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What's a Reasonable Rate of Return?

The assumed rate of return used in your investment program will determine how much you need to save to reach your financial goals and how much you can withdraw annually from your portfolio after retirement. Use a rate that is too high, and you may not accumulate the amount you need or be able to withdraw enough during retirement. But what is a reasonable long-term rate of return?

Typically, the assumed rate of return for an investment program is the average annual return for some historical period. Data is readily available going back as far as 1926. But does looking at history still make sense in the current market environment? Consider the following points:

✔ When selecting what historical period to consider, keep in mind that returns can vary substantially over different time periods. As a starting point, you may want to consider average returns for the period from 1926 to present, making adjustments from there.

✔ Understand the difference between arithmetic and geometric returns. For the period from 1926 to 2016, the arithmetic average annual return for the Standard & Poor's 500 (S&P 500) was 12%, while the geometric average return was 10%.* The arithmetic average is a simple average of the sum of each annual return divided by the number of years used. The geometric return calculates the return earned over the years, including the change in value over a specified period. Basically, you calculate how $1 would grow over the years based on actual year-by-year returns, determining what rate of return would produce the ending value. Typically, the geometric return will be equal to or lower than the arithmetic return.

✔ Don't forget to factor in inflation. When determining how

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Borrow Wisely

✔ Use debt only for items that have the potential to increase in value, such as a home, college education, or home remodeling. Avoid incurring debt on items like clothing, vacations, or other luxuries.

✔ Consider a shorter term when applying for loans. Even though your monthly payment will be higher, you will incur much less interest.

✔ Make as large a down payment as you can afford. If you can make prepayments without incurring a penalty, this can also significantly reduce the total interest paid.

✔ Consolidate high-interest-rate debts with lower-rate options. It is typically fairly easy to transfer balances from higher-rate to lower-rate credit cards. Another option is to obtain a home-equity loan to pay off consumer debt.

✔ Compare loan terms with several lenders, since interest rates can vary significantly. Negotiate with the lender. Review all your debt periodically to find less-expensive options.

✔ Review your credit report before applying for a loan, so you have an opportunity to correct any errors. ❍❍❍

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What's a Reasonable?

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much you want to have saved by a future date, your figure is stated in terms of today's dollars. Due to inflation over the years, that amount will not have the same purchasing power as it has today. You will need a higher amount at that future date for the same purchasing power. Thus, you should factor inflation into your assumed rate of return. From 1926 to 2016, inflation has averaged 2.9% annually.*

- Returns tend to regress to the mean. There is a tendency for the stock market to revert back to the average when it has had above- or below- average returns for an extended period. So following an extended period of above-average returns, it is possible that the market may go through a period of below-average returns. Thus, you may want to lower your expected annual return.

- Use conservative estimates. When deciding between a lower or higher expected return, it is usually more prudent to use the lower return. While a higher return means you will need to save less annually, you run the risk of not meeting your savings goals if actual returns are lower. Which is better — to have too much money saved when you are ready to retire or not enough? If you save too much, you can always reduce your savings in later years or spend more in retirement. The alternatives are far less attractive if you don't have enough money saved.

So what is a reasonable long-term rate of return to use in investment programs? Starting out with the average geometric return (since this is more conservative than the arithmetic return) from 1926 to 2016 of 10% and subtracting the long-term inflation rate of 2.9% would result in a return of 7.1%. You may even want to use a more conservative return if you feel the stock market may go through an extended period of below-average returns. If you'd like to discuss this in more detail, including how various rates of return would affect your long-term portfolio, please call. ❍❍❍

*The S&P 500 is an unmanaged index generally considered representative of the U.S. stock market. Investors cannot invest directly in an index. Past performance is not a guarantee of future returns. Returns presented are for illustrative purposes only and are not intended to project the performance of any specific investment vehicle. Source: *Stocks, Bonds, Bills, and Inflation 2017 Yearbook*.

Avoid Credit Card Dependence

As of the end of 2016, the total average household debt was over $132,000, which has significantly increased from 2002, when it was just over $88,000. Over the past 13 years, income has grown by 28%, while the cost of living has increased by 30% in that same time period (Source: *CNBC*, 2016).

The discrepancy between the cost of living and income has led Americans to rely more on credit cards. Approximately 70% of Americans have at least one credit card, with an average credit card balance of over $16,000. With the average credit card interest rate at 18.76%, the average household is paying almost $1,300 in interest each year (Source: *CNBC*, 2016).

Ask these questions to evaluate your credit card dependence:

- Do you rely on credit cards to make it until your next paycheck?
- Does it seem you always have to put unexpected expenses on your credit card?
- Do you spend more than you would with cash because your card has rewards?
- Do the holidays leave you with a mountain of debt?

