

PERSPECTIVES



► Quarterly Economic and Capital Markets Update

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Controlling Risk

William B. Greiner, CFA, Chief Investment Officer

Last summer, we published a piece about risk in the markets – specifically, the concept of “deep” risks versus “shallow” risks and how a deeper understanding and acceptance of both can help better inform and guide investors. In looking back on the first half of 2014, I thought it appropriate to dust off and redistribute some of this commentary, as it seems once again relevant in light of recent events and market activity.

Being professionally involved in the financial markets since the 1970s brings its advantages and disadvantages. One advantage is experience and all that comes with it. I’ve seen some very good times in the financial markets and, to be sure, some very bad times. The bear markets of the late 1970s through the early 1980s, the crash of 1987, and the secular, long-term bear market that began in 2000 – all have left their mental scars. I pause and ask: Through the last three-plus decades, what have I learned?

I don’t think the number of opportunities to create capital is significantly different now compared to what it was 30 years ago. I still harbor an innate optimistic streak. But, thanks to the mental scars I have sustained, I have a deeper, more thorough understanding of capital market risk than I did during my younger years.

“Shallow” Risks and “Deep” Risks

A book by William Bernstein, *Deep Risk: How History Informs Portfolio Design*, argues that there are two forms

of risk that every investor must measure and, to varying degrees, accept. He refers to the first, less fatal risks as shallow risks or risks that can be overcome with time. The great investment thinker, Benjamin Graham, called shallow risk “quotational loss.” For example, say you buy a stock at \$25 per share and the stock falls to \$20 per share, creating a “temporary” loss (assuming the company is well managed with good prospects). Under this circumstance, the short-term, shallow risk that was recognized by the stock moving from \$25 to \$20 per share should be temporary; that is, the stock should eventually recover from this loss and perhaps surpass the original purchase price.

Shallow risks are inevitable. They happen regularly. Over time, unless you invest exclusively in cash or CDs, asset prices change. Prices in all asset classes rise and fall over various periods of time. Downward moves in prices aren’t painless and can last a long time, but they are not permanent.

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► Special Report: Financial Planning

Understanding Executive Compensation

For many executives, the responsibilities that come with leading and managing a business can leave little time to consider one’s personal long-term financial planning goals. Much like a plumber living in a home with leaky faucets, it can be a challenge to channel one’s own professional expertise and objectively apply it to a situation. Understanding this challenge, Mariner Wealth Advisors has the experience and tools necessary to manage our clients’ most complex executive compensation packages and tailor them to meet each client’s long-term retirement planning goals. Here, we focus on different types of executive compensation packages and the various considerations regarding the accumulation and distribution phases of these different types of plans.

Nonqualified Plans – Why do Companies Offer Them?

With people living longer and wanting to retire earlier, plus the limitations of 401(k) plans and Social Security, highly compensated employees inevitably face a retirement savings gap. Nonqualified plans can help fill that gap and

give organizations an advantage in recruiting and retaining leaders that drive the company’s ongoing success. While frequently perceived as a “perk” available only to senior executives of publicly traded companies, these arrangements have in fact become an integral element of adequately and effectively compensating executives in companies of all sizes – providing an opportunity to address the retirement savings shortfall that these individuals face due to traditional planning limitations. In a highly competitive market for top leaders and executive talent, organizations of all types can benefit from the unique attributes and advantages of nonqualified plans to attract and retain key employees.

Matt Veach, senior insurance consultant at Mariner Wealth Advisors, specializes in executive compensation plans and creates plans designed specifically for the unique attributes of each business. According to Matt, “There are many different types and structures of nonqualified plans. These arrangements are highly specialized executive compensation tools that must comply with IRS, Department of Labor, SEC and some ERISA regulations. Benefit programs must be structured carefully to fit a

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Controlling Risk (Continued from cover)

Deep risks, on the other hand, represent an irretrievable, real loss of capital. Measured on an after-inflation basis, these types of risks cause a long-term or, in some cases, permanent loss in purchasing power of capital. These are the types of risks that, when realized, alter an investor's lifestyle and well-being.

