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Irrational Behavior in the Bond Market?

David B. Armstrong, CFA
Managing Director

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Monument WEALTH MANAGEMENT

I can't even begin to count the number of times I've come across the phrase "irrational behavior" in my career. I've not only studied it academically but also witnessed it firsthand. It seems that my encounters with both the phrase and the actual acts are countless.

Our behavior is shaped by trial and error and we generally learn from making mistakes and paying the price. If the price is painful, we tend to cautiously approach any similar situation in the future or flat out avoid it.

So why does it seem to me that irrational behavior by investors has time and again meant they simply can't avoid painful mistakes? The current bond market is a perfect example.

In my opinion, buying something with an expected rate of return that is negative fits the exact definition of irrational behavior—that's bonds in today's market. Recently, an investor could buy the 10-year U.S. Treasury bond with a yield of about 2 percent while the most recent decade's inflation rate was pushing 2.5 percent. So over 10 years, an investor would be receiving a real negative expected rate of return if inflation were to stay the same.

But investors seem to keep buying them and I don't know why. I'm imagining a call to a client that goes something like this, "Let's buy XYZ company stock. We will lose about 0.5 percent a year for the next 10 years, what do you think?" The response would be, "You're fired."

Investors seem to irrationally buy when things are in a bubble. Bubbles are okay for a while. There is plenty of research showing they can continue for a lot longer than most investors think they will. The challenge is not identifying a bubble, but deciding when to get out before it pops.

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Need help identifying where we are in the current bond bubble beyond the fact that real returns on the 10-year are negative? How about recent comments from Dan Fuss, manager of the $66 billion Loomis Sayles Bond portfolio, who called it, "the most overbought [bond] market I have ever seen in my life in the business."

Fuss is 79 years old, by the way.

Continued on page 2.

What's Happening at MWM?

Above & Left : We are all encouraged to attend conferences and classes to further our education.

The Washington Business Journal listed Monument Wealth Management as one of 2013's

Best Places to Work!

Here are some reasons why…

Above & Right: MWM participates in charity events, like the Send a Kid to Police Camp Golf Clinic, and we run a March Madness bracket where the top 3 winners get to choose a charity that will receive a donation from MWM.

Left: MWM keeps the kitchen stocked with drinks and snacks, and many times the staff gets treated to breakfasts or lunches.

Right: Fripp often makes office visits—it's nice having a dog around—it creates a more 'homey' feel! Visit our Facebook page for more photos with Fripp!

Right: We have access to a private cigar bar where we can gather after work.

Above: We are moving into a new office next door—the staff got to help choose the new furniture, and is in charge of picking the new seating arrangement.

Irrational Behavior in the Bond Market? *Continued...*

He goes on to say that it's not the end of the world for bonds and encourages people not to borrow money to buy bonds right now. Of course he is implying that he is witnessing investors actually borrowing money to buy more bonds.

Borrowing money to buy bonds that have a negative expected return is a serious sign of a bubble and a pretty good indicator that if you don't own them, now may not be the best time to start buying. You can write that down.

If you are currently holding bonds, you have a few options.

The first is to evaluate the coupon you are receiving, the maturity of the bond and your need for that income. Holding it until it matures is an option, but you need to be committed to that long time horizon.

Your second choice is to determine if you have a profit in your bonds. If so, consider selling them. When yields go up, they will go down in value and erode your profits. If you believe in buying low and selling high, now may be the right time. By the way, stocks still look cheap, even as we have closed in onrecord levels in most of the major U.S. indices. Warren Buffet,   arguably the most successful investor around these days, is on the record recently with that exact sentiment.

It's true that there is money to be made in any bubble. But it's almost impossible to determine when a bubble will pop, as any investor who witnessed the tech bubble in the early 2000's or the recent housing bubble understands. The difficulty in identifying the very top is what makes getting out very difficult. It's hard to think about the fact that you may lose more upside.

But when investors are borrowing money to increase positions in a market that is as overbought as anything Dan Fuss has ever seen in his investing career, I think it's safe to say it's not a good time to buy and that any move to lighten up on your existing bonds will likely be a good one.

