October 2013

# Quarterly Letter

*By Martin Weil*

*"In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497."*

~ Warren Buffett

Despite mounting uncertainty over the fiscal deadlock in Congress, US stocks rebounded during the third quarter as the S&P 500 index rose 5.2%. Foreign stocks were very strong and the Vanguard International Stock Index gained 11.6%. Bonds stabilized after a terrible second quarter, rising ½% for the three-month period.

## Model Portfolio Performance[i1]

**Model Portfolio Performance**
9/30/2013

| | Risk Benchmark | 3rd Quarter | YTD | Cumulative Since Inception | Annualized Since Inception |
|---|---|---|---|---|---|
| All Equity | 100% Stocks | 6.2% | 15.6% | 142.6% | 6.2% |
| Growth | 80% Stocks/20% Fixed Income | 5.0% | 12.3% | 132.6% | 5.9% |
| Balanced | 65% Stocks/35% Fixed Income | 3.6% | 8.2% | 138.1% | 6.1% |
| Conservative | 40% Stocks/60% Fixed Income | 2.0% | 3.7% | 121.3% | 5.5% |
| S&P | | 5.2% | 19.7% | 77.3% | 4.0% |

Our four model portfolios gained between 2.0-6.2% for the third quarter and have returned 3.7-15.6% for the year to date. These results generally match or exceed our portfolio benchmarks. Our Conservative portfolio has somewhat lagged its benchmark as we continue to err on the side of caution for our investors in this segment.

Both our overall fund selection and our allocations to non-traditional bond funds have added value in 2013. A number of our equity funds - Primecap Odyssey Growth, Oakmark Global, and Brown Capital Small Cap among others - have each risen more than 30% over the last twelve months. However, our asset allocations within the equity space – we are overweight Emerging Markets, underweight Small Cap US - have detracted from returns.

*Portfolio Update*

During the quarter, we sold the last of our holdings in Longleaf Partners following a downgrade of the fund by Litman Gregory. We first purchased Longleaf in 1999 and, along with Pimco Total Return, Loomis Sayles Bond, and Oakmark Select; it was among the longest-held holdings in our portfolios.

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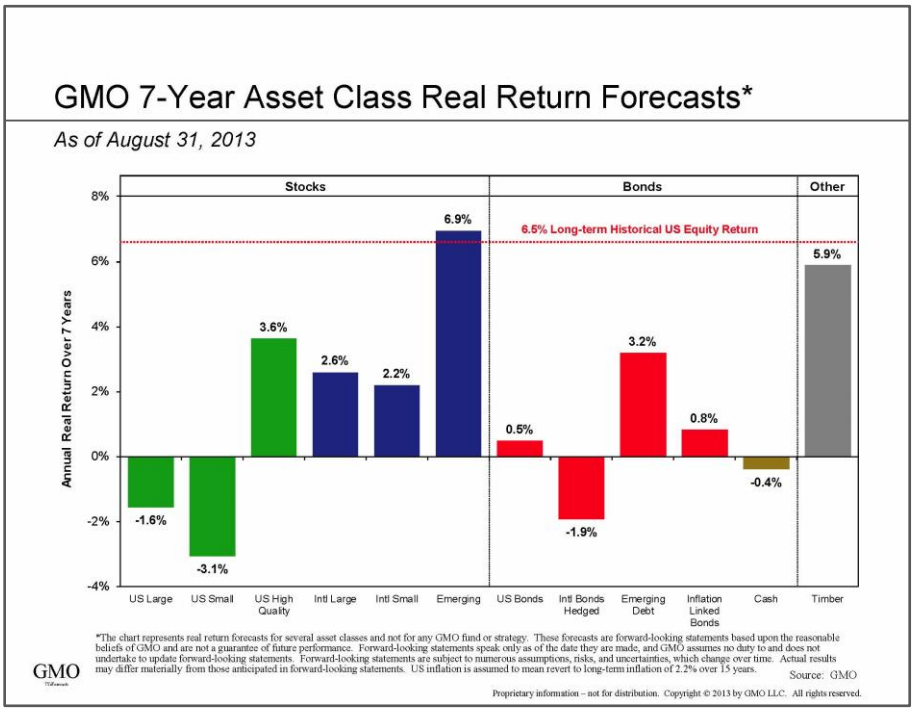
[1] There was a small error in our last quarter performance tables and this understated June's year-to-date performance for our Growth and All Equity portfolios by 0.2% & 0.4%. The numbers above include the corrected calculations.

