Q3 2016 NEWSLETTER

Contents

AWS on TD Ameritrade

We're very excited to announce our recent approval to the premier broker/custodian TD Ameritrade. TD is very selective in which Registered Investment Advisors they work with. TD brings industry leading security, technology and service.

AWA Co-hosts Webinar

On Oct 4th, Arete Wealth Australia co-hosted a webinar with Brett Evans of Atlas Wealth Management entitled 'How to manage your cross-border financial life as an Aussie Expat Living in the US.' The webinar was attended by 50 guests. The webinar was recorded and can be viewed here.

2016 Third Quarter Report: The Bull Continues

100 days after the Brexit scare, three quarters of a year after the most recent Fed rate hike, the markets once again confounded the instincts of nervous investors and went up instead of down. In the last week of September, Fed Chairperson Janet Yellen told the world that the U.S. economy is healthy enough to weather a rise in interest rates, but the Fed governors met in September and declined to serve up the first rate hike since last December 15. That was reassuring news to the Wall Street traders, and investors generally, helping to provide yet another quarter of positive gains in U.S. stocks.

The Wilshire 5000 Total Market Index--the broadest measure of U.S. equities—gained 4.53% for the third quarter, and is now up 8.39% for the first three quarters of the year. The comparable Russell 3000 index was up 4.40% for the quarter and is sitting on 8.18% gains so far this year.

Larger companies posted the lowest gains. The Wilshire U.S. Large Cap index was up 3.92% in the third quarter of 2016, putting it at a positive 8.01% since the beginning of January. The Russell 1000 large-cap index provided a 4.03% return over the past quarter, with a gain of 7.92% so far this year, while the

Student Loan Debt Analysis

Early October saw the launch of a new niche for us. As part of the comprehensive planning we do, we've been encountering a number of younger clients with high student loan balances. Relative to other firms, we've realized that we have a competitive edge in providing this advice. Topics covered in an engagement include repayment priority, forgiveness possibilities, consolidation and refinancing. We're one of the only, if not the only, student debt advisors who are refunding to our clients the commission received from making a refinancing recommendation.

Q3 - The Conference Season

In the continuing effort to stay ahead of the trends in advice, our Principal, Ashley attended 3 conferences this season; the FPA Far West Round Up, the Insider's Forum and the FPA MN Symposium for a total of 36 hours of CE. Major take-aways from the conference included sessions on student loans, financial life planning, charitable giving, international advice, and special needs planning.

What's keeping stock prices
Nobody knows the answer, but
picture isn't nearly as gloomy as
second quarter has been
spending in general and
research and development.

widely-quoted S&P 500 index of large company stocks posted a gain of 3.31% in the third quarter, and is up 6.08% for the year so far.

Meanwhile, the Wilshire U.S. Mid-Cap index was up 4.35% for the quarter, and is sitting on a positive gain of 11.31% for the year. The comparable Russell Midcap Index gained 4.52% for the quarter, and is up 10.26% for the year.

Small company stocks, as measured by the Wilshire U.S. Small-Cap index, gave investors a 7.67% return during the third quarter, up 13.03% so far this year. The comparable Russell 2000 Small-Cap Index gained 9.05%, posting an 11.46% gain so far this year, while the technology-heavy Nasdaq Composite Index gained 9.67% for the quarter and is up 6.06% heading into the final quarter of 2016.

Looking abroad, the U.S. remains a haven of stability in a very messy global investment scene. The broad-based EAFE index of companies in developed foreign economies gained 5.80% in dollar terms in the third quarter of the year, but is still down 0.85% for the first three-quarters of the year. In aggregate, European stocks have lost 2.67% so far in 2016. Far Eastern stocks are up just 1.73% for the year. In contrast, a basket of emerging markets stocks domiciled less developed countries, as represented by the EAFE EM index, gained 8.32% for the quarter, and are sitting on gains of 13.77% for the year so far.

Looking over the other investment categories, real estate investments, as measured by the Wilshire U.S. REIT index, were down 1.21% for the second quarter, but still enjoy a gain of 9.75% for the year. Commodities, as measured by the S&P GSCI index, lost 4.15% of their value in the third quarter, but are sitting on gains of 5.30% for the year so far.