If you answered yes to these questions, you are probably relying too much on your credit cards. If you are concerned that you are too dependent on your credit cards, there are steps you can take to become credit card independent.

- Put your credit cards somewhere for safekeeping to reduce the temptation to use them as your regular form of payment.

- Become more disciplined with spending by enacting a cash-only policy. While many people use debit cards as a convenient way to pay cash; be careful, because many financial institutions allow you to overdraft your account when you use a debit card and may charge a large fee for this overdraft privilege.

- Consolidate your balances to fewer cards that have the lowest interest rates and close the rest of your credit card accounts to reduce the amount of available credit and, thus, the potential amount of debt you could incur. While closing credit cards can have a negative impact on your credit score, it's still better to have a temporary credit score setback than to go deeper into debt if you can't control your spending. To reduce the impact to your score, you should also consider keeping your oldest credit card in addition to a lower interest-rate card.

- Shock yourself into reality by looking at a few important things on your credit card statement including: how much you are paying in interest on an annual basis, how long it will take you to pay off the balance and how much you will pay in interest if you are only making the monthly minimum payment. ❍❍❍

Which Is Better? Saving or Paying Down Debt?

Debt can be dangerous to your financial health. Thus, is it better to save or pay down your debt first?

The answer depends on a lot of things that are unique to each individual, such as your age, how much you've already saved, what rate of interest you're paying, and more. A review of the basics of financial planning is a good way to approach the subject. Here we outline how you should use income not dedicated to day-to-day expenses, in order of priority.

First Priority: Insurance

One of the best routes to financial ruin is to not have adequate insurance, so your first priority should be to have the correct kinds of policies in the right amounts that protect you and your family.

If you're young and unmarried, this means having basic health insurance. Beyond that, if you have a family, you need life insurance as well as short- and long-term disability insurance.

In each case, you're looking to provide yourself or your survivors with a replacement for income you and they count on. The bottom line: if you have debt, make the minimum payments until you're properly insured and you have the next two priorities covered as well.

Second Priority: An Emergency Fund

Even if you don't have a family, you need to protect yourself against a job loss or major unexpected expense. The rule of thumb is to create an emergency savings fund equal to three to six months of your income. Not only does this give you breathing room from hardships, it also affords you the flexibility to move in connection with a job change you might want to make.

You should make creating an emergency savings fund a priority. If you can't take care of priorities one and two at the same time you pay for basic necessities, like groceries and gasoline, you're living beyond your means and need to cut back on your spending.

Third Priority: Retirement Savings

Finally, before you even think about making more than the minimum payments toward your debts, it's imperative that you start saving for retirement as soon as possible. Time is both the best ally and worst enemy of the saver.

Start saving too late, and it's possible that you'll need a rate of return you can only achieve in your dreams to accumulate enough for a worry-free retirement. On the other hand, even small amounts — as little as $25 a month — put away early enough can grow to sizable amounts by the time you're ready to retire.

With these three priorities covered, it's time to consider making extra payments to tackle your debt.

Guidelines for Debt Reduction

There are a number of factors to consider when you're ready to start accelerating the pace at which you pay down debt:

✔ **Start with the highest-interest-rate debt.** Instead of paying more on every one of your debts, concentrate on the one that charges the highest interest rate. In general, these will be store credit cards, followed by bank credit cards like Visa and MasterCard. Use all your spare cash flow to pay down one at a time.

✔ **Is it tax deductible?** Debt that you can write off against your taxes is generally considered good debt. In effect, the tax deduction reduces the interest rate by your marginal tax rate. In most cases, this means home mortgage interest.

✔ **What rate of return can you expect?** The most important consideration is whether you can earn more by investing your money than the interest rate you're being charged on your debt. If you can earn more in the financial markets than your interest rate, you should invest your money instead of paying off debt. If not, it's worth it to pay off debt.

✔ **How long until you retire?** This is a key consideration when you're thinking of paying off your mortgage, especially if it's near the end of its term. At that point, the tax benefits are minimal because most of your payments consist of principal, not interest. In addition, if you're 50 or older, the monthly cash flow you'd free up could be devoted to the extra $5,000 a year you can contribute pretax to an IRA or 401(k) plan. On the other hand, if you have 10 years or more to go on your mortgage, it could be smarter to keep making the minimum payments to retain the tax advantages. As an alternative, consider the advantages of refinancing the remaining balance. At a reduced principal amount and with mortgage interest rates near historic lows, you may be able to reduce your monthly payments.

