

Year-End Letter

By Martin Weil

“Your success in investing will depend ... in part on your ability to realize at the height of the ebullience and the depth of despair alike that this too shall pass.”

~ John C. Bogle

The S&P 500 index gained nearly 12% in the final quarter and ended 2011 in the black by 2%, as US stocks rallied from their August sell-off. Foreign markets did not fare as well in 2011, and Vanguard's International Index fund ended the year with a 14.5% loss. Vanguard's Total Bond Market Fund gained 7.5% as investment grade bonds once again outperformed stocks for the year. Real estate stocks, after considerable vicissitudes, rose an average 8% in 2011.

Model Portfolio Performanceⁱ

Model Portfolio Performance 12/31/2011					
	Risk Benchmark	4th Qtr	2011	Cumulative Since Inception	Annualized Since Inception
All Equity	100% Stocks	7.6%	-6.6%	82.1%	4.7%
Growth	80% Stocks/20% Fixed Income	5.8%	-3.3%	84.0%	4.8%
Balanced	65% Stocks/35% Fixed Income	5.1%	-1.6%	95.6%	5.3%
Conservative	40% Stocks/60% Fixed Income	3.5%	1.0%	93.8%	5.2%
S&P		11.8%	2.0%	27.9%	1.9%

Our four portfolio models underperformed their risk benchmarks for the quarter, and for the year as a whole. Model returns in 2011 ranged from a positive 1% for Conservative, to a negative 6.6% for All Equity. Those clients with substantial municipal bond exposure outperformed these numbers, as our portfolio models are based exclusively on taxable fixed income allocations. I will defer a discussion of our performance numbers to the section *The Good, Bad, and the Ugly*.

Portfolio Updates

At year-end, we continued to maintain an average 5% below-benchmark Equity allocation across all our portfolios. We held an equal overweight to Fixed Income holdings in Conservative and Balanced accounts, along with allocations to Multi-Asset funds (holding equities, fixed income and cash) in all four models. During the second half of 2011, we reduced our fixed income positions in various PIMCO funds, based on their ill-timed macro-economic forecasts, using the proceeds to increase our holdings in Doubleline Total Return, another excellently managed bond fund, but one with a more agnostic view on the economy.

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“Between August and November, investors lurched from full-on buying to full-on selling on a near-daily basis, with the Dow industrials swinging an average 269 points a day. In early August, the Dow alternately rose and fell by 400 points or more for four days in a row—an unprecedented run that encapsulated the fickleness of 2011 for many market watchers.”

~ Wall Street Journal

The Good, Bad and the Ugly

2011 was a remarkably frustrating investing year – a lot of work, but in the end, little to show for it. Our client accounts ended 2011 about where they started, in spite of our best efforts to find ways to enhance their returns. I do take satisfaction in having preserved capital in 2011, as this was far from a given for much of the past year. After 2008’s financial meltdown, preserving capital, always important on my radar screen, moved to top priority. I think often about Warren Buffett’s dictum about not losing money as Rule #1, and not forgetting Rule #1 as Rule #2.

However, the price of a more cautious approach to investing these past two years has been under-performance of 2-3% relative to our portfolio benchmarks. This is not good, and is neither what I intended nor what I was able to achieve in my first six years in this business. While I do not presume to beat these benchmarks year-in and year-out, clients should expect better than I delivered in 2011.

In the spirit of honesty that I have tried zealously to adhere to, I am calling this review, *The Good, The Bad and The Ugly* (with apologies to Sergio and Clint). At the back of this letter ([Appendix A](#)), I include a numerical breakdown of how our major holdings and asset class allocations for our invested client assets performed last year. This is an instructive chart for me, and I strongly encourage readers to look it over. For those who do, I believe you will better understand my choice of titles for this section.

First, the Good:

- On the positive side of our ledger, our large overweight allocation to fixed income earned clients \$410,000 in 2011. Additionally, our allocation to “Multi Asset” funds, positions funded by reductions in US equity holdings, earned another \$90,000 for the year. I count these allocation decisions as GOOD.
- Also on the positive side were the excellent performances by several of our largest mutual fund holdings. In particular, the Blackrock TIPS and Vanguard Municipal Bond funds gave a nice boost to the taxable accounts of our Conservative and Balanced model investors. Several of our largest US equity funds – notably Yacktman, the Vanguard Dividend ETF, and FPA Crescent – each significantly outperformed their benchmarks, earning our client composite more than \$200,000. I count all these fund selection decisions as GOOD.