## Emerging Markets

We began acquiring dedicated positions in Emerging Market equity funds in our portfolios during 2012, gradually increasing our holdings as prices declined in the sector. Our allocations to EM stocks now range from 5% in Conservative portfolios to 17% in our All Equity model. To date this decision has been a detractor from our performance as EM stocks have been among the worst performing asset classes the past year, and US stocks, from which the funds were taken, among the best. We have held onto this overweight positioning (doing some tax-loss harvesting where appropriate) but it has not been easy.




We take our lead on this allocation decision from Litman Gregory, whose valuation work provides our core research, and also from GMO's Jeremy Grantham, one of the very few "experts" in the field that I maintain a high degree of confidence in. Both suggest that EM stocks are at historic low valuations levels relative to developed market and have recommended overweights for longer-term investors.

The graph shows GMO's return forecasts for the coming seven years. Emerging Markets and Timber (a specialized asset class typically accessible by institutional investors) are the clear winners in a field of otherwise muted return expectations. More modest expected performers from GMO include what they call Large "High Quality" US stocks and Emerging Market debt, two asset classes we also have significant exposure to.

It is important to remember that any multi-year return projection cannot predict what will happen to an asset class next year, or in any other. The difficulty, as with all valuation-based investors, is that the pay-off (if it is realized at all) is impossible to time with any degree of accuracy. Undervalued stocks can, and often do, continue to decline far past reasonable levels. The current situation regarding EM stocks is reminiscent of the 1998-1999 period when US value stocks were at irrationally undervalued levels, and yet growth and momentum stocks continued to soar to unprecedented valuation levels before their collapse as the dotcom era came to an end. Investor faith in value stocks was eventually rewarded as they outperformed the high-flyers by enormous margins in the subsequent 2000-2002 period. That, anyway, is the hopeful perspective.

There is a pessimistic view as well, one that cannot be easily dismissed. It revolves around the argument that the surge in the EM economies, and their stock prices, since the 1980s has been the result of our own Federal Reserve's loose money policies. As the Fed withdraws liquidity, as it eventually must, EM economies and markets could be most severely affected. A preview may have been the sell-off, and subsequent rebound, in EM stocks when the Fed first announced, and then recanted, its intention to "taper" purchases of Treasury bonds this summer. In this view, the inevitable reversal of the Fed's policies will prompt another crisis in EM markets, the sort that we have witnessed many times before. We believe that while there may be disruptions, conditions have changed dramatically since the last major crises of 1994 and 1998. Where the Chinas, Koreas, Indonesias, et al., were once massive debtor nations, today it is the developed economies that are the world's creditors with the United States' external debt the largest in recorded history. Today's creditor nations are largely the previous debtor countries in the EM universe, an intentional change on their parts intended to safeguard them against a rerun of prior crises.

## October's DC Follies

*"It just goes to show you, it's always something--if it ain't one thing, it's another."*

Roseanne Roseannadanna (Gilda Radner)

As I write this letter, Congress is engaged in a self-imposed showdown that could determine whether or not the US defaults on its obligations. The consequences of default, even the perception of a serious prospect, would take the US into uncharted territory, putting us in the company of third-rate Latin American sovereigns. Any failure by the US government to pay lenders in a timely manner would most likely unleash substantial disruptions in global capital markets. A longer-term consequence would be the damage to "Brand USA"s envied position as the world's financial leader and safe haven. It is inconceivable to me, and apparently to the markets as well, that Congress would actually allow such catastrophic self-destructive behavior to occur, political grandstanding notwithstanding. However, brinksmanship is a dangerous strategy and brings with it the risk of consequences unintended by either side. Let us hope that the market's current estimation is correct and that more rational heads will prevail in bringing us back off this ledge.

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***Affordable Care Act***

*I had wanted to provide a full write up on the Affordable Care Act in this quarter's letter but my attempts to adequately cover the ground fell short. My thanks to the many individuals who tried to educate me in recent weeks. I can recommend Bloomberg BusinessWeek's* **article by Peter Coy** *on how employees and companies will be affected. Also the resources below.*

- **Consumer Reports**
- **AARP**
- **Healthcare.gov**
- **Guide for Small Business**
- *Selected State HealthCare Insurance Marketplaces*
  - **Covered California**
  - **New York State of Health**
  - **For other states,** *scroll to bottom of the web page*

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[i]**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 often slightly underperform on a pre-tax basis.
c) Benchmarks for each model are created to represent the neutral asset allocation for each portfolio. The Vanguard S&P 500 index fund is used to model the S&P 500 index total returns. This fund, the iShares Russell 2000 index, Vanguard Total International and Total Bond index funds are the components we use for our benchmarks.
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 our model allocations 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.