July 2014

Second Quarter Letter

"Bull-markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."

~ Sir John Templeton

US stocks continued higher during the second quarter as the S&P 500 index returned 5% and has now gained 7% for the year to date. Foreign stocks rose an average 5% for the quarter and are 6% higher on the year. In spite of a widely-predicted sell-off, investment grade bonds returned nearly 2% for the three months and are 4% higher so far in 2014.

Model Portfolio Performance[i]

Model Portfolio Performance
6/30/2014

	Risk Benchmark	2nd Quarter	YTD	Cumulative Since Inception	Annualized Since Inception
All Equity	100% Stocks	3.9%	5.5%	172.2%	6.7%
Growth	80% Stocks/20% Fixed Income	3.4%	5.0%	157.4%	6.3%
Balanced	65% Stocks/35% Fixed Income	3.4%	4.9%	160.9%	6.4%
Conservative	40% Stocks/60% Fixed Income	3.0%	4.5%	137.7%	5.7%
S&P		5.2%	7.0%	99.3%	4.5%

Our models rose 3.0-3.9% for the three-month period and have gained 4.5-5.5% year-to-date. Our more equity-weighted models are outperforming our more bond-heavy portfolios, but by less than one would expect, a consequence of the strong performance of our fixed income allocations.

Emerging market exposure is again adding value to our portfolios in 2014, after having served as a drag on performance during 2013. Our continued over-weights to more defensive "high quality" large cap stocks - specifically via the Yacktman fund and Vanguard Dividend ETF - have underperformed the broader benchmark S&P 500 index.

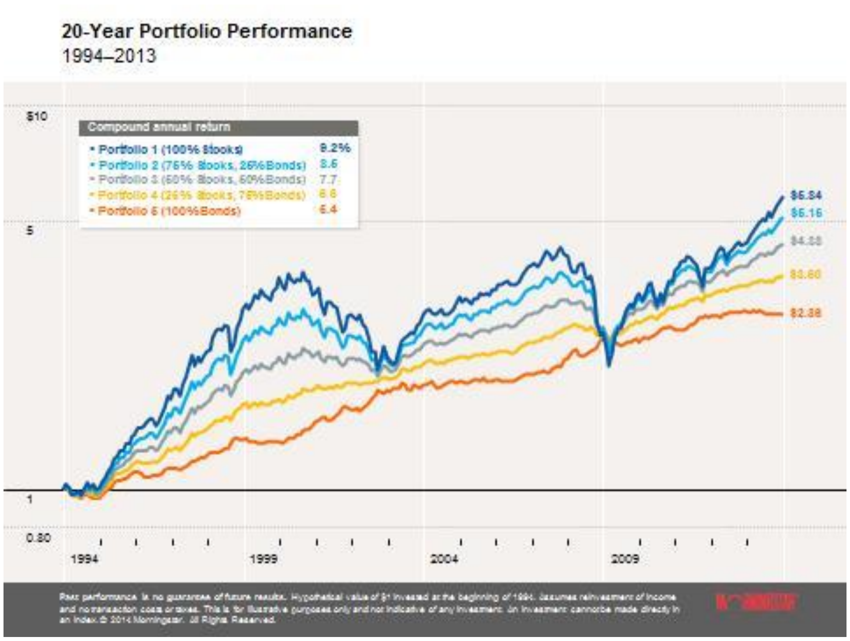
Portfolio Update

Per our last quarter letter, we are shifting some 20% of our US large-cap equity allocations from actively-managed funds to the DFA Core Equity Fund, a low-cost enhanced-index vehicle. This change reduces the expense ratios of our portfolio models by 20bps to between 0.75-0.95%. We are looking at additional use of DFA and similar funds to further lower these portfolio expenses.

Equity-Based Investing – The Longer Term

When making decisions we humans are prone to a multitude of errors, called cognitive biases by the field of behavioral economics. I want to point out three. We drastically overweight negative information. We pay attention only to information that agrees with our beliefs. We give too much weight to events and trends of the recent past when predicting the future.

