TOWNELEY
CAPITAL MANAGEMENT

SECOND QUARTER 2018 NEWSLETTER

IN THIS ISSUE

◊ Mid-Year Update

◊ The Role of Fixed Income in a Diversified Portfolio

◊ Towneley Updates

- ♦ Professional Achievements
- ♦ New Towneley Team Member

We want to hear from you

If you anticipate changes in your income, expenses, employment, health, or other major life factors, let us know so we can evaluate your portfolio in light of the new information. Contact your portfolio manager with any changes or questions.

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Mid-Year Update

The first half of 2018 has given us plenty of praiseworthy economic news. Consider the labor market:

- Unemployment has shrunk to a low we have not seen since a brief period in 2000.
- Initial claims for unemployment benefits continue to contract.
- More people are returning to the workforce.

The tax cuts passed at the end of 2017 have benefitted businesses and consumers alike, as wages have been growing and both consumers and enterprises are maintaining strong spending trends. Companies report robust earnings that have risen faster than stock prices. So, stock valuations, while still elevated, have become less expensive during the quarter. The U.S. economy appears to be sturdy, with a second-quarter U.S. real GDP of 4.1% as posted on July 27, 2018.

The news is never 100% rosy, though. So far this year, the stock market has retreated from 2017's spectacular gains. New tariffs and trade negotiations with China and other countries dominate the headlines. The threat of an all-out trade war and its implications for supply chains and inflation has churned up uncertainty. In Europe, growth has slowed, Italy has elected a populist government, and Germany and the U.S. are engaged in a trade feud.

These events have provoked doubt. Moreover, we all know that stock markets are susceptible to the bad news blues. We expect the saber-rattling and chest-thumping over trade agreements will ultimately cease as solutions emerge. Until these deals are concluded, though, volatility in U.S. and international equity markets will persist.

Every year brings its unique financial challenges and opportunities. As uncertainty and volatility have increased, fixed income continues to play a vital role in a portfolio. This quarter we take a more in-depth look at the benefits of fixed income and its function in the portfolio. ■

The Role of Fixed Income in a Diversified Portfolio

The Building Blocks of Bond Returns

Three components comprise bond returns: receipt of the coupon interest and principal payment, returns on the reinvestment of those interest payments, and capital gains or losses if the individual bond is sold prior to maturity. Interest rate changes directly impact fixed income returns. When rates increase, companies and governments issue bonds with higher coupons and investors who buy these bonds receive more income from these investments.

However, as interest rates rise, prices of previously issued bonds fall, and the price drop creates a negative pressure on fixed income returns.

For example, let's say today you purchase an individual bond maturing in 10 years for $1,000 with a coupon of 3% (you receive $30 in interest each year). One year later, you want to sell your bond, but interest rates just increased to 4%. The bond you hold is now worth less ($925) because it pays less in income than would a newer bond. An investor would prefer a bond paying 4% over a bond paying 3%, so you must sell your bond at a discounted price of $925. This reduced price brings the yield to maturity up to 4%, making the bond competitive with issues released after the interest rate increase. If the income you already received is less than the discount you took to sell the bond, the result could be a negative total return on the bond.

Factors Affecting Bond Returns	Today	One Year Later ↑
Market Interest Rate	3%	4%
Coupon Rate (semi-annual) payments)	3%	3%
Face Value	$1,000	$1,000
Maturity	10 years	9 years remaining
Price	$1,000	$925
Yield to Maturity	3%	4%

Source: *Interest rate risk —When Interest Rates Go Up, Prices of Fixed-Rate Bonds Fall;*

Current Interest Rate Environment

The Federal Reserve recently increased the federal funds rate by 0.25%, and the range is now up to 1.75% - 2.00%. The fed funds rate has increased seven times since December 2015, and the Fed plans two more rate hikes this year.

