October 2015

Third Quarter Letter

"If you invest, you will lose money if the market declines. If you don't invest, you will miss out on gains if the market rises"

~ Howard Marks

World equity indices and many bond sectors fell sharply during the third quarter. The S&P 500 index of US stocks lost 6.5% for the three months. Foreign stocks declined 12% and emerging market equities 17% during the period. In one bright spot, investment grade bonds gained 1.2% in the quarter and are now flat for the year.

Model Portfolio Performance[i]

Model Portfolio Performance 9/30/2015					
	Risk Benchmark	3rd Quarter	Year To Date	Cumulative Since Inception	Annualized Since Inception
All Equity	100% Stocks	-9.1%	-8.1%	152.0%	5.7%
Growth	80% Stocks/20% Fixed Income	-7.8%	-8.0%	140.4%	5.4%
Balanced	65% Stocks/35% Fixed Income	-6.7%	-6.5%	144.2%	5.5%
Conservative	40% Stocks/60% Fixed Income	-4.7%	-4.6%	126.4%	5.0%
S&P		-6.5%	-5.4%	110.3%	4.5%

It was an ugly three months for the equity markets and for our model portfolios, the worst quarter by far since 2011. Our four models were 4.7-9.1% lower for the three-month period. Actual client accounts performed marginally better than these numbers, as we had raised a little cash from some tax loss-selling.

For the year, a fundamental tilt towards value has been a drag on our performance. And an overweight allocation to foreign and emerging markets stocks was a major contributor to negative returns in all our models. A strong rise in the dollar has compounded the declines in our unhedged foreign market funds.

Our fixed income holdings provided some performance cushion in our Conservative and Balanced models, but not enough. We have for many years been tilted towards credit, as opposed to interest rate, exposure in our bond allocations. This served as a small positive in more benign markets, but it has proved to be an unsatisfactory allocation mix in risk-averse markets such as seen in August & September. Given that a principal reason to own fixed income in more conservative accounts is to provide a buffer in an equity market sell-off, we have been rebalancing our Conservative and Balanced model fixed income allocations towards more traditional investment-grade holdings.

A small longtime position in the Kayne Anderson oil and gas pipeline Master Limited Partnership fund in Conservative and Balanced accounts was savaged at month's end (a decline that has been largely recouped in early October). At a current yield of 9.5%, I am more likely to add to this position, than reduce it.

Portfolio Updates

We did a moderate amount of tax-loss selling in taxable accounts during August and September. Most sales were in emerging market equity and the aforementioned MLP fund. We have some cash on the sidelines in Conservative and Balanced accounts and are considering its disposition.

Can We Talk?

Global stock markets, led by a collapse in the Chinese domestic market, put on one of their periodic displays of volatility during August and September. Downside volatility - the kind that causes loss of sleep. No one gets worked up when the market spurts higher in leaps and bounds.

After several years of an abnormally benign market environment with a pleasingly, if modest, upward bias, this surge in volatility came as a surprise to many investors. One, two, even three percent daily moves followed one after another during a several week period. While I had only a few calls from anxious clients, I suspect others were gritting their teeth as the market fell, rose, and then fell again. These gyrations pale in comparison to far more turbulent periods in recent history, but that is small comfort to nervous investors watching the value of their portfolios decline.

In any serious market sell-off, I learned long ago that answering one basic question – *Is The World Ending?* - helps clarify the correct action in the face of falling markets and slumping portfolio values. The answer is almost always a resounding “No,” (although 2008 did come in as a “Maybe”). While there are <u>always</u> serious things to have serious concerns about - and the list is a long one today - the answer is also “No” now.

