First American Trust
WEALTH MANAGEMENT SERVICES

Summer 2013 QUARTERLY UPDATE

First American Trust provides investment advisory and fiduciary services for individuals, families, non-profits and corporations.

My Two Cents

By Kimberly Dwan Bernatz, CFP®, AEP®

Revisiting the *Four Percent Rule*

When we sit down with our clients to develop a plan for reasonable anticipated withdrawals during retirement, we can't stress enough the importance of revisiting that plan on an annual basis. Many assume that the *Four Percent Rule*, conventional wisdom for many retirees, is a safe assumed rate of withdrawal. Recent studies, however, indicate that the *Four Percent Rule* cannot be treated as a safe initial withdrawal rate in the present low interest rate environment.

To brush up, the *Four Percent Rule* was devised in the early 1990s by California financial planner Bill Bengen who figured that an annual 4 percent withdrawal of a retirement nest egg, when adjusted for inflation, could last for 30 years, the average period of time retirees live off a lifetime of accumulated savings. The portfolio was modeled with a 50/50 percent allocation to stocks and bonds and assumed a buy and hold investor.

A new study, *The Four Percent Rule is Not Safe in a Low-Yield World*, authored by David Blanchett, head of retirement research at Morningstar Inc.'s investment management division, found that today's low interest rates have a negative effect on bond returns, and cites 2.8 percent as a more realistic withdrawal rate for a portfolio allocated 60/40 to stocks and bonds, respectively.

While the *Four Percent Rule* may have been the standard rule of thumb based on historical averages at the time, it falls short as a one-time plan. As economic and personal landscapes constantly progress into new territory, it's important to develop a flexible plan and to revisit it every year.

According to the latest news on the street, due to the volatility of markets and the fact that people are living longer, it's vital to resist settling on an annual withdrawal rate that is set in stone throughout retirement.

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Market Watch

By Jerry Braakman

Market Review

While domestic equity markets have continued to advance on improving housing and consumer spending trends, the international and bond markets have not fared as well.

Total Return as of June 30, 2013

Index	YTD	Q2 2013
Dow Industrials	15.19%	2.91%
S&P 500	13.83%	2.92%
Russell 3000	14.07%	2.70%
All Country World x US	-0.04%	-3.11%
Barclays Int. Gov't/ Credit	-1.45%	-1.75%
Merrill Lynch 3-7 Muni	-1.73%	-0.88%
Gold (SPDR Gold Trust)	-26.48%	-22.89%

Source: Bloomberg

The U.S. economy continues to show resilience, shrugging off both increased taxes and sequester spending cuts. Consumers emboldened by higher home prices and brokerage statements continue to exhibit high confidence, which is being expressed in higher auto sales and retail sales.

Optimistic outlook on underlying strength caused the Federal Reserve to signal its intention to start unwinding its bond purchasing program in a "tapering" process, gradually reducing purchases to zero by mid-2014. These statements brought fear that the multi-year low rate environment is close to its end and resulted in a significant sell-off in bonds, causing the 10-year Treasury yield to surge from 1.62 percent in early May to 2.48 percent by quarter end.

Contrary to U.S. health, the global economy is still struggling. Europe is muddling along while stabilizing with issues of stagnation and high unemployment. Japan has embarked on a Bernanke-like plan of flooding the market with liquidity, causing its currency to weaken considerably, in hopes of boosting its exports and growth expectations.

Economic Outlook

Steady domestic economic improvement continues, as does Consumer strength, pushing through roadblocks of higher taxes implemented in the beginning of the year with government sequester spending cuts. Fueled by higher equity markets and improved home prices, we expect consumers to press on to lead economic growth.

Higher interest rates are expected to temper consumer strength, specifically mortgage rates, which have risen from 3.25 percent to 4.75 percent on a conforming 30-year mortgage. The higher rates will slow the housing markets and house price improvements, but not derail the progress thus far. Consumer confidence near post-recession highs should shrug off this third hurdle.

