Dwayne M. Dills, CPA, PC
Financial Advisor and Certified Public Accountant
1278 B • Hendersonville Road • Asheville, NC 28801
Phone: 828-398-0258 • Fax: 828-274-7020

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The Impact of Changing Rules for Wall Street

One of the key messages resonating in the aftermath of the 2008 financial crisis was that it should not have happened, and new regulations were necessary to prevent that kind of crisis from happening again. It is taking awhile, but lawmakers have passed regulations broadly dubbed financial reform.

When people talk about financial reform in the aftermath of the financial crisis, they are almost always talking about the Dodd-Frank Wall Street Reform and Consumer Protection Act, most commonly referred to as Dodd-Frank. The law, which is more than two thousand pages long, is exceedingly complex.

While passed by Congress and signed by the president, the Dodd-Frank has yet to be fully implemented. In other words, the details are still being worked out, so we will only review the bill's broad strokes.

1. Greater transparency will help you make better investment decisions — provided you take the time to sit down and really dig into the information. The provisions of Dodd-Frank, designed to give greater transparency to financial products, would have "given investors insight into the quality of the sub-prime loans underlying the securities they purchased, giving them the opportunity to discover just how much risk they were assuming and would have required some risk retention," according to Mary Schapiro, then-Chairman of the U.S. Securities and Exchange Commission (SEC).

Dodd-Frank mandates greater transparency in three ways:

- It establishes the **Office of Financial Research** to, in part, collect and analyze data to "identify and monitor emerging risks to the economy" and make that information available in public reports and Congressional testimony.
- It gives the SEC authority to impose a **fiduciary duty on brokers**

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How the Fed Influences the Stock Market

What moves the stock market? There is no easy answer to that question. Ultimately, many factors influence the stock market indices that are often referred to generally as the market.

At the most micro level, the price of individual stocks is influenced by company performance — or, more accurately, investors' perception of future company performance. At the most macro level, the prices of stocks are influenced by the economy — or, more accurately, investors' perception of the economy's future performance.

From micro to macro, the key factor is this: investor perception. Whether investors are irrationally exuberant or irrationally despondent or anywhere in between, investor perception can and does move markets. One factor that strongly influences investors' outlook of future economic performance is the Federal Reserve.

The Fed: How It Works in the Economy

The Federal Reserve has a dual mandate: to pursue the economic goals of price stability and maximum employment. The Fed affects those goals through management of the nation's supply of money and credit (in other words, by conducting monetary policy).

People sometimes talk about the Fed setting interest rates, which it does not actually do. The Fed sets a target for the federal funds rate, which is the rate banks charge each other for overnight loans and influences other interest rates. Typically, when the federal funds rate rises or falls, so do the prime rate, mortgage rates, auto loan rates, and other rates.

So how does the Fed help the economy reach its target fed

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The Impact

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who give investment advice; in other words, brokers will be required to provide only advice that is in the client's best interest.
- It requires issuers of asset-backed securities to analyze the **quality of the assets underlying** those securities and to disclose that information.

But this greater transparency is only meaningful if you take the time to do your due diligence — to read the reports from the Office of Financial Research, to read the disclosures provided by issuers, and really understand the underlying assets.

2. New rules governing rating agencies will help ensure that ratings are a reliable source of information. Investors should be able to rely on credit rating agencies (like Standard & Poor's, Moody's, and Fitch) to help them discern the riskiness of securities. Securities given the highest rating, AAA, should present the least risk to investors. But the Senate Investigations Subcommittee found that over 90% of the AAA ratings given to subprime mortgage-backed securities originated in 2006 and 2007 were later downgraded by the credit rating agencies to junk status.

So Dodd-Frank imposes new rules for rating agencies designed to infuse independence, transparency, and trust back into the ratings system:

- Mandates **more disclosure** from Nationally Recognized Statistical Ratings Organizations (NRSROs) — like Standard & Poor's, Moody's, and Fitch, for example. It requires those NRSROs to disclose their methodologies, use of third parties for due diligence efforts, and ratings track record.
- Subjects NRSROs to **expert liability**, meaning investors can bring private rights of action against ratings agencies for a "knowing or reckless failure to conduct a reasonable investigation of the facts or to obtain analysis from an independent source."
- **Ends shopping for ratings.** Issuers of asset-backed securities will no longer be allowed to select the rating agency they think will give the highest rating.

3. As a shareholder, you'll have more control over executive compensation and corporate governance. Many experts believe that the risk-taking that precipitated the financial crisis was driven by a focus in corporations on achieving ever-higher, short-term gains. So the provisions of Dodd-Frank that affect executive compensation and other aspects of corporate governance, giving the shareholders more say, are designed to mitigate that kind of short-term focus.

To accomplish that goal, Dodd-Frank gives shareholders a say on pay and corporate affairs with a nonbinding vote on executive compensation and golden parachutes, which are lucrative severance packages for executives.