Now for the Bad and the Ugly:

- Maintaining a benchmark weighting to Foreign Equity cost us \$430,000 in 2011, the result of

both falling foreign markets and currencies. While the specific funds we employed for our foreign allocations performed in line with their benchmarks, I count the asset allocation portion of this decision as HALF-BAD.

- Less immediately obvious on the chart was the underperformance of the \$5M we had invested with various PIMCO bond funds at the start of 2011. These positions earned our clients about \$50,000 for the year, compared to the roughly \$350,000 we might have earned had we invested instead in a bond index fund. I count this fund selection decision as BAD.
- Lastly, our positions in Fairholme cost clients \$225,000 in 2011, the result of a disastrous sequence of investment decisions by the fund's manager Bruce Berkowitz. This, in spite of our substantially reducing our holdings as 2011 progressed. I view this failure to exit this fund (previously our best performer) even more rapidly, as my concerns about Berkowitz grew, as UGLY.

These are the decisions that contributed most to our 2011 performance. Summing up, the positives from our GOOD decisions in 2011 more than compensated for the negatives of our BAD ones. What they could not do was compensate for the cost of our one UGLY decision as well. A lesson for me is that there will always be good and bad decisions, and hopefully the former will outweigh the latter. However, what can do serious harm to an investment portfolio are the ugly decisions, which brings me full circle to Buffett's Dictum #1 "Don't lose money." I am confident this is what he is talking about.

I'm not finished yet.

At this point, you are probably expecting someone in my position to say something about "investing for the long-term," "diversification," and "buy and hold." I will not completely disappoint, as these concepts are of fundamental importance to at least one segment of investors. We will get to them shortly. But I am going somewhere else first.

I divide my investment approach and my clients into three principal groups: (1) Those already withdrawing from their portfolios; (2) those in the early saving years; and (3) those in their prime spending years. Of the three, the latter are the most challenging, and the rules for investing this middle-years demographic's assets are less clear-cut than for the others.

- For those in withdrawal mode, two things are clear: Volatility is your enemy, as having to sell investments at severely depressed prices in order to fund withdrawals can destroy the long-term sustainability of your portfolio. In addition, spending more than a sustainable withdrawal rate will almost certainly deplete your portfolio before you yourself are depleted. Your savings do not know or care how much you need, or want, to support yourself. What you are able to withdraw safely in the long run comes down to some relatively simple math. We manage the funds of these clients with an additional layer of prudence and with a target of at least two years of expected withdrawals in cash equivalents to insure against volatility and having to sell at market lows.
- For those younger clients, (sound the trumpet): Buying and holding a globally diversified portfolio, focused on growth, is the best investment advice you will ever get. That and making sure you adhere to sufficient savings goals. What happens this coming year, or this coming

decade, in the investment markets is of no consequence to anyone saving for retirement in 20-30 years. Again paraphrasing Warren Buffett, a declining market means you can purchase more with your savings when investments are available at “sale prices.” Starting a regular retirement savings and investment plan early, before you reach group number three below, has a truly extraordinary long-term payoff.

- But what about those 40 and 50 year-olds, those in between the younger and older cohorts? The solutions to how best to invest for this group are less straightforward. People in this group are typically mid-career and often high-earning, but they are also in their peak spending years, with children and lifestyles competing heavily with the demand for savings. Those who are on track with their projected savings requirements can be invested with prudence as they decelerate from the Growth orientation of the younger group to the Conservative approach best suited to those in retirement. This “glide path” as it is called, can be fitted to each investor. However, for those who may have undersaved, the road ahead presents some challenging choices between taking more investment risk while hoping to get lucky, reducing current lifestyles in order to catch up on savings, working longer than planned, and/or lowering expectations for retirement. The financial crisis of 2008 brought this latter reality home, to one degree or another, to millions of households. What we are living through today as a nation is the adjustment phase to what, for many, may become a more or less permanent change to their financial status.

What about 2012?



As this [NY Times' Sunday Business Section](#) cover illustration shows, there are far more than the usual financial worries as 2012 begins. The media are filled with fear stories and nearly every investor I talk to, professionals as well, is anxious to their core. A Eurozone breakup; an attack on, or by, Iran; a collapse in China; not to mention a host of other possibilities would cause serious market upheaval. While I too worry about all of the above, my one true investment unease in the next three-to-five years is instead

whether we might fall into a deep deflation trap or, conversely, a version of runaway inflation. Avoiding investment missteps in the face of either of these quite opposite scenarios is what keeps me up at night. That said, the labor and manufacturing data points for the US economy are – somewhat surprisingly – starting to show some tentative signs of life.