Smart debt management is often overlooked as a way to improve your finances. Please call if you'd like to discuss this in more detail. ❍❍❍

When There Are No Buyers

Whether selling an IBM bond, 100 shares of Apple stock, a suburban NJ home or a 2010 Honda Accord, a seller seeks the highest possible sales price. What one condition has the greatest impact on the final sales price? The number of interested buyers, of course. This is most commonly understood when buying or selling real estate. Times are generally described as either a "Sellers' Market" or a "Buyers' Market." Healthy and efficient markets depend on the breadth and depth of buyers and sellers. Without one or the other, no deal gets done.

Overnight on Sunday, August 23, 2015, there was a relatively large drop in stock prices in Asia. The following Monday morning, buyers were scarce. The Dow Jones Industrial Average dropped 1,100 points, or about 6.7%, in the first five minutes of trading. The market recovered about half of this loss before the day was out, but August 23, 2015 was not a good day for investors.

During that month, about 85 billion shares of stock were traded on the New York Stock Exchange.[1] Despite the incredible depth of this market, there are times that sellers significantly outnumber buyers. Monday, August 24th was one of those days. When this happens, highly motivated sellers will continue to lower their price, until a buyer finally comes along. In times of distress, it may take a significant drop in price before a buyer eventually arrives…sometimes to an irrationally low price.

Trading volume in the U.S. stock market is immense, providing a high level of "liquidity." That said, many specific market investments have markedly less liquidity. The iShares U.S. Technology ETF (IYW) is one such investment. ETFs (exchange traded funds) are traded like stocks and generally represent a "basket" of individual holdings. The value of this ETF at any one time approximately equals the sum total of the underlying investments — its intrinsic value. This was not true for a short time on the morning of August 24, 2015. This ETF closed at $98.25/share on the prior Friday. But on Monday morning, the ETF plummeted to a low of $73.71, a drop of 25% within minutes of the open! This occurred despite a much smaller drop in its intrinsic value. Within minutes, astute traders (arbitragers) started buying the ETF under the assumption that the price should increase to intrinsic value, but the damage had been done. Many investors sold the ETF at a huge loss. The ETF subsequently closed that day at $94.84, with a relatively modest decline of 3.5% from the prior trading day.

Why would the value of a basket of stocks (the ETF) drop four to five times more than the sum total of the stocks in that basket? Because for a short time, nobody would buy the ETF. There were plenty of buyers for the underlying stocks, but too few buyers of the ETF. The price continued to drop to an irrational price, until finally buyers realized and stepped in. This phenomenon can be summarized by the investment axiom — "Markets are made on the margin." No matter how many shares of an investment exist, the price for all of those shares is set by the active buyers and sellers of those shares "at the margin," even if those active buyers and sellers represent a very small fraction of existing shareholders.

Another example of a significant, but relatively small imbalance "at the margin" occurred in 2014 and 2015. In June of 2014, the price of crude oil hit its most recent high of $111.93/barrel. By December 31, 2015, the price had dropped to $38.01…an extraordinary decline of about 66%! For the year 2015, the U.S. Energy Information Administration (EIA) estimated that on average, the world was consuming 93.8 million barrels of oil per day, and producing 95.5 million barrels per day.[2] This resulted in an oversupply condition of 1.8%. This seemingly modest 1.8% oversupply, combined with motivated sellers at the margin, resulted in a 66% drop in price for all 93.8 million barrels sold each day.

As investment advisors, we generally seek investments that offer a good deal of liquidity. We also try to avoid selling into a market in turmoil, recognizing that a dearth of buyers can lead to an irrationally low price. While stocks tend to have great liquidity, there sometimes are large swings in the number of buyers and sellers. Corporate bonds, on the other hand, have significantly less liquidity than stocks. In times of turmoil, this relatively conservative investment can experience a significant and sometimes irrational drop in market value, simply because there are too few buyers. In such an event, unless we see a significantly increased risk of default, we would certainly look to hold these investments. Our ability to hold, knowing we are assured a guaranteed return over time, is precisely the reason we generally prefer individual bonds to bond funds.

Markets are made on the margin. The small minority of active buyers and sellers of an investment set the price for all investors. The effect that a very small minority of buyers and sellers can have on the overall value of an investment can be great, especially in tumultuous markets. Successful investing requires an understanding of this condition, and an appropriate response to it.

Sincerely,

Steven Criscuolo

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Chief Financial Officer, BFS

**Investors should consider the investment objectives, risks, charges and expenses of an exchange traded product carefully before investing. The prospectus contains this and other information and should be read carefully before investing. The prospectus is available from your investment professional.*

[1] "NYSE Market Data," *1960 through 2001 NYSE Fact Book. www.nyxdata.com/nysedata/asp/factbook/viewer_edition.aspwww.nyxdata.com/nysedata/asp/factbook/viewer_edition.asp*

[2] *Guide to the Markets® U.S. 1Q 2016,* JP Morgan Asset Management, as of December 31, 2015.