So, what circumstances create deep risks? According to Bernstein, there are four historical causes of deep risk in the financial markets: inflation, deflation, confiscation and devastation. Bernstein asserts that these forces can cause assets to lose most of their value and never recover. Investors must, therefore, insure against "deep" risks based on how likely and severe they may be. Let's take a look at all four deep risk categories and provide some thoughts as to the likelihood of each risk appearing.

Devastation

Times of war or anarchy – times that normally prove unpredictable – are accompanied by terrible consequences, both in terms of human suffering and capital loss. Unless the event is global in scope, the deep risk associated with this type of calamity can be partially diversified. Gold has historically been a good harbor during these types of devastating events, as well as various types of foreign currency assets (stocks and bonds). As unpredictable as these events may be, the probability of this type of deep risk event occurring in the United States appears to be primarily centered around

terrorist activities – with most of these risks being more "localized" in nature.

Confiscation

An upward push in taxation or a seizure of assets by the government (along the lines of what occurred last year in Cyprus) is a form of deep risk. French citizens have also witnessed a wealth tax in which assets over a certain amount were taxed or confiscated by the government. Historically, foreign holdings (which are out of reach of politicians) and real estate (particularly foreign real estate and farm land) are two asset classes that have provided a hedge for this type of risk, depending on local laws and tax policy. While some would argue differently, in light of current domestic tax policy and recent events in Washington, the likelihood that U.S. investors will ever face true deep confiscation risk remains rather remote.

Deflation

Deflation is defined as a persistent drop in the value of assets. Real, financial and labor assets are included in this definition. This is a rare risk – one that hasn't occurred often since the Great Depression. Japan has been shaken by deflation risks over the last 30 years but has more recently attempted to shake loose of this awful destroyer of social and individual wealth. Central banks have found the power and the will to forestall strong deflationary risks. In portfolios, deflation is best fought with exposure

Total Return for Specific Asset Classes

| | Second Quarter Return | Year-to-Date Return |
|------------------|-----------------------|---------------------|
| MSCI ACWI | +5.22% | +6.51% |
| S&P 500 | +5.22% | +7.12% |
| Russell 2000 | +2.04% | +3.18% |
| MSCI EAFE | +4.31% | +5.22% |
| Emerging Markets | +6.71% | +6.13% |
| Alerian MLP | +14.16% | +16.28% |
| US REIT | +7.15% | +18.24% |

to high quality, long-duration fixed-income (bond) assets and global stocks, as deflation risks can impact one country and not others. U.S. investors have been facing some deflation over the past several years, although the Federal Reserve is fully aware of the potential impact and has been taking action to prevent this risk from becoming truly deep.

Inflation

Going forward, inflation is the likeliest source of deep risk that we may see. Historically, inflation has had the power to destroy up to 80% of the value of a bond portfolio (after inflation) over periods spanning up to 40 years. According to Bernstein, that is deep risk at its deepest – a hole so profound that most investors wouldn't be able to escape it in a lifetime. Bernstein believes that the ►

This June, members of the Mariner family applied their efforts with a Kansas City area Habitat for Humanity. The family whose home we helped to build is one that has worked very hard to overcome extremely difficult circumstances. It was fun to see this group spend a couple of days together to help turn the tide their way. Well done team! ►



► Special Report: Financial Planning

Understanding Executive Compensation (Continued from cover)

company's unique business situation and meet ongoing regulatory requirements. Keeping your plan aligned with these objectives, in addition to ongoing plan administration and management, is paramount. However, individual education and consulting for plan participants must also be facilitated in order to ensure that benefits are maximized and efficiently utilized."

Qualified and Nonqualified Plans

Before discussing the various compensation programs, it is important to review the differences between "qualified" and "nonqualified" retirement plans.

