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SECOND QUARTER 2015

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Q1 Market Update
(all values as of 3/31/2015)

U.S. Stock Indices

S&P 500	2,068 (+0.44%)
Dow Jones	17,776 (-0.26%)
Nasdaq	4,901 (+3.48%)
Russell 2000	1,253 (+3.99%)

Global Stock Indices

FTSE (London)	6,773 (+3.15%)
DAX (Germany)	11,966 (+22.03%)
CAC (France)	5,034 (+17.81%)
Nikkei (Japan)	19,207 (+10.06%)
Emerging Mkt.	166.85 (+11.59%)

Bond Indices (Bloomberg)

U.S. Gov't.	123.99 (+1.77%)
U.S. Corporate	139.78 (+2.23%)
U.S. High-Yld	153.77 (+2.63%)
Eurozone	139.50 (+4.31%)
Emerging Mkt.	147.53 (+1.97%)

Commodities

Gold (per oz)	1,183 (+0.17%)
Silver (per oz)	16.66 (+6.10%)
Oil (WTI, barrel)	48.66 (-8.98%)

Fixed Income Yields

U.S. 2-Year Treasury	0.58%
U.S. 10-Year Treasury	1.96%
U.S. 30-Year Treasury	2.55%
U.S. High-Yield Index	6.19%

Currency Exchange Rates

Euro/Dollar	1.07
Pound/Dollar	1.49
Dollar/Yen	119.92

Location, Location, Location

When it comes to portfolio construction best practices, most of us are aware of the benefits of asset allocation and diversification. But with tax-deferred retirement accounts becoming an ever-larger part of the average investor's investment portfolio, asset *location* has arguably become just as important as its much more famous allocation-focused cousin. According to research from Vanguard, proper asset location techniques could add as much as 1% annually to investment returns over the long run, all without taking an ounce more risk.

At its core, asset location is a tax minimization strategy that aims to optimize the benefits of tax-deferred retirement accounts. By taking advantage of the fact that different investments receive different tax treatment from the IRS, asset location strategies are able to direct the appropriate assets to their proper investment vehicles, so as to minimize the "tax drag" on investment returns.

How does it work?

The most basic asset location prescription is to hold tax-inefficient assets (bonds, REITs, preferred stock) in tax-deferred accounts, and to hold tax-efficient assets (index funds, most ETFs) in taxable accounts. Since the primary purpose of a tax-deferred account is, of course, to defer taxes, it should be clear that those assets which would otherwise generate the largest recurring taxable gains should be concentrated in these tax-deferred accounts. So, any investment that tosses off a significant amount of annual interest should ideally be held in a 401(k) or an IRA.

But there is another equally important point to be made here. Investments like stocks, which are typically held for a number of years (if not decades), can generally qualify for long-term capital gains treatment, which means a lower tax on the gain than would otherwise stem from the (higher) ordinary income tax rates. For those in the lowest tax brackets, the long-term capital gains tax could even be zero. However, if those stocks are held in a tax-deferred retirement account like a 401(k), then the gains on those assets will ultimately be taxed *at ordinary income rates*, since all withdrawals from tax-deferred accounts are taxed as ordinary income, regardless of the original source of those earnings.

It's also worth noting that for dividend-paying stocks, most dividends also enjoy long-term capital gains treatment as "qualified dividends". Therefore, even if your stock (or stock fund) is throwing off a lot of income in the form of dividends, that doesn't necessarily mean it should be stashed in your IRA along with the rest of your income-generating assets. It's important to think about *how the investment income would be taxed* if it were held in a taxable account. If it would be taxed as ordinary income, then it's probably best stashed in a tax-deferred retirement account; if it would qualify for long-term capital gains treatment, then it's better off in a taxable brokerage account.

Who can benefit?

Anyone who has investments in both taxable and tax-deferred accounts can avail themselves of the benefits of asset location. Generally, an even split between taxable and tax-deferred assets will be optimal, but the benefits will vary depending on the investor's overall portfolio allocation.

