

Special points of interest:

- Factors that Influence the Price of Gold
- Diversifying Fixed Income Assets Can Reduce Interest Rate Risk
- Muni Bonds and Late-Cycle Performance
- Short-term Expectations Versus Long-term Reality
- Why Invest in REITs
- The Big Picture. 2018 Global Markets Performance

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Overview

Within this edition we explore the attributes of gold and factors that influence its price. We drill down into the importance of diversification within the fixed income asset class. We further explore

the attractiveness of tax-free bonds as a late economic cycle investment. We address the relevance of short-term versus long-term performance from an historical perspective. We wander into the world

of real estate and examine the attractiveness of REITs and finally we visit global investment returns for 2018 and put the US stock market's advance in perspective.

What Drives the Price of Gold?

Atomic number 79, atomic mass 196.66. The most malleable of all metals. So soft, one ounce can be beaten out to a sheet with an area of 300 sq. ft. Gold, scarce and precious. Investors have valued gold as a safe haven in times of economic turmoil and market uncertainties. In October of 2007, gold spiked from \$662 to \$829 per ounce of US bullion. During the same time, the reality of the mortgage crisis began to materialize. In February of 2009, gold again spikes higher to \$982, as the S&P tumbles. Gold continues its upward trend into December 2010 to \$1,217 as the Euro crisis captures the headlines, many doubtful

the \$110 billion-dollar loan will bail out Greece. Gold reaches a high of \$1823 in September of 2011 as the occupy Wall Street movement comes together. Uncertainty drives investors to the safe-haven of gold. Or does it? In January of 2014, the S&P has its worst New Year start in history. Gold continues to decline from its September 2011 high, dipping to \$1202 an ounce. Into December of 2015, investors continue to abandon gold as China devalues its currency and growth slows. Now in the final quarters of 2018, gold continues to languish despite present political unrest. What truly drives gold is more than rhetoric from

the grim reaper. During 2007-2011, the US dollar was weak. The strength of the economy was in question. Inflation expectations were high. Stock market sentiment was bearish. Currently strong fundamental and technical factors continue to depress gold. With stocks strong, there is little appetite for precious metals as a safe haven. When there is a bearish shift in market philosophy an actual (or anticipated) uptick in inflation, a weaker US dollar and of course a few grim headlines, the opportunity to return to the beloved element, gold, as a place of value will be dazzling.

Fixed Income Diversification Matters

Interest rates are rising. Maybe not extreme, but even a moderate 50-basis-point (1/2%) jump from current levels to about 3.5% has implications for investors. **What should you consider? Diversification matters.** Different types of fixed-income securities respond differently to rising rates. In general, corporate bonds (both investment-grade and high-yield), floating-rate notes, emerging-market debt, shorter-term issues, and certain types of structured securities may reduce the risk of losses during periods of rising rates. On average, longer-maturity, higher-rated bond sectors underperform during periods when Treasury yields are rising. Active management may offer advantages over indexing. **Greater flexibility can help mitigate interest-rate sensitivity.** Recently, public debt has crowded out private debt. For bond indexing strategies, the result has

been much greater representation of Treasury securities, longer duration, and heightened sensitivity to interest rates. In contrast, non-Treasury debt instruments can represent compelling relative value. Identifying such opportunities requires a careful, discriminating approach to security selection. **While fixed-income losses due to rising interest rates present a risk, market fears may be disproportionate to the severity and lasting impact of the losses actually incurred.** Such fears are based partly on exaggerated expectations for the scope of future rate increases. What happens when rates rise sharply? Since 1956, there have been five years — 1959, 1969, 1994, 1999, and 2013 — in which long-term interest rates² jumped by at least 50 basis points (+0.50%) over the course of the year and intermediate-term government bonds realized losses for that year. Returns for those years were -0.39%, -

0.74%, -5.14%, -1.77% and -3.68%, respectively. However, those one-year losses reversed relatively quickly. Three-year returns (encompassing the current year and the subsequent two years) for 1959, 1969, 1994, 1999, and 2013 were 1.97%, 1.58%, 4.19%, 5.47%, and 2.14%, respectively. In fact, since 1956, intermediate-term U.S. government bonds have been positive over all rolling 3-year periods. There is no guarantee that fixed-income markets will repeat this pattern of short-term reversals when the next interest-rate cycle plays out. **In the long run, the risk of being underexposed to fixed income due to market timing may outweigh the risk of exposure to rising interest rates.** We believe fixed-income exposure can continue to play a useful role in our clients' portfolios, if managed effectively despite the vulnerability of bond valuations to rising interest rates.



