Perspective

January 2014 By Davis Riemer

DHR Investment Counsel, Ltd.
The Fine Art of Wealth Management

In this *Perspective*, as in past January issues, we focus primarily on reporting and discussing historical performance of investments and markets. We provide several charts to support the discussion, among which is the separate Annual Review of Selected Investment Funds, included herewith. Following this discussion of historical performance, we comment briefly on some challenges in seeking future satisfactory performance.

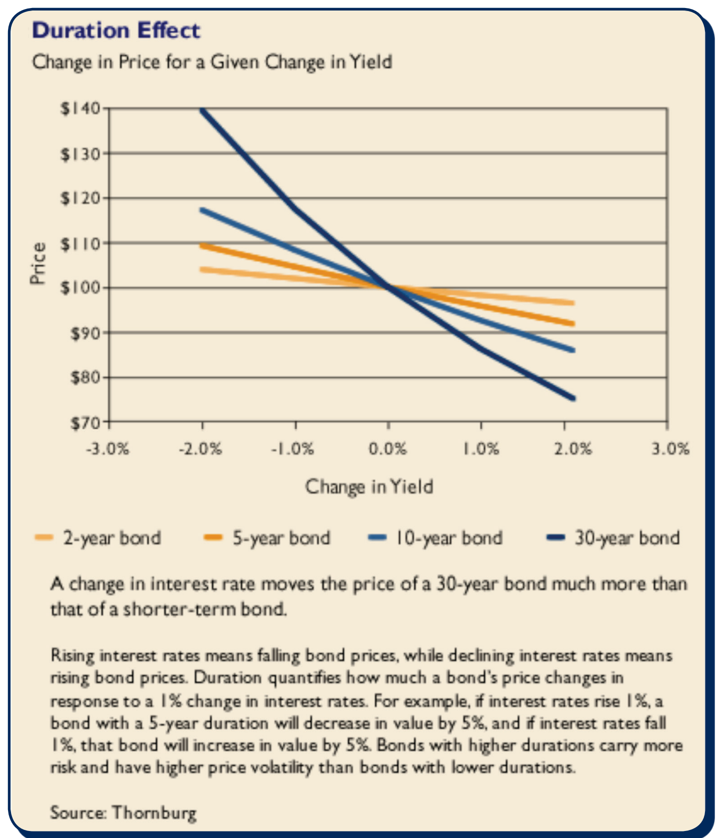
Performance of Investment Markets in 2013: Domestic Bond Market

Below are two charts that display the performance of some of the basic benchmarks for bond market investing. The first shows yields on various maturities of U.S. Treasury bonds in 2013. The second chart (which also appeared in the last issue of *Perspective)* helps in understanding losses in bond portfolios last year.

Chart 1 displays the change in Treasury (and therefore all bond) yields between January 1 and December 31, 2013. Remembering that bond prices move in opposite direction to yield, you can see that rising interest rates were the underlying cause of price declines for bonds and bond funds in 2013. Even after the increases, however, interest rates remain significantly lower than their historical averages. Although the Fed has begun to "taper" its bond buying stimulus from $85B to $75B per month, debate persists about how long the Fed will continue this stimulus, when and the degree to which it will reduce, to what extent their action or inaction will affect both long and short interest rates, how much of the expected change in rates is already factored into the prices and how much more change might occur.

Treasury Bond Yields in 2013

	1/1/2013	12/31/2013
Five Year Treasury Note	0.8%	1.2%
Ten Year Treasury Note	1.7%	2.8%
Twenty Year Treasury Note	2.4%	3.8%
Thirty Year Treasury Note	2.8%	4.2%



A change in interest rate moves the price of a 30-year bond much more than that of a shorter-term bond.

Rising interest rates means falling bond prices, while declining interest rates means rising bond prices. Duration quantifies how much a bond's price changes in response to a 1% change in interest rates. For example, if interest rates rise 1%, a bond with a 5-year duration will decrease in value by 5%, and if interest rates fall 1%, that bond will increase in value by 5%. Bonds with higher durations carry more risk and have higher price volatility than bonds with lower durations.