These three decision-error biases are hard at work affecting investor behavior, and since the drama of the 2008 financial crisis, have led many to avoid the equity markets, even as these latter plowed steadily upwards. This avoidance is not wholly irrational – our biases would not have evolved through the millennia if they did not function well as survival tools. Once bitten, twice shy, the saying goes.



But the problem is that these fear-reinforcing biases have historically not served investors well. Equities are a core driver of wealth enhancement, although the journey can be truly stomach churning. Even the worst of market calamities has been surmounted with time. Note the dark blue line in the graph[1] showing the 20-year performance of a 100% equity portfolio. Contrast its volatility, and also its ending value, with the various equity/bond blend portfolios - light blue, grey & yellow - or with the orange line representing a portfolio of 100% investment grade fixed income. The more stocks, the higher return, but at the price of a far more unsettling ride.

Yes, you can lose a tremendous amount of value in a severe bear market such as during 2000 or 2008. But over time, market gains have restored those losses. Investors who stayed the course after 2008, admittedly a very difficult decision, were rewarded. Market sell-offs, small and large, will happen. But losses are only on paper for those investors who do not need to sell. I underline that last as this is an important take away. And it leads to these observations.

1. If you are young and in the early part of your career, you naturally have a long investment horizon. Your highest returns are likely going to be earned by an equity-heavy investment portfolio. Make sure however that you start with a portfolio you can live with through both the ups and the downs, what I call all-weather investing. If the market sells off, or worse seems to totally collapse, you need to be able to let your portfolio ride out the downturn without great

[1] 20-year returns of sample index asset allocation portfolios provided by Morningstar

personal anxiety. In the long run, you are going to come out ahead, probably way ahead.

2. If you are regularly withdrawing money, or plan to start withdrawing money from your savings in the coming few years, the approach to portfolio building needs to be from a risk-management point of view, as opposed to the return-maximizing approach described above. Major drawdowns can ruin the sustainability of your portfolio should you need to sell investments to fund withdrawals while prices are depressed. Volatility is now your enemy, and this means you need to lower your equity allocations. And maintain a reasonable cash position as insurance against the worst.

The Second Half

"The Golden Age of the Central Banker is a time for investment survivors, not investment heroes."

Ben Hunt

Equity valuations today continue to suggest that returns over the next several years will be well below historical averages. I have been writing essentially this same sentence for more than five years and yet the markets have far out-performed my low expectations. Valuations that were elevated in 2012 have continued higher still. It has been nearly three years since the last significant equity market decline, a 15% sell-off during summer 2011. Investors should not be at all surprised by an eventual correction of this magnitude or greater. And while my crystal ball is still broken, I recommend we all check that our investment seat belts are securely fastened. Real corrections are unpleasant affairs and whenever the next one happens, it could seem as if it is a repeat of the 2008 crash. It may well be, but I doubt it.

Ben Hunt, quoted above and one of my favorite investment observers, is among those who credit the Federal Reserve's unprecedented monetary policies with artificially fueling stocks and other assets. The Bank of International Settlements lately chastised the US saying that continued loose Central Bank monetary policy was creating "extraordinarily buoyant" asset prices. Another of my "go-to" prognosticators, Paul McCulley, recently returned to PIMCO, disagrees with this position wholeheartedly. We live in, as the Chinese curse has it, "interesting times."

Coming full circle back to the Templeton quote at the very top of this letter, the current bull market was born on extreme pessimism (2009), has grown on skepticism (2010-2013, and I confess to being one of the skeptics), and is today maturing on optimism. In spite of the many geopolitical and economic concerns that one could point to, I see few signs as of this writing of the widespread euphoria that typically accompanies a stock market bubble or a bull market top.

Hoping everyone reading this letter has a relaxing break this summer

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[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 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.