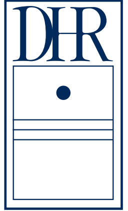
Perspective

January 2015 By Davis Riemer



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

Hello, *and Happy New Year!*

In this, DHR's first *Perspective* of 2015, we start with a few rather philosophical comments about investment performance. From there, we review the markets and the performance of our funds during the year. Lastly, we address some changes coming to DHR in 2015, about which we are quite excited. We trust that, as all these changes take place, you will share our view that they contribute positively to our work and to your experience.

Investment Performance

Readers of previous first-of-the-year annual Perspectives will recall that, in this issue, we discuss historical investment performance. No different this time. The following discussion has three parts – some philosophizing followed by comments on investment markets generally in 2014, and a review of the performance of the funds we use in client portfolios. To supplement the last point, we suggest you refer to the separate chart we have enclosed - *The Annual Review of Selected Investment Funds*, in which you will find historical performance reported for almost all of the funds we use. We have shown the last ten years individually, as well as cumulatively for 3-, 5- and 10-year periods. We find that the numbers justify the expectations we had for them.

Some Philosophy About Investment Performance

Reason might tell you that the best approach to investment is to maximize your return. However, reason and judgment sometimes have contrasting views. Judgment supports the assignment of value to various parts of our lives. Good judgment requires questioning the assumptions underneath our reasoning. So, for example: Why is more return, i.e. more money, better? Money is a tool – it is not the end. If, as a tool, it were truly free, then fine – but it is not. We must "pay" for it – with risk, volatility, losses, time, energy and worry. If judgment can lead us to a better understanding of the goals we seek in life, and if that end is met by a reasonable return on our resources, then why should more return be sought, when that comes at a cost to other aspects of life? How do we assign value to the various parts of our lives?

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The Buddhist philosopher and teacher, Thich Nhat Hanh, tells a story which I have used as an analogy to investing. A monk was riding a running horse. A man stopped him and asked: "Where are you going?" The monk answered: "I don't know. Ask the horse!" Nhat Hanh then used this story to address our own lives, saying that each of us rides our own "horse" of "habit energy," his words for the sub-conscious forces that carry us along, day by day, setting the course for our decisions, our actions and even our lives. By analogy: What is the "habit energy" of the typical investor? It is the "habit energy" of seeking higher performance and more return. For many, this "horse" never stops running and never reaches a destination. Western Social Scientists who work with Behavioral Psychology and Behavioral Economics recognize this horse, although they label it with an academic term – "cognitive bias." This horse, this force, can drive one's pursuit of investment performance – to want "more," to compete with others, to placate fear or even to quell anxiety related to money. Furthermore, these biases tend to cause us to underestimate risk, overestimate our abilities, improperly evaluate historical data, project recent history too far into the future and / or seek only facts that confirm our existing paradigm. These effects are well known to social scientists and to an increasing number of medical researchers. So, if these characteristics paint the picture of "the horse of habit energy" that investors ride, one can see how they can cloud one's perception and understanding of risk, impair judgment, often render irrational one's choices, and sacrifice the opportunity for peaceful thought about more important things in life. We believe that rational thought should drive the questions and answers in this matter. The "horse of habit energy" here is the force of past thoughts, feelings and biases. that combine to influence decisions to the degree that, what we think is rational, is often not. At the very least, we should understand and acknowledge the extent to which we rationally control our decisions – or do not.

Although without the benefit of Thich Nhat Hanh's metaphor, I have thought about this "horse" for years. How does it influence investors' thought? What effect does it have on behaviors, both mine and others? This question might seem too esoteric to matter when selecting mutual funds, but it does matter. It matters more than any external criteria imposed on the process. The issues it presents remain in front of us (because they remain within us) at all times and so affect our "rational" thought. Their effect tends to produce sub-optimal decisions. Long term investors are better prepared for success when they know their own tendencies.

We all know the classic philosopher's dictum: "First - Know Thyself" (a mandate far more easily expressed than mastered). Recent and current research into perception, cognitive processes, memory and interpretation truly tell us humans: "Don't believe everything you think."

Another example of distorted thinking that can result from something that "everybody knows" is

the strategy of trading in and out of investments as short term conditions change. This idea has gained some popularity at the end of 2014, as diversified investors have seen their portfolio returns lag those of the more exciting U.S. stock market. In this case, the "horse" wants not to be left behind or finish behind others. Some styles are intended to increase performance in the near term, by selling losers, buying winners or to trying to anticipate interest rate moves and the Fed. William Simon, an investment industry writer and spokesperson on fiduciary and investment matters, wrote about that in the text below, which I quote. I particularly like his last paragraph.

