an investment newsletter you can trust from

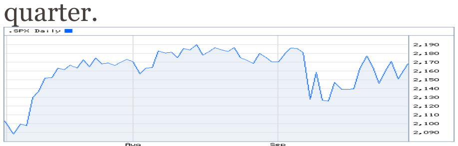
PHILLIPS FINANCIAL

A foundation of trust

October 2016

A Review of 3rd Quarter 2016

The third quarter experienced most of its gains during July. In the remaining two months, we saw a lot of churning in August and then some volatility in September as investors bounced between worries about oil prices, interest rate increases by the Fed, and the US presidential election. Below is a chart of the Standard and Poor's 500 Stock Index price changes for the quarter.



Source: Standard & Poor's

The US stock market, as measured by the S&P 500, is up 7.8% on a total return basis for the calendar year. In our January 2016 newsletter, we reported the average projected return for this year by the pros interviewed by Barron's was near 10%. It would be nice to get a double-digit return this year after the mediocre return in 2015 of just over 1%. As we go into the fourth quarter of the year, analysts are hopeful that the increased earnings for US companies that they have been predicting will materialize. While the stock market often reacts to news events over the very short term; earnings are what eventually determine stock prices. Investor focus will soon, for the most part, be on the quarterly earnings announced in October. The **hope** is that they will signal some future improvement to the very sluggish economy.

The Anniversary of Indexing and Phillips Financial

On August 31, the Vanguard S&P 500 Index Fund celebrated its 40th anniversary. The 500 Index Fund, originally named the First Index Investment Trust, was the world's first index mutual fund when Vanguard founder John C. Bogle launched it in 1976. When first introduced, investors were slow to incorporate such a strategy into their investments. Also, competitors were derisive of this "passive" investment style – some even characterizing it as un-American.

The Fund was designed to track an index developed by Standard & Poor's that included the largest 500 companies whose stock is publicly traded in the US. The index is based on the market capitalization of the companies, i.e., price per share times the number of shares outstanding. If Apple (which did not exist at the time of the founding of the Fund), as an example, represents 3% of the total value of the 500 stocks in the index, then Apple will be 3% of the Vanguard fund. In short, the performance of the Fund will be the same as the market (made up the 500 stocks) less any expenses.

Indexing has become one of the cornerstones of investing today. It provides diversification, it is potentially tax-efficient, and it can be carried out at a low cost. Many product sponsors now offer indexed investments; and new indices continue to be developed. The benefits of indexing is proven by their history of out-performing the majority of actively managed mutual funds over the long term, as illustrated in S&P Dow Jones Indices SPIVA Scorecard available at https://us.spindices.com/documents/spiva/spiva-us-mid-year-2016.pdf. Index strategies accounted for 34% -- or about $34.7 **trillion** -- of all mutual fund and exchange-traded fund assets as of the end of 2015 according to Strategic Insight.

When Phillips Financial first developed its investment management approach in 2001, we were not comfortable with the traditional approach employed by most advisers at the time. After much research, we adopted the index-based foundation we still employ today. Our model portfolios were based on indices that represented the major asset classes as well as important sub asset classes. Additionally, we were among the first advisory firms serving primarily individuals to use Exchange Traded Funds (EFTs). ETFs are investment companies that hold a portfolio similar to an index mutual fund but are traded on major stock exchanges throughout the trading day. Phillips Financial portfolios were developed to incorporate the findings of academic studies that indicated certain factors could lead to performance enhancement over long periods of time. This led us to develop model portfolios which had some over-weighting of smaller US stocks as well as "value" stocks. (Refer to the penultimate paragraph of this article for an explanation of "value".)

We initiated this approach with our clients in 2002; and we have continued to extensively study over the years how to build upon that foundation. While the fundamentals of our philosophy have remained intact, we have periodically introduced nuances into our portfolios after much study and deliberation. A recent example is the introduction of currency-hedged foreign bond ETFs that track indices developed by Barclays, a leading index provider for fixed income investments.

The Phillips Financial Investment Committee, working with leading ETF providers such as Blackrock, has recently been studying products that track other than traditional market-capitalization-weighted indices. For example, indices and products aimed to reduce portfolio volatility have been developed. Other products with the goal of seeking out-performance have been developed. In the latter category, factors such as quality (financially healthy firms), value (inexpensive

stocks as measured by a ratio such as price-to-book), size (smaller companies), and momentum (trending stocks) are employed in the development and management of the index.