For example, if Investor A is a 25-year-old worker with an 80% portfolio allocation to stocks, but 90% of his investment assets are held in his company's 401(k) plan, then he'll have no choice but to hold the majority of his stocks in a tax-deferred account, since it's all he has. On the other hand, if Investor B is a 60-year-old retiring entrepreneur with a 70% allocation to bonds, but who never set up a 401(k) plan for himself at work, and therefore holds 80% of his investments in his taxable brokerage account, then he'll face the same problem in the opposite direction—he'll be forced to hold bonds in his taxable brokerage account, where he'll be subject to taxation as the interest income is earned.

But in these sorts of cases, not all is lost. Investor B, for example, could consider investing a portion of his taxable account in municipal bonds, which enjoy tax-exempt status. Investor A, meanwhile, could have more freedom to invest in certain tax-inefficient stock funds, such as actively managed mutual funds, which typically generate more ongoing income than their passively managed companions.

What are the potential drawbacks?

In addition to the potential investment type/account type mismatch mentioned above, there are certain other drawbacks to asset location strategies. For one, if an investor is dependent upon the income that his investment portfolio provides, then it won't be optimal to shield all of the income-generating assets in a tax shelter account. This dynamic can typically be most pertinent for early retirees, who may no longer be earning salaries but who are unable to fully access the funds in their retirement accounts because of their age (since withdrawals from tax-deferred plans typically carry a tax penalty until age 59 ½).

Also, since stocks are typically more volatile than bonds, if your taxable account holds nothing but stocks, then your liquidity may suffer, and you may find that your money isn't accessible when you need it because your most-accessible investments are also your most volatile (i.e. least reliable). Therefore, for those investors who adopt a particularly extreme asset location slant, it might be advisable to hold a bit of extra cash in an emergency fund, so as to guard against those liquidity concerns.

Another consideration would involve investment or fund choice—if the bond fund options in a workplace 401(k) plan are unattractive from a risk-reward standpoint (as compared to the alternatives in a taxable account), then the benefits of asset location may not be sufficient to overcome the negative portfolio effects of a suboptimal investment. You don't want to hold onto a bad investment just because it's theoretically tax-optimal—remember, choose your investments first, and then think about tax treatment, never the other way around. Don't let the tax tail wag the investment dog.

It bears mentioning that asset location strategies are somewhat complex, including some issues that are more intricate and nuanced than an article of this length can address. For most investors, it will be difficult to set the time aside (or have the relevant expertise) to get the details right. But this is one area where the help of a qualified advisor can ultimately make a big difference. At Cypress, we incorporate the asset location philosophy when building out portfolios for all of our clients, and we'd be happy to help you consider how and where to use it best.

Regardless, if you have a tax-advantaged retirement account, you should know how it does and doesn't work for you. If you don't give thought to the full long-term tax implications of investing in a tax-sheltered account, then you could ironically be better off not investing in one at all. Don't be that investor.

Germany Issued 5-Year Bonds At A Negative Rate For The First Time Ever

Equity Overview – Global Equity Markets

In our Q1 letter, we mentioned that the world's central banks seemed to be heading in opposite directions heading into 2015, and we hinted that the long-running outperformance of the U.S. equity markets versus their international counterparts might therefore be overdue for a reversal. We didn't know just how right we'd be.

In late January, European Central Bank (ECB) President Mario Draghi announced a massive open-ended quantitative easing program, modeled after the U.S. Federal Reserve's recently completed initiative. While widely expected and long-awaited, the program was nevertheless greeted with the enthusiastic response that the ECB decision-makers had desired.

European stock markets took off across the board, with Germany leading the way. After treading water and gaining only 2.65% in 2014 (compared to a double-digit gain for the S&P 500), Germany's DAX index soared by 22% in the first quarter, comfortably marking new all-time highs for the index. Meanwhile, the S&P 500 traded sideways (+0.44%) amid speculation that the Fed would soon raise rates.

