CLAYTON
FINANCIAL SERVICES, INC.

the Quarterly
Q2, 2015

Greek Drama? Oh, Yes. Global Tragedy? Unlikely.

by James Walden, CFA®
Director of Portfolio Management

One of our investing themes for 2015 is that of volatility in financial markets, and just like in the first three months of the year, the markets delivered it in the second quarter. The S&P 500 was up in April, essentially flat in May, and down in June; including dividends, the S&P was up 0.3% for the entire quarter. While modest, this total return was still better than the -1.7% return of U.S. bonds in the quarter (as measured by the benchmark Barclays U.S. Aggregate Bond Index) as yields rose on longer-term bonds.

The source of much of the volatility during the second quarter comes from the ongoing political and economic events unfolding in Greece and the rest of Europe… let's briefly recap. Several years ago, after Greece revealed that its national finances were in worse shape than originally thought, the country was cut off from raising funds in the financial markets as global investors were rightfully concerned they wouldn't get their money back. To prevent further disaster right in the midst of the global financial crisis, Greece received a financial lifeline from authorities including the International Monetary Fund (IMF) and the European Central Bank (ECB) (Europe's version of our Federal Reserve); however, this bailout came with strings that imposed painful cuts in government spending and tax increases for Greece to help get its budget deficit back in order. These "austerity" measures have been very unpopular with Greeks, and in January 2015, Alexis Tsipras was elected Greek Prime Minister after running on an anti-austerity campaign and vowing to obtain relief from the strict bailout terms. For various political, social and economic reasons, Greece's creditors are opposed to loosening the terms of their financial assistance.

As we write this on July 1, the situation is quickly coming to a head. After months of negotiations, Greece and its creditors have failed to come to terms on renewing Greece's emergency financing (Greece still needs it), and Greece technically defaulted on a repayment to the IMF on June 30. The Greek people are currently set to vote on a referendum July 5 on whether to accept the newest bailout offered by creditors and their terms. Many view the referendum as whether Greece will stay in the Eurozone.

And it's Greece's fate in the Eurozone that is the real issue underlying the current volatility. If Greece were to exit the common-currency bloc, some fear it could send the rest of Europe in a downward economic spiral and lead to another financial crisis.

We won't speculate on the results of the scheduled referendum, or whether the referendum marks the end of discussions between Greece and its lenders, or whether

continued on page 2…

SAVE THE DATE!

Economic & Investment Seminar

Plan to attend our upcoming seminar to hear Clayton Financial Services' economic and investment update. Space will be limited so let us know if you plan to attend!

Presenter: Randy Clayton, CFP®
James Walden, CFA

Times: **Tues, Aug. 11, 2015**
Noon – Light lunch provided
Wed, Aug. 12, 2015
Noon – Light lunch provided
Thur, Aug. 13, 2015
Noon – Light lunch provided
6 pm – Hors d'oeuvres & wine

Place: Clayton Financial Services Office,
716 S. Kansas Ave.
Topeka, KS

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NAPFA
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Inside this issue…

Greek... *from page 1*

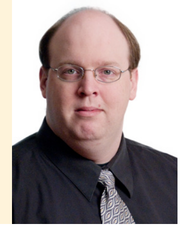
Greece will ultimately leave the Eurozone. However, our analysis suggests that any impact from the worst-case scenario of a messy Greek exit will be minimal:

- Most of the debt that Greece owes and would likely be unable to repay already belongs to public institutions like the IMF and ECB. This is in stark contrast to just a few years ago when European banks held a much greater share and in contrast to who held the bad mortgage investments that triggered the Wall Street crisis in 2008.
- The ECB, poised to continue using a page taken from the Fed's playbook, can dramatically ramp up its current QE to help support the rest of Europe and its financial system.
- According to Standard & Poor's, Greece accounts for less than 2% of the European Union's GDP.

We don't think any market negativity around this to be more than short-term noise that typically comes with uncertainty. To be sure, either course will be painful for Greece, but we think the broader impact will be largely contained. But the situation remains fluid, and we will certainly adjust our thinking as necessary and take any appropriate measures.