This article and others written by David B. Armstrong can be found on www.usnews.com.
*Please see additional disclosures on the back of this newsletter.**

Find us Online!

Defining Your Investment Risks

The term "risk management" is a bit like the term "happiness"— everyone wants it, but few can define what it really means.

Timothy R. Lee, CFP®
Managing Director

Following the 2008 financial crisis and the ensuing stock market rebound, many investors are now trying to get a firm grasp on the meaning of risk. Without a clear definition, managing risk is essentially impossible for many investors. However, there are some highly effective approaches for both defining and managing risk. I'll lay out the basics below.

The dictionary definition of risk is simple, and also unhelpful:

"Risk is the exposure to the chance of injury or loss."

That's obviously too broad for most investors. On the other end of the scale, large institutional investors have used a complicated version of a fairly simple concept for many years called "value at risk" or "VaR".

VaR is essentially a measurement of the probability of a risk of loss on a given asset or portfolio of assets.

There are entire teams of mathematicians employed on Wall Street whose only role is to define this term, and to do so in a highly specific way. This definition is to going to be too specific and complicated for most investors. For us to use the definition, it needs to be specific but still broadly applicable.

In my experience, a more effective definition of risk will break out specific types of risks into component parts, which lets us to focus on the true cost of an adverse outcome, and then mitigate the specific downside risks one at a time. Among others, investors face the following key risks—price risk, liquidity risk, geopolitical risk (terror attack, etc.), interest rate risk, inflation risk, political risk, default or credit risk, exchange rate risk and operations risk.

In our financial advisory practice, we've devised a process which allows us to strike a happy medium between the broad "chance of injury or loss" and specificity of a mathematically derived measure of that chance of loss on a portfolio of financial assets. We call it "The Triangle." Essentially, it mimics Maslow's hierarchy of needs, and is broken into three blocks: survival, lifestyle and legacy. These three areas relate not only to assets, but just as importantly to liabilities. In other words, we help our clients to identify, categorize and then organize their assets and their expenses and liabilities (or future expenses discounted into current liabilities) which provides a simple breakdown of the funding source for any given expense or cost.

This breakdown of expenses and funding then allows us to match investment strategies and asset allocations to the appropriate level of risk for any given spending need. Obviously, this requires at least a basic current budget and a guess about future costs and expenses. Generally, those data points are easy to estimate. Additionally, it is typically easy to assign a timeline and likely range to any of the various expense categories.

For example, "survival" costs like food, clothing, healthcare and shelter are expenses which are immediate, recur almost every day and are non-negotiable. In contrast, a "lifestyle" expense like a vacation trip is something that is generally planned in advance, is flexible in terms of costs and can be negotiated or adjusted. Finally, a "legacy" budget item such as the cost of college education for your children is something you can plan for years into the future, and can have a great degree of flexibility.

