TRUST

INVESTMENT PERSPECTIVES

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Should Anyone Buy Bonds?

Past performance is not a predictor of future results. We know what this means, but our mental calculators have a hard time accepting this as fact. We often frame even the most basic investment decision of stocks vs. bonds through the rear-view mirror of just-passed returns. Recent markets are a good example. Bonds (Merrill Lynch Govt/Corp) have averaged a paltry 2% return over the past five years, while stocks (S&P 500) have returned a strong 15%. This begs the question: *why buy bonds?*

Let's explore this question starting in April 2009, at the bottom of the financial meltdown. Say you have $1 million with the goal of living off your investment income. You can invest either in a stock fund or a bond fund. The bond fund earned $41,000 in income over the following 12 months, while the stock fund earned $25,000. Selecting the bond fund seems the obvious choice in order to achieve higher, dependable income, especially on the heels of the biggest drop in stock prices and dividends since the Great Depression.

This first-year income is not the full story though. After the initial 12 months following April 2009, interest rates dropped to levels never seen before, and stocks delivered one of the longest and largest bull markets on record. Of course, no one knew it would work out like this. But this is where we are today. We draw lessons from our experiences, especially our most recent ones.

While we don't know what the future holds, we do know from long-term experience that most companies raise their dividends over time. This means the income from the stock fund increases in most years, eventually overtaking the income from the bond fund. Starting at the market bottom in 2009, the stock fund took only four years to generate as much income as the bond fund (panel A, on page 3). So by 2013, the stock fund was sending you a bigger check than the bond fund. Bad news for income-oriented investors who put all of their nest egg in the bond fund.

But wait, it gets worse for investors who chose all bonds over stocks. Investing the same $1 million today (December 31, 2016) will generate income of around $23,000 from the bond fund over the next 12 months vs. $22,000 from the stock fund, assuming no change in interest rates or dividends during the second half of 2017. In other words, not only do stocks deliver income growth, they are generating almost as much immediate income as bonds - plus offering appreciation potential.

Little wonder some investors are asking: *Why buy bonds?*

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Robert A. McCormick
Senior Executive Vice President & COO

MARKET RECAP

Both U.S. and international markets posted strong results in the second quarter.

	Second Quarter	YTD	Past 12 Months
Dow Jones	4.0%	9.3%	22.1%
S&P 500	3.1%	9.3%	17.9%
EAFE (Int'l)	6.1%	13.8%	20.3%

Our Highest Achievement

Letters from future entrepreneurs.

"I'd never leave Biztown if I was to live there. I was so happy being there you don't even know. I hope you know that you should never stop doing what you are doing. I can't wait till I have kids and they go to Biztown and tell me how much fun they had." Kalii

"I was the CFO of the professional offices and I worked on the computers. Then I went to the store and bought nothing. It was ok. I love that you put your time and effort in to making this for us. Love," Addison

"You get to learn what it feels to be part of a business. I worked as a financial advisor. It was fun going to the bank and the food at Arby's was really good. The lemonade was good too. Then L. kept dancing, so I gave him a quarter and he stopped dancing. Once again, thank you." Cliff

"I learned that working as a team is great." Abdullah

"I was responsible for going to each business and counting how many chairs, tables, computer monitors, clocks and desks there were. Each item costs a certain amount of money, so I also had to multiply. Here's an example: the chairs were $28 each, and there were three chairs. It would be $84. Then after that I would have to add all of that up and write down the total. Thank you for sponsoring the professional offices at Biztown. Sincerely," Alexa

"I was the financial advisor. The best part was getting money. The hardest part was depositing at the bank." Jayden

"I would like to thank you for everything. Biztown opened my eyes to the real world. Everyone should see it. Best day ever." Kileigh

Trust Company of Oklahoma is a proud sponsor of Junior Achievement Biztown, a program that combines in-class learning with a day-long visit to a simulated town. Biztown allows elementary school students to operate banks, manage restaurants, write checks, and vote for mayor. It helps students develop entrepreneurship, financial literacy and work readiness.

A Long Time Ago in an Investment Galaxy Far, Far Away...

Let's go back in time to 1976 and explore a contrasting "why" question when the investment world was different. Apple Computer launched this year, one year after Microsoft booted up. The very first index fund, Vanguard 500 Index Fund, started trading. At the same time, the stock market was treading water. The Dow crossed 1,000 after initially surpassing this level in 1972 and coming within a few points of 1,000 in 1966. Investors would have to wait until 1982 before the Dow stayed above 1,000 for good. Sixteen years of going nowhere for stocks.