"I really don't concern myself with what my investments - and, by extension, the financial markets in which they are invested - are doing, because I don't have any control over them. Instead, I focus on the controllable, which is to invest in a low-cost portfolio that diversifies risk deeply and broadly. In fact, the return on any given investment for any given time period – whether a year, a month, a week, a day – is simply a random variable subject to inherent uncertainty. No one can know today what the actual return will be on an investment in the future. Even though investors have no ability to control the uncontrollable – namely, return – ironically, they often focus solely on return in determining what investments to select for their portfolios.

It is obvious that investment winners and losers will be revealed in a track record for any given past time period. However, no one can know the names of the future winners or losers today, in advance. A mountain of robust academic studies over the last half-century has demonstrated convincingly that there's no reliable way to predict when - or which, or even if - investment winners (or losers) from the past will win (or lose) again in the future. Nonetheless, billions of dollars in marketing costs are expended every year by mutual fund families, banks, insurance companies, and the like to obscure – largely successfully – this essential fact of investing and keep it from investors. This marketing provides such entities with a more pliable marketplace that will more readily buy into their latest investment ideas."

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Reviewing the Markets in 2014

By the end of 2014, the U.S. stock market had reached all-time high prices, which tended to mask the increase in volatility during the year. Volatility visited not only our market, but also all global stock markets, bond markets and currency markets as well. In the fourth quarter, our stock market did quite well, rising 5% on the S&P500. On the other hand, for the unhedged U.S. Dollar based investor, every broad international stock market index we examined was negative. This resulted from a 5% rise in the dollar against the Euro, a change which benefits international travelers but not international investors. Assume the price of a U.S. Dollar in Euros rises while you own a European investment,

which you then sell. When you bring the proceeds back to our dollars, you will have to spend more of your Euro money to recapture the original U.S. Dollar value, because those dollars have become more expensive. That shows up as lower return on the original investment. You will see in the next paragraph that, when measured in their own currencies, the 2014 returns to international market indexes were generally positive, while U.S. Dollar investors had losses.

Over the year 2014, among benchmarks in our domestic stock market, the best performance came from large cap blend (S&P500) at 13.7%. The lowest return occurred in the domestic small cap value index (Russell 2000 Value), which underperformed all the other domestic stock indexes, increasing only 4.2%. International investment benchmarks for the year (shown in their own markets and also for U.S. Dollar investors) performed as follows: MSCI World ex-USA: In local currencies: + 6.3%; for a U.S. Dollar investor: - 4.3%. MSCI Emerging markets: in local currencies: + 5.2%; for a U.S. Dollar investor: - 2.2%. The best performers in our portfolios for the entire year were the domestic REIT funds. Domestic REITs rose 32% and global (excluding U.S.) REITs rose 10.9%.

In our bond market, yields remained at very low levels. For the year, the three-month T-Bill paid four-one-hundredths of one percent. The one year index paid 18 one-hundredths of one percent. At the end of the year, the Ten Year Treasury Bond offered a yield of 2.17%, which was down from 3.03% twelve months earlier. The municipal bond sector, in general, continued to outperform the taxable bond sector.

It was an emotionally frustrating close to a strategically frustrating year. Comparative performance (portfolio to benchmarks) went against DHR portfolios. For some, that can produce uncertainty and possibly anxiety about whether one is "doing the right thing." However, for a long-term investor, this phenomenon – comparative performance going against you – is a fact of life, a recurrent visitor, to be understood and accepted, as a necessary concomitant of long-term investment strategy. Nevertheless, it does have an effect on people's thinking and can tend to cloud clear reason with emotion. If you feel uncertain or have questions, please call to talk it over.

Reviewing the *Annual Performance Review of Selected Investment Funds*

With the proliferation of the number of numbers over time, the density of this Annual Report has been increasing as well. We will improve readability next year. In the meantime, please bear with us.

The report covers most of the funds we use, and shows the investment return in each of the last ten years, as well as the cumulative return for the periods of three, five and ten years, all ending December 31, 2014. In addition, it shows the return of a benchmark index for each of the asset classes reported. You can compare the return of the fund to that of the index. Some indexes serve better as proxies than others, so understanding and judgment must accompany comparisons.

The actual performance, as shown, makes comparison fairly straightforward. Please let us know if you want some help or interpretation that could help your understanding. DHR might have information that you would not necessarily gain on your own.

We want to review the performance of our funds relative to their benchmarks, even though it might raise the question: "If we say that one cannot beat the market, why this comparison?" The number of investment strategies available in the markets has grown significantly since 1987, when DHR began. Our own understanding has had to keep pace, which has required that we refine our expressions about expectations, strategies and results.