In our current competitive-easing environment, it seems as though the stock market spoils belong to the region whose central bank is the most active. But as of now, we're still treating the recent European outperformance as more a matter of playing catch-up, rather than a signal of a broader paradigm shift.

Sources: S&P, Wall Street Journal

European Bond Yields Go Negative – Fixed Income

In the wake of the ECB's quantitative easing announcement, interest rates across the continent moved into uncharted territory. In late February, Germany issued five-year bonds at a negative interest rate for the first time in the nation's history. Even the German 30-year bond boasted a yield of less than 1%, closing the quarter with a rate of just 0.58%.

Country	10-Year Gov't Bond Yield	Yr-over-Yr Inflation Rate
Switzerland	-0.08%	-0.8%
Germany	0.20%	0.3%
France	0.49%	-0.3%
Italy	1.29%	-0.1%
United Kingdom	1.56%	0.0%
Portugal	1.67%	-0.2%
United States	1.89%	0.0%
Brazil	4.38%	7.7%
Greece	11.31%	-2.2%

Meanwhile, in Switzerland, bond yields moved into negative territory for every maturity out to ten years, as the thirst for investment yield drove just about every fixed-income instrument into rarified air in terms of pricing. Yields went so low in Switzerland that even a corporation, Nestle, saw its bonds trade at negative yields, meaning that Swiss investors were actually paying the company for the right to lend it money. Interesting times, indeed.

Of course, it must be said that investors are not crazy, so much as they are responding to a very unique economic environment. In the world of government bonds, the interest rate paid (or required by investors) is as much an indication of broad macroeconomic factors as it is of the issuing body's creditworthiness. With most of Europe now mired in a deflationary environment (as our table shows), a negative-yielding asset can still ultimately have a positive inflation-adjusted return.

The relatively higher yield on U.S. government bonds, then, is not an indication that Italy or Portugal is a more creditworthy nation (far from it, of course), but simply a recognition that the nations' economies are headed down two decidedly different paths, as are their central banks. With the ECB committed to—and possibly in just the early innings of—its easing program, while the Fed across the pond discusses whether or not to *raise* interest rates, it's clear that the respective interest rate environments continue to diverge.

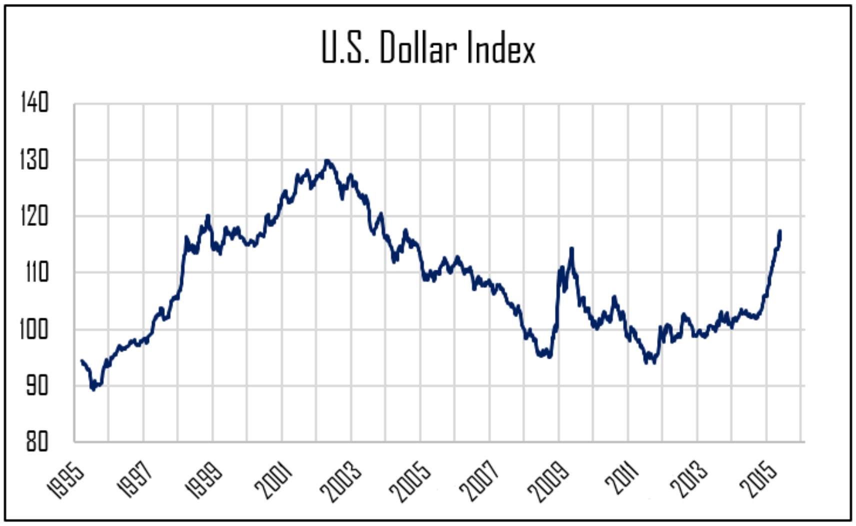
What these yields will mean for the regions' respective stock markets is yet to be seen, but indications from U.S. markets have been mostly encouraging so far.