Source: Thornburg

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Performance of Global Stock Market Benchmark Indexes in 2013

The next chart displays the performance of benchmark indexes of global stock markets and REITs. In very brief form, it shows you that equity did well last year, and domestic equity did *very* well. The Russell 3000 index includes the 3000 largest companies (of approximately 5000 total) in the country, which together represent about 90% of the equity capital in that 5000. The Russell 2000 includes the remaining companies and capital. We use the "EAFE" ("Europe Australia Far East") to represent both large and small companies in the free market countries of those geographic regions, both developed and developing. Emerging Nation markets substantially underperformed those of Developed Nations last year, as you can see below. With this chart as background, you can gain a better understanding of the performance of the funds shown on our seperate "Annual Performance Review." When comparing index benchmarks to actual funds, it is important to remember that indexes are not directly investable. They have no costs, such as management, trades and internally generated tax liabilities.

Performance of Stock Market Indexes in 2013

	Percent
Domestic Market	
Russell 3000	33.6%
Russell 2000	38.8%
S&P 500	32.4%
Foreign Markets	
EAFE Developed Markets	23.3%
EAFE Emerging Markets	-2.3%
Real Estate Investment Trusts	
NAREIT	3.2%
DJ Global REITs	2.1%

The "Annual Performance Review of Selected Investment Funds"

With this *Perspective*, we enclose DHR's "Annual Performance Review of Selected Investment Funds." This large chart presents a good opportunity to assess your investments by comparison in a variety of ways. By studying the performance for the funds DHR uses, and over each of the last ten years as well as for three multi-year periods cumulated for three, five and ten years, one may compare fund-to-fund, fund-to-benchmark, fund-to-market and market-to-market.

Briefly, for those who might be reviewing the chart for the first time: Using your portfolio "Investment Position Report" (enclosed in your package), identify a fund (position) you would like to analyze and note the "asset class" in which it invests (e.g. "Domestic Stocks of Large Companies"). Then, on the large "Annual Review" chart, find that asset class designation in the left hand column. Within the category of that class we list the several funds in which DHR invests clients' money and, in addition, (in green) one of the professional benchmarks that measure the performance of that asset class. You may then compare how that asset class (or "market") performed over the various time periods, and the degree to which the benchmark performance varied from that of the several funds in the class.

For the year 2013, most of the equity funds we use outperformed their benchmarks. Some people think that five years is the best period over which to assess performance, but the events of the last five years do not support extrapolation for future five year periods. Even ten year comparisons contain problems with respect to future projections, but they are far more relevant to investment decisions than are one and five year periods. When you examine the 'Ten-Year" column, we think you will be pleased with the results.

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The following discussion summarizes some of the numbers in the chart.

We expect Vanguard's equity index funds to match the performance of their market-weight-capitalization benchmarks. However, Vanguard has expenses which benchmarks do not. This can cause the performance of Vanguard's index funds to fall short of their benchmarks by an amount generally less than one-quarter of one-percent. However, because the funds can generate small amounts of revenue in addition to gains and dividends, most of these funds out-performed their benchmarks over ten years.

Over time, which does not mean over each one-year period, we expect that our DFA funds will outperform those same benchmarks. That expectation is a logical implication of the differences in the way the Fama / French Three-Factor Model of equity markets recommends portfolio construction be done. (See October 2013's *Perspective*.) But, since we all know that theory doesn't always work out as anticipated, it is especially gratifying to see it go right for our clients so consistently throughout the categories.

An additional contribution to lower-than-benchmark performance is the expense of tax management within some of the funds. Tax management strategies are complicated to implement and therefore cause higher expenses. The question is whether, on an after-tax basis to investors, they generate a higher return than the benchmark does. That's a significant hurdle, because indexes don't have much turn-over, which is a source of taxability for investors. Without a cumbersome process of calculating and estimating after-tax returns for a variety of tax brackets over a number of years, it is hard to say precisely how well they have done. However, the analysis we have done suggests that they merit positions in our portfolios.

In the two bond fund categories, you will notice a "mixed bag" of results in 2013. The dominant factors that drive results in bonds are quality and maturity, respectively the "default risk" and the "term risk." We use only high quality bonds, where benchmarks use the broader "credit market" also, which include slightly lower quality bonds as well as high quality. While that has contributed somewhat to differences in return, the principal contribution to performance in the last year has come from term risk. Over the twelve months, rates have risen, causing values to fall. But, through the year, rates have bounced, causing trouble for bond portfolio management. DHR has remained primarily in short maturities for defensive reasons. However, that has meant that, when the Federal Reserve raised short rates, the values of short bonds fell. In a "buy and hold" process, it was very difficult to walk through that rainstorm without getting wet. Some active managers succeeded, but we remain skeptical about their ability to persist in that result.

