July 2015

Second Quarter Letter

"The world will only end once. For every other time, there is risk control."

~ Jawad Mian

The S&P 500 index of US stocks ended a fraction of a percent higher for the second quarter and has gained 1% for the year to date. Foreign stocks have outperformed with Vanguard's foreign stock index fund rising 1.3% for the quarter, and 5.3% for the first six months of 2015. Bonds stumbled with a decline of 1.8%, the worst quarterly showing for the US bond index in two years.

Model Portfolio Performance[i]

Model Portfolio Performance
6/30/2015

	Risk Benchmark	2nd Quarter	Year To Date	Cumulative Since Inception	Annualized Since Inception
All Equity	100% Stocks	**0.0%**	**1.1%**	**177.3%**	**6.4%**
Growth	80% Stocks/20% Fixed Income	**-0.2%**	**0.8%**	**160.7%**	**6.0%**
Balanced	65% Stocks/35% Fixed Income	**-0.5%**	**0.2%**	**161.8%**	**6.0%**
Conservative	40% Stocks/60% Fixed Income	**-0.6%**	**0.1%**	**137.6%**	**5.4%**
S&P		**0.3%**	**1.2%**	**124.9%**	**5.0%**

After two-plus years of above average gains for both the stock and bond markets, returns have been far harder to come by of late. Our four models were flat to down a fraction for the second quarter. Year to date, they are slightly higher.

The broad sell-off in the bond markets drove the small losses this quarter. All of our bond funds declined during the period, though most held up better than the index. There were no standouts in the quarter, positive or negative, in our equity fund holdings. For the year to date, our allocation to the Yacktman US equity fund has been a drag on performance and our overweight to foreign equity funds has been a positive.

Portfolio Updates

During the quarter, we sold our holdings in the Touchstone Sands Growth fund. In fixed income, we added PIMCO Income, a non-traditional bond fund with low interest rate risk. We continue to pare the number of equity funds in our models with a goal of getting back to the 10-12 total equity funds we held in each prior to the financial crisis. The number of fixed income funds in our models, however, will remain above our norm for the foreseeable future.

We continue to reduce the average expense ratio in all of our portfolios. At quarter's end, this ranged from 0.73% for our Conservative model to 0.86% for All Equity. We are closely monitoring our fixed income positioning both for interest rate risk in a rising rate environment and for credit risk in the event the economy or markets turn down.

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By Martin Weil

July 2015

When the Federal Reserve Raises Rates

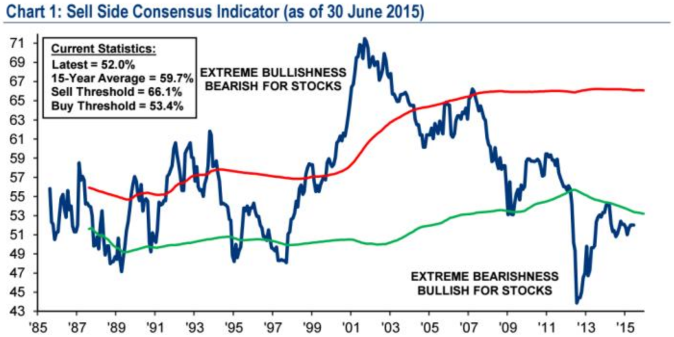
An excessive amount of ink has been spilled over the question of the Fed's inevitable decision to start raising short-term interest rates and what the consequences of this policy shift might be. The historical data are ambiguous and I don't know of anyone with a crystal ball for the economy or the markets. Nevertheless, some pundit or another will manage to get the call "right" by pure chance, thus staking them to their 15 minutes of fame. For myself, I find the situation nicely summed up in a memo by Howard Marks of Oaktree Capital:

- *Today's ultra-low interest rates have brought the prospective returns on money market instruments, Treasuries and high grade bonds to nearly zero.*
- *This has caused money to flood into riskier assets in search of higher returns.*
- *This, in turn, has caused some investors to drop their usual caution and engage in aggressive tactics.*
- *And this, finally, has caused standards in the capital markets to deteriorate, making it easy for issuers to place risk securities and – consequently – hard for investors to buy safe ones.*

Marks concludes his client memo with the well-worn Warren Buffett quote:

"…the less prudence with which others conduct their affairs, the greater prudence with which we should conduct our own affairs."