Interest in Interest Rates: Expected Fed Policy and You

J.D. Kaad
Portfolio Analyst



In December 2008, the Federal Reserve cut its target interest rate to around 0% in an unprecedented move to help combat the global financial crisis. This was a watershed moment, as this short-term rate, also known as the "fed funds rate," is the benchmark banks use to set interest rates for all kinds of loans. By reducing the fed funds rate to near zero, the Fed looked to entice U.S. consumers and businesses to borrow and spend, thereby aiding the recovery and growth of the U.S. economy. The Fed has kept its target near zero ever since as it has patiently sought the evidence it needs to determine the economy is strong enough to function without the Fed's extraordinary help.

The Fed committee responsible for interest-rate policy meets about every six weeks. During the past few years, there has often been a mild to moderate price decline in domestic equities in the days leading up to and on each Fed meeting. This is from concerns that the Fed is poised to hike interest rates too prematurely for the convalescing economy, which in turn will hurt corporate earnings or will make stocks a less-attractive investment. When it is declared that rates will remain unchanged, a rally in equities often ensues. This behavior by the markets begs the question, "What will occur when the Fed does increase interest rates?", because there are now indications that this may happen sooner rather than later.

Judging by the few initial interest rate increases we have seen in the last 30 years, it is likely that when the Fed raises rates the markets will enter into a pullback. Although if one looks at the market's historical reaction over the following three months the market has been up by mid-single digits. The reason why increases in interest will not have a more substantial negative effect on the equity markets is very simple. Initially there will be a great deal of shock at seeing the FOMC move rates upward after 7 years of perpetual low rates. Once the shock has worn off, the investors will realize that the increase in rates is genuinely good news.

The pending initial hike by the Federal Reserve should be welcomed; it signals that the Fed believes that all the measures taken by the government throughout the recession and the recovery have worked. This move means that the U.S. economy is growing, that employment is healthy, and inflation has returned to an appropriate level. A further reassuring factor was voiced by Fed Chairwoman Janet Yellen when she stated that "increases will be gradual and shallow". This means any initial increase in interest rates will be more of a symbolic gesture and will unlikely be immediately followed with further increases.

The final question that needs to be answered is, "What is Clayton Financial Services going to do when the inevitable bump in rates does come?" We think that the equities in our portfolios are already well-positioned to ride out any near-term noise associated with a rate hike (although there could be some initial volatility). The managers of our core fixed-income funds have all taken measures to mitigate the risk of rising rates. For some of our other "opportunistic" fixed-income names, higher interest rates could actually be a benefit.

The Other Dimension of Risk

Here's another reason why most investors don't get all the returns the market is offering. When it comes to investing in the stock market, the risk that everybody talks about is the ups and particularly the downs, the bearish periods when the market falls dramatically and keeps falling for months or even years. (Think: 2000-2002 or 2008)

The real damage isn't the fall itself, but the fact that many investors watch the ongoing free-fall with increasing horror until they can't stand the pain any more, sell out of the market at or near the bottom, and then lick their wounds on the sidelines and miss the recovery. Over the course of this round trip, they lose real money, while those who had the fortitude to hang on recovered their losses.

Recently, professional advisors have begun talking about a different dimension of risk, which is just as insidious, just as potentially damaging to the wealth of their clients, but much-less-widely discussed. It's called "frame-of-reference" risk.

Frame-of-reference risk can be defined as the risk that people will look at the performance statement of their diversified investment portfolio and notice that its return is falling short (sometimes far short) of the market index they're most familiar with-typically the Dow or the S&P 500. They abandon the diversified Investment approach and concentrate their holdings in the local market right as the other investments they sold are about to take the performance lead. To see why this is a risk at all, consider the bull market in tech stocks in the late 1990s. Figure 1 shows the rate of return in the late 1990s and early 2000s of U.S. stocks compared with an ABCD portfolio consisting of equal parts U.S. stocks, foreign stocks, commodity-linked equities and real estate investment trusts—a diversified mix of risk assets, rebalanced each year.

