Blue Bell

PRIVATE WEALTH MANAGEMENT

In our last quarter newsletter we discussed the equity markets reaction to the potential tax relief American corporations are hoping for. Statutory corporate tax rates for US corporations are the highest of all G20 countries (39.5% top rate vs. 12.5 % Ireland, 25% China, 28% UK, and 30% Germany). Any reduction in corporate tax rates and regulations will be viewed positively by the equity markets, surely some of this is already priced into stocks. Now it is a wait and see game, health care reform has proven difficult and worries about the scope of tax reform are growing. This is a risk that must be monitored.

We also discussed the fact that current S&P 500 valuations are slightly rich on a price to earnings ratio. While P/E ratios remain marginally elevated, comparing S&P valuations versus bonds of all types, the S&P500 becomes fair to slightly undervalued. This can be measured by the Earnings Yield Spread which can be used to evaluate equity prices versus fixed income. The EY spread is calculated by taking the EPS estimates of the S&P 500 over the next 12 months and dividing that by the S&P value to determine the Earnings Yield of the S&P500. Once the S&P500 yield is determined, the spread is calculated by subtracting the S&P yield versus the yield on fixed income. The EY spread versus 10 year treasuries and corporate bond yields (Moody's Baa seasoned corporate bond yield) points to equity valuations that are reasonable from a historical standpoint and favorable against fixed income of all types. This is precisely the reason why we are recommending that investors manage risk using hedging strategies such as covered call writing, and buffered equity linked notes as opposed to simply allocating to fixed income. With elevated fixed income valuations we believe that risk management through hedging versus a simple fixed income allocation will continue to prove beneficial over the long-term.

Economic expansion as measured by GDP continues and is now in its ninth year of growth which is longer than all but two previous expansions. However growth has been slow averaging around 2% since 2009. This slow economic expansion is probably a reason to not worry about length, it is also likely contributing to low market volatility. Job growth continues in the US as the unemployment rate has fallen to 4.7%, lower than it has been 82% of the time over the past 50 years and half of what it was in 2009. This signals that domestic companies are confident and believe that the economic expansion will continue.

The business climate remains strong, corporate earnings have been impressive and US competitiveness continues to grow even as the Federal Reserve has raised rates. A potential positive for corporate earnings could be a declining dollar as the rest of the world is finally strengthening. 40% of the S&P 500 revenue is derived abroad and a lower dollar would support competitiveness.

Economic growth has been slow but steady and likely to continue, earnings will likely also continue to grow at a slow and steady rate. We don't foresee any catalyst, other than a significant reduction in corporate tax rates that will lead to explosive growth. Risks do remain, what will come of the President's tax plan? What will the Federal Reserve do and how will the markets react? And of course Geopolitical risks remain and are almost impossible to predict. As discussed above equity valuations are likely slightly elevated from a historical perspective but not as overvalued as many alternatives such as fixed income. As a result we continue to recommend achieving risk management by hedging equity exposure as opposed to allocating to fixed income. As always we take seriously the trust that you place in us and welcome any questions that you may have.

Blue Bell PWM

Blue Bell Executive Campus

Suite 305

470 Norristown Road

Blue Bell, PA 19422

Tel: 610.825.3540

Fax: 610.825.9690

www.bluebellpwm.com

2017 Summer Newsletter

Beware of "Hidden" Costs In Mutual Funds

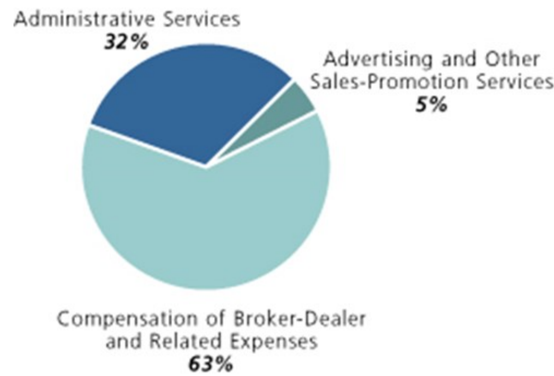
Since the 1960's, mutual funds have seen an exponential increases in demand. Mutual funds have basically become a "go-to" investment for retail and institutional investors alike. According to Investopedia, over $28 trillion is currently invested in mutual funds worldwide! Today, investors often praise mutual funds for their diversification and professional management.