What investors grew to believe back then was vastly different than some of the principles investors live by today. There was not the unshakable faith in equities. High interest rates (soon to be much higher) combined with a directionless stock market meant investors had little incentive to load up on stocks. A 1979 BusinessWeek headline actually proclaimed, "The Death of Equities."

The challenge was particularly true for those living off their income. Beginning in January 1976, our $1 million bond fund would have earned $75,000 for the next 12 months, while the stock fund would have earned only $41,000. Bonds started out with a huge income advantage over stocks, which dissipated very slowly. It took 12 years for the income stream from the stock fund to equal the income stream from the bond fund (**panel B, on page 3**). Stock dividends were still growing, but 12 years is a long time to wait to catch up.

The question of that era: *Why buy stocks?*

Different experiences lead to different lessons. Hindsight tells us that the lesson many concluded in the 1970s to buy only bonds was ultimately the wrong lesson. In spite of stocks showing no price gains for 16 years, dividends grew by 5% a year, helping offset cost of living increases. Besides, bonds were only delivering a return of 7%, in line with inflation over 16 years.

Bonds Aren't Stocks – They're Not Supposed to Be

Returning to the present day, many take it for granted that stocks will *always* do better than bonds. Yes, there will be "corrections," but those are opportunities to buy the dips. Even in the financial meltdown, most buy-and-hold shareholders

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were rewarded – eventually, of course. The average time to recover from bear markets since 1926 has been three years. Why buy any bonds if you don't need any of your principal for three years?

Here's why:

- Hindsight bias: Past drops may seem like no big deal, but it's different when you are in the midst of a bear market with no crystal ball to be found. Living through it can be painful and cause you to sell at the wrong time – after stocks have taken a big hit.

- Recency bias: Our recent experiences weigh more heavily than lessons from the distant past. Given recent returns, this bias is understandable - but misguided. The stock market's current valuation is consistent with mid-single digit future returns, not double-digit.

- Volatility's drag: Bonds, notably short-term bonds, are less volatile than stocks. Take too much money out of your portfolio in really bad markets and your portfolio may not recover as depletion occurs much faster with high volatility.

- Market timing futility: Most stock market gains and losses occur over a very few number of days. The odds of selling out and going to bonds right before a crash (then getting back in right after) are horrible. Trying to time interest rates hasn't worked well for most investors either.

- Dividend risk: In the meltdown, dividend cuts were quite large – totaling approximately -26% from high to low. If you invested $1 million at the top of the market in October 2007, it would have taken eight years for the stock fund's income to surpass the bond fund's income (**panel C**).

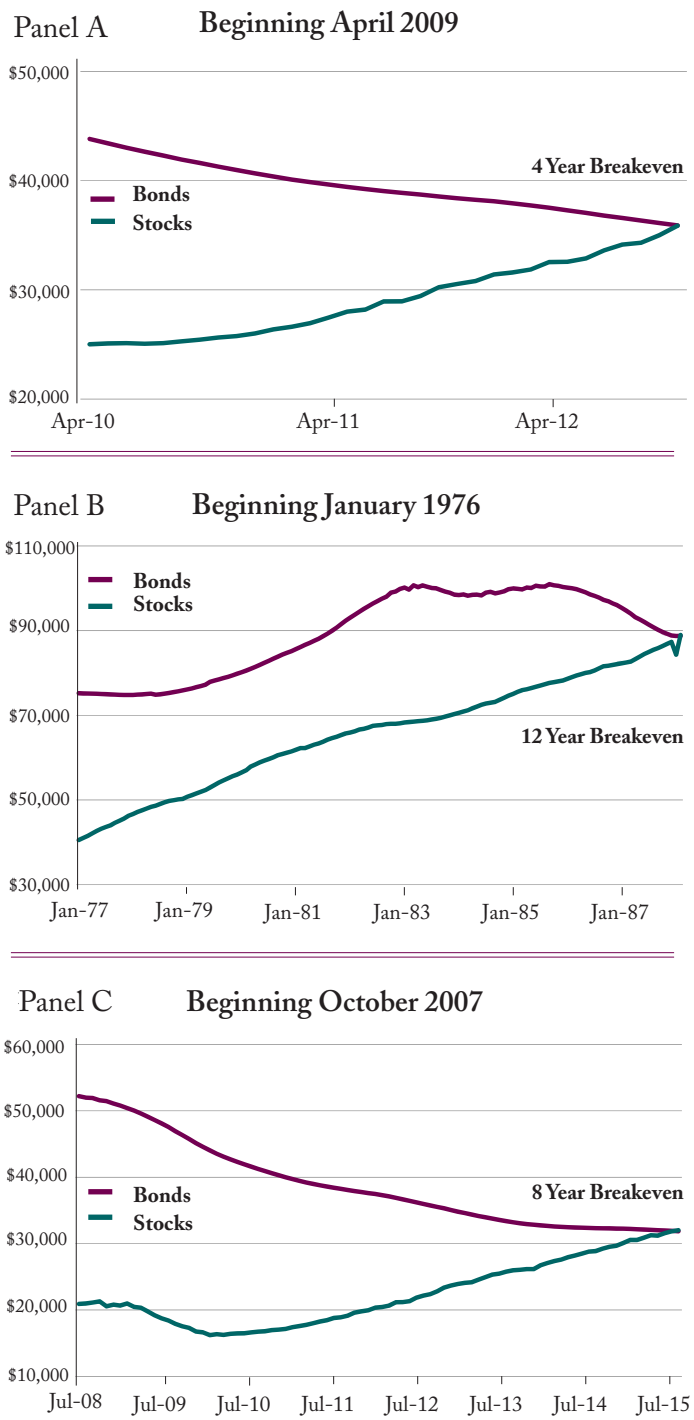
- Bond-stock connection: If interest rates were to rise sharply, bond prices will drop, but it would likely be negative for stock valuations as well. Changes in interest rates have had and will have a big impact on stock prices.

