Accelerating change is the new normal. We have to get used to it, or get off the grid completely. We only recommend that for people who are prepared to hunt for food.

The level of angst and hyperventilation experienced by the markets, media, and various pundits after the British vote to LEAVE the European Union was remarkable, especially the lopsided criticism of those daring to vote to LEAVE the gentle benevolence of the Brussels-based bureaucrats. How dare they - don’t the rubes realize how bad this will be for them?

As the British would say, Balderdash! There is already discussion around efforts by Great Britain to put forth its own trade deals without interference from its continental “friends.” Things change, but often for the better.

Markets swooned, but suddenly rallied as the world sobered up. As of this writing, markets have recovered all of their losses, and are setting new highs. The whole episode gave us an opportunity to acquire beaten down shares at lower prices than the week before. When opportunity knocks...

Markets continue to be challenged by diminished global growth prospects, and are projected to provide muted returns over the longer term. This has created an environment where short-term bursts of fear on the part of investors may result in violent moves.

As we review the annual long-term asset allocation studies of other investment firms, an interesting relationship between classic return and risk measures is prevalent across almost all asset classes. Typical is a projected 6% total return for domestic equities, with an expected standard deviation of perhaps 15-18%. That is a lot of stomach-churning angst for most people, and hardly seems worth it....

Except that cash still yields close to zero, and $10 Trillion (and rising) of global government bonds carry negative interest rates. We wrote about negative interest rates last quarter – the situation has become more pronounced as more bonds fall into that zone. As of this writing, US 10-year Treasury Bonds trade at a 1.35% yield, and may be headed for further declines. Global finance is operating on another plane of existence right now.

Modern Portfolio Theory – RIP?

To say the least, the current state of global finance has generated some non-traditional musings on Modern Portfolio Theory (MPT), and it raises interesting questions regarding MPT’s applicability to the 21st century investing environment. As a Chartered Financial Analyst®, whose career has been predicated upon utilizing the fundamental tools of MPT, it almost appears sacrilegious to question the basics of it. On the other hand, slavish commitment to data from eras when global finances were far different than today also defies common sense.

For example, we recently consulted with a retiring professional to review a proposed financial planning solution generated by a well-known firm (who shall remain unnamed), and were asked to supply our opinion. The solution was driven by a traditional MPT approach, utilizing historical data on risk and total return for various asset classes, to build the most efficient, risk-adjusted portfolio in order to meet the individual’s retirement needs. We took great issue with the proposed solution because of its over-reliance on historical data.

Currently, there are a number of huge problems with formulaic MPT tools:

- They project the future based on the past. One must look forward, and not simply project historical risk and return assumptions.
• Bond market returns and risk of the past thirty years will in no way represent the next thirty years. Negative interest rates, anyone?
• Risk needs to be re-defined from standard deviations or beta measures, as technology, low-cost trading, and indexation all have served to increase correlations across asset classes.
• Risk needs to be re-defined to account for real risk to one’s financial standard of living, especially as that risk relates to total return expectations.

Today, for example, using the historical-data approach results in including far more bonds in a portfolio than appears sensible when looking forward. There are other problems with adherence to MPT, but these are the biggies. So, like old dogs, we must learn new tricks, or re-learn old ones.

Our preferred method of building a portfolio examines the client’s requirements and risks first. This is the liability side of the equation, to be balanced with an appropriate asset mix. In simplest terms, lifetime income needs should be reasonably secured first, with riskier assets utilized only after the first priority is met. Risk is defined within the context of the client’s whole asset base, including real property, business interests, and family considerations.

In the good old days, this was called income-based investing. If correctly executed, it minimizes the risk in an MPT total return world of being forced to sell assets at the bottom of a correction, crash, Brexit, or recession.

The way the world is structured right now, bonds carry elevated risks with little (and sometimes negative) returns, while forward projections of returns across asset classes are very muted, meaning the capital gain portion of total return is less important. Steady income generators like blue chip dividend-paying stocks are more likely to match a client’s liability.

**Investment Considerations**

The markets have been behaving pretty much as expected for the past couple of years — sideways with a lot of volatility. Today we are at the top end of a trading range, and we will be more inclined to harvest profit than invest aggressively in a weak global economy.