Positive contributions

- High consumer confidence and spending
- Low inflation led by U.S. Dollar strength

Detractors

- Higher interest rates including mortgage rates
- Imports outpacing exports, as global growth is larger concern than the U.S. economy
- Lower U.S. government spending offset by improving state and local finances and spending

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Investment Outlook

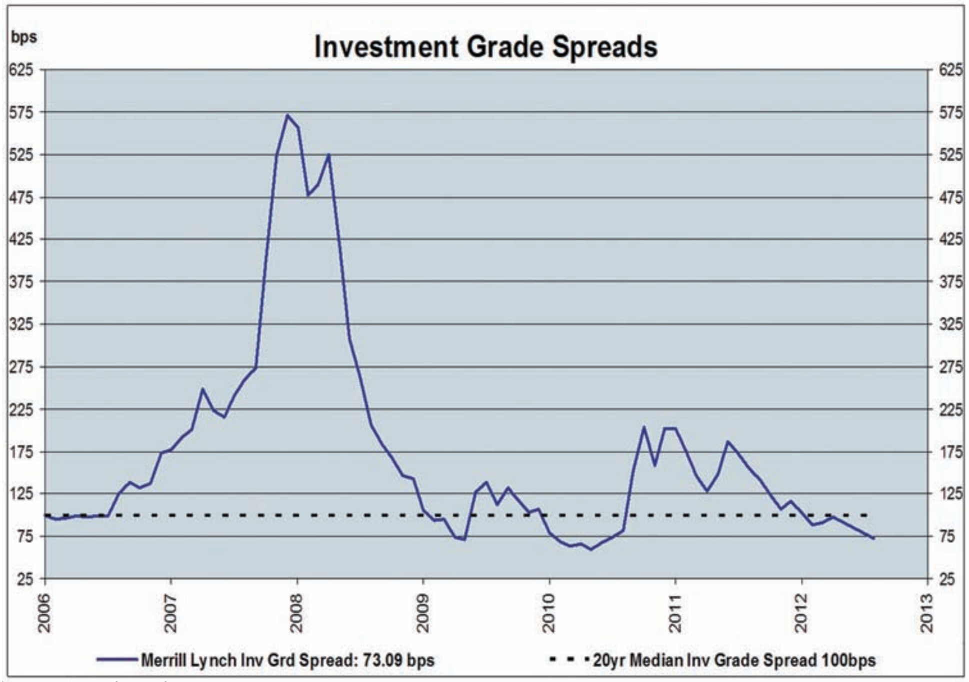
While we are still confident on corporate earnings driving the equity markets to new highs, the leading concern relates to the bond market and the impact of higher rates on bond prices.

Bond portfolios were negatively impacted from a rapid rate increase after an extended run to lower rates to provide significant returns. The increase in rates has delivered a more normal yield curve that better rewards investors for locking up their funds in bonds. With an improving economy and minimal inflation, current rates are more attractive. We are hesitant to believe that the Fed will stop its tapering as quickly as the market anticipates as the increase in market rates will temper economic output. The current pace of rate increases can't be maintained without consequences to the economy that would slow the unwinding of the Fed stimulus. Hence, current yields are fair and with further increases in yield, bonds become compelling.

"Fueled by higher equity markets and improved home prices, we expect consumers to press on to lead economic growth."

For investors already invested in bonds, we urge folks to adopt a long-term perspective. The higher rates allow us to invest in higher yield as bonds mature, raising income expectations going forward. Although rate increases impact valuations immediately, as those bonds are held to maturity, we expect to recover such deterioration over the remaining maturity timeframe. An improving economy also reduces the default risk of bond issuers. The combination of higher yield and lower default expectations drives our view of underlying bond market improvement.

To reduce the impact of rising treasury rates on our client portfolios, we continue to overweight corporate bonds versus governmental issuers. As the economy improves, the probability of corporate issuer defaults diminishes, allowing for lower credit risk premiums (see Investment Grade Spreads chart). The lower credit risk premium can partially offset the increase in the treasury (risk-free) rate. Similarly, municipal bond credit spreads have continued to decrease with improving state and local tax collections. Recently, the state of California has enjoyed credit rating upgrades in light of the dramatic improvement of budget deficit expectations.



Source: Bloomberg

"The state of California has enjoyed credit rating upgrades in light of the dramatic improvement of budget deficit expectations."

In times of market flux, we urge investors to stay disciplined to their objectives. Our fixed income philosophy maintains stable while adjusting to current market conditions. Such discipline allows us to temper the latest media fear mongering, which often provides more investment opportunity than assistance. As our recent experience in equity market turmoil in 2007 and 2008 has again demonstrated, recently setting new all-time highs, the most out of favor asset classes often provide the best longer term investment results. And while high-yield bonds are safe for the long term, we continue to take advantage of other opportunities that enhance returns in an ever-changing market.

As ever, feel free to contact us to discuss your financial objectives or further explore the vast array of wealth management services we offer.

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These factors and others that may come up reinforce our philosophy of the importance of assessing withdrawal and return rates each year to determine if you are on track with your plan or if adjustments need to be made.