Munis and Late-cycle Performance

The tax-exempt municipal market “munis” has displayed a number of characteristics historically that could make it attractive for U.S. taxpayers late in this expansion. Historically, municipal bonds have outperformed when rates are rising. On a pretax basis, munis have outperformed taxable investment grade corporate bonds in three of the last four Fed tightening cycles. **On an after-tax basis, the benefit has been more pronounced: Munis have outperformed investment grade credit, U.S. Treasuries and mortgages in all four tightening cycles since 1987.** Munis also have lower correlations to

risk assets than many taxable fixed income alternatives. **Over the past decade, both investment grade and high yield munis have shown about one-third the correlation to equities compared with their taxable counterparts.** Over the past 20 years, during periods when the S&P 500 declined at least 10%, munis outperformed equities by an average of 23% and investment grade corporate bonds by an average of 1.33% after accounting for federal income taxes. While the late-cycle performance of municipals has been strong historically, it's important to consider what might be different this time around. A

key shift from past cycles is the sharp reduction in bond insurance on new muni issuance, from over 50% before the crisis to about 5% today. This has, in many ways, transformed the municipal market into a credit market. **Underlying credit fundamentals will play a larger role in performance at the turn of this cycle, making active selection critical.** While greater credit challenges are expected, a number of muni segments should prove more resilient. These include essential-service revenue bonds in favorable service areas and select government obligation (GO) bonds.

Short-term Craving Vs. Long-term Performance

We live in a world craving short-term gratification. Often many act without calculation of risk and reward. It is “I want this, and I want it right now.” This attitude (short-termism) is often seen in investors. Behind all the numbers and multiples, earnings reports, and talk about long-term investing, investors often want instant gains. **Studies show that chasing short-term performance is costing investors between 80 to 150 basis points per year.** In addition, often “short-termism” results in money being wasted through excessive trading costs incurred when changing from one investment strategy to another. Consider that, a lot of time is often spent picking the manager who has the right philosophy only to throw it all out the window if short-term performance lags. Even Warren Buffett has suffered several periods of underperformance without damaging his reputation as one of the world’s most successful investors. Companies and investment managers are guilty of encouraging

short-term thinking by practices such as reporting corporate earnings quarterly, providing short-term guidance, and providing short-term performance reporting. All these practices are of questionable value. Studies show that investors will not reap the benefits of an active manager’s skill unless they judge the performance over a full market cycle which usually lasts seven to ten years. **During a typical cycle, managers typically miss their benchmark between two and four years.** For money managers persuading investors to accept regular periods of underperformance remains a tough proposition. Moving away from short-term performance chasing would be helped not only by deemphasizing short-term thinking and practices and by examining the time periods over which a manager holds securities. Often, it’s for seven years or more. This should be no surprise since it takes time for growth to be achieved. To illustrate this point, compare the

performance of the S&P 500 Index EFT/SPY and the iShares MSCI Emerging Market ETF/EEM since 2003 to present. An initial \$100,000 investment in EEM would have grown to \$258,840. A similar investment in the SPY would have grown to \$216,240. The EEM investment outperformed by \$42,600 for the entire cycle. Over shorter cycles the asset classes had considerable divergence. Over four shorter cycles between 2003 to September 2018, EEM provided returns of 375.83%, (April 2003 to October 2007)-58.81%, (November 2007 to January 2018) 122.35% and -17.66% (February 2018 to September 2018). The SPY which produced returns of 68.26%, -41.75%, 212.91% and 3.11%. It’s unclear that chasing short-term performance would have enhanced returns. Overtime the faster growing sector produced superior performance. **In the investment world, time matters and it’s valuable.**