Markets are priced principally on a combination of three factors: economic fundamentals, investor psychology, and the interest rate environment (or better, the availability of affordable credit). Over time, the relative importance of these three variables ebbs and flows. With even marginally improving economic fundamentals, and a Fed committed to a hyper-low interest rate policy, two of our three major factors are positive. Only investor sentiment remains profoundly negative. If this were to change, equity markets could rapidly surprise on the upside.

This is by no means a forecast for 2012. With an historic debt overhang in the developed economies still

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needing to be unwound, the potential for stock markets to return to the “good old days” of double-digit, multi-year, gains is essentially nil. But simply expecting this coming decade to mirror the last is as foolish as was expecting the 2000’s to mirror the 1990’s. Those professionals whose analysis I most trust (specifically [Jeremy Grantham at GMO](#) and [John Hussman at Hussman Funds](#)) forecast that stocks should return an average 5-6% per annum over the next 7-10 years, easily outpacing investment grade fixed income. And yes, they are expecting significant ups and downs in both the stock and bond markets along the way. After a decade of earning nothing in stocks, a modest 5-6% annual return might be a welcome plus for investors.

So I end this letter on a note of guarded optimism. Those of you who have known me long enough know that I am at heart an unabashed contrarian. And contrarians tend to be early, potentially imprudently early, on their timing. As I review the truly frightening inventory of systemic financial challenges that are our lot, I remain mindful of this timing trap. Against a world in full debt deleveraging mode, it is hard to imagine the immediate road ahead to be a smooth one. Seat belts for investors are still in order in 2012. That said, I will be actively watching these coming months for opportunities to bring our portfolios back to their benchmark risk weightings.

Giving Back

As is our practice, we are pleased to give something back each year to the communities in which our clients reside. At the end of 2011, MW Investment Strategy made contributions to ten area food banks: San Francisco Food Bank, Marin Community Food Bank, Community Action of Napa County, Redwood Empire Food Bank (Sonoma County), Alameda County Community Food Bank, Los Angeles Regional Food Bank, Orange County Food Bank, Food Bank for New York City, Utah Food Bank, and The Food Depot of Northern New Mexico.

Appendix A: All MW Investment Strategy Managed Accounts - 2011

	POSITION AT START OF YEAR	CONTRIBUTION TO 2011 PERFORMANCE	POSITION AT YEAR END	2011 RETURN
US Larger Capitalization:				
Fairholme Fund	\$1,205,782	(225,925)	\$69,840	-30.6%
Fmi Large Cap Fund	\$1,357,363	40,334	\$1,031,869	4.2%
Nuveen Tradewinds Value	\$737,922	(32,835)	\$384,443	-4.7%
Primecap Odyssey Growth	\$904,790	(30,176)	\$906,988	-3.2%
Vanguard Div Appreciation	\$388,146	22,295	\$350,033	5.8%
Yacktman Fund	\$878,164	91,087	\$1,558,863	7.4%
Other	\$2,560,530	-\$4,073	\$2,371,312	
Total US Larger Capitalization	\$8,032,697	(139,293)	\$6,673,348	
US Smaller Capitalization:				
Kane Anderson MLP ETF	\$0	26,309	\$177,074	19.7%
Westport Small Cap Fund	\$70,256	(11,768)	\$154,882	-7.2%
Other	\$349,411	-\$7,089	\$309,039	
Total US Smaller Capitalization	\$419,667	7,452	\$640,995	
Foreign & Global Equity:				
Oakmark Global Fund (I)	\$1,133,554	(207,281)	\$1,193,324	-13.9%
Oakmark Intl Fund	\$331,686	(58,152)	\$158,498	-16.0%
Thornburg Intl Value	\$522,596	(66,171)	\$430,389	-13.2%
Vanguard Intl Eqty Index	\$157,270	(21,979)	\$116,373	-14.6%
Other	\$1,221,731	(76,194)	\$706,131	
Total Foreign & Global Equity	\$3,366,837	(429,777)	\$2,604,715	
Multi-Asset Funds:				
Fpa Crescent (I)	\$2,397,141	84,710	\$1,645,166	5.3%
Hussman Strategic Total	\$668,374	17,129	\$173,237	3.9%
Other	\$965,538	-\$9,978	\$2,036,844	
Total Multi-Asset Funds	\$4,031,053	91,861	\$3,083,173	
Fixed Income:				
Blackrock Inflation	\$64,649	19,869	\$177,625	13.1%
Doubleline Total Return	\$703,539	80,487	\$1,727,913	8.7%
Loomis Sayles Bond	\$1,767,987	68,004	\$2,091,817	3.4%
Osterweis Strategic	\$1,008,561	46,360	\$1,495,791	3.0%
Pimco Emrg Local Bond	\$2,549,416	(988)	\$1,276,814	0.2%
Pimco Total Return	\$439,642	24,181	\$1,008,075	3.5%
Pimco Unconstrained Bd	\$2,166,831	9,662	\$1,021,041	0.6%
Thornburg Strategic Muni	\$321,047	40,096	\$342,415	12.5%
Vanguard CA Muni	\$571,990	87,472	\$816,665	10.9%
Other	\$1,071,022	\$34,090	\$1,149,566	
Total Fixed Income	\$10,664,684	409,233	\$11,107,722	
Total Other Asset Classes	\$855,354	8,767	\$774,091	
Total Cash Management	\$3,570,986	33,440	\$5,777,510	
TOTAL ALL INVESTED ASSETS	\$30,941,279	(18,317)	\$30,661,554	

