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Quarterly Newsletter - January 2015

January 15, 2015

Dear Client,

Human psychology is what it is. If something feels good let's do it again. If it feels bad let's stop. Doing well (making money) feels good. Doing badly (losing money) feels bad. Put these together and standard investor behavior emerges ? sell what has done badly and buy what has done well. This is called returns-chasing and it is the dominant behavior of investors. One sees this in individuals, pension funds, hedge funds ? everywhere. It is just natural. And it does not work. We have said this many times in our letters.

But it is hard or even impossible to believe that it doesn't work. How could it not work? Buy what has done well and sell what has done badly. If a given fund has done well then buy it. If it has done badly then sell it. How could that not work? And that behavior is certainly evident in the markets now ? with new money flooding into U.S. assets, which have done well recently, and out of non U.S., which have done badly.

Let's allow the data to speak for itself. Vanguard has recently published a large study of returns-chasing versus buy and hold investing. Using data from Morningstar they compared buying funds with the best three year performance record and then switching to the current best performers once a year vs simple buy and hold ? and buy and hold wins decisively. The study is called Quantifying the Impact of Chasing Fund Performance. We are including a copy of the study with this letter. We strongly urge you to read it. Then meditate on it and then read it again. This is a big study, done by a firm with big data and fast computers. They looked at every U.S. equity fund and did separate returns analysis for every Morningstar style type. They created and analyzed forty million different return paths. And the results are clear. Returns-chasing is just not a good idea. Returns-chasing did worse than buy and hold, worse on absolute returns and worse on risk adjusted returns. And this did not include the tax or transaction costs of portfolio turnover ? which would have made the return gap significantly larger. To have the thought ?Mutual fund A has done well so I should buy it. Mutual fund B has done badly so I should sell it' is to have thoughts that are not supported by the evidence presented by Vanguard. To quote the study:

Although it may be possible to tweak the performance chasing rules and scour the historical data to find situations in which a buy-and-hold strategy has underperformed, our analysis supports the difficulty of succeeding with performance-chasing strategies in general.

Scouring and tweaking is tempting. The data period for the Vanguard study was the ten years ending 12/31/2013. This was a time of tremendous market volatility. Expand the time period and consider the events since 12/31/1999. First the tech crash, then a recovery led by the international stocks and most especially by Chinese growth and the commodity producing nations that supplied it. Then the crash of 2007-2009, the largest market crash since the depression, and then a second recovery, lead this time by the U.S., a recovery that has moved U.S. equity prices up by more than 200% from the 2009 lows. Surely performance-chasing should work in volatile markets like these. Perhaps the Vanguard look-back rules to pick over-performing funds were too long. Vanguard used three-year performance. Perhaps one should buy the funds that have done the best over the past one year, or three months, or fill in the blank. Ok. Bingo. We have the rules. The hard part is following them into the unknown future. One is always aware of the risk. Perhaps the funds will go down as much as they had gone up before they were bought, and, of course, much more rapidly. How long should losers be held? What happens when the method apparently stops working? When the losses and fear arrive? The investment rules are changed, of course, or abandoned, with bitter regret. Often they succeed for a time, then are leveraged up with borrowed money, and then blow up. Investment history is littered with failed performance-chasing methods, methods that have often lost a very great deal of money very quickly.

Diversified buy and hold investing as we practice it, using passively managed index style funds plus rebalancing, means sitting with the losers and in fact buying more of them. We wish to be on the other side of the performance-chasing strategy described by Vanguard. If performance-chasing does worse than buy and hold, which the Vanguard study indicates that it does, then the careful disciplined reverse of performance chasing, which is what we do, should do at least slightly better. We absolutely do not want to run

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the risk of only owning funds that have done well recently. The risks inherent in this are just too great. Our goal is not simple rate of return but rather rate of return achieved in a sufficiently balanced way so that the portfolios we manage can be used to generate income, primarily retirement income. If we own a number of relatively low-correlated asset classes, and rigorously rebalance back and forth, it is our opinion that this method will produce the return and volatility outcomes best suited to our clients.

Have we succeeded? Does this method in fact work? We believe that our investment experience since 1999, exactly the very volatile period discussed above, shows that it does work. There is a consensus in the financial planning community that a 4% inflation adjusted draw rate is a reasonable and relatively safe draw rate ? a rate that can be sustained for the many years of retirement. We have done studies of this, and we believe the 4% number is generally too low. If a diversified portfolio such as ours is used, we believe a 5% rate, adjusted for inflation, is quite reasonable. Our investment experience since 2000 provides evidence for this. We have a model of the performance of our method. This model shows that our portfolios, if invested at least 50% in equities, could have generated a 5% draw rate, adjusted monthly for inflation, over the 2000-2014 period and still would have had more money in the account at the end than the account started with. And this in the face of the most volatile market since the 1930's. We are pleased and proud of this.

There are, however, no guarantees. Such a draw rate needs to be protected by clear rules ? rules for draw reductions should market conditions require it and allowance for draw increases when the markets do unusually well. We review these rules in our financial planning process. Our investment performance results come from the fact that we can and do deliver the returns the markets offer. The U.S. equity markets have done well primarily because of the aggressive policies of the U.S. Federal Reserve. Europe has not been so lucky. The U.S. recovery from the 2007-2009 crash has been quite rapid. Not so in Europe. Had the market experience been as bad here as it has been in Europe draw reductions would now be in order.

We believe the Vanguard study has given additional evidence for our method. We consider our investment approach to have been validated both by this data and also by our actual results. We see absolutely no other reasonable way to invest. But there are no guarantees. We invite you to come in and discuss draw rates and rules. About as much fun as going to the dentist perhaps ? but very important, or so we believe.

Happy New Year. And Joy to you and all your loved ones.

Jim, John, Richard & Ryan