January 2014

Year-End Letter

By Martin Weil

"One of my principles is that we never know where we are going ...but we ought to know where we are."

~ Howard Marks, Oaktree Capital

The US stock market was the place to be as the S&P 500 index returned 32% for the year, closing out 2013 with a gain of 10.5% for the 4th quarter. This was the best annual performance for US equities since 1997, and it trumped that of all other major markets. Foreign markets rose a more modest 15% for the year, with gains in Developed Markets offset by losses in the Emerging Markets sector. The Vanguard Total Bond Market Index declined 2.4% for the year, its first loss since 1999. Gains in the corporate and other bond sectors moderated the impact of declines incurred in US Treasuries and municipal markets.

Model Portfolio Performance[i]

Model Portfolio Performance
12/31/2013

	Risk Benchmark	4th Quarter	2013	Cumulative Since Inception	Annualized Since Inception
All Equity	100% Stocks	6.3%	22.9%	157.9%	6.5%
Growth	80% Stocks/20% Fixed Income	5.6%	18.6%	145.7%	6.2%
Balanced	65% Stocks/35% Fixed Income	4.0%	12.5%	147.6%	6.2%
Conservative	40% Stocks/60% Fixed Income	3.0%	6.8%	127.9%	5.6%
S&P		10.5%	32.2%	95.8%	4.6%

Our four portfolio models ended 2013 with gains of between 7% for our Conservative Model to 23% for our All Equity portfolio. Our portfolio model returns for the 4th quarter ranged from 3-6%. These are terrific numbers on an absolute basis, welcome in any year. However, their luster is somewhat diminished when compared to the stunning 32% return in the S&P 500 index.

The specific funds our clients are invested in kept pace in 2013 and several of our core equity funds (Oakmark Select, Primecap Odyssey Growth, Brown Capital Management Small Cap, Artisan Global Value & Oakmark International) posted benchmark-beating returns for the year. Our two best performing fixed income funds - Loomis Sayles Bond & Osterweis Strategic Income, both "unconventional" bond funds - earned 6% each for the year, insuring that our overall fixed income allocations were a net positive for performance in 2013. The dominant detractor from our overall portfolio performance in 2013 was our asset allocation, discussed in more detail below.

Portfolio Update

We added Dodge & Cox Income to our roster of investment-grade fixed income funds, with initial positions being funded by the sale of a portion of our Pimco Total Return holdings. In the first quarter, we will be adding Baron Emerging Markets to our roster of foreign stock funds.

Our Asset Allocation, and our Answer to the Question "Why Bonds?"

In 2013, investors increasingly were induced to relinquish their fears of a relapse of the 2008 financial crisis and are now seeking, as opposed to fleeing, risk assets such as stocks. Score one for the Federal Reserve and its global colleagues. Fixed income investors fared less well in 2013, as high single-digit losses in government bonds were offset by small gains in other fixed income sectors.

We stuck by our valuation discipline throughout 2013, which meant an underweight for our US equity allocations and also an underweight to risk assets in general for our Conservative model investors. Where the successful strategy would have been "All In" to US Equities, we stayed "80-90% In" relative to our portfolio benchmarks. As a result, our models have lagged their benchmarks during two of the past three years, which is nothing to brag about. We expect to do better for our clients over the longer-term.

Specifically, we swapped a reduction in US equity exposure for comparable increases to Foreign & Emerging stocks, based on their far more attractive relative valuations. In this, we have followed the lead of Jeremy Grantham, Litman Gregory and other key strategists whom we rely on for this analysis. In 2013, foreign equity returns lagged that of the US market. Our allocation to Emerging Markets stocks by itself cost our models an average 2% points of gain. We expected (and still do expect) an outsized return from these positions. However, I am all too aware that the timing of any "payoff" from value-driven investment themes such as this, if it indeed materializes, is unpredictable. The wait can try the patience of investor and investment manager alike.

It is easy to see now that we were too early into the EM fray. The last time our portfolios badly lagged their benchmarks was during 1997-98, the result of overweighting value stocks versus the soaring tech stocks of the era. I remember being accused at the time by some young tech millionaire that I had grown "too old" (I was then 50!) and that "everyone knows that the world has changed." Two years later, we were vindicated with multiple years of substantial outperformance. But it was a very difficult wait.

Why Bonds?

Bonds have been a terrific investment since the early 1980s. The long decline in bond interest rates are the principal reason that our less risky portfolios – Conservative & Balanced – kept pace with the longer-term performance of our more stock-heavy Growth & All Equity models from inception through 2012. It has been a truly remarkable run. Today, most analysts agree that this trend is over and moving the other direction, if not already, then in the coming years. If rising rates will inevitably cause bond prices to decline, why do we continue to own any bond allocations at all?

In a diversified portfolio, investment-grade fixed income is the first-line shock absorber against the higher volatility, and the larger drawdowns, of an all-equity portfolio. Nothing protects a portfolio in a crisis like cash and Treasuries. However, we increasingly shifted our fixed income allocations to much shorter durations and to more credit exposure than the benchmark over the past few years as a defense against potentially rising rates. This swap to more unorthodox fixed income was a successful strategy as interest rates crept higher in 2013. We would expect this positioning to continue to be successful in a further

rising rate environment.

