The Economy and Markets:

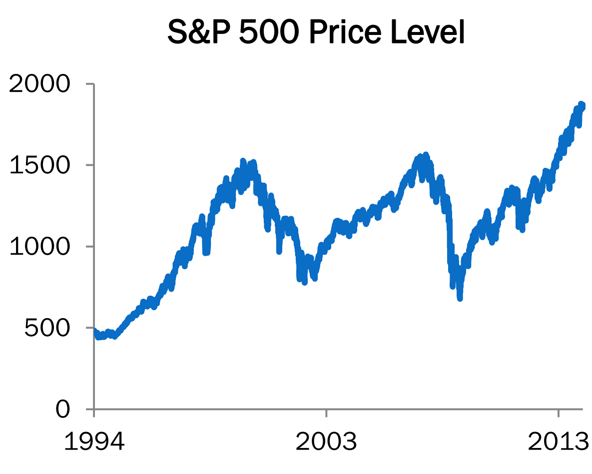
U.S. financial markets appear healthy. The stock market as a whole has been doing very well, with the S&P 500 closing on March 31 at a level of 1,872.34. The Price-to-Earnings ratio (the "PE ratio") of the S&P 500 (averaged from its constituent stocks) is 19.84, which is a bit on the high side for my buying preference, but not terribly so. This measure is commonly used to determine how "expensive" the stock market is. The average PE ratio for the S&P 500 since 1981 is 20.92. It is worth noting that the VIX, which is a measure of the volatility of the S&P 500 and commonly referred to as the "fear index" is relatively low at 13.88% at the end of March (its average since 1990 is 20.14%). I tend to prefer to invest counter-cyclically to this measure – I'd ideally prefer to invest when the world is fearful. On balance, I'd say you face a relatively "typical" risk profile when entering the equity market at this time.

Markets at a Glance (March 31, 2014)	
S&P 500	1,872.34
Dow Jones	16,457.66
10 yr. U.S. Treasury	2.72%
3mo U.S. Treasury	0.05%
GDP Growth (last quarter)	2.6%
Unemployment Rate	6.7%

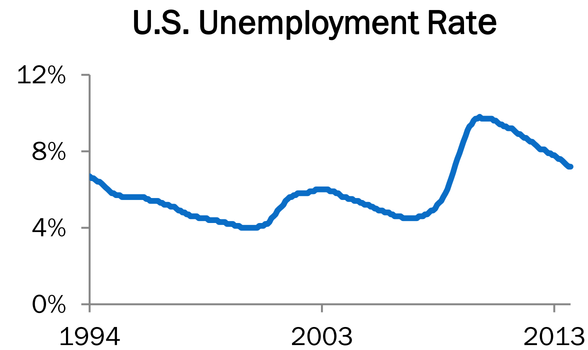
The recent major political disruptions of markets, most notably threats by public officials that the United States may not honor its debts, appear to have subsided. If this stays this way, it will have a buoyant effect on asset markets, as the uncertainty created by political risk reduces asset prices.

As of March 31, the 10-year U.S. Treasury yield is 2.72%. This is a very low level, meaning consumers are able to borrow very cheaply. It is relatively bad news, however, for individuals trying to save. Safe investments are rewarded with historically low yields at the moment.

At the end of the first quarter of 2014, the real U.S. economy appears to be in relatively good shape. As the unemployment rate of 6.7% provides an indication, the labor market in the United States is still struggling a bit. However, as can be seen in the figure provided on the next page, this unemployment rate is steadily improving. Indeed, the major concern at this point is primarily the "long-term" unemployed, as these individuals are very difficult to place into a new job. Losing them from the workforce permanently damages the production possibilities in the United States. Concern about the labor market is the primary reason the Federal Reserve continues to keep interest rates at historically low levels. Current forecasts are that the Fed will continue to do so until the middle of 2015. It would not surprise me if they continue to do so even longer. However, it should be noted that with the appointment of a new Federal Reserve Chair in Janet Yellen, there is increased uncertainty about the future actions of the Fed.



Despite the extended period of low interest rates, inflation appears to be tame. Using the Consumer Price Index (CPI) change as a measure, 2013 exhibited inflation of 1.5%, and 2014 appears to be running a bit below that mark. It is these low inflation rates that lead me to believe that the Fed can keep rates low without igniting inflation, at least at this time.



Quarterly Special Topic:
The Nonsensical U.S. Retirement System
(and why it should infuriate you)

The 401(k) was invented, in 1978, largely by accident. It is named after the subsection of the IRS code that defines it. Originally, this section of code was intended to limit the amount of cash-deferred compensation to which highly paid executives had access. In the early 1980s small changes were made to the code that allowed the form of the 401(k) that we see offered by companies today. In 1979, 84% of workers that participated in their firm's pension plan had access to "defined benefit" plans, and 16% had only "defined contribution" plans to choose from, such as 401(k)s. By 2011, 69% of such participants had access only to 401(k)-style plans. What are the implications of the largest economy in the world designing its pension system by accident? The biggest implication is that the risk of funding retirement has been shifted from companies to their employees. The risk borne by retirees is significant, and terribly inefficiently allocated. Consider some simplified numbers. The median household income in the United States in 2012 was $51,324. This is about how much is earned annually by such professions as family therapists, crane operators, electricians and steel workers. The most common "rule of thumb" of investment advisors is that you should spend no more than 4% of your retirement nest egg each year in order to make it last as long as it should (this is an imperfect rule, but we are just using rough numbers here). So, in order to retire and replace its income, the median household in the United States should save $1,283,000.

There are very, very few family therapists, crane operators, electricians or steel workers that can manage a $1.2 million portfolio efficiently. They simply haven't been trained for it. In 2008, the S&P 500 lost almost 40%. How many hundreds of thousands of retirees were a year or two from retirement, right on track having accumulated, say $1 million - and then lost almost $400,000 of it in one year? Responsible portfolio specialists managing a pool of retiree risk would likely have hedged this risk to a large extent. The losses wouldn't have been nearly as great. Further, as professionals they would (hopefully) not have exhibited the documented behavior so often shown by academic studies to be exhibited by individual investors – the tendency to reduce stock holdings at market bottoms, missing the subsequent upswings. For those keeping score, a household with $250,000 in income would need $6.25 million to replace their income at retirement. A 40% hit would result in a loss of $2.5 million.

The political pressure to keep the existing system is great. Wall Street contributions to political activities totaled in the neighborhood of $200 million in 2012. Pundits care who this money went to, but that is completely beside the point. It went to both major parties in large sums. Why is this important? The median 401(k) expense ratio is about 1.4% (the asset-weighted average is lower). Consider the median retired electrician-headed household that managed to navigate the turbulent waters above and amass $1.283 million. Every year, their 401(k) charges them, on average, $17,962 - this, for a portfolio that generates $51,324 per year. So the electrician pays almost 35%(!) of their retirement income annually to Wall Street firms that run their 401(k). If they roll those assets into an IRA, and then hire a financial adviser to do the job, the cost is almost as steep, if not more. According to a recent Forbes magazine article, the average commission-based financial advisor charges 1% of assets. For our electrician, that's still $12,830 a year, or about 25% of the income generated by the portfolio. And that is assuming that none of the investments recommended by the financial advisor are mutual funds, which is highly unlikely. $200 million in political contributions in protection of the financial community's ability to siphon off up to 35% of U.S. retirement income is a likely reason why you've heard nothing from politicians about the reform of this system, despite its obvious faults and the terrible state of Americans' retirement finances.

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