Qualified plans, such as most pensions and 401(k) plans, meet Internal Revenue Service Code requirements and are therefore eligible for certain tax benefits. Qualified plans are covered by The Employee Retirement Income Security Act (ERISA), and the qualified plans' assets are held in a trust account separate from the employer's assets. The IRS limits the amount of compensation (\$260,000 in 2014) that can be taken into account by a qualified plan for purposes of determining benefits and contributions.

In contrast, nonqualified plans fall outside of ERISA guidelines and are designed by companies to compensate key executives and highly paid employees.

One example of a nonqualified plan is a deferred-compensation or supplemental plan, which has specific provisions. Employees may generally make annual elections regarding how much current compensation to defer to the future and when to begin withdrawals. These elections are usually irrevocable.

Nonqualified plan elections do not necessarily carry over from year to year. If you elect to defer 50% of your bonus this year, for example, it does not mean the election will be automatically triggered next year.

Many companies have other forms of nonqualified plans, including stock options and restricted stock plans. These types of plans can be complicated and if mismanaged or not properly implemented, an individual may miss an opportunity to realize additional tax-deferred savings.

The Benefits and Pitfalls of Deferred Compensation

A deferred compensation plan is a nonqualified plan under which an executive can elect to defer the receipt, and therefore the taxability, of a portion of his or her current salary and/or bonus to a future period, such as the start of retirement. The deferred income earns a rate of return either set by the company (for instance, the prime interest rate or prime plus some percentage) or as available from a menu of investment choices.

At the payout date, the executive receives, over a pre-selected period (such as 15 years), the deferred income plus the accrued income and/or appreciation on the invested balance. The benefits of compounding income on a tax-deferred basis can add up to a substantial sum over time. Note that the deferred compensation, including any appreciation, plus income from the investments, is taxable upon receipt. Given the deferral of taxable income and an attractive earnings rate, it usually makes sense to take full advantage of this plan.

Understanding the Risk

When you elect into a company's deferred compensation program, the income you defer becomes a corporate liability and you become a general unsecured creditor of the company, so you stand in line behind the secured creditors of the company with respect to this deferred money. You are subject to general creditor risks and loss of principal if your employer fails or declares bankruptcy; so, company viability over the long term must be taken into consideration. As we have seen with employers such as Enron, World Com, and Lehman Brothers, no company is too big to fail.

In order to protect this type of nonqualified compensation, some employers will establish secular trusts or rabbi trusts. These types of trusts can help protect the deferred compensation from different types of risks, which might include claims of creditors, change of company ownership or other unforeseen factors. These trusts are treated differently from a tax perspective, so it is important to consult a tax professional before adopting these protective strategies.

Timing the Payout

The artful decision in any deferred compensation plan is the timing of the payout.

Typically, the executive can elect to begin receiving payouts at a set date in the future or at the earliest of either retirement/termination or a change in company control. Payouts can be received as a lump sum or as an annuity over a specified period of time. Each individual's ►

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best insurance against inflation is a globally diversified stock portfolio with some “diversifiers” included (hedge, precious metals, real estate).

With all this being said, if an investor is concerned about inflation (and we believe anyone who has more than a three-year time horizon should be), holding too much of a portfolio in stocks can drive shallow risk levels through the roof. While they do provide long-term benefits in a period of rising inflation, stocks can also provide some hair-raising experiences over the short-term (1987 and 2008-2009 are examples of this).

It’s worth noting that shallow risks can become deep risks when too much quotational risk is assumed in a portfolio (in other words, when an investor has too much stock or other volatile asset class exposure). For instance, an investor who sold stocks out of fear during the lows of 1987 or 2008/2009 effectively turned a shallow risk event into a deep risk event. The loss the investor experienced was therefore locked in and became rather permanent.

The key to successful investing is finding a balance between asset classes that can offset deep risks while at the same time not exposing the portfolio to an excessive amount of quotational or shallow risks.

