April 2016

First Quarter Letter

"If you want to feel short, stand next to somebody tall. Want to feel badly about your portfolio? Compare it to the Standard & Poor's 500-stock index."

- Jonathan Clements

After logging its worst start to a calendar year in history, the US stock market rebounded and the S&P 500 index ended the first quarter with a 1.3% gain. International developed markets declined for the three month period, while emerging market equities were higher. A standout asset class during the quarter was longer-dated government bonds with 3+% gain.

Model Portfolio Performance[i]

Model Portfolio Performance 3/31/2016				
	Risk Benchmark	1st Quarter	Cumulative Since Inception	Annualized Since Inception
All Equity	100% Stocks	**-0.9%**	**163.1%**	**5.4%**
Growth	80% Stocks/20% Fixed Income	**-0.4%**	**149.4%**	**5.1%**
Balanced	65% Stocks/35% Fixed Income	**-0.4%**	**149.7%**	**5.2%**
Conservative	40% Stocks/60% Fixed Income	**1.0%**	**130.7%**	**4.7%**
S&P		**1.3%**	**128.0%**	**4.6%**

Our model portfolios returns ranged from a positive 1% to a negative 1% for the quarter, each model trailing their respective benchmarks. An underweight in government bonds was a major cause of the underperformance in our Conservative & Balanced portfolios. Atypically poor performance by our core US growth mutual funds was a drag on the returns for our Growth and All Equity models. A fuller discussion of our analysis and the adjustments we are making going forward follow on the next pages.

Portfolio Changes

We continue to add to the "alternatives" allocations in our Conservative and Balanced investment models. Positions include funds specializing in commodity futures trading, long/short equity and other non-traditional strategies. These positions serve two roles: their non-correlated investment styles should further diversify overall portfolio risk, and secondarily, the single-digit return potential these funds offer should be compatible with what we expect to be an ongoing low-return environment for traditional stock and bond investments.

At the start of the new quarter, we are initiating a new position in the higher quality end of the sold-off non-investment grade (high yield) fixed income space with purchases of the Buffalo Hi-Yield Bond Fund.

We have steadily increased our holdings in index and other passive funds within our large cap US stock allocations. Where tax considerations permit, we are selling several actively-managed funds that have

steadily underperformed the past several years. Passive funds from Vanguard, DFA and others now represent an average 70-75% of our Large Capitalization US equity allocations.

Can Active Management Still Be Expected To Outperform?

If the last three to five years are to serve as a guide, the answer to this question is apparently not. At least not when it comes to investing in the Large Cap US stock asset class that makes up the core of most investor portfolios. While it has always been the case that a majority of active managers underperformed a market index such as the S&P 500 over any given period, it was also true that there existed a smaller but meaningful percentage of managers who were able to add positive value over time, what in the business we call "alpha."

When I first began professionally managing client portfolios in 1998, I turned to what I knew best from twenty prior years as a private investor. My most important learning was that with hard work and diligence, one could identify superior investment talent whose contributions would positively contribute to investor performance. This, combined with a value-based asset allocation discipline – that is overweighting undervalued asset classes and underweighting overvalued ones – has been a formula for our superior portfolio returns. However, since 2008's financial crisis, this once highly successful practice has turned into a largely futile exercise.

Much has been written about how the "heavy hand" of the Federal Reserve (and other central banks around the globe) has grossly distorted the investment markets. I am not enough of an economist to be able to cogently explain how this heavy hand is warping the markets and making a mockery of the traditional rules of prudent investment. Frankly, it doesn't matter. The markets do not lie and they are telling a very unusual story. We find ourselves in a persistently low-return investment environment, fostered, we believe, by the unprecedented policies of the Fed in the aftermath of the financial crisis. Against this low-return backdrop, active management has by and large been unable to earn its higher costs. This has been true for the overwhelming majority of active managers and asset allocators.

While I have always held the belief that "this time is different" is a very dangerous phrase for investors, this time something is in fact very different. A handful of high-flying stocks have comprised the vast majority of the US market's returns the past several years, while at the same time, the average US stock has floundered. This divergence has not been kind in particular to our favorite type of manager, those value investors who look for underpriced and out-of-favor companies. At seven years and counting, we are experiencing the longest period of value-versus-growth underperformance in history. Negative fund flows – investors moving from active to index funds – have only exacerbated the difficulties for active managers. This latter trend, which began slowly enough with the advent of iShares in 2000, has gained considerable momentum since the financial crisis.

Where Do We Go From Here?

The question for an asset allocator with an active management bias, such as myself, is whether all this represents a permanent change as many are suggesting. Or whether we are simply in a long and unusual period in our economic and investment environment.

An important job for any investor, and an imperative one for the professional, is to continue to learn from one's inevitable mistakes. In the longer run, I do not believe that building portfolios based on an active management discipline is a mistake. The rules have likely not been overturned, nor has investment talent suddenly become incompetent. As with prior cycles, I expect that this one too will likely end. However, I do not believe that the current trends will change until we arrive at a "regime change" at the Fed – by which I mean a normalization of interest rate policy. That, by most accounts, is many years ahead. In a continuing low-return environment, costs become an overriding consideration. Thus, acting as a prudent fiduciary of client assets, I am moving the majority of our US Large Cap asset allocations to low-cost passive funds and ETFs, at least until this cycle has run its course.

All other aspects of our core investment management discipline remain unchanged. We start with a deep-seated commitment a fiduciary standard, to wit, avoiding conflicts of interests and putting each client's best interests first. To this we add a broad diversification discipline to prudently manage risk. Chasing performance has never been our style, and investors who do typically end up in the 30-50%[1] of investors who will fail to reach their life's major financial goals. With a diversified portfolio, you are by definition never going to be at the top of the performance charts, and, more importantly, never at the bottom. It is this very moderation of returns that provides the highest longer-term benefit.

Perhaps most critically, we adhere to an appropriate risk model for each client's goals and their respective investment horizon. Whether that client is in accumulation – that is, during their younger, higher-earning years – or they are nearing or in distribution – that stage of life where one begins to use one's accumulated savings – there is a risk benchmark appropriate to their needs. Accumulators can afford both significant risk and volatility in their portfolios whereas for distributors, too much volatility can destroy even the best financial plan. While we await a return of higher performing investment markets, we remain confident that we best serve our clients by helping them to stay clearly focused on their longer-term financial goals.

[1] "Living Life on the Flip of A Coin," Donald Loeper, CIMA, January 2001

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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 <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.