No decisions have been made yet as to whether or not it makes sense to incorporate some of these products into our standard models. If we do make such a decision at some point, further information will be provided in client investment review discussions and in future newsletters.

Aging and Finances. Article No. 1 in a Series

A Most Important Conversation

Many of our clients have elderly parents or other relatives for whom they may soon be responsible. Many other clients are, wisely, looking ahead to their own older years to determine how best to protect themselves and their family from unnecessary financial risks. In either scenario, it's important to understand the issues and the steps to take to mitigate risk and improve the financial outcome for everyone concerned.

When it comes to thoughts of aging, it's human nature to avoid contemplation and say, "We'll just cross that bridge when we come to it." Unfortunately, when it comes to the perils of financial mismanagement combined with the inevitability of aging, waiting until we've "crossed that bridge" can be too late. Studies show that financial decision-making is one of the first skills to be negatively impacted by the natural decline of cognitive abilities. Cognitive decline begins at different times and progresses at varying rates depending on the individual. On average, though, financial decision-making skills are found to begin declining significantly in our 60s and 70s.

The majority of investors nationwide do not plan for the risks that can result from decreasing financial skills. These risks — including exposure to fraud, expensive legal actions, and stressful family conflict — to their wealth, themselves, and their family, can be avoided or reduced. The first steps are to implement the necessary conversations and then develop a plan to protect one's financial interests. The good news is that it's never too early to start this process!

The Conversation

While the order in which these conversations occur is not definite, it is important that each of the participants be brought on board in a timely manner and that information is shared openly and honestly. You may wish to begin the conversation with:

- your financial advisor
- your parents or the person(s) about whom you are concerned
- your spouse
- a family member or other person who may be responsible for your care (or the care of your loved ones)
- and/or other relevant people such as attorneys, bankers, business partners, etc.

The discussion may start as simply as "Have you (or we) thought about these issues?" The goal is to make the conversations low-pressure but straightforward, and to identify the proactive measures that need to be taken. The point is to identify ways to help, to lower stress, and to limit risk for everyone; for example:

- sharing financial, investment and bank records, including passwords
- identifying the location of important documents (e.g. wills, birth certificates, mortgages, living wills, etc.)
- knowing important medical information, such as doctors' contacts and health insurance cards
- knowing who has — or discussing who should have — power of attorney or access to (and signing authorization for) financial accounts

The following scenarios may not match your specific situation, but they may prompt some points to consider as you plan your discussion:

- How might a husband and wife decide how much of their wealth they will leave to charities and how much to their children; and at what point to share this information with their children?
- What if a young adult plans to use money from a trust, but for a reason with which the trust proprietor does not believe is prudent?
- Who, beyond the married couple, needs to know that a prenuptial agreement is in place?
- Should a family relationship that has been severed because of a long-ago money-related disagreement be reassessed?
- What to do now that the number of grandchildren is increasing?
- How to fairly "take care of" adult children who are living in extremely disparate financial situations?
- What if there is an unexpected terrible illness or disability in the extended family that requires financial assistance?

The sooner these conversations occur, the less stress they are likely to induce. It is important to understand that these concerns are not about taking away independence, but rather to reduce the amount of risk, expenses, and family stress. Financial professionals are a key part of this equation for our clients: the better they understand your concerns and the specifics of your situation, the better they can give guidance and help you plan for the best-case financial scenario for you and your family.

For Further Reading

- State Street Global Advisors. "The Impact of Aging on Financial Decisions: The One Risk You Can't Afford Not to Hedge." https://www.ssga.com/investment-topics/defined-contribution/2016/The-Impact-Of-Aging-On-Financial-Decisions.pdf
- Fidelity. "Leading Indicators of Enduring Family Harmony: How interactions around money and wealth can predict the future of family relationships" https://www.fidelity.com/viewpoints/personal-finance/five-indicators-of-family-harmony?ccsource=email_weekly

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Market Recap: Asset Class Performance – Table

The following table is a regular feature of our newsletter to provide information about the total return performance (i.e. price movement plus dividends) over various time periods of the indices that track many of the major asset classes.

