

# K M S

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## A New Oil Paradigm Shuffles the Deck

Twice in three years we've featured the U.S. renaissance in oil and gas production. Now a plunge in oil prices is feeding consumer pocket-books and reshuffling the economic and strategic cards across the globe.

OPEC's recent decision to sustain current production levels looks like a high stakes game of chicken. These countries produce 40% of global oil but failed to anticipate the magnitude of the U.S. production surge – up 80% in six years. That *increase* is greater than the output of every OPEC country except Saudi Arabia. And it has coincided with recovering production in some previous trouble spots just as economic activity appears to have stalled in some key corners of the world.

This is a decidedly different dynamic from the well-worn story of tight oil supplies and rising demand from China and other emerging economies. Now exporters strategize to hold market share and see who'll be able to keep the crude flowing if prices slip lower. Current levels may curtail some higher-cost production, but the U.S. surge is proving resilient, and technology moves on. The International Energy Agency (IEA) estimates that just 4% of U.S. wells need oil above \$80 per barrel to be profitable. Some sources believe most shale oil and Canada's tar sands can be economic even if oil approaches \$50 per barrel.

Meanwhile, some key OPEC members – notably Venezuela and Iran – are stressed. Russia is not in OPEC, but oil generates 40% of its state budget. The ruble has tumbled along with oil, boosting the cost of Russia's heavy dependence on imported food and consumer goods.

Regions that are heavy oil *importers* are getting a welcome break. This includes much of the Eurozone

and Japan, both of which have been flirting with recession. There are a number of beneficiaries across Asia, including China and especially India, which imports about 85% of its oil. Lower prices are a timely counter to the subcontinent's chronically high inflation and heavy government energy subsidies.

For the U.S. the broadest benefit is to consumers, but industry gets a cost break as well. Oil and gas *producers* face more challenging economics, especially those carrying significant debt. But the U.S. is still

the world's most diversified, highly integrated economy, and it's hard to see how a big energy cost cut can be anything but net positive.

Any analysis of the new energy paradigm starts and ends with the fact that oil is, well, fluid. The IEA pegged third quarter demand at 93.06 million barrels and production at 93.62 million – an oversupply but not a vast oversupply. Eight years ago, with oil near current levels, we ran a piece titled *Oil Prices Could Go Either Way, and Surely Will*. Since then oil has fetched as much as \$150 and as little as \$40. Things change, and then change again. ■

## And a Rather Mixed Deck It Is

Stock investors suffered some nervous moments this fall as the cautious optimism that had prevailed for months was upset by a whiff of recession in Europe, slower growth in China, and a re-heating of geopolitical hot spots. With relative calm having been restored, let's review.

The U.S. appears to have resumed its once familiar role as a prime driver of global growth, or at least a key offset to weakness elsewhere. Those external uncertainties and a stronger dollar may keep the Federal Reserve's foot light on the interest rate pedal, although the latest employment numbers support the case for letting rates rise.

**Europe's** economic numbers have ticked down, even for Germany, the continent's strong player. The European Central Bank has committed to do "whatever it takes" to keep the economy on track, probably including purchases of sovereign bonds. The ECB's recent stress tests suggested that Europe's banks are generally healthy, and the weakness in European equities may prove

to be a fair entry point. But they could face a headwind if the dollar continues to rise versus the euro.

**Japan's** stock market had an impressive run the past two years, encouraged by Prime Minister Abe's initiatives to reform corporate governance and boost profitability. However, U.S. investors saw those returns dampened by the yen's steep decline against the dollar.

**China's** growth may have cooled, but the third quarter still saw a 7.3% annualized bump in GDP. This included industrial production, critical for the Chinese economy. The managed transition from a heavy investment focus to a more consumption-driven economy looks to be alive and reasonably well.

Other **Emerging Markets** are closely tied to China, but country fundamentals and valuations vary widely. Astutely managed, locally denominated EM sovereign debt may be an interesting contrarian play, particularly in Latin America where currencies have been bashed. All in moderation, of course. ■

## A Debate that Won't Go Away, Probably

Big debates in the investment world often turn on incremental margins averaged over large samples and dubious assumptions. So their import for real investors can be marginal as well. The great determinants of investment success tend to be harder to measure or predict with any real precision.

One such debate is over whether investor portfolios are better served by a "passive" indexed approach or a quest for superior "active" management. For all the numbers-crunching by both sides, there's good reason to doubt that either will gain the upper hand permanently.

It is not surprising that over the course of major market cycles, the *average* active fund manager underperforms the benchmark for that management style or market sector. Money management is a very crowded field. Aggregate portfolio holdings and average results should be expected to cluster near a benchmark, *minus* average fund expenses, trading costs, liquidity considerations, etc. A benchmark index is a virtual construct, so even a fund designed to mirror an index should be expected to underperform by some small expense margin.

Investment time frame also plays a big role. A benchmark index is, by definition, fully invested (virtually), while the average actively managed fund is not. This portends a margin of underperformance for any period in which market results were broadly positive, such as the past several years for U.S. equities.