However, what is rather unknown are the numerous "hidden" fees associated with mutual funds. Unlike common stock, where investors only compensate brokers based off agreed-upon trading commissions, mutual funds incorporate various expenses. The two most prevalent mutual fund expenses are management fees and 12B-1 fees. Management fees are costs incurred for the services of investment managers. Management fees are usually set between 0.5% and 2.0% of net AUM (Assets Under Management), depending on the firm. Companies state that management fees should be positively correlated to the expected performance of fund managers. Thus, for managers with strong past performance, management fees would tend to be higher. 12B-1 fees are relatively less acknowledged than management fees. 12B-1 fees cover a company's annual marketing and distribution costs. These fees are set between 0.25% and 1% (maximum allowed). Firms stress the importance of the 12B-1 fees to investors, stating that increasing assets and economies of scale will help them in the long-run.

What makes mutual fund costs "hidden" is not the fact that they are concealed from prospective investors. Both management and 12B-1 fees are clearly stated in the prospectus shown to investors before a purchase. Rather, it is the end-use of these fees that should concern investors. It is required that management fees be paid regardless of manager performance. This notion is quite alarming, based off the consistent lackluster returns mutual fund managers have garnered. According to a recent SPIVA scorecard, 66.11% of large-cap fund managers underperformed compared to the S&P 500 in 2015. Ultimately, mutual fund companies are charging investors for poor performance. In addition, the firms that do in fact outperform rarely ever maintain their success. According to recent research conducted by S&P Global, only 4.28% of managed funds stayed in the top quartile between September 2013 and September 2015. In an industry where managers rarely ever exceed their benchmark, investors are paying unnecessary fees for the illusion that managers can offer a competitive advantage.

Firms will also insist that more marketing to consumers will increase the size of the fund and in turn, increase existing investors' profit. With over $28 trillion invested in the global mutual fund market, it is hard for companies to justify levying 12B-1 fees to increase economies of scale. Bigger is not necessarily better when dealing with the size of a mutual fund as there is evidence that larger funds actually underperform smaller ones. According to a 2014 study from Novus Research, smaller managers have outperformed larger managers by 2.2% per annum over the past 10 years. The main reason for this disparity is due to a phenomenon called asset bloat. Asset bloat refers to the constraints managers face as AUM increase. It tends not to be an issue for bond, index, or money market funds which operate in large market segments and have higher liquidity. However, for equity mutual funds, asset bloat makes it challenging for fund managers to invest actively and effectively. As AUM increases, the number of fitting investments shrink and transaction costs rise. Fund managers are put in a predicament; they must decide whether to expand their stock selections or increase positions in stocks they already own. Often times, when mutual funds become so large, they perform like indexes rather than individually managed funds. The expansion of these funds takes out the role of the manager completely.

Additionally, excessive marketing does not need to be exercised by behemoth companies such as Vanguard and Fidelity because of their popularity amongst investors. Thus, these "marketing" fees are actually charged for superfluous reasons. Today, 12B-1 fees are mainly used to reward intermediaries for selling a fund's shares. As the pie chart from ICI portrays below, only 5% of 12B-1 fees are actually allocated to advertising and other sales-promotion services! The bulk of 12B-1 fees, 63% to be exact, are allotted to the compensation of the broker. This compensation adds no value-added service to the investment and does not increase the performance of the fund; it simply helps brokers put extra cash in their pocket.