It is always fun to say "We beat the market." In fact, we appreciate the purpose of Dimensional Fund Advisors, as stated by their CEO and founder David Booth, which is to "seek better returns" (than the broad market provides). However, that is not DHR's primary goal when selecting funds. We seek to compose portfolios with funds that can be held for a number of years and which complement each other in their diversification, to the end of meeting clients' goals for financial security. When the performance of an individual fund falls below benchmark performance, we scrutinize it. In this case only one fund in the system has a level of performance that creates concern on our part – the First Eagle Overseas Fund, which is an actively managed fund. Because the fund manager changed several years ago, we have been selling out of this fund every year and now have relatively small amounts invested in it.

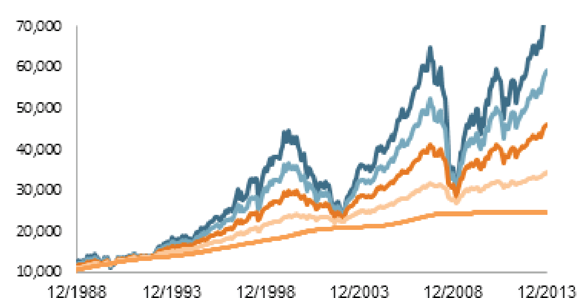
Performance of Globally Diversified Benchmark Portfolio

In 2008 and 2009, all investors experienced profoundly negative economic and investment events. Many people questioned whether they should still invest for retirement and long term goals in the financial markets. However, although the markets have been very volatile through the last six years, investors have seen a reaffirmation of the merit of long-term investment principles — namely, focusing on a long-term orientation, diversification, balance and cost. For example, a balanced portfolio of 60% stocks and 40% bonds is now significantly above where it was before the crisis began. Investors who stayed the course should be patted on the back for staying invested in the markets. While they were exposed to volatility, their patience was ultimately rewarded by higher returns.

The following chart illustrates, in model form, the historical performance of globally diversified whole portfolios, with differing ratios of stocks and bonds, all with asset classes represented with index benchmarks. These are "modeled" results, used to illustrate a point. The differences between the models and DHR portfolios do not nullify the value of comparison. Despite their being models, in which the indexes used do differ somewhat from our portfolios, we think it is better to be "approximately correct" than "exactly wrong." Mixes with larger allocations to stocks are considered riskier but have higher expected returns over time. Both expectations – higher risk and higher returns – are clearly shown below as both the degree of volatility and also the final return correspond exactly to the portfolios' allocations to stocks. As you review this, compare your own allocation to those in this chart. Consider your time frame, your needs and goals and your risk tolerance. When we meet, let's discuss your thoughts.

Growth of Wealth: The Relationship between Risk and Return

These portfolios illustrate the performance of different global stock/bond mixes and highlights benefits of diversification.



Period Returns (%) ** Annualized*

Asset Class	YTD	1 Year	3 Years*	5 Years*	10 Years*
100% Stocks	23.44	23.44	10.33	15.53	7.72
75/25	17.24	17.24	7.87	11.79	6.43
50/50	11.27	11.27	5.33	7.95	4.96
25/75	5.54	5.54	2.71	4.04	3.33
100% Treasury Bills	0.02	0.02	0.04	0.07	1.54

To the Future:

By this time in your relationship with DHR, you do not need reminding that historical performance provides no predictive information, or if it seemingly does, that information gets overwhelmed by surrounding "noise." More significantly, however, historical analysis occupies a second order of importance. Achieving financial security doesn't necessarily result from doing better than someone else. The first order of importance, the process with greater influence over one's own long term success, involves the careful review of one's goals, expectations, needs and time frames, followed

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by an evaluation of portfolio construction, risks assumed and returns sought. Regular, reflective and deliberative consideration of these matters will do a great deal to promote the likelihood of success.

DHR's Forecast: In 2014, "The Stock Market Will Fluctuate" *(Thanks, JP Morgan)*

Every January, forecasts for the coming year in the investment markets spring up, like pennant dreams in spring training. Looking back, I do not remember any forecast from last January that called for our stock market to rise 33% in 2013. Yet, that's what happened, so almost all those forecasts must go into the failed-forecast-graveyard.