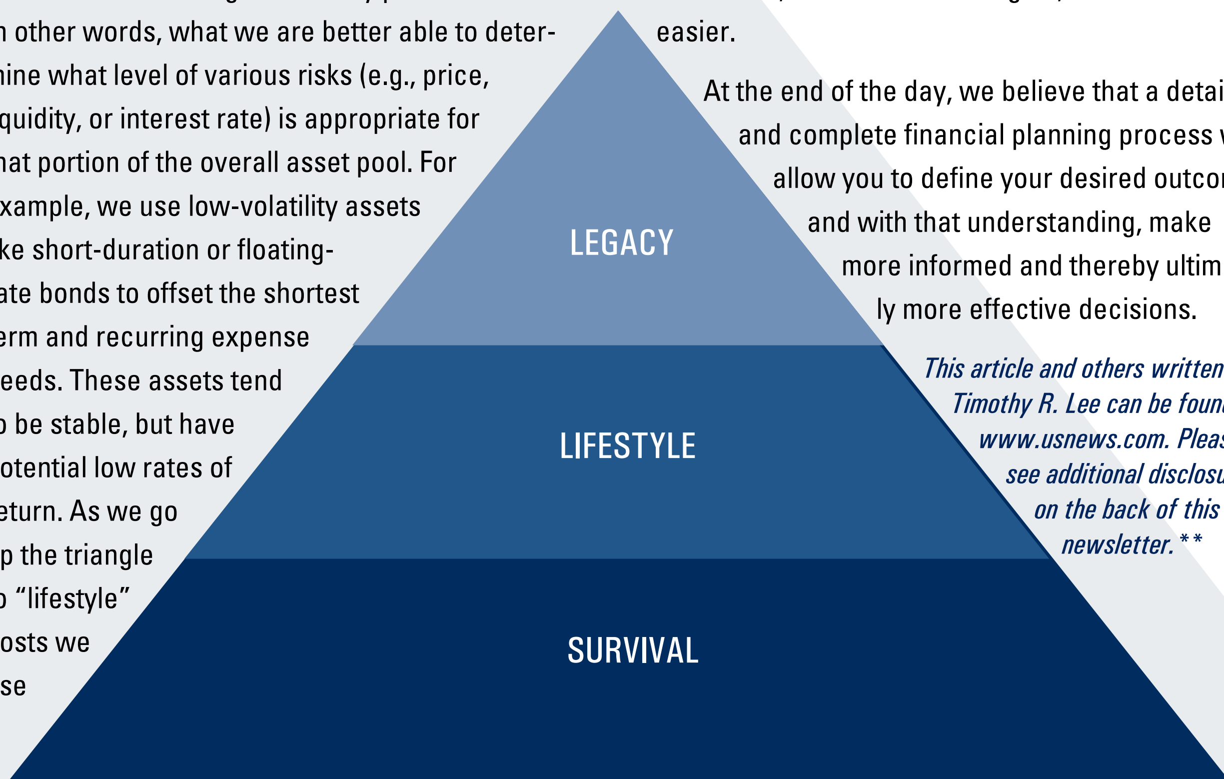
The value of this approach is that it allows for the creation of "risk budgets" for any portfolio allocation. In other words, what we are better able to determine what level of various risks (e.g., price, liquidity, or interest rate) is appropriate for that portion of the overall asset pool. For example, we use low-volatility assets like short-duration or floating-rate bonds to offset the shortest term and recurring expense needs. These assets tend to be stable, but have potential low rates of return. As we go up the triangle to "lifestyle" costs we use more volatile assets like stocks, commodities and REITs, which historically have tended to perform well over longer periods of time, despite short periods of poor performance. Finally, with the longest-dated expenses or assets to be passed on to the next generation we use illiquid assets like directly-owned real estate, 529 plans or a private business, which are expected to produce strong long-term returns, though often have short-term costs and poor liquidity.

This process has also helped us to combat the age-old cycle of fear versus greed, which historically has driven unproductive investor behavior of selling low and buying high. By defining and segmenting a budget for each of the three blocks of the triangle, we are able to more effectively align the allocation of the portfolio with the reality of spending needs. Additionally, we are able to rebalance as the different parts of the portfolio perform over time.

While it's not as simple as an online calculator, by breaking the various parts of spending and assets into smaller, more definable targets, it becomes much easier.

At the end of the day, we believe that a detailed and complete financial planning process will allow you to define your desired outcome, and with that understanding, make more informed and thereby ultimately more effective decisions.

*This article and others written by Timothy R. Lee can be found on www.usnews.com. Please see additional disclosures on the back of this newsletter.***



Monument
WEALTH MANAGEMENT

1701 Duke Street, Suite 425
Alexandria, VA 22314
703-504-9600
info@monumentwm.com
www.monumentwealthmanagement.com

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Monument removes the anxiety and uncertainty that can accompany financial success through a rigorous focus on long-term cash-flow based private wealth planning for every possible scenario and goal.

Monument clients benefit from 'entrepreneurs advising entrepreneurs' and the seamless access to the firm's team of founders, superior investment management expertise, and a candid relationship with personal advocates who prize integrity and independence above all else.

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***Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price. Stock investing involves risk including loss of principal. The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings. Investing in Real Estate Investment Trusts (REITs) involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained. Prior to investing in a 529 Plan investors should consider whether the investor's or designated beneficiary's home state offers any state tax or other benefits that are only available for investments in such state's qualified tuition program. Withdrawals used for qualified expenses are federally tax free. Tax treatment at the state level may vary. Please consult with your tax advisor before investing.*