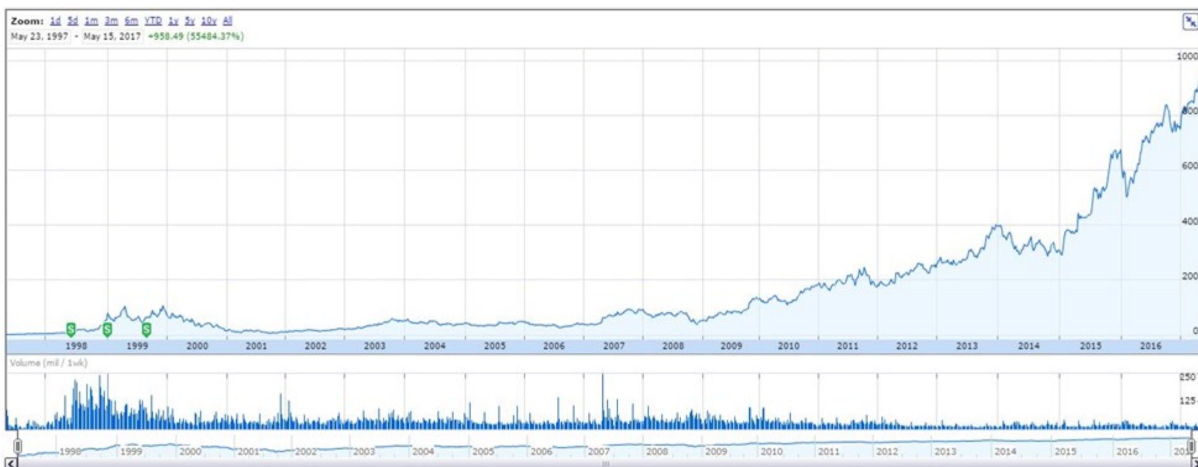
So are mutual funds poor investments? Not entirely. Low cost mutual funds can still be viable vehicles for diversification. Over time, these investments have the potential to deliver decent returns. If you decide to invest in a mutual fund, seek smaller funds with low expenses! In fact, funds with lower expenses have been shown to generate greater returns than funds with higher expenses.

Due to the fact that the overwhelming majority of fund managers underperform and 12B-1 fees provide no added value to investors, mutual funds may not be the best investment for you. An excellent alternative to a mutual fund is an ETF, or exchange-traded fund. An ETF is a security traded on an exchange during the day and tracks an index, commodity, or a basket of assets like an index fund. Because it acts like an index, ETF's provide instant diversification. However, what separates an ETF from a mutual fund is its lower costs. According to Morningstar, the average ETF expense ratio is less than the average actively managed mutual fund expense ratio. ETF's also do not charge 12B-1 fees or any sort of load! ETFs provide many similar advantages mutual funds offer but can be available at much lower costs.

Hindsight is 20/20

Amazon had its initial public offering (IPO) 20 years ago this past Monday on May 15, 1997 and has grown to arguably be the most disruptive force in the retail and technology space today. The stock price has gained an astounding 36% compounded annually since its first day of trading. According to The Wall St. Journal, a "$10,000 investment in Amazon Inc. 20 years ago would be worth $4.9 million today." It can be very easy as an investor to say you would have purchased Amazon stock at the IPO and held onto it knowing what you know about the stock performance today.

The chart below shows the remarkable growth of Amazon's stock price from the IPO until today.



It is very easy to look at the first chart and say that you would have stayed invested in Amazon for the long term, yet it would have been very difficult to watch a portfolio holding decline as much as Amazon did during the tech bubble of 2000. It would have been even more difficult to foresee just how disruptive Amazon would become when it was thought of as only an online bookstore and purchase more shares at the lows of the stock in 2001! Many critics on prominent television and in print had declared the online retailer dead. A Newsweek article quoted a story from the Washington Post from February 21, 2001 where the author said he "expects the Internet retailer to run out of money adequately fund its operations later this year." Nearly 12 years later, Amazon founder Jeff Bezos bought the Washington Post.