Model Portfolio Performance Disclosures:

- a) Performance shown is for each portfolio model and is not a composite of the performance of actual client accounts. While our goal is that each client account will closely mirror the holdings and performance of our models, client account performance may, and does, vary according to several factors. Some of these are listed below. In addition, there have been periods, and may again be in the future, when our evaluation of major economic and/or market events leads us to manage client account allocations in a materially different manner than is shown in our models. At these times, client performance results will vary from that of our models.
- b) All MWI managed client accounts are based on one of four diversified model portfolios, composed of no-load mutual funds, exchange-traded funds and other publicly traded securities. These four models are geared to different levels of investor risk tolerance. New accounts are invested following one of these models, typically using dollar-cost averaging over a period of months, not to exceed one year. Once an account is fully invested, it is expected to track the performance of its underlying model. Exceptions to this include accounts with restrictions such as: the client-directed retention of legacy holdings and/or excess cash, substantial withdrawals or additions. Accounts smaller than \$100,000 are restricted by purchase minimums at certain mutual funds and as a result do not hold all the same positions. The performance of these accounts may differ somewhat from these models. Accounts employing municipal bond funds in place of the taxable bond funds used in models will slightly underperform on a pre-tax basis.
- c) Benchmarks for each model are custom created following the neutral asset allocation for each portfolio. They are constructed from Vanguard's S&P 500 index fund, iShares Russell 2000 index, Vanguard Total International and Total Bond index funds. The S&P 500 index is calculated with dividends included.
- d) Net of fees: The performance for MWI model portfolios is calculated net of our maximum annual management fee, and brokerage charges, if any. The returns of the portfolio benchmarks do not include any fees or charges other than those of the index vehicles employed in the benchmark. All returns assume dividends and income are reinvested.
- e) Rebalancing: Model portfolios are routinely rebalanced every six to twelve months on the last day of a quarter. Actual client accounts may be rebalanced as needed. With tax-efficiency a part of our decision criteria, taxable accounts may be rebalanced less often and/or less completely than retirement and other accounts not subject to current taxation. This may result in performance discrepancies between taxable and non-taxable accounts managed following the same portfolio model.
- f) Model allocation changes: Changes to model allocations are infrequent but can and do occur at any time. When a model is changed, allocations to client accounts are changed as soon as is practical. However, changes to the model portfolios are only recorded for performance purposes on the last day of any quarter.
- g) Closed funds: From time to time, mutual funds that form part of MWI model portfolios close to new investors. Clients already owning closed funds in their accounts will generally continue to hold and/or add to their positions. New client accounts will be invested in alternate funds. At year-end, MWI will substitute in its models for any funds that have closed during the year with the alternate funds available then to new clients. As a result, performance disparities may develop between older and newer client accounts, and between older client accounts and current model performance.
- h) Historical performance is not a guarantee of future results. While the performance period since January 1999 includes both rising and falling stock markets, there can be no assurance that the portfolios will perform as well under future market conditions.