July 2016

Second Quarter Letter

“There are decades where nothing happens, and there are weeks where decades happen.”

- Vladimir Lenin (attributed)

Rebounding from yet one more shock, the S&P US stock index closed 2.4% higher during the second quarter. Foreign stocks struggled, but were able to eke out fractional gains in the wake of the UK’s unexpected vote to quit the European Union. Investment-grade bonds continued their consensus-defying rise and have returned 5.5% for the year to date, well ahead of the S&P’s 3.8% gain during the same period. The year’s top performing asset classes so far have been emerging market stocks, real estate trusts, and commodities.

Model Portfolio Performance[i]

Model Portfolio Performance
6/30/2016

	Risk Benchmark	2nd Quarter	Year to Date	Cumulative Since Inception	Annualized Since Inception
All Equity	100% Stocks	**1.4%**	**0.4%**	**166.8%**	**5.8%**
Growth	80% Stocks/20% Fixed Income	**1.5%**	**1.2%**	**153.3%**	**5.5%**
Balanced	65% Stocks/35% Fixed Income	**1.2%**	**0.9%**	**152.9%**	**5.4%**
Conservative	40% Stocks/60% Fixed Income	**1.3%**	**2.3%**	**133.8%**	**5.0%**
S&P		**2.4%**	**3.8%**	**133.5%**	**5.0%**

Our four model portfolios rose 1.2-1.5% during a tumultuous second quarter. For the year, our Conservative model leads the pack with a 2.3% cumulative return, thanks to its heavier weighting in taxable and tax-free investment grade bonds. Allocations to developed overseas markets reduced the returns in all of our models. However, after several disappointing quarters, our emerging market stock exposure added measurably to returns for the quarter and the year.

Portfolio Changes

As outlined in our April letter, we repositioned a majority of the Large Cap US equity allocations in our four models out of actively-managed mutual funds and into Vanguard index funds and ETFs, lowering the total portfolio operating expense ratios for our investors by 10-15 basis points (0.10-0.15%) per year. A nominal savings in normal times to be sure, but one that materially increases in value in today’s very low return market climate.

During the quarter, we sold our holdings in the Trim Tabs’ Buy Back ETF that has been a top-performing US equity ETF the past three years. In June, the fund’s sponsor Advisor Shares inexplicably removed Trim Tabs Asset Management as manager and we judged Advisor Shares’ choice of replacement manager to be significantly inferior.

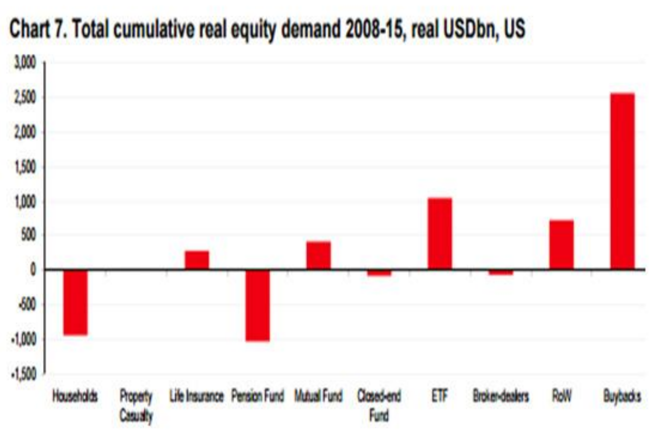
Higher. But Why?

That the major US stock indices should bounce back so emphatically from the global sell-off following June's Brexit shockwave reinforces our notion that US equities remain in a continuing trend higher. Bonds are also extending what has been a truly historic run, one that dates all the way back to 1982. The question for me, as a market value fundamentalist, is what is continuing to drive this steady grind higher by both US stocks and bonds - in light of what most agree are not particularly attractive risk/reward fundamentals for either at this stage?

The simple explanation – at the risk of stating the blindingly obvious - is that there are more willing buyers than there are willing sellers for both US stocks and bonds. No difference here than in any other market, be that market for stocks, bonds, soybeans, real estate or baseball players. The question becomes then not why are the stock & bond markets going higher, but who are these buyers?

The answer for bonds is generally presumed to be the world's Central Banks. These latter have massively intervened in the bond markets since the financial crisis, determined to keep interest rates low. They have been uncommonly successful at doing so. And with many developed nation's bonds now yielding zero, or less than zero (negative interest rates) rates of return, the nominal 1.5% yield per annum on a deemed-to-be ultra-safe 10-Year US Treasury bond becomes pretty attractive by comparison. "Lower for longer" is how many describe the road ahead for interest rates, implying that for now, the risks of deflation still outweigh the risks of inflation.