> ***"An annual review of a portfolio is essential to increase the probability that an investor's retirement goals are met."***

It's interesting to note that the very definition of retirement has changed with the times. In the past, retirees looked forward to exiting the workplace to live off their pensions. Today, "retirees" prefer to stay active, working part-time or as a consultant. While longer life expectancies can create concerns about outliving one's assets, longevity can give investors an opportunity to focus not only on income but on growth aspects of their retirement portfolios to protect against cost of living increases.

Although bond yields have trended down for the last 30 years, so has inflation, and we do not expect the short term, low rate environment to persist indefinitely. The fact is, there are many parts to the equation and that's why a set withdrawal rate is not the best course of action.

A well-designed and regularly visited plan that can see an investor through unforeseen ups and downs seems a better way to go. An annual review of a portfolio is essential to increase the probability that an investor's retirement goals are met.

That's where a trusted financial advisor comes into play. We at First American Trust uphold the highest fiduciary standard of care in tune with the current economy when working with our clients, and we routinely conduct portfolio reviews with them as part of our regular services to be sure they are on track with their goals. To ensure that your portfolio is positioned to meet your retirement needs, now may be the time to sit down with one of our Wealth Management Advisors to develop and implement a strategy that's in step with today's economy and that's best positioned for your future needs.

> ***"It's vital to resist settling on an annual withdrawal rate that is set in stone throughout retirement."***

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Events & Happenings

First American Trust Client Lends a Helping Hand to Local College-bound Students

"We don't necessarily pick the smartest child or those with the best SAT scores, but those who have a dream of accomplishing something great for themselves and their families," says Joan Heid, head of the Dennis John Heid Memorial Scholarship Foundation and a First American Trust client.

Founded in 2008, the Heid Foundation honors Joan's brother in memoriam. He died after graduating in the 1960s from Santa Ana High School. A student from her brother's alma mater is selected each year for a full-ride scholarship based on academic accomplishments and the candidate's desire to succeed through education. Joan Heid says some scholarship recipients have wonderfully supportive families and no resources while others endure obstacles such as homelessness and gang violence. "All of these students are motivated and grateful to be given the opportunity to attend the college of their dreams."

Since its founding, the Heid Foundation has sent students to UCLA, the University of Alabama, UC San Diego, Notre Dame, UC Santa Barbara and Chapman College.

Girls, Inc. Annual Luncheon

Donor Gena Reed joins Sue Stern, former Girls, Inc. board member, at the annual luncheon.

For the third year in a row, First American Trust hosted a Day of Gratitude luncheon, a venue that recognizes the support of donors and volunteers of Girls, Inc. Orange County. The organization supports 4,000 girls a year from four to 18 through life-changing programs that focus on improving self-esteem, boosting grades, preparing for higher education and becoming economically independent women, among other things. During the event, a $500,000 gift was bestowed on the organization from Gena Reed, cofounder of Paragon Biomedical and past president of Girls, Inc., in memory of her late husband, Nick Reed. The two have been long time supporters of Girls, Inc., whose motto is to inspire all girls to be "strong, smart and bold." The generous donation will go toward scholarships.

Events & Happenings

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A Spring Forum for CPAs & Attorneys

We held an educational forum for attorneys and CPAs in May on the subject of "Low Interest Rate Gift Planning" and "Community Property Retirement Benefits & IRAs: Perspective & Risk Analysis." The event, held in Orange County and San Diego, brought professionals together to discuss options and learn from two keynote speakers. Attorney-at-Law Edward V. Brennan, listed in Best Lawyers in America, and Attorney-at-Law William Finestone, a frequent lecturer on the continuing education circuit, treated First American's guests to a morning of new information that also offered two hours of MCLE and CE credits to recipients.

First American "In the News"

In May, NPR, Bloomberg Businessweek and The Washington Times picked up an Associated Press story where our chief investment officer, Jerry Braakman, author of Market Watch for the Quarterly Update, was interviewed. The stock market had closed out its fourth straight week of gains and the media contacted Braakman for his take. "The advance is being underpinned by investors moving back into stocks, reversing years of outflows of funds from equity markets," Braakman was quoted as saying. Some $17 billion dollars had been invested into domestic equity mutual funds since the start of 2013. "This market rally still has legs, partly because we've seen huge retail inflows back into equities," Braakman told reporters. "It's hard to beat the money flow." Braakman's expertise was also sought after for stories that ran in Wall Street Journal and on CNBC Asia's Squawkbox program.

First American Named a Best Place to Work in San Diego

Local offices in San Diego are coordinating a celebration for a regional recognition of being acknowledged as a 'Best Workplace.' This special designation for First American is a result of an employee satisfaction survey and will be featured this summer in the *San Diego Business Journal Best Places to Work* special edition.

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