On the bond side, the interest rate story is essentially unchanged: rates are still low, once again confounding all the experts who have been expecting significant rate rises for more than half a decade now. 10-year U.S. government bonds are currently yielding 1.59%. Three-month notes were yielding 0.27% at the end of the quarter, while 12-month bonds were paying just 0.58%. Go out to 30 years, and you can get a 2.32% annual coupon yield.

high while sentiment appears to be—let's call it "restrained?"
a deeper look at the U.S. economy suggests that the economic
it is sometimes reported in the press. Economic growth for the
revised upwards from 1.1% to 1.4%, due to higher corporate
especially as a result of increasing corporate investments in
America's trade deficit shrank in August. Consumer spending—

Three Year Anniversary

On August 6th, Arete Wealth Strategists celebrated its 3 year anniversary. There are many milestones - we moved states, took on staff, have been quoted in the media, and given many presentations.

Travel Plans

Next Bay Area trip:

Oct 26th - Oct 29th, 2016

Jan 2017

which makes up more than two-thirds of U.S. economic activity, rose a robust 4.3% for the quarter, perhaps partly due to higher take-home wages this year.

Meanwhile, if someone had told you five years ago that today's unemployment rate would be 4.9%, you would have thought they were highly optimistic. But after the economy gained 151,000 more jobs in August, unemployment remained below 5% for the third consecutive month, and the trend is downward. At the same time, average hourly earnings for American workers have risen 2.4% so far this year.

Based on their reading of the Treasury yield curve, economists at the Federal Reserve Bank of Cleveland have pegged the chances of a recession this time next year at a low 11.25%. They predict GDP growth of 1.5% for this election year—which, while below targets, is comfortably ahead of the negative numbers that would signal an economic downturn. (In general, a steep yield curve has been a predictor of strong economic growth, while an inverted one, where short-term rates are higher than longer-term yields, are associated with a looming recession.)

The U.S. returns have been so good for so long that many investors are wondering: why are we bothering with foreign stocks? A recent Forbes column suggested the answer: historically, since 1970, foreign stocks have outperformed international stocks almost exactly 50% of the time, meaning the long trend we've become accustomed to could reverse itself at any time.

Nobody would dispute that the economic statistics are weak tea leaves for trying to predict the market's next move, and it is certainly possible that the U.S. and global economy are weaker than they appear. But the slow, steady growth we've experienced since 2008 is showing no visible signs of ending, and it's hard to find the usual euphoria and reckless investing that normally accompanies a market top and subsequent collapse of share prices. At the current pace, we might look back on 2016 as another pretty good year to be invested, which is really all we ask for.

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Deutsche Bank's Woes

You may have been reading something about problems with one of the world's largest lending institutions—Deutsche Bank—without understanding what the issue was. The bank has been reportedly due to pay a whopping $14 billion fine over its role in the 2008 market crash—specifically for selling junk mortgage pools to investors while knowing full well that they were junk. However, other reports say they bank may be able to settle with the U.S. Department of Justice for a mere $5.4 billion.

Deutsche Bank happens to be Germany's largest lending institution, although the firm appears to have transferred most of its corporate energies from lending to the diciest corners of the U.S. investment market when it acquired Banker's Trust Company. At the time, Banker's Trust was a convicted felon ineligible to transact business with municipalities and corporate customers after pleading guilty to institutional fraud related to its handling of complex derivatives and dormant customer accounts. The merged bank then spent much of the first part of the 2000s creating and peddling exotic investment products and trading aggressively in the same securities for its own account. In Europe, meanwhile, the bank loaded up on so many risky sovereign loans from Spain and Italy that it now faces a potential combined credit risk of 30 billion euros from that source alone. The bank's total capitalization has been reported at $17.9 billion.

This risky behavior was certainly not uncommon—U.S. lenders engaged in the same activities, and Lehman Brothers and Bear Stearns did not survive them—and the ending was not unpredictable: after 2008, the bank's balance sheet was loaded with complex derivative investments that were hard to value or unload, and there were enormous liabilities looming over its future. Most importantly, from the standpoint of investors, the share price has fallen from 50 euros in 2010 to just over 10 euros (roughly $13) currently.