Again, with hindsight, it is easy to say you would have stayed invested over this period of time yet even during an "average" year, it can be extremely difficult to stomach a 14% decline in your portfolio. To put this in perspective, a $1,000,000 portfolio would see a loss of $140,000!

This is where having protection using a covered call strategy and index-linked notes can help mitigate losses during inevitable market downturns. Nothing is fool-proof and there is no "magic-bullet" in investing but having a long-term plan along with downside protection or hedging strategies in your portfolio can help you keep emotions in check and weather these drops in the stock market.

Reminders

- If you mail a check, please make the check payable to "Charles Schwab & Co, Inc." with your account number written on the check.
- Talk to your children about the benefits of starting a Roth IRA.
- SAVE NOW! Please consider setting up online access to view your accounts online and to receive your statements and trade confirmations electronically.

PLEASE REMEMBER THAT PAST PERFORMANCE MAY NOT BE INDICITIVE OF FUTURE RESULTS. DIFFERENT TYPES OF INVESTMENTS INVOLVE VARYING DEGREES OF RISK, AND THERE CAN BE NO ASSURANCE THAT THE FUTURE PERFORMANCE OF ANY SPECIFIC INVESTMENT, INVESTMENT STRATEGY, OR PRODUCT MADE REFERENCE TO DIRECTLY OR INDIRECTLY IN THIS NEWSLETTER, WILL BE PROFITABLE, EQUAL AND CORRESPONDING INDICATED HISTORICAL PERFORMANCE LEVEL(S), OR BE SUITABLE FOR YOUR PORTFOLIO. DUE TO VARIOUS FACTORS, INCLUDING CHANGING MARKET CONDITIONS, THE CONTENT MAY NO LONGER BE REFLECTIVE OF CURRENT OPINIONS OR POSITIONS. MOREOVER, YOU SHOULD NOT ASSUME THAT ANY DISCUSSION OR INFORMATION CONTAINED IN THIS NEWLETTER SERVES AS THE RECEIPT OF, OR SUBSTITUTE FOR, PERSONALIZED INVESTMENT ADVICE FROM BLUE BELL PRIVATE WEALTH MANGEMENT LLC. PLEASE REMEMBER TO CONTACT BLUE BELL PRIVATE WEALTH MANAGEMENT LLC IF THERE ARE ANY CHANGES IN YOUR PERSONAL/ FINANCIAL SITUATION OR INVESTMENT OBJECTIVES FOR THE PURPOSE OF REVIEWING/ EVALUATING/REVISING OUR PREVIOUS RECOMMENDATIONS AND/OR SERVICES. PLEASE ALSO ADVISE US IF YOU WOULD LIKE TO IMPOSE, ADD, OR TO MODIFY ANY REASONABLE RESTRICTIONS TO OUR CURRENT WRITTEN DISCLOSURE STATEMENT DISCUSSING OUR ADVISORY SERVICES AND FEES REMAINS AVAILABLE FOR YOUR REVIEW UPON REQUEST.

BBPWM Team

Scott Miller Sr.
Partner
jsmiller@bluebellpwm.com

Scott Miller Jr.
Partner
smiller@bluebellpwm.com

Justin Capetola
Partner
jcapetola@bluebellpwm.com

Jon Sobotkin
Partner
jsobotkin@bluebellpwm.com

Miguel Biamon
Senior Investment Advisor
mbiamon@bluebellpwm.com

Hank Fox
Investment Advisor Representative
hfox@bluebellpwm.com

Christopher Paleologus
Vice President
cpaleologus@bluebellpwm.com

Jim Behr
Investment Advisor Representative
jbehr@bluebellpwm.com

Ryan Malloy
Intern

Kevin Scott
Intern

Pete Zaharchuk
Intern