An overlooked answer to why stocks keep going higher in this lackluster economic recovery may well be an ongoing near-record level of corporate stock buy-backs. Company after company has been using massive cash hoards and historically cheap debt to repurchase their shares. According to the chart at right[1], corporate share buybacks have been, by a wide margin, the largest source of US stock purchases since 2008. These buy-back programs both create buyer demand and simultaneously reduce the supply of shares outstanding. Less supply, all other things being equal, means higher prices for the shares remaining. This is, of course, good for existing holders, who include retail & institutional investors, and, lest we forget, all those in senior management who are amply compensated via the level of their company's stock.



[1] Study by HSBC cited at MarketWatch

It appears from the chart that if buybacks were removed, you would eliminate almost the entire net demand for US stocks over the last seven years and, by extension, perhaps much of the market's rally since then.

Eventually all things come to an end. Both the extraordinary market interventions by Central Banks and the current excess of corporate buybacks will as well. Predicting when, though, is a fool's game. But the time would not seem upon us quite yet. Any trend change is most likely to occur when either the cost of money (interest rates) starts to rise meaningfully, or should the economy start picking up steam.

Rising interest rates can cause a rush to the bond-holder exit door, sparking the very bond market scenario that many smart money managers have been warning about, quite incorrectly as it turns out, for more than five years now. On the other hand, a more robust economy would divert a significant portion of the funds now used for share buybacks into more productive investment. Perversely, a shift into a higher economic gear, normally good news for the economy and markets, might then cause a sharp fall in stock prices. This somewhat stunning concept is to my mind emblematic of the Alice in Wonderland market we have been navigating since 2009.

What You Can Control

I have spent the first part of this letter, and a great portion of many of my earlier letters over the years, writing about the economy and markets. These are without a doubt interesting subjects and in many ways bear on our longer-term financial well-being. But as interesting as these subjects are to speculate upon, both are wholly out of our personal control.

What is under our individual control are the daily choices we make that have considerable effect on our longer-term financial well-being. Making these as intelligently as possible is what financial planning is all about. And it is why I have come to realize how much more important these both small and large decisions are than what the S&P index may return this year or next.

So grab that cup of coffee as I walk you through a rapid-fire tour of the basic why's and how's of financial planning. I assure you it will be well worth your time to consider your financial life with regard to the below. So let's dive right in.

> When it comes to financial planning, the most important concern is … hint: it's not your investment portfolio. It is:

1. **Savings:** There is literally <u>nothing</u> anyone can do that is more certain to lead to a successful financial future than ample and regular saving, during your earning years as you are able, via both pre-tax (IRA, 401K, etc.) and after-tax vehicles. This is a habit ideally started in your 20's in order to have the biggest payback from long-term growth compounding. Apart from building a business, or inheriting great wealth, there is simply no better way to insure your financial future.

2. **Insurance:** Along the way to financial freedom, there are innumerable risks to households and individuals. Some of these – like the loss of life or the disability of a primary earner – can be catastrophic. Catastrophic risk is what insurance is best used to protect against. Major property; liability; term life and disability for earners; and long term care policies for those in their later years - these are the standard recommendations.

3. **Estate Planning:** Most of us behave as if we don't believe we are going to die – at least not this year. Estate planning with a qualified attorney, or even DIY using one of the legal websites, is the <u>one</u> financial planning topic that takes the most effort to coax clients into completing. Anyone, especially anyone with children, who does <u>not</u> have a will or an estate plan is simply being irresponsible. Medical directives and powers of attorney are highly recommended while completing this process.

4. **Taxes:** As my CPA colleague Peter likes to remind his clients, you should be happy to pay taxes because it means you are making money. Your choices about personal finances should be informed, but certainly not driven, by their tax consequences. For anyone with more complex finances than just a predictable income from employment, I recommend an annual tax-planning session with your tax preparer before year-end.

5. **Investments:** I put investments last, not because they are the least important, but because I spend so much time elsewhere focusing on these. The most important choice in an investment portfolio is your asset allocation. This should be undertaken prudently and according to your investment time horizon. At the simplest, those who are younger can and should invest those funds they are able into a diversified, growth oriented, long-term asset allocation. Those in retirement and/or spending their savings should invest for capital protection, protection which includes countering the hidden wealth-eroding effects of inflation. Everyone else is generally somewhere along the continuum between these two when determining an appropriate mix of growth assets and capital protection.

The above are the topics I spend the most time on with and for my clients. If you are a client, or not, and have questions about how the above relates to your personal financial situation, please let me know.

[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.