Sources: Bloomberg, Financial Times

THE DOW JONES COMMODITY INDEX HAS LOST MORE THAN 25% IN THE LAST YEAR

Strong Dollar Leads to Slump in Commodities – Commodities

With the cessation of the Federal Reserve's open-ended quantitative easing program late last year, the U.S. dollar began strengthening nearly overnight against other global currencies. The incredibly rapid rally in the greenback brought the dollar index to its highest level in over a decade, spelling trouble for dollar-denominated commodities.



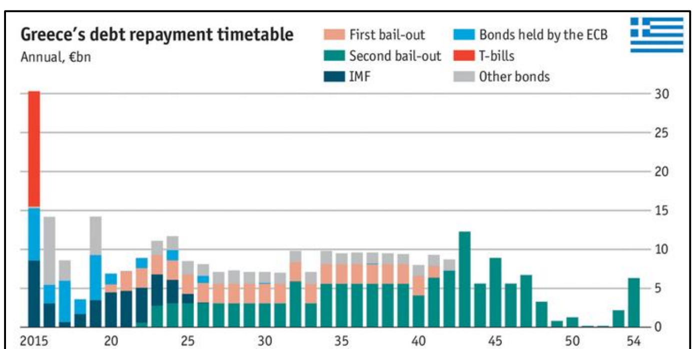
What began as a steep selloff in crude oil prices has now spilled over into many areas of the commodities complex, impacting prices in coffee, sugar, lumber, wheat, natural gas, and even corn. Overall, the Dow Jones Commodity Index lost nearly 5% of its value during the first quarter of 2015, extending its year-over-year losses to more than 25%.

Naturally, the deflationary impact of these price drops has caught the eye of Federal Reserve Board members, many of whom are concerned about the rise in the dollar and what it may mean for longer-run inflation expectations. If the dollar continues to rise, it will become much more difficult for the Fed to justify raising interest rates later this year, since such an increase would likely only fuel the appreciation in the dollar. With the real economy seemingly ready for a more hawkish Fed, the activity in the dollar index and the commodities space could considerably complicate future Fed actions. As usual, the next few Fed meetings will bear close watching.

Source: Federal Reserve Bank of St. Louis

Greek Debt Making Headlines… Again – International Politics

For at least the third time since 2010, Greek government debt has come to dominate the media's attention in Europe, as the nation's new leftist government attempts to amend the terms of its various bailouts from the European Central Bank and the IMF.



Source: RBC Capital Markets, via Economist.com

At issue currently is a "cash crunch" that once against threatens to derail Greece's ability to meet its many obligations. Without another tranche of debt from its existing creditors, the nation may be forced to default on a portion of its debt, much of which comes due in 2015 and must be either repaid or refinanced. Without agreement on a comprehensive package of economic reforms, such refinancing seems unlikely.

Greece is ultimately a bit player in the European economy, with a GDP barely 1/20th the size of Germany's. But against the backdrop of an activist ECB, Europe can't afford many unwelcome "surprises", out of Greece or anywhere else.

Sources: EuroStat, Economist

*All market data indicates total return, including capital gain/loss and reinvested dividends; index data sources: Yahoo, Bloomberg. The preceding newsletter is for general information and educational purposes only. It is based upon publicly available information from sources believed to be reliable; we cannot assure its accuracy or completeness. This material is not intended as an offer or solicitation for the purchase or sale of any securities. The views and strategies discussed herein may not be appropriate or suitable for all investors. This material is not intended to suffice as accounting, legal, tax, or estate planning advice. All forecasts mentioned are for illustrative purposes and should not be interpreted as investment recommendations. The information presented is not specific to any individual's personal circumstances. To the extent that this material concerns tax matters, it is not intended to be (and cannot be) used by a taxpayer for the purpose of avoiding penalties that may be imposed by law.