October 2014

Third Quarter Letter

"We have two classes of forecasters: Those who don't know – and those who don't know they don't know."

~ John Kenneth Galbraith

In spite of a sharp decline during September, the S&P 500 index of larger US companies ended the quarter with a gain of 1%. The Russell index of smaller US companies fell 7%. Foreign stocks slumped as developed markets declined an average 6%, and emerging markets an average 4%. Bonds were flat for the period, with one bright spot being a 1-2% quarterly gain in the municipal bond sector.

Model Portfolio Performance[i]

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9/30/2014

	Risk Benchmark	3rd Quarter	YTD	Cumulative Since Inception	Annualized Since Inception
All Equity	100% Stocks	**-2.3%**	**3.1%**	**166.0%**	**6.4%**
Growth	80% Stocks/20% Fixed Income	**-1.6%**	**3.3%**	**153.2%**	**6.1%**
Balanced	65% Stocks/35% Fixed Income	**-1.4%**	**3.5%**	**157.2%**	**6.2%**
Conservative	40% Stocks/60% Fixed Income	**-1.1%**	**3.3%**	**135.0%**	**5.6%**
S&P		**1.1%**	**8.2%**	**109.6%**	**4.8%**

The third quarter did not reward investors with globally diversified portfolios. While our models held their own against their benchmarks, the negative returns to foreign equity in particular meant our portfolios declined between 1-2% for the three months. For the year to date, our models and their benchmarks have returned 3-4%, conspicuously less than the 8% return in the S&P index. On the next page, we review again why, in the face of this outperformance by the S&P 500, we steadfastly adhere to a diversified portfolio strategy for clients.

Portfolio Update

The very public resignation of Bill Gross from PIMCO likely marks the end of their recent troubled period. For ten years, beginning in 1998, Gross' PIMCO Total Return was the backbone of our portfolio fixed income allocations. During that timeframe, the fund contributed substantial added-value ("alpha" in investment lingo) to our client account performance. As Total Return grew, becoming at one point the largest mutual fund in the world, its performance began to suffer and in 2008, we began to trim our positions due to concerns about the size of its asset base. At the time of Gross' resignation, our allocations to the fund were less than a quarter the size of what they were at their peak in our models. We will likely exit these residual positions shortly, more a reflection of the availability of attractive substitutes than out of any fundamental concern about PIMCO. We plan to continue to hold positions in their All Asset fund, a multi-asset vehicle managed by Rob Arnott, in our Conservative and Balanced models.

In general, we continue to be overweight US Large Cap vs. Small Cap and overweight Emerging Markets. In fixed income, we are overweight credit exposure via mortgage & corporate debt and underweight interest rate exposure.

A Year That Tries Men's Souls

Well, investment advisor souls in this case.

In the late 1990s, more specifically 1997-98, a small subset of stocks drove US market averages ever higher. Valuations rose to unprecedented levels as investor mania for Anything.com ruled the day. As a fundamental value-based investor, I underweighted the high-flying sectors in my models, sticking to the discipline I knew. Jeremy Grantham of GMO, one of the people I most respect in this business, often remarks that sticking to value during that period came with costs – for clients whose portfolios underperformed as a result of this approach -- and for the advisors who risked losing those clients as a result of lagging performance. It was a difficult time professionally. There were moments when I feared that perhaps the ground had shifted, that the basic rules of investing I had always known had changed. And that maybe for once, "This time was different."

I am reminded of that era as the S&P index continues to soar ahead of just about all other investment asset classes. Valuations are stretched, not to 1998 or later levels to be sure, but into a range that suggests much lower returns for stocks lie ahead. A look at almost all other US market indices reveals that, as in the late 1990s, the recent advance in the S&P index is not reflective of the US stock market as a whole, but the result of large gains for a dwindling selection of stocks. As in 1997-98, a diversified portfolio approach is lagging. As in 1997-98, value is not keeping pace. And investors, understandably, may again wonder why they are not keeping up.

It would be nice to believe that an investor, or an investment advisor, could predict which investment class was going to outperform in the coming year, and which is not. Equally important, one should know when to pile into risky assets and when to flee. Sadly, that is just not possible. Over the short time frames that most of us pay attention to - a quarter, perhaps a year, the record of market timing is dismal to say the least. Over longer-time frames, the data repeatedly show that returns to historically over-valued asset classes will be lower than for historically under-valued ones. It is the most reliable risk-optimized approach to returns that I know. But it is far from perfect, and has no predictive value as a short-term timing tool.

I like to think of investing as imagining you are driving on a very fast, very busy, freeway, a freeway with dozens, if not hundreds of lanes. Because different lanes (investments) move in the short term at different speeds, commuters (investors) sometimes try to get ahead by repeatedly changing to the faster lane, only to find the lane slowing and their expected gain illusory. The approach amplifies their risks and increases their stress levels to boot. Picking a lane (investment approach), fast or slow, as fits your timeframe and tolerances, and then letting the flow of traffic (markets) get you there may lack the & exhilaration of trying to get ahead. But it is the surest way to get to your destination (financial goal) as safely as possible. I have long told clients that investing should not be exciting and that if they want excitement, to go to Vegas (or maybe today that would be Macau).

Coming back full circle to my 1998 story, it was another year or more of painful underperformance before those of us holding steadfastly to a diversified value-based approach to portfolio building were vindicated. It felt like a lot longer.

My Investment Committee

I made a mistake in 2007, one that I had told myself I would not do. In the investment business, as in most undertakings and contrary to what many would have you believe, you make your share of mistakes. The trick is getting more things right than wrong, and here I think I have earned my keep.

The mistake I refer to above was failing to pay enough attention to GMO's Jeremy Grantham. Jeremy, though he is unaware of it, is a core part of my unofficial "investment committee," that also includes Litman Gregory, Morningstar, and myself. In late 2007, alone among my "committee members," Jeremy was counseling advisors to take risk off the table. Not run for the hills, but to moderate one's exposure as much as one prudently could. I went part ways down that road, but with 20/20 hindsight I wish that I had gone further. Jeremy had been my guide-star through the dot-com bubble and after the 2008 crisis again proved the worth of his advice, I promised myself I would not ignore what he had to say, especially when markets started to get overvalued.

So what does the estimable Grantham have to say today? That the US market is again over-valued, and that a serious day of reckoning is coming, but not yet. Not yet. A correction is overdue for sure, but a major reset of valuations remains somewhere down the road. Over the next 5-7 years, Grantham stands by his position that the most attractive investment sectors are what he calls high quality US stocks, i.e. large, brand name companies with defensible markets and strong balance sheets, and emerging markets. Neither asset class has excelled in the rally these past two years, but Grantham, and I, believe that over the full market cycle, an overweight to these investment sectors will be rewarded.

Personal Net Worth Statements

In response to the significant interest expressed in last year's Client Satisfaction Survey, I have been testing several solutions that can provide clients with a secure online statement net worth from all sources. I am in the final stages of trying out three options I think offer the best balance of convenience and security and I look to be able to offer this as a new service to clients sometime in the coming months.

[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.