Deutsche Bank was not the biggest offender for the 2008 crisis based on the size of its fine—that "award" goes to Bank of America and its Merrill Lynch subsidiary, which was slapped with a $16.6 billion penalty for its nefarious role in the subprime crisis. Nor do analysts believe the bank's existence is in jeopardy. At least one German magazine has reported that the German government has opened discussions to bail the bank out with (German) government money, and failing that, the bank may decide to sell shares to the public to recapitalize.

For those of us who thought that the purpose of lending institutions was to lend money into the economy—not play fancy tricks with tricky investments and gamble their own and our money in the more exotic corners of the markets—the Deutsche Bank debacle suggests a lesson: that greed always seems to find a way to punish those who rely on it as a business or investment philosophy.

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Directors' and Officers' Liability for Nonprofit Organizations

Many 501(c)(3) nonprofit organizations have inspiring stories behind their creation. It's not uncommon for passionate founders and directors to devote years of hard work and their own funds to move the conception of an idea into the birth of an organization dedicated to their cause. Often with little or no monetary compensation, nonprofit directors and officers rely on intangible rewards—the stories of the difference they've made in the community and peoples' lives—as incentive to continue laboring over their mission.

But a costly lawsuit could quickly put an end to that story. Do people really sue nonprofit organizations? The answer is yes. As society becomes more litigious, nonprofits are increasingly vulnerable to lawsuits that threaten their operations and, in some instances, drain their limited funds to the point where they have to close their doors. At the point where a nonprofit reaches insolvency, directors' and officers' personal assets are at risk.

Although armed with perpetual energy for their cause, nonprofit officers and directors are sometimes ill-equipped with the business acumen or financial resources to manage the liabilities of their nonprofit in the same way as a for-profit corporation. Some simply don't understand or are not cognizant of their legal liabilities. This article outlines the risks that nonprofit directors and officers can encounter, including information about the legislation that affects nonprofits, the types of claims brought against directors and officers, and ways to mitigate the risk of a costly claim.

The Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act (SOX) Act of 2002 was created in response to the major corporate scandals of publicly traded companies such as Enron and Tyco in the early 2000s. Enacted to protect investors in those companies, SOX aims to increase the truthfulness in corporate disclosures.

While the majority of the SOX provisions appertain to publicly traded companies, nonprofits are required to comply with two provisions: Whistleblower Protection and Document Destruction. Under the Whistleblower Protection provision, nonprofit directors and officers must not retaliate against those who report suspected illegal activities in the organization. This means that your employees and volunteers can express concerns about unethical and unlawful practices that happen in your organization without fear of reprisal from you or other members of the management team. Under the Document Destruction provision, nonprofit directors, officers and employees cannot destroy documents that are intended for use in official proceedings. This means your organization must retain certain documents, such as financial records and board meeting minutes, for a specific period of time. Each state has specific regulations for how long documents must be kept.

Some states require nonprofits to adhere to more than the two required SOX provisions; and some nonprofits have voluntarily adopted all of the provisions as a best practice to bolster their credibility and promote financial transparency in their organization.

Areas of Nonprofit Directors and Officers (D & O) Liability

In addition to the two SOX provisions, there are a variety of other liabilities that can affect nonprofit directors and officers. According to a 2011 survey conducted by Towers Watson, a global professional services company, 48 percent of the surveyed nonprofit organizations reported claims in the last 10 years, which were more claims than the public and private companies reported.

Some major areas of exposure for nonprofit directors and officers include: employment practices, fiduciary duty breaches, conflict of interest, government enforcement actions and misuse of funds.

Employment Practices

For nonprofits that hire paid employees, employment practices liability is a significant risk. The same employment laws that apply to for-profit corporations are also applicable to nonprofits.

With a limited budget, most nonprofits don't have a human resources department or the knowledge of employment practices that a for-profit corporation may have. Either directors and officers don't realize they're liable, or they have poorly defined employment policies and procedures in place.

To mitigate the risk of an employment practices claim, invest the time in developing a hiring policy and an employee handbook. Criminal background checks, education checks and past employer references can uncover information about a potential troublesome employee. For all paid staff members and even volunteers, provide an employee handbook so they are aware of their job duties, vacation time, benefits and other organizational policies. Maintain accurate personnel files on all employees and record all incidents in which you had to reprimand, discipline or terminate employees, as these records are necessary in the event of a lawsuit.