By 2020, the rate may reach 3.5%. (The Fed sets the rates on the very short end of the yield curve, but the market sets all longer-term rates, so rates don't necessarily all move together.) As short-term rates have been increasing since 2015, long-term rates have stayed relatively flat until this year. Wage increases in the U.S. surpassed expectations, increasing the chance of price inflation within the domestic economy. As a result, longer-term rates started to move up as well. With both shorter-term and longer-term rates increasing this year, bond returns were negative for the year-to-date (YTD) period through June 30.

We anticipate interest rates will continue to increase in 2018, as increased business and consumer borrowing, along with soaring government borrowing resulting from more aggressive fiscal policy in Washington bolster the likelihood of future inflation. Higher interest rates give the Fed more room to reduce them if the economy should begin to slow and need a nudge to avoid a recession.

The Upside of Fixed Income Investing When Interest Rates Climb

All else being equal, fixed income securities will be issued with higher coupon rates when interest rates climb, so bond funds bought in a higher interest rate environment will provide more income than bonds bought when interest rates were lower. Investors have recently been receiving more income as interest rates on bank accounts, money market funds and bonds have been increasing. As interest rates increase, investors can use the increased income from interest payments to reinvest in fixed income mutual funds at higher rates, further benefitting from compounding interest. These higher income distributions should lead to higher nominal returns in the future. Rising rates initially cause short-term pain as bond prices decline, but the higher payments create a long-term gain.

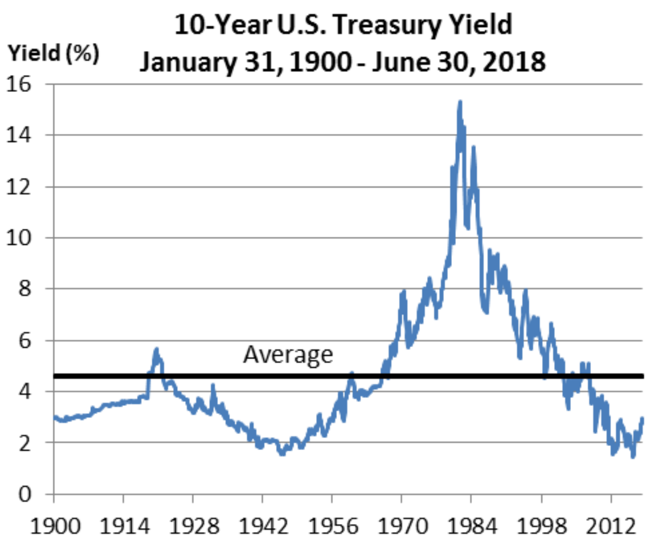
- As interest rates increase, the negative impact of rising rates due to capital losses diminishes. All else being equal, a 1% increase in interest rates will have a more significant effect on bond returns when rates are near zero than would a 1% increase in interest rates when interest rates are at 4%. As interest rates increase, higher coupon payments will offset more of the decline due to prices decreasing.

- When interest rates decrease, increasing the allocation to lower quality or high-yield bonds can provide the same amount of income as investment-grade corporate and municipal bonds had produced in a higher interest rate environment. Of course, a higher allocation to high-yield bonds would also introduce more volatility in the portfolio. As interest rates increase, the portfolio can generate the same amount of income with less risk if we decrease the allocation to high-yield bonds and increase the allocation to investment-grade munis and corporate bonds.

Buffering Impact on Towneley Client Portfolios

The average 10-year U.S. Treasury yield since 1900 is 4.6%, but 65% of the time it has been below 4.6% and 56% of the time it has remained below 4.0%. Historically speaking, the chances are high that rates will remain below or at the mean in the near future.

If the Fed continues to increase the fed funds rate over the next 18 months and the 10-year U.S. Treasury were to revert to the mean of 4.6%, interest rates will go up by another 1.7%. One way to minimize the loss in fixed income when interest rates are increasing is to lower the average duration in the fixed income segment. We recently increased our allocation to shorter-term bonds in client portfolios. We expect this adjustment to help cushion the adverse effects on the bond portion of portfolios if interest rates continue to rise.