Those with the courage to go "all in" six years ago are to be congratulated. For most mere mortals, the contribution of active management through difficult market periods may be much more critical. Few factors outweigh the value of helping to counter the cumulative effect of our own worst instincts, insecurities, and overshoots.

Some comprehensive studies purport to have uncovered certain manager attributes that correspond to a propensity for achieving above

## Taking a Lead From the Leading Indicators

Major economic and market turning points are devilishly difficult to predict. But analysts never tire of trying, and significant bear markets often accompany a truly challenged economy.

One useful tool is the Leading Economic Index® (LEI) for the U.S., maintained by the Conference Board. The LEI is a composite average of ten individual leading indicators that build on common patterns in economic data to form a projection of where the economy may be headed over the next three-to-six months. These indicators cover a very broad swath of economic activity, and their respective year-over-year percentage changes are averaged to produce the LEI percentage reading.

First released in 1959, the LEI

### U.S. Leading Economic Index® Components

1. Avg. weekly hours, manufacturing
2. Avg. weekly initial claims for unemployment
3. Manufacturers' new orders, consumer goods & materials
4. ISM® Index of New Orders
5. Manufacturers' new orders, nondefense capital goods, excluding aircraft orders
6. Building permits, new private housing units
7. Stock prices, 500 common stocks
8. Leading Credit Index™
9. Interest rate spread: 10-year Treasury bonds over the federal funds rate
10. Average consumer expectations for business conditions.

does have a credible record of pre-saging the economic environment. According to a review by Ladenburg Thalmann Asset Management, when the LEI has turned negative recessions were often uncomfortably close. With the LEI at a positive reading of 5% or less, recession was an average of 20-30 months off. Above a 5% reading, the average length of time to a recession jumped to about 50 months. The LEI en-

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Investment Performance Review	TOTAL RETURN * (dividends and capital gains reinvested)			
	--- Annualized thru Dec. 5, 2014 ---			
Selected Mutual Fund Categories *	1 yr.	3 yr.	5 yr.	10 yr.
Large-Cap Stocks (Core)	16.3 %	19.3 %	14.3%	7.3 %
Mid-cap Stocks (Core)	12.1	18.2	15.3	8.3
Small-cap Stocks (Core) †	6.3	16.9	15.0	7.8
Foreign Stocks (Multi-cap) †	2.2	10.8	5.9	4.9
Emerging Markets †	1.2	3.9	2.6	8.5
Natural Resources	-12.0	1.0	5.0	7.1
Real Estate Related	26.2	16.2	16.2	7.6
Flexible Portfolio	6.3	9.3	8.6	6.0
General Bond	6.3	5.1	6.1	6.3
Int'l Fixed Income †	1.0	1.8	2.4	4.1
High-Yield Taxable Bond †	2.4	8.1	8.5	6.5
General Municipal Debt	9.8	5.3	5.3	4.1

\* Source: Lipper, as reported in the online *Wall Street Journal*, December 6, 2014.  
**Past performance is NOT indicative of future results.**  
 † Small-cap stocks and high-yield (lower rated) bonds pose more risk and price volatility than those of larger, established companies. Securities of companies based outside the U.S. may be affected by currency fluctuations and political or social instability to a greater extent than U.S.-based companies.

average results over extended time periods. But these are not perfect causal relationships; that would be too easy. In the end, the reality of

changing markets and evolving investment vehicles may keep this debate going strong, a perpetual example of *unsettled* science. ■

## Point-Counterpoint on a Rule of Thumb

It's an oft-cited investing adage: Subtract your age from 100 to determine the *percentage* of your portfolio that should be in stocks. Like most generalizations, this has some conditional utility. The premise is that a young person has a longer time horizon to ride out volatility and the inevitable bear markets to reap the higher long-term returns historically delivered by equities. But *long-term* is the key condition, and the formula has its critics.

Rob Arnott, founder of Research Affiliates, recently described the 100-minus-your-age approach as "allergic to arithmetic and empirical testing." His main complaint stems from all-too-common investor behavior. A recent Fidelity study of 12.5 million retirement plan participants showed that 41% of investors age 20 to 39 cash out some or all of their plan assets when changing jobs. If those withdrawals are subject to tax and penalty and occur when stocks are down, it's a big hit to long-term savings accumulation.

Over the past 25 years, 20-somethings have experienced an unemployment rate more than twice that of workers 45 or older. They're especially vulnerable during economic slowdowns, often accompanied or preceded by weak stock markets. Retirement plan assets may turn out to be short-term if one hasn't also socked away a meaningful, available emergency fund.

At the other end of the age curve, the formula would have those in or nearing retirement ratcheting down stock exposure in favor of bonds. But these are typically more experienced investors, less vulnerable to job loss, and with a clearer view of their sources of retirement income. Government data and actuarial tables indicate that 39% of 65-year-old women and 29% of 65-year-old men will see a 90th birthday. The growth potential of stocks may be critical in maintaining purchasing power and building a financial legacy.

