April 2015

First Quarter Letter

By Martin Weil

"Why are interest rates so low? The best answer is that the advanced countries are still in a 'managed depression'. ..

If you had told people a decade ago that this would be today's reality, most would have concluded that you were mad. The only way for you to be right would be if demand, output and inflation were to be deeply depressed — and expected to remain so."

~ Martin Wolf, Financial Times

The S&P 500 index ended a volatile first quarter with a small gain. Foreign stocks were big winners as the index of international stocks rose more than 5% during the period. This latter comes in spite of a sharp rise in the value of the US dollar, without which the foreign stock gain in dollar terms would have been 10% points higher. Bonds continued their winning streak with the index rising 1.6%.

Model Portfolio Performance[i]

Model Portfolio Performance
3/31/2015

	Risk Benchmark	1st Quarter	Trailing 12 Mos	Cumulative Since Inception	Annualized Since Inception
All Equity	100% Stocks	0.9%	4.8%	174.7%	6.4%
Growth	80% Stocks/20% Fixed Income	1.0%	4.9%	161.2%	6.1%
Balanced	65% Stocks/35% Fixed Income	0.7%	4.3%	163.1%	6.1%
Conservative	40% Stocks/60% Fixed Income	0.7%	3.6%	139.2%	5.5%
S&P		0.9%	12.6%	124.3%	5.1%

Our model portfolios returned about 1% for the quarter, performance in line with the S&P 500 index, albeit with substantially less risk exposure. However, the lower risk exposures in our models have detracted significantly from performance during the last two years.

Active management and managers with a value bias, both of whom we are partial to, have struggled mightily in this recent market cycle. Few have managed to outperform the indexes, fewer in fact that at any point that I can recall. While, the longer-term returns of our four models continue to be very attractive relative to our benchmarks and to the S&P, the performance gap is narrowing.

Portfolio Updates

We are adding a small position in the AQR Managed Futures fund to our "alternatives" investment holdings to further diversify both our Conservative and Balanced portfolio models. We have been searching for a suitable investment vehicle in this space for some time but, until now, have been unable to identify a fund that met our fundamental criteria: low fees, investor-centric approach and manager integrity. The AQR fund takes a very conservative approach to an inherently volatile investment strategy.

In order to reduce the end cost to clients of our portfolios, we have moved 30-40% of our US stock allocations to index and enhanced-index funds. All our portfolio models remain weighted towards Large Cap vs. Small Cap US stocks. Emerging Markets are over weighted in our foreign equity allocations. In fixed income, we remain overweight credit and underweight interest rate risk.

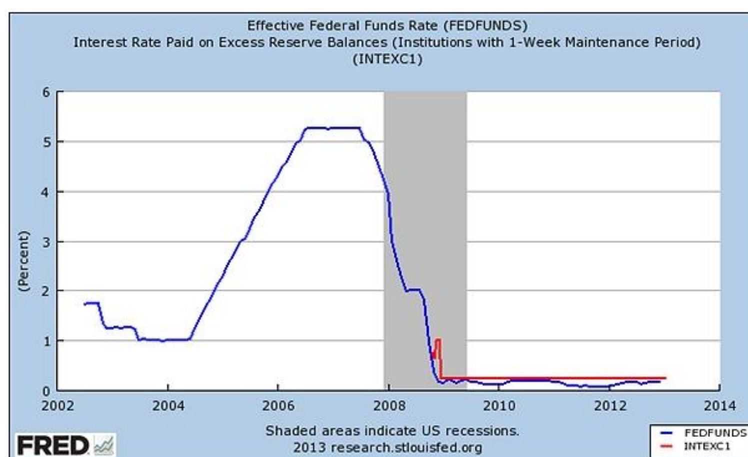
The First Rule

Warren Buffett's well-known Rule #1 of investing is "First, don't lose money." His Rule #2 is "Don't forget Rule #1." Long-time admirers of Mr. Buffett that we are, we have assiduously adhered to these precepts since the train wreck that was 2008's financial crisis. We have not lost money for any client, and in fact, have made them all quite a tidy sum.

Alas, that has not been nearly good enough when measured against the "what could have beens." Another famous dictum we might have heeded in recent years is "The best defense is a good offense." Or, put another way, "Take your foot off the brakes, Martin." The "brakes" in this case being a moderate under-exposure to risk: in both our equity and fixed income allocations. This bias towards risk-aversion is solidly based in our valuation discipline that has suggested for some time that longer-term stock market returns are likely to be well below average. I, and all those value types who follow these same metrics, have been repeating this same litany for two years or more. To date, we all have been clearly incorrect.

Well, what is done is done. The best one can do is to improve going forward. The worst one can do is to try to over-compensate for the past in order to "make up for lost time," or lost returns in this case. That is definitely not my style. I have seen far too many an asset manager crash and burn taking that approach. Not going to happen here.

Whither the Fed. Why It Matters



The Federal Reserve is signaling its intent to raise short-term interest rates, the first such hike since 2006. As the chart shows, the Fed slashed their benchmark short-term Federal Funds rate in the aftermath of the financial crisis, and has kept it at record lows ever since. Central Banks around the world, from Japan to Europe, followed suit. Mr. Bernanke, then Chair of the Fed and scholar of the Great Depression, held that the premature tightening of global monetary conditions after 1929's market crash was the determining factor in precipitating the Great Depression. While economists have heatedly debated Fed policy, Mr. Bernanke held sway. Monetary policy remained ultra-accommodative, with round after round of Quantitative Easing (QE), and interest rates remained

well below what critics believed was appropriate. These actions were, by the admission of some at the Fed, educated improvisation on their parts in the face of a massive systemic crisis. History will judge whether it was this course of action that avoided another Great Depression. Given the actual outcome, I am certain Mr. Bernanke feels no need to apologize.

But to give the critics their due, there have been worrisome side-effects of the Fed's policy. Thanks to the lack of return available from safer assets, investors and savers alike have been forced to take on an increasing amount of risk in order to meet their goals. "Risk On" as they say in the investment business. The result has been a US stock market that has soared in spite of a relatively mediocre economy. The question now is what happens as the Fed inevitably changes course.

We may have had a preview in March when current Fed Chair Yellen in March indicated a possible change in policy and the market quite promptly sold off 5%. When the Fed actually does raise short-term rates, will market sentiment switch precipitously from "Risk On" to "Risk Off," with a resulting major stock and bond market sell-off? The historical data on markets during prior periods of Fed tightening are not as negative as some suggest. However, the problem with the historical data is that there is little in our current environment that is the least bit "similar" to prior periods.

Having ended QE in 2014, the Fed's next step is to raise short-term interest rates, "normalize" them is the operative language, in a manner that does not drive our less than booming economy back into recession. They may begin to do so in June, and they may defer all the way into 2016. They have no road map for how they are to safely exit this six-year experiment. Much will necessarily need to be accomplished with the same improvisational spirit that guided the Fed when they undertook these policies in the first place. Coming full circle back to the Martin Wolf quote that starts this letter, we find ourselves in a world for which there is little precedent in modern times.

Important Documents

At the end of this packet, you will find our most recent ***"Statement of Material Changes"*** *and a copy of our standing* ***Privacy Policy Statement****, which Registered Investment Advisors are required by the SEC to provide annually to their clients.*

Our full ADV, Part 2 is available on request by emailing kyle@mwinvest.com.

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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 Total US Stock, Total International Stock 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.