- Positives of higher rates: For shorter term bonds, an increase in rates places less pressure on prices since maturities are near. Likewise, the benefit of higher income is felt relatively quickly.

With interest rates low and equity valuations high compared to history, both bonds and stocks look to offer positive but below-normal returns over the next five-to-10 years. Nothing to write home about from either one.

History shows the risks of excluding either stocks or bonds from a portfolio. For most of us, the question we should be asking ourselves is "how much," not "why". Given that dividend income is competitive with interest income, the exact answer depends upon how strongly you view the above considerations. Throw in some intestinal fortitude and you have a good recipe for navigating future markets.

ANNUAL INCOME EARNED FROM A $1,000,000 INVESTMENT



Stocks: S&P 500 | Bonds: Merrill Lynch Government/Corporate Index. | All income distributed monthly.

The Fiduciary Rule
What It Means For You

Recently I had the strangest dream: Paul Revere, iconic folk hero of the American Revolution, was shouting at my window, "The red tape is coming! The red tape is coming!" And indeed, it did. At 11:59 p.m. on June 9, 2017, the highly publicized Department of Labor Fiduciary Rule finally became effective.

After years of debate, new rules have been established for firms handling retirement accounts. This regulatory change is so sweeping that it covers over 1,000 pages and affects the entire landscape of retirement savings, from 401ks to IRAs. Many in the financial industry have lobbied Congress, decrying the new requirements as excessive regulation. And there may be some truth to that. It's hard to argue that 1,000 pages of anything aren't excessive. But this rule makes at least one fundamental change that will benefit many Americans with IRA assets: all advisors must now act in the client's best interest.

The Old Standard

Previously, an advisor could make recommendations on a simple suitability standard, meaning that the advisor was required to contemplate a client's circumstances and recommend an investment appropriate for those circumstances. That standard *seems* reasonable enough on its face; so why change anything?

Conflicted Advice

The old standard did not address conflicts of interest. Advisors compensated by commissions have an inherent conflict. They have a monetary incentive to steer investors toward products that pay the largest commissions. This fact does not mean that all commission-based advisors are scoundrels, but there are significant pressures that may affect their advice. Imagine a scenario where an advisor has two products considered suitable for a client. One pays a 2% commission; the other, a 5% commission. Which product is likely to be recommended?

I recently evaluated an equity indexed annuity that a client had purchased from an advisor. The advisor's company approved the sale as "suitable." The advisor earned a 7% commission. Meanwhile, the investor only experienced a 1.94% average annual return in one of the best bull markets of all time. Even worse, the client cannot leave the product until 2024 without incurring significant charges. Whose best interest was served in this situation?

The New Standard

At its basic level, the new rule changes the duty owed by an advisor to an investor. Any advisor working with IRAs or qualified retirement plans will now owe clients a fiduciary duty, which is the highest standard of care. An advisor serving in this capacity has a legal obligation to act only in the client's best interest. The suitability standard no longer applies to advice about retirement assets, such as IRAs. Understandably, firms who have advised clients under a commissioned-based model are adapting their systems to comply.