4. You'll have a voice in SEC rules and regulations. Dodd-Frank also provides investors a chance to regulate the regulators. The Investment Advisory Committee, established by Dodd-Frank, is a committee of investors designed to advise the SEC on its regulatory priorities and practices. Dodd-Frank also creates the Office of Investor Advocate within the SEC to "identify areas where investors have significant problems dealing with the SEC and provide them assistance" and an ombudsman to handle complaints.

5. The SEC will have more access to your information, which is a good thing. While most Americans bristle at the thought of the government having access to their private, personal financial information, the provisions of Dodd-Frank that give the SEC some access to certain investor information is designed to ensure that investors' money is where their hedge fund manager says it is — to protect investors from another Bernie Madoff. Dodd-Frank accomplishes this by requiring hedge funds and private equity advisors to register with the SEC as investment advisors and provide information about their trades and portfolios.

6. You may have reduced access to certain types of investments. Probably one of the most well-known aspects of Dodd-Frank is the Volcker Rule, which is broadly designed to prevent the kind of intermingling of risk that hit the financial system in 2008. Specifically, the Volcker Rule prohibits banks, their affiliates, and holding companies, as well as nonbank financial institutions supervised by the Fed, from engaging in proprietary trading, investment in and sponsorship of hedge funds and private equity funds, and limits relationships with hedge funds and private equity funds.

The Volcker Rule may mean restricted access to the kinds of investment opportunities that banks used to make available to their high-net-worth clients. Before the financial crisis, many banks invested their own money in hedge funds and private equity funds and also opened those individual funds to their wealthiest clients. Under the Volcker Rule, such funds will largely disappear.

In addition, Dodd-Frank raises the bar for investors to meet the legal definition of accredited investor. Previously, a net worth of $1 million, or a $200,000 salary for three consecutive years, qualified an investor as accredited, which meant that the investor could access certain types of investments — such as limited partnerships and hedge funds — not available to other investors. Under Dodd-Frank, an investor's primary home is not included in the $1 million calculation, which will considerably shrink the pool of investors who qualify for those limited access opportunities.

Dodd-Frank is an absolutely massive piece of legislation that touches every corner of the U.S. financial system. Its rules were undoubtedly meant to protect investors and to prevent another 2008-like financial crisis. How Dodd-Frank impacts the financial system once all of its rules have been implemented remains to be seen.

How the Fed Influences

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funds rate if it doesn't set the rate directly? Through what's called open market operations, essentially buying or selling government securities. When the Fed wants to lower the fed funds rate, it engages in expansionary monetary policy. It buys government securities, which means that it's sending more cash into the economy — specifically to banks. Banks want to loan that money, so they lower interest rates to entice more borrowers.

How Fed Actions Affect the Market

Since the financial crisis, the Fed has been engaged in a series of stimulus programs known as quantitative easing. The current program entails $85 billion in monthly bond purchases. As a result of these programs, interest rates have remained near historic lows.

But the Fed can't keep interest rates low forever, because low interest rates put upward pressure on inflation. So the Fed's job is a balancing act, trying to keep unemployment low and inflation at a target level of about 2%.

In recent months, as the economy has continued to show signs of improvement and employment levels have continued to rise (even as the unemployment *rate* has not fallen dramatically), market watchers have all assumed that the Fed would soon announce it would scale back its economic stimulus programs.

The Fed did just that on June 19 when Fed Chairman Ben Bernanke announced after the Federal Open Market Committee meeting that the Fed intended to begin gradually reducing monthly bond buying this year, depending on continued economic strength. When the stock market reacted strongly, he later backtracked, indicating it would be some time before the Fed would reduce bond buying.

How Should You React?

As an investor, what does the Fed's influence on markets mean for you? It's not wise for individual investors to buy or sell investments based on what the Fed has said it might or might not do at some uncertain point in the future.

What individual investors should do is review investment portfolios annually. From changes in Fed policy to changes in asset value in different classes, an annual review of your portfolio — and tweaks to your investments to ensure that your portfolio remains in line with your financial strategy — is the right way to ensure that you are maximizing performance given market fluctuations that are out of your control. Please call if you'd like to discuss this in more detail.

Lessons Learned about Stock Investing

The stock market volatility of the past few years has taught some valuable lessons about the stock market:

- **The market tends to revert to the mean.** There is a tendency for the stock market, when it has an extended period of above- or below-average returns, to revert back to the average return. Thus, following an extended period of above-average returns in the 1990s, the stock market experienced a significant downturn, helping to bring the averages back in line.
- **Don't chase performance.** Investors often move out of sectors that are not performing well, investing that money in investments that are currently high performers. But the market is cyclical, and often those high performers are poised to underperform, while the sectors just sold are ready to outperform. Rather than trying to guess which sector is going to outperform, make sure your portfolio is broadly diversified.
- **Avoid strategies designed to get rich quick in the stock market.** The stock market is a place for investment, not speculation. When your expectations are too high, you have a tendency to chase after high-risk investments. Your goal should be to earn reasonable returns over the long term.
- **Don't avoid selling a stock because you have a loss.** When selling a stock with a loss, an investor has to admit that he/she made a mistake, which is psychologically difficult to do. When evaluating your stock investments, objectively review the prospects of each one, making decisions to hold or sell on that basis.
- **Make sure an investment will add diversification benefits to your portfolio.** Diversification helps reduce the volatility in your portfolio, since various investments will respond differently to economic events and market factors. Yet it's common for investors to keep adding investments that are similar in nature. This does not add much in the way of diversification, while making the portfolio more difficult to monitor.
- **Check your portfolio's performance periodically.** While everyone likes to think their portfolio is beating the market averages, many investors simply don't know for sure. So thoroughly analyze your portfolio's performance periodically. Compare your actual return to the return you targeted when setting up your investment program. If you aren't achieving your targeted return, you risk not reaching your financial goals. Now honestly assess how well your portfolio is performing. Are major changes needed to get it back in shape?
- **No one knows where the market is headed.** No one has shown a consistent ability to predict where the market is headed in the future. So do not pay attention to either gloomy or optimistic predictions. Instead, approach investing with a formal plan so you can make informed decisions with confidence.