Index	% Last Quarter Return 07/01/16 – 09/30/16	% Year-to-Date Return 1/01/16 – 09/30/16	% Cumulative 1 Year Avg. 10/01/15 – 09/30/16	% Cumulative 3 Year Avg. 10/01/13 – 09/30/16	% Cumulative 5 Year Avg. 10/01/11 – 09/30/16	% Cumulative 10 Year Avg. 10/01/06 – 09/30/16
Barclays Aggregate Bond Index	0.46	5.80	5.19	4.03	3.08	4.79
S&P 500 Index	3.85	7.84	15.43	11.16	16.37	7.24
S&P 500 Value Index	2.94	9.36	15.98	9.34	15.87	5.53
S&P Mid Cap 400 Index	4.14	12.40	15.33	9.35	16.50	**9.11**
S&P Small Cap Index	7.20	13.88	18.12	9.04	17.86	8.71
S&P Small Cap 600 Value Index	7.23	**16.62**	**20.94**	8.66	**18.09**	7.77
MSCI EAFE Index	6.43	**1.73**	6.52	0.48	7.39	1.82
MSCI Emerging Markets Index	**9.03**	16.02	16.78	-0.56	3.03	3.94
Wilshire REIT Index	-1.21	9.75	17.94	**14.34**	15.82	5.93
S&P GSCI Commodities Index	**-4.15**	5.30	**-12.21**	**-22.16**	**-12.61**	**-9.04**

Source: Standard & Poor's, Barclays Capital, Morgan Stanley Capital International, Wilshire Associates, Fidelity Investments, BlackRock, Inc.
Green = best performing asset class
Red = worst performing asset class

Definitions:

▪**Barclays Aggregate Bond Index.** An index originally developed by Lehman Brothers and now managed by Barclays Capital to track the general performance of the domestic taxable investment grade bond market.

▪**S&P 500 Index.** An index that measures the large-capitalization sector (generally greater than $5 billion of market capitalization) of the U.S. equity markets. t is a capitalization-weighted index from a range of securities chosen by Standard & Poor's for liquidity and industry group representation. Prior to Dec. 16, 2005, the S&P 500/BARRA Value Index contained the half of the stocks, as measured by market capitalization, in the S&P 500 Index with the lowest price-to-book ratio. As Dec. 16, 2005, the S&P 500/Citigroup Value Index became the benchmark for identifying U.S. large-cap value stocks.

▪**S&P MidCap 400 Index.** An index that measures the mid-capitalization sector (generally $1.5 billion to $5.5 billion) of the U.S. equity market. It is a capitalization-weighted index from a range of securities chosen by Standard & Poor's for liquidity and industry group representation.

▪**S&P SmallCap 600 Index.** An index that measures the small-capitalization sector (generally $300 million to $2 billion) of the U.S. equity market. It is a capitalization-weighted index from a range of securities chosen by Standard & Poor's for liquidity and industry group representation. Prior to Dec. 16, 2005, the S&P SmallCap 600/BARRA Value Index contained the half of the stocks, as measured by market capitalization, in the S&P SmallCap 600 Index with the lowest price-to-book ratio. As of Dec. 16, 2005, the S&P SmallCap 600/Citigroup Value Index became the benchmark for identifying small-cap value stocks.

▪**MSCI EAFE Index.** An index developed by Morgan Stanley Capital International Inc. as an equity benchmark for performance of publicly traded securities in developed international markets.

▪**MSCI Emerging Markets Index.** An index developed by Morgan Stanley Capital international Inc. as an equity benchmark for performance of publicly traded securities in emerging markets.

▪**Wilshire REIT Index.** An index developed by Wilshire Associates to track the general performance of Real Estate Investment Trusts (REITs) traded on domestic equity markets.

▪**The S&P GSCI Commodities Index.** An index developed by Standard & Poor's and Goldman Sachs that is based on a production-weighted basket of principal physical commodities that reflects the level of commodities prices at a given time and is designed to be a measure of the performance over time of the market for these commodities.

Index returns are for illustrative purposes only, and do not reflect any management fees, transaction costs or expenses. The performance of an unmanaged index is not indicative of the performance of any particular investment. It is not possible to invest directly in any index. Past performance is no guarantee of future results.