Fiduciary Duty Breaches

Similar to for-profit corporations, nonprofit directors and officers are also responsible for fiduciary duties owed to the nonprofit, to the other directors and officers, and to third parties such as donors and members. Directors and officers can be liable for grossly neglectful decisions and wasting resources. This is known as the "duty of care." The three fiduciary responsibilities include:

- **Duty of care.** Directors and officers must exercise reasonable care, actively participate in decision- making and are held liable for ordinary negligence. Ignorance is not an excuse.
- **Duty of loyalty.** An officer or director must not use his or her position to pursue outside transactions or interests.
- **Duty of obedience.** Directors and officers must comply with all federal and state reporting requirements, and ensure the nonprofit is dedicated to its stated mission statement and goals.

Fiduciary duties for nonprofit directors and officers are similar to the fiduciary duties for-profit corporation directors and officers owe their shareholders. Lawsuits for a breach of fiduciary duty can be brought by fellow officers and directors, the state attorney general, the nonprofit's members or the IRS. In some fiduciary breach cases, the IRS could revoke a nonprofit's 501(c)(3) tax-exempt status.

Conflict of Interest

A breach of the fiduciary duty of loyalty is usually manifested in the form of a conflict of interest. This occurs when directors and officers use their power for their own interest, or that of another interest or entity. Conflicts of interest include self-dealing or benefit activities in which officers, board members or staff have personal financial gain from the nonprofit.

It is crucial for a nonprofit to self-monitor potential conflicts of interest that exist among board members and directors. For example, you may have a board member who serves on the board of two different nonprofits competing for the same grant funding. Develop a conflict of interest policy and ask directors and officers to disclose all conflicts of interest on an annual basis.

Government Enforcement Actions

Nonprofits must follow applicable laws, including tax, civil rights and ordinary negligence. Nonprofits must follow applicable laws, including tax, civil rights and employment laws. All nonprofits must file an annual tax return with the IRS. Nonprofits with annual gross receipts of less than $50,000 must file the Form 990-N (e-Postcard) and those with annual gross receipts over $50,000 must file the Form 990. Directors and officers must ensure these forms are filled out correctly and are submitted by the deadline. A nonprofit's 501(c)(3) tax-exempt status could be in jeopardy if you fail to file or file the form past the deadline without asking for an extension.

Excessive employee compensation is closely monitored by the IRS and could result in costly fines. Employee compensation must be reasonable and comparable to other nonprofits of a similar size. On the new IRS Form 990, a nonprofit must report if any employees are compensated more than $100,000 annually.

Additionally, the state attorney general's office usually monitors nonprofits to ensure they are following their stated mission and goals and applicable state laws. Conducting activities outside of your mission could expose you to scrutiny. Some of these activities simply might require you to pay a tax, such as if the activity generates revenue, but penalties and loss of tax-exempt status could result if the activities are unrelated to the mission.

Misuse of Funds

A nonprofit relies on grant funding and donations to operate, but it is important that funds are used for the stated mission and goals. Directors and officers are liable for how funds are used. Even if you were

not present at a meeting where a financial decision was made, you can still be liable for the misuse of funding.

Misappropriation of funds can also be tied to claims made by donors that a nonprofit did not use their donation for an intended purpose. Some donors sue nonprofits that misrepresent their financial status. If a donor designates funding for a particular project or program, they can enforce the terms of the gift. Although these claims are not as common, you should still be wary of the liability.

To mitigate this risk, directors and officers should always aim to present a transparent financial picture of their organization to avoid lawsuits from donors. Accurate bookkeeping and filing the IRS Form 990 in a timely manner is essential. Be aware of volunteers or employees who handle money as there could be a risk of swindling funds.

Immunity and Indemnification

Given all of the potential claims that can be made against nonprofit directors and officers, there is *some* protection against potential lawsuits.