Revisiting Risk in 2014

Aside from providing some renewed perspective, a discussion of risk and Bernstein’s definition of deep and shallow risks is timely as we close out the second quarter

of 2014. In the short-term, investors may face some shallow risk in the form of increased volatility as lofty valuations and a market that continues to march higher could signal an impending price correction. This should not be construed as a departure from our current view that we are returning to a secular bull market, but rather, that the market might be getting ahead of itself in its pursuit of such.

The larger concern as we look ahead toward the second half of the year is inflation – one of Bernstein’s deep risks. Thus far, inflation has remained mostly benign, but the last data we received was sharper than expected. The U.S. Consumer Price Index (CPI) for all goods increased by 2.1% year-over-year in June, with a 1.9% year-over-year increase in core CPI (which excludes food and energy prices). Federal Reserve chairman Janet Yellen discounted much of this as “noise” in a recent statement and reaffirmed the Fed’s commitment to keeping rates low, despite an acceleration of growth in certain areas of the economy and an improvement in the overall unemployment picture. Unemployment fell to 6.1% in June, a five-year low that beat Fed expectations.

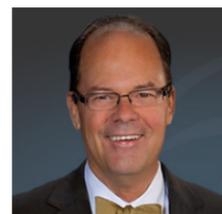
When it comes to any potential action, we continue to believe that the Fed will err on the side of allowing inflation to creep toward the hotter end of its comfort zone, rather than derail growth that remains, for the time being, tepid at best. First quarter earnings for the S&P 500 rose just 1.2% year-over-year, while the final estimate revision for first quarter GDP was a surprising

-2.9%. Some of this was the result of the severe winter season that impacted much of the United States, but it nevertheless raises concerns that there may be some underlying issues hindering sustainable economic growth.

What It All Means

Long-term, risk-controlled, superior returns are what all investors seek. To successfully manage a portfolio, we must gain an understanding of each client’s “tolerable” and “intolerable” risks and actively manage the balance of risk/return attributes as an investor’s needs change. To this end, the difference between deep and shallow risks must be periodically reviewed.

In an environment where significant returns have occurred within a narrow range of assets, investors are often inclined to “follow the herd.” It is important, however, to consult with your wealth advisor prior to making any major asset class shifts, as your advisor possesses both the expertise and the long-term perspective on your specific financial plan that is necessary to hopefully avoid or reduce the potentially devastating impact of deep risks.



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situation is unique. Important considerations include where the individual will live when retired and the projected tax bracket.

A 10-year annuity represents a compromise between extended income tax deferral and your risk as an unsecured creditor. An annuity of that length (or longer) presents the advantage that, should you establish residence in a more tax-friendly state after the payout begins, the remaining annuity payments will be subject to the income tax laws of only the new resident state. That is because tax is due on nonqualified income (e.g., deferred compensation) in the state that it is earned, unless the payment is paid out annually over 10 years or longer. (Take, for example, a New Jersey employee who retires and moves to Florida the year after retirement. If he or she had a nine-year payout or less, the income will be taxed in New Jersey and he/she will need to file New Jersey tax returns as a non-resident. If the payout is 10 years or more, the payment would be subject to Florida tax law. With no income tax in Florida, the payments would be non-taxable in that state.)

In comparing the overall benefit of deferred compensation to receiving the income as you earn it, consider your tax brackets now and in the future. For example, do you anticipate that your income tax rate will decrease in later years? Be sure to weigh the risks of deferral against the tax benefits as you determine when and how much to defer and the optimal timing of the payout.

Additional Compensation: Stock Options and Restricted Stock

Today, there is increased scrutiny from the public, shareholders and the press of the relationship between executive compensation and company performance. As a result, in an effort to spur executive and, therefore, company performance — and to take the spotlight away from salaries and cash bonuses — employers are increasingly offering diversified compensation packages that include stock options and restricted stock. These instruments also have the secondary benefit of helping improve executive retention.

