January 2016

Year End Letter

"“The Year Nothing Worked”

~ Bloomberg headline

“Know what does work? Having a timeframe more than one year.”

~ Bill Mann, The Motley Fool

The S&P US index of US stocks rebounded during the 4th quarter, ending 2015 with a 1% gain. This token return masked increasing weakness in the broader equity markets as the year progressed. Small cap US stocks declined 4% in 2015 with similar losses in global stocks. Emerging markets had a miserable twelve months, losing 16%. Bonds were flat overall for 2015, concealing price declines in corporate and high yield bonds. Municipal bonds were a rare standout asset class, returning an average 3% for the year.

Model Portfolio Performance[i]

Model Portfolio Performance
12/31/2015

	Risk Benchmark	4th Quarter	2015	Cumulative Since Inception	Annualized Since Inception
All Equity	100% Stocks	5.4%	-3.2%	165.6%	5.9%
Growth	80% Stocks/20% Fixed Income	4.2%	-3.2%	150.4%	5.5%
Balanced	65% Stocks/35% Fixed Income	2.6%	-4.1%	150.6%	5.6%
Conservative	40% Stocks/60% Fixed Income	0.9%	-3.8%	128.5%	5.0%
S&P		7.0%	1.2%	125.0%	4.9%

Our models were 1-5% higher during the final quarter, but ended with losses of between 3-4% for the year. These calendar year returns lagged our respective benchmarks by an average 2.5%, an unprecedented occurrence in 18 years of managing client portfolios.

The few bright spots in our portfolios were our core stock holding Primecap Odyssey Growth, gaining 6% on the year, as well as single digit gains in our core fixed income fund Doubleline Total Return and the various municipal bond funds we own in client taxable accounts. These modest gains, however, were more than offset by losses in our emerging market funds, sub-par performances in our large cap US stock mutual funds and, in a decision that dates to 2012, a portfolio overweight to credit risk vs. interest rate risk in fixed income. The performance of Conservative and Balanced accounts was hurt as well by a small position in the Kayne Anderson MLP fund. I am not unhappy to see the end of 2015.

YE Tax Loss Harvesting

Clients with taxable accounts will have noted an uncharacteristically large volume of trades during 2015’s final quarter. Much of November, and up until the very last day of the year, was spent identifying and harvesting tax lots that could be sold at a loss to offset gains from year-end fund distributions and profitable sales earlier in the year. Through this flurry of activity, I was able to significantly reduce, or even eliminate, what otherwise would have been large capital gains tax liabilities in 2015. (Not my favorite part of the job of an investment manager.) However, “When the world gives you lemons, you make lemonade.” As a result, many taxable accounts had sizable cash positions heading into year-end.

“The worst year for asset-allocating bulls in almost 80 years.”

The quote is from the Bloomberg article which headline begins this letter. The Bloomberg writer claims that the fundamental diversification approach espoused by ourselves, and supported by the historical record, failed investors in 2015. While it is without doubt that diversified portfolios failed to beat the one major asset class index – the S&P 500 – that was positive for 2015, I think the strategy did just fine. Diversification is never supposed to earn you the highest return. Conversely, it is never supposed to earn you the worst either. Over time, this latter “failure,” to earn the worst return, has far greater impact on a portfolio than does a single year, two or three of outperformance on the upside. This is a simple fact of mathematics. So get used to it Bloomberg. As The Motley Fool counters, it all depends what your time frame is. Traders have one-year time frames; investor time frames span many years, even decades.

That is not to say our performance this past year was better than sub-par. Attempts to add value amidst the reality of a listless market by proactively navigating the small zigs and zags it offered created a lot of extra activity with little or nothing to show for it. Warren Buffett is fond of saying, after a year where his performance did not live up to expectations, “Our investors would have been better off had I stayed in bed and done nothing.” I note that Buffett’s Berkshire Hathaway declined 12.5% in 2015.

“We Are Not Very Good at Predicting Recessions”

That was former Chair of the Federal Reserve speaking in December to an assembly of PIMCO clients in San Francisco. “No s*** Sherlock,” was my unvoiced response. The Fed, and economists in general, whether in academia or finance, have an appalling track record at predicting the future course of the economy. Thus, Bernanke’s sanguine view of the current state of the US economy, and PIMCO’s similar position that things are “ok” in the markets, left me entertained, certainly educated, but decidedly unpersuaded.

PIMCO’s Mark Seidner interviewing Ben Bernanke in San Francisco

PIMCO and Bernanke’s views could not have been in more stark contrast to a presentation just the day prior by Jeffrey Gundlach, manager of the now wildly successful DoubleLine Total Return and other funds[1]. Gundlach painted a picture in which most risk assets – from junk bonds to emerging markets to commodities – were already in a significant bear market and that were it not for a handful of S&P stocks (today’s usual

[1] MW Investment Strategy owns PIMCO’s Income Fund and DoubleLine’s Total Return fund in client accounts. Both rank in the ten funds with the most assets in our client portfolio composite.

suspects – Facebook, Amazon, Netflix, Google – dubbed FANG), the S&P index would be following. I believe he even used the phrase “whistling past the graveyard,” as he implied that we were on the cusp of a recession, which would likely take risk assets even lower.