However, our more "credit sensitive" bond allocations diminish a good portion of the disaster-protection features otherwise available from investment-grade fixed income. This protection factor is one of the main reasons we hold fixed income in our portfolios in the first place. In a market meltdown, our unconventional bond funds could suffer price declines – not as bad as equities but far worse than traditional fixed income funds. So our approach is a double-edged sword. I noted recently that every major investment bank is now recommending some version of this exact fixed income strategy. And the financial news seems to have a daily story about increasing risks to fixed income. Sometimes, everyone is right. But this is becoming, as they say, a "crowded trade." Given our inherent contrarian tendencies, we will be revisiting this thesis on fixed income, specifically as regards the portfolio protection needs of our Conservative & Balanced models, in the coming months.

Model Portfolio & Benchmark Allocations as of 12/31/13

	Conservative		Balanced		Growth		All Equity	
	Current Target	Benchmark	Current Target	Benchmark	Current Target	Benchmark	Current Target	Benchmark
Fixed Income	56%	55%	35%	35%	20%	20%	00%	00%
Cash	08%	06%	05%	00%	00%	00%	00%	00%
Large CAP US	20%	27%	35%	41%	45%	48%	58%	58%
Small CAP US	02%	04%	03%	06%	05%	9%	06%	12%
Intl/Global	10%	08%	18%	18%	25%	23%	36%	30%
Other	05%	00%	04%	00%	02%	00%	00%	00%

Allocations are current as of this writing but may change at any time.

Quo Vadis?

Typically, investment managers take this opportunity at year-end to opine on the direction of the market(s), and investor returns, in the year ahead. For myself, I side with Howard Marks, quoted at the top of this letter, in saying "I have no idea." Momentum has built for stocks as long-sidelined cash and a steady flight of funds out of fixed income continue to drive equity prices higher. The Federal Reserve has signaled a continuation of ZIRP (Zero Interest Rate Policy) through 2014 if not beyond. "Animal spirits" are rising as investors are induced to move from risk-aversion (fear) to return-seeking (greed). We would be irresponsible to ignore these factors in developing our portfolio allocations for the coming years.

The domestic economy continues to rebound from the depths of the financial crisis and this is reinforcing investor optimism in a virtuous cycle. At current pricing, the US equity market seems to be discounting "perfect weather" ahead. While nowhere near the extremes of 2000, valuations for US stocks are

nevertheless far from bargain range. The developed world economies have yet to work off their excessive debts acquired over two-plus decades of financed consumption. That process has historically taken a decade or more, and we are just 5-plus years in. As debt levels are gradually reduced, economic growth can be expected to remain muted. And lurking behind it all is the unprecedented policy of the Federal Reserve, and what the eventual unwinding of that policy might trigger. The markets for now appear to be little concerned.

For younger investors, at the outset or mid-career, 2013 has demonstrated that we should to unleash our caution. Market declines, even the most frightening as in 2008, should be of little concern. We need not be as prudent in defending their portfolios against shorter-term market turmoil. Periodic deposits into a 401k, IRA, or investment account coupled with a growth-oriented portfolio is the best prescription. For our part, we will redouble our efforts to ensure you earn market returns or better in 2014 & beyond.

For those who, like myself, are no longer quite so young, excessive volatility is truly an enemy to be held at arm's length. That is why we redoubled our attention to risk-management for these investors in the years before, during and after the 2008 financial crisis. A strategy of maximizing returns can have dire consequences once one has started withdrawals. For those for whom savings is currently, or will soon be, providing a significant source of support, protecting those assets must come to the fore. Lowering volatility and portfolio drawdowns, keeping a safe cushion of cash to fund withdrawals, all of which reduce returns in years like 2013, are essential strategies to sustaining the viability of one's finances over an expected lifetime.

While we are always happy to do well with our annual returns, our principal job is to serve the longer-term needs of our clients. As we can neither predict nor control what the markets will bring in 2014 or beyond, we focus our energies on making sure we have done everything in our power to help each of our clients on the path towards successfully achieving their essential financial goals.

2013 Contributions

At year-end, MW Investment Strategy made contributions to food banks in the following communities where our clients reside:

- San Francisco/Marin, Alameda, Contra Costa, Napa & Sonoma Counties.
- Los Angeles & Orange Counties
- New York City & Mercer County NJ
- Salt Lake City
- Santa Fe

[i] **Model Portfolio Performance Disclosures:**

a) Performance shown is for our portfolio models 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.
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: 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. As a result, these accounts will not hold all the model portfolio positions and their performance may differ somewhat from these models. Accounts employing municipal bond funds in place of the taxable bond funds used in models may slightly underperform on a pre-tax basis. In addition, there have been periods, and may again be in the future, when our evaluation of economic and/or market conditions leads us to manage client account allocations in a materially different manner than is shown in our models. At these times, actual client performance may vary from that of our models.
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 <u>not</u> 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.