DHR reviews material on the process and results of forecasting in a number of different intellectual disciplines – finance, economics, politics, public life, weather, etc. – and that review consistently demonstrates that forecasters are more often wrong than right. For example, if they get the event right, they might well get the timing wrong, which, in the investment markets (where they say "timing is everything") proves disappointing. Despite this, most investment fund strategies rely on their managers' forecasts of future outcomes for the securities in the portfolio. We have discussed this before. Of course, some managers will make correct forecasts and will consequently enjoy good performance as a result. Can they do it again? Some will, yes. Who? Aye, there's the rub. How long? I can easily find funds and managers that outperformed last year, or over the last ten years, or even over the last fifteen years. However, nowhere have I found support for the idea that accuracy in investment forecasts can be achieved reliably, or that a forecast-based fund selection process can accomplish that successfully. At DHR, we make our decisions differently and invest without using forecasts. We invite your qustions and a conversation on this at your convenience.

Now You See 'em, Now You Don't (Winners)

Many investors, having granted that they themselves cannot foresee the future correctly, take solace in the idea that they can pick someone else who can. They do this using a variety of methods, but all (including Morningstar) rely heavily on combinations of past performance and current comments from managers or writers. Why people can both say one thing and do another eludes me.

In January, whether the outlook for the economy and markets looks good, flat, grim or volatile, it seems that the arrival of every new year brings back this comment: "This is a stock picker's market." Of course the speaker means that the indexes will not perform as well as an active stock picker, (all of whom will beat the market and all of whom live in Lake Wobegone). Well, of course, we know that they cannot "all" beat the market and that the speaker has implied that s/he will, while others might not. So then, how does one separate the true seer from the non-sighted? We can easily see who *did*, but who *will?*

Vanguard conducted a study covering the period from the start of 1998 through December 2012, which included all actively managed U.S. equity funds in existence on January 1, 1998. The study tracked their performance over the succeeding 15 years and it casts some light on "picking the winner(s)."

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At the start, there were 1,540 funds. Over the fifteen years, 45% of them went out of existence, 55% survived, and, at the end, 18% "beat the market," although importantly, they did not outperform consistently. With that data, one might say: "One in five? Not bad. I'll do some research that will improve the odds to, say, one in four or three."

However, it is not so simple. Of the 275 funds that survived and outperformed, no fund did so every year. No fund did so "every year but one." One fund managed only three sub-par years and seven funds managed only four. Ninety-seven percent of them experienced at least five calendar years of below market performance. Now imagine yourself, each January, reviewing the historical record. How will you decide whether your fund – regardless of the results of the year just ended - should be kept or sold? If it went down the prior year, should you avoid it? (Every fund went down at least once). If you had been patient and waited another year after a year of sub-par performance, then would you sell after two? Three? At any point in time, how would you know that any single fund will be one of the very few that will do well and not one of the very many that will not? The problem repeats every year, of course. This task defies a rational approach.

Knowing that you could pick a clunker, would you put all your money in a single fund? Complicating the matter is the fact that, at the beginning, one would almost certainly decide to diversify – to "spread the bet" – using more than one fund. What happens to the odds of success when you pick three or four funds? I will not belabor that question, but will move to another aspect of it, which makes the problem even knottier. Suppose one or two "beat the market" but two or three do not. By how much will the four, in aggregate, "beat the market?" The odds do not favor a strong result. Topping it off, transaction costs and taxes paid when moving money around further reduce the level of success. With each step, the probability of superior performance gets lower and slower. Then, success in one period means nothing for the next. Last, if (as professionals do) one adjusts the return (downward) for the risk taken, well – why bother? Can one not learn from the experience of others?

Choosing past winners for a portfolio does increase the risk of shortfall, by increasing the influence of chance and randomness. One of the best papers on the matter was published by Eugene Fama (recent Nobel award) and Ken French. The sum of their major effort is that, while every year a certain percentage of participants finish in the top quartile, one cannot tell why. One cannot distinguish the results of intention from the results of chance. That does not mean that intention counts for nothing. It does mean that there is risk in that path. Even the use of a term like "It is 'difficult'to beat the market" can imply that it is a learnable skill, just "difficult" to learn. In my opinion, it is as learnable as consistently flipping a coin heads more often than not.

Vanguard's founder, Jack Bogle, often advised people not to try to be "the winner," but rather seek to be "a winner," which he demonstrated can be done with the use of index funds. That makes sense. To go one more step, we believe that it is possible to improve even those results in a way that is sound theoretically, sound statistically and demonstrable empirically. As always, we invite conversation about these conclusions.

On another matter, let's all pray for rain in California!

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