Update – January 15

As I write this, the S&P stock index has fallen 9% during the first two weeks of 2016 and is some 12% off its all-time high set in 2015. This time, even the high-flying FANG stocks were not immune.

Clients came into 2016 with cash levels 10-15% higher than our portfolio model targets. The additional cash came from reductions to higher risk positions – emerging markets equity and various credit exposures in fixed income – as a result of tax-loss selling with a dose of added defensiveness. A typical Conservative portfolio was 35% equity/50% Fixed Income/15% Cash (vs. a targeted 40/55/5); Balanced accounts averaged 50% equity/40% Fixed Income/10% Cash (vs. 60%/40%); and Growth accounts 70% Equity/20% Fixed Income/10% Cash (vs. 80%/20%). Our few All Equity accounts remained fully invested.

Where we purchased holdings, we added to taxable government or municipal bond funds and continued to increase our allocation to alternative strategies. Two weeks ago, I fully expected to redeploy the balance of this excess cash into “risk” assets opportunistically as early as January.

Given the severity of the recent sell-off, markets may have further to fall in the coming weeks or months. Fear selling – which is what is taking over markets now – feeds on itself and typically climaxes in a burst. For growth-oriented portfolios, I would be looking to deploy cash back into risk assets. For Conservative and Balanced, I am taking a more cautious approach, especially as the mandate for the former is to “preserve wealth.”

The important thing to remember during stressful markets is that “Unless you need the money now or in the near future, a market decline doesn’t matter nearly as much as it may seem at the moment.” In reality, your investment assets are for the benefit of your “future,” and not your “present,” self. Succumbing to emotional reactions today may serve to comfort your present self, but may very well do disservice to that future self who needs these assets to grow over the longer-term. Your future self will likely care little, if at all, about today’s volatility, so long his or her goals are achieved. This is precisely the reason we work so hard with clients to define and quantify their most critical longer-term goals.

One last note, on the “unless you need the money now” point. For clients who are withdrawing funds for their current needs, I made sure this past Fall to liquidate enough positions so that there is two years of expected withdrawals set aside in cash equivalents. Further positions will not need to be sold at depressed prices to fund a client’s projected needs.

2016 looks to be a challenging year, but from the perspective of an asset manager, one that may offer some real opportunities to earn clients a decent longer-term return as prices and valuations at last fall to more attractive, and in some cases even compelling levels.

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MW Investment Strategy News

Keeping a promise I made to clients a year ago, I am happy to report that MW Investment Strategy has concluded a “guardian” agreement with Van Hulzen Asset Management. This replaces a similar arrangement that I had for many years with a colleague until he retired in 2014. A guardian agreement is intended to provide continuity for client financial accounts and other matters in the event that a solo practioner such as myself is incapacitated. It comes into play only in the case of my disability or death, events one does not like to contemplate, but that are of course risks specific to a one-person business such as mine.

Van Hulzen Asset Management was founded and is managed by Craig Van Hulzen with a team of eleven. They bring the same commitment to fiduciary care, due diligence and client focus to which I have dedicated my own practice. This fiduciary commitment is far and away the most important feature I was looking for in identifying an appropriate partner for this role. While Van Hulzen is based in El Dorado Hills, just east of Sacramento, Craig and his team have clients throughout California and the United States, as do I. Like me, they travel to meet with their clients. This is an atypical practice that I have found to be invaluable in acquiring a deeper understanding of my clients and their goals over the years.

In addition to their client-centric focus, Van Hulzen approaches financial planning and investment management with the same diversification philosophy and deep due diligence as I have. As an added plus to our “guardian” agreement, I look forward to informally adding the Van Hulzen team to my list of resources for investment research.

In all of the above, I am endeavoring to remain acutely mindful of my fiduciary responsibility to insure that client service and management needs are assured, even if adverse circumstances arise. In the meantime, please rest assured that I am here, working diligently on your financial concerns and investment matters.

Company Charitable Contributions

As has been our practice for some ten years, MW Investment Strategy made year-end gifts to the following nonprofit food banks in the communities where our clients reside:

Northern California: San Francisco & Marin Food Banks; Alameda County Community Food Bank; Food Bank of Contra Costa County; Napa Valley Food Bank; Redwood Empire Food Bank; Santa Clara Second Harvest
Southern California: Los Angeles Regional Food Bank; OC Food Bank
Out-of-State: Food Bank of New York City; Mercer Street Food Bank, NJ; Three Square, Las Vegas; Utah Food Bank

[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.