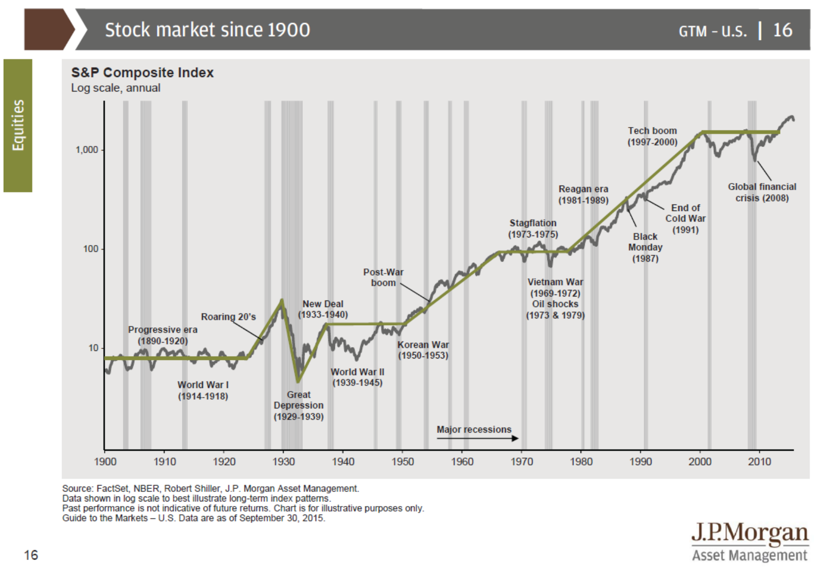
The disciplined approach holds that markets will recover in the longer-term and the real challenge is to be certain that one is not compelled to sell assets at prices that are temporarily depressed during market sell-offs. Unless one is leveraged - another problem all unto itself - selling is typically driven A) by expected or unexpected cash needs; B) out of a belief that the answer to the question above might be “Yes;” or C) because an investor discovers him or herself to be less risk-tolerant than they thought they were when markets were going up.

My approach to the “A” problem is to have ample cash set aside – a rainy day fund if you will – for those clients who are taking withdrawals. These cash-equivalent positions can be sold at par, or very near, to fund cash withdrawals from an account, leaving invested assets in place to recover any lost value. So for my clients who are withdrawing cash, these short-term market sell-offs are not a concern.

My response to the “B” problem is above. The world is <u>not</u> ending and markets will recover from whatever setbacks we may be due, be it in months or worse, years. But an investor’s investment approach and policy <u>should be for years</u> and thus if we have set a client’s portfolio allocations to the correct time horizon, this also is not a problem.

The “C” problem requires a conversation. If you worry every day about your portfolio when market conditions get ugly, then it may be time to revisit your portfolio risk level. We have worked diligently to set a risk level for each client that is appropriate to their particular longer-term goals. But sometimes these are incompatible with the client's own risk tolerances. The latter are only truly revealed during periods like the one we have just been through. Please do call if you would like to revisit how much risk is prudent for you and your portfolio.

Is The Selling Over?



As the market dropped like a stone on Monday, August 24, falling some 1,000 points at the open, I thought back to what the occasional prospective client has told me in early meetings, "I want to make a lot of money… but I don't want to take a lot of risk," or some variation. Deep in our hearts, we would all love to find that surefire, risk-free, investment that makes all the money we ever dreamt of but does not expose us to loss. Like the fountain of youth, that investment does not exist in the real world. As the quote at the top of this letter aptly puts, markets go up and markets go down. And your investment portfolio will do so as well.

The chart above[1] puts the returns in the US stock market in suitable perspective. Yes, there have been notable periods when investors suffered enormous losses – 1929-30 foremost among these. But apart from these rare events, we can see a market that divides itself into long periods of steady uptrends and other long periods of sideways up-and-down action. Our valuation discipline suggests that, in spite of the all-time new highs in the US market since 2013, we are still in a broad sideways market that began with the bursting of the Dot Com bubble in 2000. If true, we would expect more, possibly more dramatic, declines in our future. It is also possible that a new rising trend started when the market bottomed out in early 2009. Unfortunately, we won't know this for many years, even decades. Regardless, I continue to expect average returns for both stocks and bonds to be below par for several years to come, though markets in any one year can surprise. In the face of uncertainty, our job is to be a careful steward of the capital entrusted to our management, growing wealth for those whose goal is appreciation, and preserving it for those whose goal is maintaining their purchasing power over their lifetimes.

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[1] JP Morgan, Chartpack, Oct 2015

[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.