**I’M JUST NOT READY FOR A ROBOTIC DENTIST**

Have you ever read a deed from the 1800s? Many of them were written in beautiful “copperplate” script, a pen-and-ink style that was taught to lawyers, accountants, and many other business people. Copperplate scriveners became obsolete years ago. They were replaced by typewriters operated by secretaries, and in recent decades by computers operated by the professionals themselves. Now artificial intelligence (AI) is arriving, the recent fatal crash of an autopilot-driven car notwithstanding. It will change the roles, skills, and value delivered by professionals.

Lawyers, accountants, physicians, pharmacists, architects, airline pilots, and many others, including financial advisors, already are affected. AI and its precursors already are doing many of the things these highly educated pros used to do. Space is too limited here to do more than mention a few examples. Pharmacists’ tasks selecting and counting pills is an obvious example. Medical diagnosis by AI is more complex but is coming. Automatic landing systems have been standard on many airline planes for years. Architects have used and in some cases have been replaced by CAD-CAM systems.

In financial and legal services, the norm in recent decades has been for professionals to use software systems to do things that would be too time-consuming to be practical without them. Most of these have not evolved into AI, but they will.
Changes are sometimes resisted. Currently, regulators of professional services (usually at the state level) are coping with advocates of consumer rights (usually at the federal level). For example, the regulators of the legal profession in North Carolina are engaged in a years-long negotiation with the Federal Trade Commission (FTC) and with companies such as LegalZoom over what constitutes the unauthorized practice of law. My favorite is a lawsuit between the FTC and the Board of Dental Examiners. I'm just not ready for a robotic dentist!

Accountants and tax preparers are keeping an eye on “return free filing.” Forget about TurboTax. Forget about a flat tax. The new threat to the professionals is being proposed by “consumer advocates” such as Elizabeth Warren: Let the government prepare your tax return. It’s not exactly AI, but there are big computers behind the scenes, and I doubt they are being programmed to resolve questions in favor of taxpayers. Are there roles for professionals even with return free filing? Of course there are, but they are different from the current roles.

My purpose is not to wail against innovation. Those who do will go the way of the copperplate scriveners.

My purpose is to assert that innovation will not eliminate the need for professionals any time soon. It simply will change what we need for them to do. In the investing world, there is a development that’s often called “robo-investing.” It is more than quantitative investment management or indexing. Can a computer system that’s not yet AI invest as well as a human? In some ways, yes, I’m sure it can. I’m also sure that for the foreseeable future it will be no substitute for eyeball-to-eyeball contact, sometimes clouded by tears of fear, grief, joy and the like, when determining one’s needs and goals, and strategies for meeting them.

Let the robot implement the strategies (maybe), but I’m still not ready for a robotic dentist.

**THE SANDWICH YEARS**

The more clients with whom I work, the more aware I become of the cycles of a financial life and how each stage has its own distinct challenges. While everyone’s situation is different, there are certain financial challenges which echo through each stage of life. Financial Planning is a framework for making smart financial decisions to address these challenges, no matter the stage of life.

It seems that most financial planning is focused on the challenges (both financial and emotional) of the transition from a steady paycheck into the retirement stage where savings are being tapped. There is an understanding of how good financial projections and a trusted financial planner can ease the transition, so this is often the life stage when clients first seek the help of a financial planner.

I would argue, however, that the Sandwich Years are more emotionally and financially challenging than the transition to retirement. Unfortunately, these challenges are less often addressed using a Financial Planning framework and a trusted planner.

Couples in the Sandwich Years face a large number of competing priorities. They need to provide time and support for children as well as to save for college; they frequently need to provide time and support for parents and in-laws. Often, (especially if a contemporary dies) there is a greater appreciation of their own mortality which may lead to a greater desire for life insurance or disability insurance. Recognizing that life is fleeting can also lead to a conflict between saving for the retirement years and enjoying life now (sometimes known as a mid-life crisis). Balancing the competing goals and fears, especially if spouses have different money personalities, can be confounding and stressful. A trusted financial planner can help navigate the often conflicting priorities.

It is easy to bury our heads in the sand and keep telling ourselves that we can do the planning later, but the earlier we begin the planning process, the less stress we will have as we approach the transition to retirement.
### Core Macro Asset Allocation
3rd Quarter 2016
Strategy 4 Moderately Aggressive

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<th>Category</th>
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<td>Small and Mid-Cap Equities – US 16 %</td>
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