Stock Options

Employee stock options give the employee the right, but not the obligation, to buy a fixed number of shares of company stock at a pre-set price over a specified period of time, usually ten years. The employee doesn’t own the underlying shares until he or she exercises the stock option. In other words, buys the stock.

Stock option grants are typically awarded after the company’s board of directors approves the plan. The amount, timing, grant price, vesting schedule and term are usually beyond the executive’s control. The only decisions the executive can make are when to exercise the options, which is largely an economic decision, and when to sell the shares, which is a decision that must be based on both economic and tax considerations. These decisions should be made in the context of the overall portfolio and its asset allocation.

An option is “in the money” when the current market price of the underlying stock is greater than the grant price of the option. While the rewards are great if the company’s stock rises, the options could become worthless if the underlying stock’s value decreases below the pre-set grant price. Determining the optimal time to exercise an option is a complex matter, and is best undertaken with the help of an experienced financial advisor.

Stock options include nonqualified stock options (NQSOs), incentive stock options (ISOs), and stock appreciation rights (SARs). NQSOs are the most common type of options granted to employees, whereas ISOs are less common today. NQSOs and ISOs have common features but differ in their income tax treatment (as discussed below). Although not as popular as NQSOs, SARs are still in use. SARs give the executive the right to receive the difference between the price of the stock on the first measurement date and the price of the stock on the second measurement date in either cash or company stock.

Restricted Stock

Restricted stock, which is becoming more popular as an executive compensation award, is a “promised” stock that is not fully transferable until certain conditions are met, such as continuous employment and specific performance criteria. Typically granted by public companies, restricted stock shares have substantial risk of forfeiture due to these conditions. However, once you meet the conditions and become fully vested, you become a shareholder just as if you purchased common stock in the open market. Unlike

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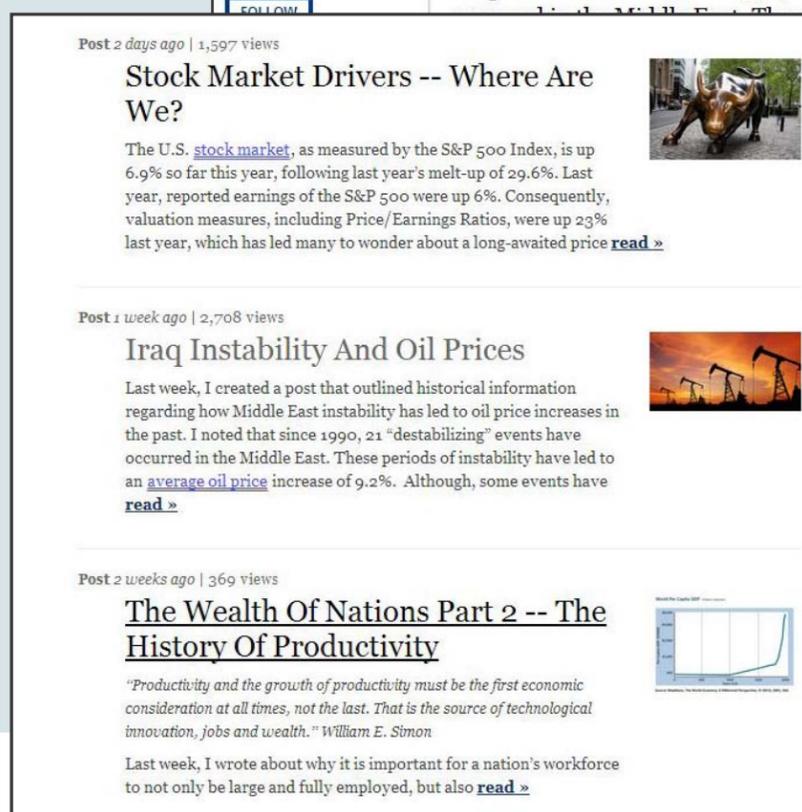
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We are pleased to announce that our own chief investment officer, Bill Greiner, is now a Forbes contributor.