This question has some urgency given the popularity of target date

## A Triple Play for Tax-Deductible Savings

We tend to think about tax-favored retirement savings as those vehicles explicitly identified as such: IRA, 401(k), etc. A broader perspective would include any vehicle that can provide tax benefits today and boost the accumulation of resources to cover reasonably predictable expenses in retirement.

Contributing fully to retirement plan accounts is a great start. But if you can comfortably stash *more* than those limits, two other vehicles – Health Savings Accounts (HSA) and Donor Advised Funds (DAF) – deserve a look. Healthcare costs are a big concern for retirees, and most folks don't abandon charitable interests in their golden years.

The budget deal two years ago raised marginal tax rates for many upper-income households, and that boosts the value of a tax deduction today. And there's another advantage to building HSA and DAF balances. Future HSA withdrawals for qualified medical expenses, includ-

ing health insurance premiums, are not taxed. Nor are the future grants from a DAF to one's favorite charities, since transfers to the DAF itself represent irrevocable, deductible gifts to that tax-exempt vehicle.

The common theme is the strategic use of tax-favored vehicles to control more assets longer, and to spend them more tax efficiently over time. IRA and 401(k) accounts have specific annual contribution limits, as do HSAs which also require one to maintain an HSA-qualified, high-deductible health plan.

Contributions to a DAF are not specifically limited and can be made with appreciated assets for a market-value deduction rather than selling the asset and incurring capital gains taxes. Those assets are then irrevocably earmarked for charitable purposes. This can all take some planning and a more expansive discussion with your tax and investment professionals. But the triple play may be there to be made. ■

## Is There a QLAC in Your Future?

No, that's not a typo. QLAC stands for Qualifying Longevity Annuity Contract. Last summer the Internal Revenue Service issued new regulations to facilitate the use of QLACs in retirement plans.

Unlike an immediate annuity, a longevity annuity locks in an income stream that won't start for perhaps a couple decades. Until recently that concept presented a problem in a tax-qualified retirement plan account. A 65-year-old looking to

build that element of "longevity insurance" into her retirement account knows that at age 70½ she'll have to start required minimum distributions (RMD) based on the *total* value of her IRA(s). The value of a longevity annuity could boost the taxable RMD amount and affect the remaining liquidity and investment options in those retirement accounts.

That's where the change in regs comes in. The IRS will allow the value of a QLAC to be excluded from the IRA balance used to determine the RMD. With that wrinkle ironed out, insurance companies and plan sponsors can turn their attention to incorporating QLACs as an efficient, flexible tool for enhancing long-term income security.

The Treasury Department and the IRS also issued guidance clarifying that target date funds serving as qualified default investments in a re-

funds in qualified retirement plans. These investments generally involve more equity exposure for young participants and a glide path to much more conservative positioning as the participant's retirement date draws near. But that's just one tool in the box, and a rule of thumb is just a starting point to be tempered by the realities of human behavior and individual circumstances. ■

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retirement plan may include annuities among their fixed-income holdings. This could include annuities that begin paying out immediately after retirement as well as the long-term deferred variety described above.

There is still the fundamental question of when and whether an income annuity, immediate or deferred, makes sense. The up-front cost is sensitive to prevailing interest rates, so today's historic low rates imply relatively high cost. Howev-

er, locking in supplemental income against the possibility of living into one's 90s can provide psychological and strategic support for more productive investment of other assets.

Longevity annuity buyers do reap a price advantage based on simple time value *plus* what insurers euphemistically call *mortality credits* – the actuarially anticipated rate of intervening deaths within a given pool of aging contract holders. Currently, a 55-year-old man can

buy lifetime income of about \$480 monthly for \$100,000, or he could use that \$100,000 for a longevity annuity locking in just over \$2,000 a month starting at age 75, or \$6,800 a month starting at 85.

That's probably enough shop talk. Rising longevity is both a blessing and a risk. Americans looking to their retirement plan assets as the lynchpin of lifetime income security can expect to see more built-in, annuity-based offerings. ■

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tered that +5% "green zone" in early 2014 and recently approached the +7% level.

A sense of the *probability* of a near-term recession can help manage portfolio risk. But it can be costly to wait for a strongly positive LEI reading to move back into stocks. The market has posted some of its strongest performance early in economic recoveries, with the best returns coming on the heels of negative readings of -10% or worse. This simply reflects the market's tendency to overshoot on the downside near recession troughs, setting up the potential for substantial bounce-backs.

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Given the economy's healthier tone in recent quarters, stronger performance might be expected from growth stocks as opposed to value names. But if the LEI were to rise above the +10% level, history would suggest a potentially overheated condition from which near-term returns have often been flat to negative.

The LEI is just one tool for assessing the investment environment and gauging relative risk and opportunity – a broader and perhaps more objective measure than whatever single data point is hogging the headlines on any given day. ■