An Important Investment for Retirement Years

REITs are total return investments typically providing high dividends plus the potential for moderate, long-term capital appreciation. Long-term total returns of REITs tend to be similar to those of value stocks and more than the returns of lower risk bonds. Because of the strong dividend income REITs provide, they are an important investment both for retirement savers and for retirees who require a continuing income stream to meet their living expenses. REIT dividends are substantial because they are required to distribute at least 90 percent of their taxable income to their shareholders annually. Their dividends are fueled by the stable

stream of contractual rents paid by the tenants of their properties. The relatively low correlation of listed REIT returns with the returns of other equities and fixed-income investments also makes REITs a good portfolio diversifier. REIT returns tend to “zig” when those of other investments “zag,” helping to reduce a portfolio’s overall volatility and improve its returns for a given level of risk. REITs historically offer investors: **Competitive Long-Term Performance.** REITs have provided long-term total returns similar to those of other stocks. **Substantial, Stable Dividend Yields.** REIT dividend yields historically have produced a steady stream of income

through a variety of market conditions. **Liquidity:** Shares of publicly listed REITs are readily traded on the major stock exchanges. **Transparency:** Independent directors, analysts and auditors, as well as the business and financial media monitor listed REITs’ performances and outlook. This oversight provides investors with a measure of protection and more than one barometer of a REIT’s financial condition. **Portfolio Diversification:** REITs offer access to the real estate market typically with low correlation to other stocks and bonds.

About Stark Financial Advisers

Stark Financial Advisers is a registered investment adviser affiliated with R.M. Stark & Co., Inc., an SEC registered broker dealer. SFA seeks to achieve positive returns over a long-term investment horizon by creating and maintaining the optimum portfolio for each investor. We view the optimum portfolio as one having the highest potential return consistent with the risk tolerance and investment horizon of the owner.

We also understand the relationship between risk and return and seek to reduce risk through targeted asset allocation among numerous asset classes. Each asset class has separate and distinct characteristics, including returns and risk that can be measured over time. While all classes are cyclical, they often trend in different directions. Two portfolios, each having similar return prospects, may have substantially different short-term risk characteristics. Clearly, the lower risk portfolio would be the choice of most investors.

Of course, all investments contain risk and there is no guaranty of positive returns; losses can occur. For additional information and a complete performance history, please visit www.starkadvisers.com.

Pursuant to Rule 204-3 of the Investment Advisers Act of 1940, we are required by the Securities and Exchange Commission to offer each client a copy of Form ADV Part II that describes our firm and methods of operation. To receive a copy, please call our Managed Account Services Department at (800) 410-0704.

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Global Markets and Performance

We hear so much about how well the stock market is doing. Yet, when we view our statements our personal performance doesn't seem to track its performance. Don't fret, despite the short-term disconnect you are probably doing fine. Here are the facts through mid-September. Year-to-date only one major equity sector was higher, U.S. stocks led by Large and Small caps up 8.7% and 13.1% respectively. Stocks around the world ex U.S. were off -5%. Japan was the best performing foreign market down -2.6%. Asia-ex -Japan shed -7.3%. Most bond sectors lost ground with U.S. Investment Grade issues off -2.4%.

Only one bond sector was positive, U.S. High Yield ahead by 2.3%. Precious metals continued their decline with Gold off -8.3% and copper off a stunning -17.6%. We all would prefer to make money all the time. It's not always the case especially in the short-term. If you have a diversified portfolio, there is a good chance you are down for the year. Keep in mind that the pendulum swings back and forth from one extreme to another. Recently, money has flowed into U.S. equities and out of almost everything else.

But as a sector gains value another loses often making the loser a better value. Consider current dividends. The dividend yield on U.S. Large Caps has fallen to 1.9%. Small caps on average yield 1.2%. These yields are well below the world average of 3.3% and are an indicator of current value. If you have a portfolio that is properly diversified for your risk tolerance and investment objectives, you are probably doing fine. Just be patient. As we previously wrote, "in the investment world, time matters, and it is valuable."



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As always, the professional staff at Stark Financial Advisers thanks you for your confidence and business