Statutory Immunity

The Revised Model Nonprofit Corporation Act of 1987 states that directors must actively participate in decision-making and act carefully in fulfilling their responsibilities. If decisions are made or actions are done in "good faith," directors and officers can claim immunity in potential lawsuits. Even if it was considered a bad decision, you will not be held liable if you can attest that the decision was made in good faith.
However, while immunity protects directors and officers from guilt, you can still incur court costs proving that you are immune.

Some important things to note about immunity:

- If a director or officer is paid, he or she is not immune.
- If a director or officer acted with gross negligence, he or she is not immune. Simply put, gross negligence is carelessness or reckless disregard, causing harm to the safety, lives or property of others.
- Immunity from liability does not mean directors and officers are immune from being sued and incurring the court costs of proving your immunity.

Indemnification

Directors and officers can also be protected with indemnification, which is when the nonprofit uses its own resources to pay for legal costs for claims that result from board service. This protects directors and officers from using their personal assets to pay for legal costs. Some nonprofits have an indemnification policy written into their bylaws. However, keep in mind that if the nonprofit's financial assets deplete, the personal assets of directors and officers are at risk.

Transferring Risk with D & O Insurance

Since indemnification and statutory immunity have its limitations, some risk may have to be transferred by purchasing a Directors and Officers (D & O) insurance policy. Depending on the size and budget of the nonprofit, it's typically not a large expense, but can save the nonprofit in the event of an expensive claim.

Also, D & O insurance can offer protection for board members who would otherwise have to use their own personal assets to prove immunity or pay for defense costs. Potential board members are often reluctant to join a board if a nonprofit does not have D & O insurance.

While Arete Wealth Strategists does not provide specific advice on the placement of D & O insurance, we can make referrals to specialists who can.

Structural Struggle

Why has the American economy grown so slowly since the Great Recession? This year, GDP growth will fall somewhere in the 1.5% to 1.8% range, below the 3% growth rate that is considered a sign of robust economic health. Critics have blamed everything from China's slowdown to globally outsourced manufacturing to fiscal fights in Washington. But new research from economists at the Federal Reserve Board points to a different—and much simpler—explanation.

The researchers started with a demographic prediction model. The model recognizes that the economy was destined to grow rapidly when the workforce is heavily weighted toward young accumulators, as it was in the 1960s and 1970s when the Baby Boom generation entered the workforce. The good times continued as the labor force matured and the Boomers reached a high consumption stage of their lives.

But then the Fed economists asked: what happens when the Baby Boomers start to retire, as they did starting in 2005, and in increasing numbers since? The boomer generation had fewer children than their parents did, so the research shows that as the workforce aged and retired, there were fewer people in the workforce. Economic output inevitably declined, no matter what happened in China or the manufacturing sector.

Over the past decade, the research shows that what economists call "capital"—machines, factories, roads, buildings, etc.—has become abundant compared to labor, which has depressed the return that investors receive for investing in capital. This doesn't just mean slower economic growth; it also leads to a decline in interest rates. This helps explain why interest rates rose in the 1960s and 1970s, and have gradually declined in the subsequent decades.

The conclusion? The U.S.—alongside many other developed nations—is experiencing a decline in workers compared with retirees, which happens to coincide with the lingering effects of the financial crisis. The power of demography is like the tide; don't blame the government or the Fed for not intervening, because they don't have the power to overcome the shortage of workers. More babies, and maybe more immigrants, represent better solutions.

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Getting Value in a Vacation Home

There are two great reasons for buying a vacation home: You want one and you can afford to buy it. Buying a vacation home as an investment, however, should not be your primary motivation.

Some vacation properties can also be good investments. Others aren't. As recent history has shown, real estate prices can go down as well as up, and there are no guarantees. There are, however, some guidelines that can help you find a vacation home that will provide value along with pleasure.

The Rules Have Changed

Consider first whether you want to buy or rent and, if you choose to buy, where and how. There was a time, back before tax-reform legislation in the 1980s, when there were compelling tax advantages to financing a second home. You're still able to deduct mortgage interest on one such home; but, unless it is income-producing property with its attendant complications, the once-valuable depreciation write-offs are gone. To help decide whether buying a vacation home is right for you, consider the following.

How Often Would You Use the Property?

If you plan to spend just one week, or even two, out of every 52 at a vacation home you purchase, you would probably be spending a lot of money for each day there. Mortgage payments continue all year long, as do payments for insurance, taxes, and necessary regular maintenance. If you'd be paying full price but getting only part-time use, consider renting.