How This Might Affect You

Some of the nation's largest investment management companies are making radical changes to their client service model. Some firms are dropping commission-based retirement accounts from their platform. In one instance, an institution informed some IRA clients that their "financial adviser will no longer be able to provide investment guidance."

Still, other firms plan to continue charging commissions. They will rely on provisions permitting them to offer conflicted advice if they disclose their conflicts and enter a contract with the client promising to act in the client's best interest. If you have a commission-based IRA with an investment firm, you may anticipate future changes to your account.

What Makes Trust Company Different

If your IRA is with TCO, don't expect any change in your relationship with our firm. We have served our clients with a fiduciary duty since our founding in 1981. We do not receive product commissions. We have no incentive to steer you to a particular investment. We manage your wealth for your benefit – not someone else's.

We didn't need Paul Revere to warn us that the red tape was coming because we didn't need a rule to tell us the right way to do business.

Ryan Short
Trust Officer

Smart Homes – Back To The Future

I can still remember turning the TV dial to watch "Back to the Future Part II" in the late 1980s and thinking to myself: "Finger scanning, talking to a remote control, flying cars, and hover boards would never exist in my lifetime." Science fiction back then. Not today. Now in my mid-thirties, I am installing in my home a CO2 and smoke detector that will send a text message to my phone if there are any issues within that device. I am even pondering the idea of purchasing a robotic vacuum that will clean the house while I'm gone.

Home automation (or smart home) is revolutionizing the way we live. In a smart home, household devices are connected wirelessly through WiFi and controlled remotely by the homeowner via an app on smartphone or tablet. Anything from a single lightbulb to a fully integrated network of features can be connected in a smart home (lighting, heating and air, sound systems, security cameras, home appliances, window shades, pet feeders, and cooking utensils—just to name a few).

Convenience and Savings

You might use Amazon Echo, Echo Dot or Google Home to control music, check the weather, and review schedules for the day, for example. You can even open the garage door and unlock the front door as you pull in. And, the days of forgetting an item you need at the grocery store are almost behind us. Refrigerators can now send you pictures of the food on your shelves, grocery lists, and expiration dates.

Part of the allure of the smart home technologies comes from the desire to save time and money. In fact, Nest Learning Thermostat asserts it can save you an average of 10-12% on heating costs and 15% on cooling.

We are starting to see smart homes beginning to affect the real estate market. In a 2015 survey of more than 500 Coldwell Banker realtors, one in three noted that homes with automated technology sell faster than homes without. According to the German company Deutsche Telekom, nearly 300 million homes will be "smart" worldwide by 2020.

The convenient inventions we saw on "Back to the Future" are now our norm. In fact, today's smart homes are more in line with the futuristic home in the 1960s cartoon "The Jetsons"!

Katherine Chandler
Trust Officer

SPOTLIGHT

Women in Recovery (WIR) is an intensive outpatient alternative to incarceration for eligible women facing long-term prison sentences for non-violent, drug-related offenses.

A Family & Children's Services (FCS) program operated in partnership with the George Kaiser Family Foundation, WIR works closely with the criminal justice system and various community partners to ensure program participants receive supervision, treatment for substance abuse and mental health conditions, workforce readiness training and family reunification.

Addiction, abuse and poverty are factors that impact the vast majority of WIR participants. The organization helps women conquer drug addiction, recover from trauma and acquire the essential economic, emotional, and social tools to build successful and productive lives.

WIR is designed for women who are dedicated to changing their lives and becoming positive, contributing members of the community. More cost effective than incarceration, WIR is a smarter way to promote public safety, reduce crime long-term and improve the future for the next generation of children in Oklahoma.

With a focus on improving the lives of at-risk women and their children, WIR breaks the cycle of intergenerational incarceration and strengthens women and their families. Since WIR began, 313 women have graduated and 1,223 children have been impacted by the program. In February 2017, WIR celebrated its 20th graduating class.

FCS sets women on a path to recovery and, in the process, makes the community a better place for all. For more information about Women in Recovery, visit www.fcsok.org.

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Our Team of Professionals In OKC.

Left to right: Katherine Chandler, Zac Reynolds, Jean Kates, Cameron Turner, David Stanley, Scott Cravens, Max Rhodes, Sara Wilson, Alex Kaiser, Janie Cotton.