Chart 1: Sell Side Consensus Indicator (as of 30 June 2015)



Source: BofA Merrill Lynch Global Research US Equity & Quant Strategy
Note: Buy and Sell signals are based on rolling 15-year +/- 1 standard deviations from the rolling 15-year mean. A reading above the red line indicates a Sell signal and a reading below the green line indicates a Buy signal.

That all said, perhaps the most important near-term driver of the markets is money flow and sentiment. The chart at left from BofA shows that, after a nearly 200% gain in the S&P index since the financial crisis, market professionals' sentiment remains decidedly negative, a bullish sign in contrarian language.

The Biggest Risk to Your Portfolio?

If asked to answer the question above, most investors would say a market crash or a major bear market. And if they are within a few years of retirement, that is probably the correct answer. Market risk is a significant hazard and should be moderated in portfolios during this critical 5-10 year period. But market risk is not the only menace to wealth, and in many cases it is not even the most dangerous one. Two others routinely ignored by investors come quickly to mind: Inflation and Longevity.

Over time, inflation eats away at the real (purchasing power) value of cash and other assets. $100 in 10 or 20 years is typically worth much less than the same $100 today. Risk control for inflation requires that portfolios contain an appropriate allocation to assets that tend to move higher with inflation: inflation-linked bonds, stocks, real estate and other hard assets.

With ongoing advances in medicine adding years to expected lifespans, longevity may represent the greatest financial challenge of all. When I meet today with clients, I routinely discuss with them the surprising probabilities, and financial challenges, of their living well into their 80s, and even 90s. Some of us may live to 100. "Oh, I'll be dead long before then," is a common response. Maybe not….

For those of us in good health, educated and reasonably well-off, we are advised to consider how we are going to live past 85 or 90, both practically and financially. The practical part means considering who is available to take care of you in your later years, how you would like that care to be delivered, and what resources you have available to finance that care. We have accumulated a lengthy list of resources in the past few years to assist clients with this thought and planning process.

On the financial front, it means planning for the risk that savings amassed during the working years for a desired retirement lifestyle may in some measure have to be husbanded instead against uncertain and unexpected needs in a far future. For the financial planner, this unknown – whether a client will live to 90 or beyond – poses a fundamental dilemma. The most basic prudent advice is to not overspend in early retirement. But this advice is not always what clients want to hear when they find themselves with the time, and the money, to finally do what they have always dreamed of doing.

Longevity risk is a very serious challenge with few "good" solutions. One constructive approach is to defer taking Social Security benefits until age 70. As I explain to clients (who admittedly often resist), this strategy insures higher income in later years, and is an optimal use of Social Security old-age insurance that you "pay for" by having less income in earlier retirement. To date, the only other meaningful option is a product called "longevity insurance." Essentially a deferred income annuity, longevity insurance pays you a monthly income for life, but with payments that do not start until age 85[1]. While this insurance against a financial shortfall in later years is a financial planner's dream, longevity products have not gained much traction in the marketplace. I am hopeful this will change in the coming years.

Research has repeatedly demonstrated that we humans are not well equipped to make optimal decisions between present consumption and future. The difficult practical and psychological tradeoffs here are made even more difficult by the fact that one is certainly alive now and is only possibly alive later. My job is to help clients make better choices that meet the needs of both their present and future selves.

Racing to a close here, I want to return to where this letter began. I do not believe (Greece, China, climate change, what have you) that the world is coming to an end. But I recognize that the future is both unknown and uncertain. That leaves me with the one tool I can employ - risk control, or the term I much prefer, risk management. As a financial planner and investment advisor, risk management is at the core of what I do.

[1] According to Michael Kitces, a 65 year old married male could today purchase $31,000 of annual lifetime income for $100,000. That is, $31,000 of income that does not start until he reached age 85.

[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 <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.