There are good reasons for buying a vacation home, not the least of which is a simple desire to own the place and do what you want with it. But renting lets you experience vacation life in different places, and is relatively affordable. Rents can run from $500 to $2,000 a week or more, depending on location and amenities. At the end of your stay you close the door and forget about the place. Financial planners say that if you're just looking for a few weeks of vacation a year, it's probably cheaper in the long run to rent. An extra attraction to renting is that it gives you a chance to test different locations before settling on one to buy.

How Desirable Is the Location?

The old real estate saying goes like this: "What are the three most important things about selling a house? Location. Location. Location." The same holds true for a vacation home. Are you looking at a simple cabin in the backwoods or a comfortable house or condo in or near an attractive resort area? A rural hideaway may be great for hiking or just getting close to nature, but don't expect its value to appreciate as fast as a more comfortable place located near amenities.

With the graying of the Baby Boom generation, some analysts predict an increasing demand for country getaways in the future. That great population bulge is rapidly approaching an age when many can be expected to spend the money they've been working for and take life a bit easier.

Keeping that in mind, the best investment for future resale would probably be a fully equipped getaway that could double as a second home, perhaps on waterfront property or with privacy-protecting acreage. Amenities are important. Younger people often don't mind minor inconvenience, but older people look for microwaves, dishwashers, and even hot tubs. That condominium on the ski slopes should not be "bare bones."

Mortgage Tips
• A 20% or greater down payment may be required. • Smaller down payments may mean paying more in private mortgage insurance than with a primary residence. • The property must be a single-unit dwelling or condominium that is occupied by the owner for a portion of the year and unencumbered by a time-sharing ownership agreement. • Borrowers cannot currently own rental property in the location of the vacation home. • The property must be suitable for year-round occupancy.

You Don't Have to Be Rich

The vacation home doesn't have to be a stand-alone house. A condominium purchase can let you have a home in a terrific location that would be otherwise unaffordable.

For value today, look for that house, condo, or timeshare in a location that has activities in more than one season. Keep in mind, too, that vacation properties often become retirement homes. So safety, taxes, and the availability of cultural opportunities should be considered. With those things in mind, look for bargains in lesser-known places; investigate upswing markets, places that haven't yet become overrun or overpriced.

Look for areas where the local economy is strong and taxes are low. You don't have to be near a city, but you should be within a reasonable distance of populated areas to have access to services like quality medical care.
Another reason for being near more populated areas is that such a location allows you the opportunity to try to rent out your property when you're not using it to help cover mortgage payments and, perhaps, sell at a profit later on. With the right choices, returns can exceed the future payoff from stocks.

Tax Considerations

If you rent your home for 14 days or less a year, you do not need to report the rent. Beyond that, however, the IRS considers the rent taxable income. But you may then be able to deduct all of your rental expenses if you had a net profit on the property (deductions are limited if you report a loss). These are guidelines only; your specific tax obligations should be discussed with a qualified tax advisor.

Tax Considerations
• You can deduct mortgage interest on two houses, to a limit of $1 million. • You can rent your vacation home for up to 14 days without having to report the rent as income; if you rent for more than 14 days, the home is considered investment property and rent must be reported as income. • Rental deductions are based on the portion of the year the property is rented. • You can use the property for the greater of 14 days or 10% of the total days it is rented and maintain your tax advantages. Maintenance days do not count as personal-use days but should be documented. Use by in-laws or other part-owners counts as personal use even if rent is charged. **Source:** Internal Revenue Service.

Location Winners

Florida is, as it has been for years, a number one location for vacation homes. While Florida's east coast has been traditionally the most popular (and expensive), the west coast has also grown in popularity in recent years.

Elsewhere, properties within driving distance of popular resort areas have a good chance of healthy appreciation while giving you the realistic option of renting when you're not there. Although prices are generally higher on the west coast, other winners include Oregon's northern coast and Colorado's ski resort areas.
But the best location for you is one where you feel at ease and that is convenient to get to from your primary residence. Depending on how you live, that could mean a three-hour drive or a five-hour airplane flight.

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