Business Data

Indicator	Month-end Aug-13	Sep-13	Oct-13	Dec-12	Oct-12
Prime rate	3.25	3.25	3.25	3.25	3.25
3-month T-bill yield	0.04	0.01	0.05	0.09	0.13
10-year T-note yield	2.86	2.79	2.66	1.80	1.79
20-year T-bond yield	3.61	3.53	3.41	2.56	2.55
Dow Jones Corp.	3.17	3.09	2.98	2.70	2.66
GDP (adj. annual rate)#	+0.40	+1.10	+2.50	+0.40	+1.30

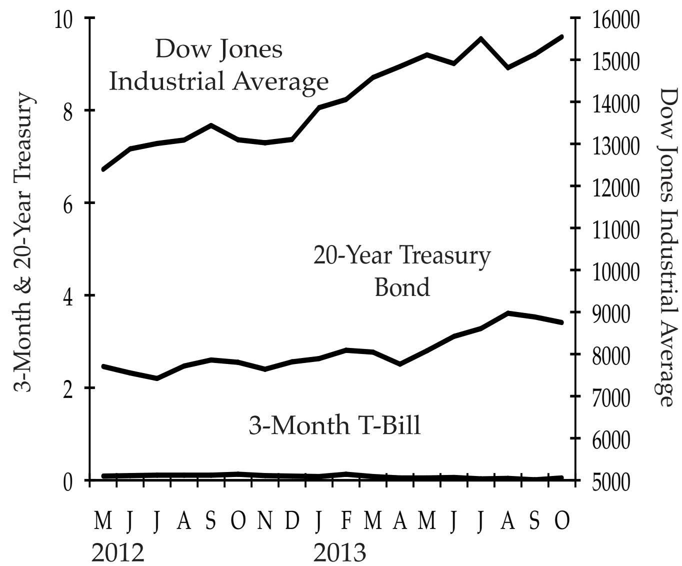
Indicator	Month-end Aug-13	Sep-13	Oct-13	% Change YTD	12 Mon.
Dow Jones Industrials	14810.31	15129.67	15545.75	18.6%	11.8%
Standard & Poor's 500	1632.97	1681.55	1756.54	23.2%	24.4%
Nasdaq Composite	3589.87	3771.48	3919.71	29.8%	31.7%
Gold	1394.75	1326.50	1324.00	-20.3%	-23.0%
Unemployment rate*	7.40	7.30	7.20	-7.7%	-7.7%
Consumer price index@	233.50	233.60	233.90	1.6%	1.1%
Index of leading ind.@	95.40	95.90	96.60	3.4%	0.8%

— 4th, 1st, 2nd quarter @ — Jun, Jul, Aug * — Jul, Aug, Sep

Sources: *Barron's, Wall Street Journal* Past performance is not a guarantee of future results.

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield

May 2012 to October 2013



News and Announcements

Your Stock Allocation

Your asset allocation mix represents your personal decisions about how much of your portfolio to allocate to various investment categories, such as stocks, bonds, and cash. How much you allocate to each category depends on your financial objectives and personal circumstances. However, it is a percentage that is likely to change over time. Some factors to consider when deciding how much to allocate to stocks include:

- **Your risk tolerance** — The advantage of including both stocks and bonds in your portfolio is that when one category is declining, the other category will hopefully offset this decline. One way to assess the percentage of bonds to hold in your portfolio is to look at how holding varying percentages of stocks and bonds would have impacted your average returns.
- **Your time horizon** — The longer your time horizon for investing, the more risk you can typically tolerate in your portfolio, since you have more time to overcome any significant downturns in your portfolio. Certainly, individuals with short time horizons, perhaps five years or less, should be very cautious about how much to allocate to stocks. But as your time horizon lengthens, you can theoretically add a higher stock mix to your asset allocation.
- **Your return needs** — Your need to emphasize income or growth is likely to change over your life. When you are trying to accumulate significant assets for a goal far in the future, you may want to allocate more of your mix to stocks. However, when your needs for a predictable income stream become more important, such as when retirement approaches, you may want to allocate more to bonds.

If you'd like help assessing how much to allocate to stocks and how to diversify, please call.

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