Source: Towneley Capital Management, Inc.; Global Financial Data Inc.

Increasing interest rates typically coincide with a strengthening economy**.** Forecasters expect GDP, a central indicator of economic strength, to grow in the near future. Equity markets may also benefit from a healthier economy. When interest rates are below 5%, as they are now, rising rates have historically been associated with rising stock returns, so stocks could do well in the near term.

Investment-grade bonds have a low to negative correlation with equities, so including this bond exposure can help to reduce volatility in the total portfolio.

For example, over the last 42 years, the Barclays U.S. Aggregate Bond Index has had only three negative years; the biggest loss was -2.9%. Since 2000, the S&P 500 has logged four negative years, with the worst annual return of -37.0% and an average return of -20.0%. When the S&P 500 had a negative annual return, the Barclays Aggregate had positive returns in every year and averaged 8.9%. The positive returns in fixed income during negative years in the stock market illustrate the low-to-negative correlation between equities and bonds. These returns also highlight the diversification benefits of the more stable returns in bonds.

Equity and Fixed Income Comparison

When the S&P 500 Index had a negative annual return between 1/1/2000 – 12/31/2017

Index	Year			
	2000	2001	2002	2008
S&P 500	-9.1	-11.9	-22.1	-37.0
Barclays U.S. Agg Bond	11.6	8.4	10.3	5.2
60% S&P 500 / 40% Barclays U.S. Agg Bond	-1.0	-3.7	-9.8	-22.1

Source: Morningstar Direct

Investment in fixed income funds continues to be an excellent diversifier to equity funds and helps stabilize returns for clients planning to take withdrawals from their portfolios. Investors with higher allocations to bond funds may see low to negative returns in 2018, but the future for fixed income is starting to look a little brighter as interest rates increase. Higher interest rates should allow investors the ability to meet their goals with lower risk in the near future and will help the Fed when the next recession does occur. ■

Towneley Updates

Professional Achievements

Research Analyst, Sasha Childers now holds the designation of Certified Investment Management Analyst® (CIMA®). The Certified Investment Analyst Management designation program is a highly-acclaimed international, technical portfolio construction program with an effective emphasis on the combination of theory and practical application. Ms. Childers performs detailed portfolio analysis utilizing her natural curiosity and appreciation for numbers, statistics and risk management. Knowledge gained through the CIMA designation program also strengthens her skills in the development, implementation and refining of analytical frameworks at Towneley.

Mr. Gardner is our Director of Client Impact, and serves as Towneley's institutional lead in transforming the nonprofit sector by helping organizations thrive, make a difference, and last forever. Mr. Gardener is now an Accredited Investment Fiduciary® (AIF®) designee, increasing his fiduciary knowledge and skill in serving Towneley clients' best interest. In applying this new designation, he helps world-changing organizations address the unique challenges they face on the road to growth and monumental impact.

New Towneley Team Member

Towneley is proud to announce the addition of Shannon Torrez to the Towneley team. Ms. Torrez brings a wide range of talents to her dual role as strategic assistant to Towneley president, Tracy Kuntz, and as the company's innovation leader. She specializes in applying high level organizational, problem-solving and marketing skills toward the consistent success of the Towneley brand. Ms. Torrez volunteers her free time mentoring college-bound girls through the nonprofit organization, Girls, Inc. of Orange County. She earned her B.S. in marketing from the University of Phoenix.

Interested in Making a Difference?

Did you know that Towneley offers Socially Responsible (SR) investing options? In general, socially responsible funds operate like comparable non-SR funds, except that SR fund managers focus to some extent on selecting companies with positive Environment, Social, and/or Governance (ESG) factors. SR fund managers may also seek to avoid companies with a negative record in ESG areas, or that have ties to specific "undesirable" products or practices like tobacco, alcohol, gambling, or weapons.

If you are interested in learning more, please contact your portfolio manager for details.