FIGURE 1

"Frame-of-Reference" Risk

Year	(1) Portfolio ABCD Equal Allocation*	(2) Portfolio A U.S. Stocks	(3) = (1) – (2) Difference ABCD minus A
1994	4.46	1.29	3.17
1995	21.16	37.47	-16.31
1996	24.65	23.08	1.57
1997	10.38	33.25	-22.87
1998	-1.04	28.77	-29.81
1999	21.14	20.99	0.15
2000	13.26	-9.13	22.39
2001	-12.77	-11.88	-0.89
2002	-0.47	-22.12	21.65
2003	31.43	28.69	2.74
2004	20.00	10.88	9.12
2005	14.00	4.89	9.11
Standard Deviation	12.70	19.56	
Simple Average Return	12.18	12.18	
Compound Annual Return	11.49	10.52	
Sharpe Ratio	0.65	0.44	
Future Value $1	$3.69	$3.32	
Compound Return 1994–1999	13.05	23.55	
Compound Return 2000–2005	9.96	-1.14	

* Annually rebalanced equal allocation across U.S. Stocks, Non-U.S. Stocks, Real Estate Securities, and Commodity-Linked Securities.

Source: © 2008 Roger C. Gibson

Notice that in 1995, the diversified portfolio got walloped by the U.S. market—a difference of more than 16 percentage points. In 1997 and 1998, the differences were even more pronounced: almost 23% and just under 30%. This was a time when many investors were telling their advisors that the rules of investing had changed, that technology, clicks and eyeballs were the new standard by which stock values should be measured.

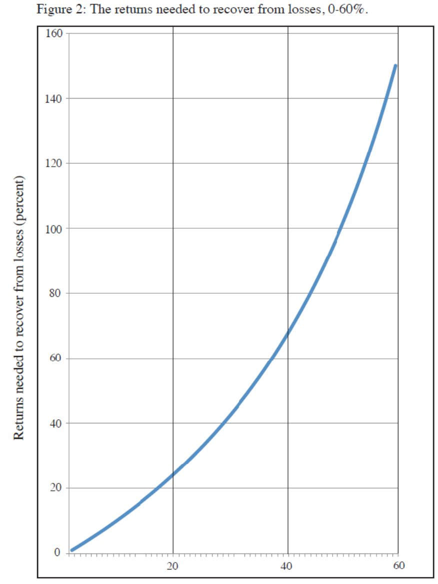
If they abandoned their diversified ABCD strategy at or near the bottom, in late 1999, these investors would have been concentrated in U.S. stocks in 2000, when the diversified approach beat the U.S. market by more than 22 percentage points. They would have missed the great return of a diversified portfolio in 2002, when it outperformed U.S. stocks by 21%. The next three years also saw the diversified portfolio beat a concentrated U.S. stock holding, as commodities, real estate and foreign stocks delivered solid returns.

The advantages of buy and hold are relatively straightforward—even if they're not easy to appreciate during a market downturn. But what, exactly, are the advantages of hanging onto a diversified portfolio?

One answer lies in the mathematics of returns. Notice (Figure 2) that gains and losses are not symmetrical, and the differences become greater with magnitude. A loss of 10% requires a modest 11% gain to get back to the original portfolio value. But a 20% loss requires a 25% gain, a 30% loss doesn't recover until the portfolio has achieved a subsequent 43% gain, and a 50% loss doesn't get back to even until the battered portfolio gone up 100%.

FIGURE 2

Figure 2: The returns needed to recover from losses, 0-60%.



When a portfolio holds different asset classes, which move up or down out of sequence with each other (which, in the vernacular, are "not highly-correlated"), it tends to smooth out yearly investment performance. Portfolios that deliver smoother returns don't have to experience extreme recovery to stay in positive territory. As a

The Other Dimension… *cont. from page 3*

result, they will have higher terminal values than choppier portfolios, even if the average yearly return is the same.

