Treasury yields continue to grind lower and are trading within shouting distance of the bottom of our expected trading range (2.40% to 3.00%). At 2.50%, 10-year Treasury yields are now some 50 basis points below where we began the year. Some of the primary factors which have recently influenced rates include: (1) uncertainty regarding the pace of economic growth in the second quarter; (2) a flight-to-safety trade spurred by geopolitical events in the Ukraine; and (3) on a relative basis, Treasuries look attractive when compared to other developed market debt (e.g., 10-year German Bonds and French debt are currently yielding only 1.32% and 1.78%, respectively).

To the surprise of many, fixed income returns continue to outpace equities year-to-date, with Barclays U.S. Aggregate returning 3.58%. Performance has been broad based across sectors with municipals, investment grade corporates and high yield bonds returning 5.71%, 5.32% and 4.19%, respectively. Taking into consideration the current starting level in rates, along with the fact that many fixed income sectors are trading near all-time tights in terms of spread, we remain tactically underweight the asset class with modest return expectations going forward.

John Silvis named Chief Investment Officer

We are pleased to announce the promotion of John Silvis to Chief Investment Officer. Since joining the firm in 2000, John has been a significant member of our Investment Team. As the leader of the Investment Team, John launched our ETF/mutual fund platform, was responsible as the architect of our current Global Asset Allocation platform and, with Rick D'Amico, developed our Liquid Alternative investment offering. John is a CFA charter holder and he currently serves on the Benjamin Rose Institute Investment Committee. He is active on the Board of the CFA Society Cleveland, where he is currently Treasurer and Chairman of the Investment Committee.

Please join us in congratulating John on this well-deserved honor!

Estate Planning in Light of New Legislation
By Thomas A. Seifert, CPA/PFS
Partner

As the federal estate tax exemption is currently set at $5,340,000 per taxpayer ($10,680,000 for couples) with annual increases for inflation, most individuals will not be subject to federal estate tax. In addition, there is now the concept of "portability" in which any unused exemption from the deceased spouse can now be carried over to the surviving spouse and used to make gifts or to reduce taxes at the second death. Another positive change is that Ohio has completely repealed its estate tax. As such, much of the estate planning that was required is no longer necessary and might actually be counterproductive. For the majority of taxpayers, estate planning has shifted from estate tax savings to income tax savings.

For many married taxpayers, the traditional AB (also referred to as a Bypass or Credit Shelter) trust design needs a make-over. Traditional AB trust designs might incur higher income taxes after the first death and reduced basis increase at the second death. However, new trust designs being developed by estate attorneys can mitigate against this risk, as well as provide for the many "non-tax" advantages of having assets in trust (such as asset protection, asset management and restricting the transfer of assets by the surviving spouse) over outright bequests. Also, these new trusts could provide flexibility, should there be future changes in estate tax laws and asset values.

These new trust designs might use the basic AB trust construct, but add a formulaic approach to some of the benefits and powers that the surviving spouse might be afforded. For example, under certain circumstances, the trust document may give the surviving spouse a general power of appointment over some or all of the assets in the credit shelter trust established at the first spouse's death. The surviving spouse would have this power should there be (1) appreciated assets in the existing trust and (2) if inclusion of these assets in his or her taxable estate would not cause an estate tax liability. This general power of appointment will cause estate tax inclusion over the appreciated property that is subject to it, thereby providing a step-up in basis to such extent. This basis step-up will reduce capital gains incurred by the beneficiaries upon sale of the inherited assets. Additionally, language can be added to the trust document so that the beneficiary of the trust (surviving spouse) is treated as the owner of the trust for income tax purposes, even if no income is distributed to him or her (this adds another layer of complexity, but may be warranted in certain circumstances). This would mitigate the fact that trust income is taxed at the highest tax rate (39.6%) at only $12,150 of income. Individuals do not hit that rate until over $406,750 of income (married couples over $457,600).

In summary, these new trust provisions offer all of the benefits of a traditional AB trust design, while largely avoiding the potential basis and income tax concerns.

It is understandable that these nuances and concepts are difficult to grasp, but for those individuals with taxable estates under $10.68 million, this is a "call to action" for you to discuss this matter with a member of your Fairport team and/or your estate attorney.

Fairport Moves to Theater District in June

We are excited to announce that, as of June 16th, Fairport's office will be located in downtown Cleveland. Our new office will be housed in the U.S. Bank Building at the corner of Euclid and East 14th in the heart of the Playhouse Square theater district.

We are confident that the new space will enhance the client experience with its welcoming design, casual meeting rooms and reserved guest parking in attached garage. Additionally, the location provides increased opportunities to more closely collaborate with clients' tax, legal and other professional advisors, most of whom have offices downtown.

The new location at 1350 Euclid Avenue was chosen due to clients' familiarity and comfort with the theater district, highway access and centralized location for the firm's 24 employees. The decision was cemented by the opportunity to have a front row seat for the neighborhood transformation project. Click here to read more.

Fairport News

Fairport believes in supporting the community as a company and through encouraging employees to participate and hold leadership positions in professional, charitable and community organizations. Read about our new designations, recent accolades and community involvement.

Ken Coleman joined the Greater Cleveland Partnership Government Affairs Council.

Pete DeVito was re-elected to his second term as Treasurer for Merrick House.

Jan Havener has been asked to serve on the Board of Lake Erie College. Located in Painesville, Ohio, Lake Erie College provides an environment that stimulates intellectual curiosity, personal development and community involvement to prepare students to succeed as practitioners, professionals and responsible citizens in a contemporary world.

Aaron Nuti has achieved the Chartered Alternative Investment Analyst (CAIA) designation.

CAIA is the only professional designation entirely dedicated to alternative investments. Aaron recently passed the second and final exam requirement necessary in order to be recognized as a CAIA designee. The CAIA exam(s) require a comprehensive understanding of core and advanced concepts regarding alternative investment instruments, structures and ethical obligations.

Congratulations, Aaron!

Emily Shacklett has been appointed as the Chair of the Food, Beverage and Service Committee at the Union Club.

Fairport Continuing Education

Fairport employees frequently attend conferences, continuing education seminars and informational webinars to keep up-to-date with new strategies and industry trends relating to the wealth management needs of our clients. From investment management to client service to technology, read more about the conferences we've recently attended.

Rick D'Amico attended J.P. Morgan's 2014 Wealth Management Summit in New York City. This exclusive, invitation-only event allows attendees to interact with some of J.P. Morgan's most senior investment professionals, while also networking with peers.

Kristen Lucas and **Lindsay Suster** attended the 9th annual YWCA Cleveland Women's Leadership Conference. The conference theme was "The Innovative Leader" and featured nationally acclaimed keynote speakers, powerful breakout sessions, book signings, vendor marketplace and a chance to network with hundreds of professional women.

Tom Seifert and **Pete DeVito** attended the Smith & Condeni Select Strategies for Insurance and Estate Planning Conference.

John Silvis kept current on investing trends by attending the Inside ETF conference in January, the Schwab Investment Symposium and First Trust Investor Symposium in April and the Blackrock Investment Forum in May.

Newsletter Disclosures

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