Bill posts regular economic and capital markets updates on his blog, which can be accessed at www.forbes.com/sites/billgreiner.

Bill's most recent posts discussed the instability in Iraq and its impact on oil prices, current stock market drivers, and the history of productivity over the last 2,000 years.

Please join us as we follow Bill. And share Bill's blog with your Facebook friends. It's a great opportunity to share with others.



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stock options, it is unlikely that your restricted stock will ever lose all of its value.

In terms of tax treatment, you don't have to report income when you receive restricted stock from an employer.

However, when the stock vests, whether or not you sell it at that time, you must report the value of the stock as income, including any appreciation. The income is taxed at ordinary tax rates, and is subject to withholding, Social Security and Medicare tax.

If you make an "83(b) election," you pay ordinary income tax in the year you receive the restricted stock rather than when the stock vests. Any appreciation that occurs in the value of the stock after the transfer date is not recognized until the stock is sold and, then, it is taxed as capital gain. If you hold the stock more than one year, you will qualify for the preferential long-term capital gains tax rate.

Unless you have other available funds to pay the taxes, it may not be a good idea to make a Section 83(b) election if receiving the stock will result in a substantial amount of income and current tax liability, since there will be no receipt of cash with which to pay the tax. Additionally, if the stock does not appreciate, or actually decreases, you may wind up paying more tax than you would have without the election.

Taxation Differences Between NQSOs and ISOs

When you exercise a NQSO, the spread between the grant price and the fair market value on the date of exercise (the "bargain element") is treated as compensation in the year

of exercise and is taxed at regular income tax rates. It is also subject to Social Security and Medicare tax. When the stock is eventually sold, the gain (if any) between the fair market value at the time of exercise and the sales price is taxed at capital gains rates (short- or long-term depending on the holding period).

ISOs have more favorable initial tax treatment than NQSOs, in that, except for the Alternative Minimum Tax (see AMT and ISOs below), there is no tax liability generated by the option exercise itself as long as you hold the stock. The growth in the stock value when the shares are eventually sold (the difference between the grant price and the sales price) can be treated as capital gains if the stock is held for at least one year from the date of exercise.

AMT and ISOs

In the year of exercise, the spread between the grant price and the fair market value on the day you exercise the ISOs (the bargain element) has to be reported as taxable compensation for Alternative Minimum Tax (AMT) purposes. (If you exercise and sell the stock in the same calendar year, the bargain element is reported for regular tax purposes but not AMT.) Any AMT tax paid on the transaction results in a credit that can be used to offset the regular tax upon the sale of the underlying shares.

The AMT is a separate tax regime. Its original intent, when it was instituted in the late 1960s, was to limit the effect of certain loopholes by subjecting wealthy taxpayers to additional taxes. Today, many taxpayers, not just

the wealthy, are subject to the AMT. If you are a senior executive, chances are that you are subject to the AMT (particularly if you live in a state with high income and/or property taxes) and there is not much you can do to avoid it.

The AMT essentially eliminates the tax benefits of ISOs over NQSOs for those taxpayers subject to the AMT. This is the primary reason for the decline in popularity of ISOs.

Conclusion

Mariner Wealth Advisors has experience and expertise in all facets of executive benefit planning and nonqualified retirement plans. Your advisor can incorporate this expertise into your overall financial plan, including advice related to investment management, accumulation, tax considerations and effective distribution strategies to help you meet your long-term financial and retirement objectives.

By working with experts in the area of executive compensation, individuals can gain confidence that the benefits they have spent a career earning will be implemented in a way to support their goals and dreams in retirement. Should you have any questions about your executive compensation plan or any other aspect of your overall financial plan, please don't hesitate to contact your wealth advisor at 1-866-346-7265 or visit our website at www.firstpointfinancial.com.

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