Another answer lies in the idea of reversion to the mean. When one asset class (like U.S. stocks) is soaring, and everything else is lagging, that means the soaring asset class is getting relatively more expensive than the others. Eventually, prices will return to normal in both directions, and the other investments will have their day in the sun. So when someone abandons a diversified investment approach after years of underperformance, she loses twice. She has already paid the "penalty" (so to speak) for being diversified when diversified was losing to U.S. stocks. Then, when she goes all-in on U.S. stocks, she loses the "benefits" that eventually follow when those other asset classes go up faster than the Dow. The late 1990s and early 2000s were a perfect example of this.

This can be summed up neatly by looking back at the investor's dilemma during the tech bubble. People who held a diversified nix of the four asset classes—U.S. stocks, foreign stocks, commodity-linked investments and real estate-enjoyed a 13.05% average yearly return from 1994 through 1999. They achieved a 9.96% return in the subsequent five years, from 2000 through 2005.

Were they happier with their higher return in the first five years? No. They were firing their advisors, because the U.S. stock market happened to be gaining 23.55% a year, and they felt like losers. Were they unhappy with the lower 9.96% yearly returns the diversified portfolio delivered in the subsequent few years? No; in fact, they were ecstatic, because their portfolios were outperforming at a time when the U.S. market was losing value.

Of course, many investors today are facing this frame-of-reference risk head-on. The U.S. market has been booming since the bottoming out in March of 2009, while the rest of the world has been mired in a recessionary hangover. Commodities—most notably oil, but also gold—have been retreating lately. Real estate had a bad stretch after the Great Recession. It's easy to question the value of those other assets in a portfolio with the benefit of hindsight. But with the benefit of historical perspective, the underperformance of broad asset classes usually reverses itself, and we never know exactly when that will happen.

At times like we are experiencing today, when the U.S. markets are enjoying a long uninterrupted run of good fortune, frame-of-reference risk starts to come out of the closet and threaten your financial health. All we know about frame-of-reference risk is that, just like the more well-known volatility risks, it lures investors to abandon their long-term strategy at the wrong time—and when people give in to it, it becomes a net destroyer of wealth.

New Faces

In recent months, you may have noticed a new name—or two, or three—on some of your correspondence from Clayton Financial Services. Because of this, we thought we would take a moment to explain some of the changes that have been taking place around the office.

As our Client Services Administrator, one of Emily Schallock's job responsibilities is to take care of any Fidelity paperwork or processing needs for clients. She has been instrumental in keeping CFSI up-to-date with Fidelity's features including their latest offering: eSignature, which will allow clients to electronically sign certain Fidelity documents rather than having to do everything via regular mail. Be on the lookout for any forms that may come from her and feel free to let her or your Planner know if you have any issues or questions.

Jacquie Munoz is a Registered Paraplanner at CFSI. She has been working closely with our Financial Planners to assist with several items related to meeting preparation and follow-up. One of Jacquie's primary responsibilities is assisting with the data gathering process when preparing for meetings. Included in this process is the sending and monitoring of PreciseFP which is our new online data-gathering questionnaire. Jacquie and the Planners continue to strive to make this questionnaire as user-friendly as possible since we know this can be an arduous task for many clients. As you schedule meetings with your Planner, don't be surprised if you receive an email invitation from Jacquie to fill out this electronic questionnaire.

With the title of Office Administrator, Roxane Stueve wears many hats here at CFSI. In addition to being the first smiling face you'll see when you come through our door, Roxane has also been enlisted to help make phone calls reminding clients of upcoming meetings. The latest addition to her list of job responsibilities is assisting the Planners with sending clients our Finametrica risk tolerance questionnaire prior to meetings – this is also an electronic questionnaire that you may find in your email inbox prior to a scheduled meeting.

Many of these items are a work in progress and we welcome any feedback you may have. We appreciate your patience as we work to provide the best client experience possible!

Barbara Heller
Senior Financial Planner
Elizabeth Young
Senior Financial Planner
Kathleen Heit
Associate Financial Planner
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Associate Financial Planner

The strength of tradition; the power of innovation.

Individualized financial planning and asset management.

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