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The traditional "active management" strategies rely primarily on two types of decisions – selection of individual issues and timing of transactions – both of which we call "judgment" decisions, such as which individual investment (e.g. company share) to transact and when to buy or increase, or to sell or to reduce. The evidence on the long-term success of active management in these decisions is overwhelming and overwhelmingly negative. Success comes only to a few, who, because leadership changes over time, we cannot reliably identify in advance.

"We believe that markets work".

Our readers know about "index" investing, in which decisions are based on rules and are totally passively generated. We use some of the index funds offered by Vanguard. We also call index investing "rules-based" investing, which distinguishes it from judgment-based. DFA practices "rules-based" investing, but most of their funds are not truly indexed. Their rules separate securities into groups and then, for each one of their funds, they invest in one group, without timing or individual selection being involved. However, unlike Vanguard, they do not attempt to replicate an index or a benchmark exactly. The groups that they select are thoroughly supported by investment theory and academic research *and* - have a long history of performance that exceeds their benchmark.

We believe that markets work. They "clear" prices, in that they set equilibrium prices between sellers and buyers, they aggregate and disseminate information and they make it very difficult for an individual to generate better results than the aggregated market result. When we evaluate the performance of an index mutual fund, we measure it against the fund's benchmark. However, benchmarks have no costs. If the fund's performance before its own costs equals that of the benchmark, then the fund has met its objective. If, after subtracting its costs (the "Operating Expense Ratio, or OER), the fund's performance equals or exceeds the benchmark, then that is so much the better. Here follows a review of the performance of the funds in the chart, consistent with comparison to benchmarks.

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We begin with the "Ten Year Growth of $1" column, for two reasons. One can easily relate to dollar accumulation numbers and the longer period allows more confident conclusions. (If you had invested $1.00 at the beginning of the period, it would have grown to the amount shown in the cell). Forty-nine funds have records shown on the chart, of which we excluded 14 and also REITs, for lack of ten year records. We then eliminated the money market fund, because it is not an investment position. The net result available for comparison is 32 funds.

Of the 32 funds, 19 generated performance equal to or greater than the benchmark and 13 less. At this point, we are not concerned with those whose performance was more than satisfactory, but rather with those 13 that "fell short." In the "Growth of $1" column, you will see that most of the equity funds have risen to $2.00 or greater. So, each dollar invested in one of those funds on the first day of the ten years would have grown to the amount shown in the column. Let's compare the "wealth" of the investor to that of the asset class benchmark. Of the domestic equity funds that underperformed the benchmark, all but two came within two cents of the accumulation total. One of them missed by three cents. In other words, the ten-year shortfall was generally about 1%. However, one of them – the Vanguard Value Index Fund – fell short by 4%. Interestingly, the closest fund in strategy to it is the DFA Large Cap Value fund, which exceeded the benchmark performance. We have generally preferred the DFA Fund and see no reason to change.

In the international equity area, both large and small company asset classes had much the same results. Shortfalls ran around 1-3% of the final total. Only one "outlier" shows up on the negative side – the Vanguard Emerging Markets Fund. This is curious, because of all of the five emerging market funds, it is the only one that attempts to track the index exactly.

Among bond funds, the same result was obtained – shortfalls were very small. One fund excepted – but it is the municipal bond fund, whose yields are expected to fall below the benchmark for taxable bond yield.

When making these comparisons, we also compared the amount of shortfall to the operating expense of the fund. Except for the Vanguard Emerging Markets Fund, all of the amounts by which the funds underperformed their respective benchmarks were less than their operating expense ratio. That means that they all created before-cost investment results that were better than their respective benchmark.

Please let us know if anything in this report raises questions or concerns. We will gladly explain whatever you need.

Anticipating Changes at DHR in 2015

As mentioned, we expect a number of changes at DHR in 2015 and we greatly look forward to them. They will include: changing staff roles, new billing procedures, new report formats, new software at the heart of the practice, increased use of technology in communications, increased use of our new planning software "Money Guide Pro" – which we hope to use in virtually all client situations - smoother trading procedures and more.

The "more" includes three changes we describe in more detail here. They are: Shannon Stone's increased responsibilities and role, DHR's new relationship with the consulting firm Superior LTC and our new conference and reception spaces.

It is a great pleasure to watch the growth and maturation of staff and we look forward to Shannon handling increased responsibilities. Having spent a dozen or so years with different organizations in the financial field, Shannon began her work at DHR expecting that she would occupy a permanent and valuable support position. In those prior years, concurrently with her work in finance, Shannon had trained and operated as a performance coach, and felt a commitment to helping people. Then, at DHR, she saw how financial services can be delivered in a new and compelling way. After thinking about it for a some time, she decided that she wanted to be an Advisor here. So, her next step was more education. It was hard work, but she completed her CFP (Certified Financial Planner) courses, exams and obtained her certification. No small mountain, that. In the last year, she has been at the conference table in many meetings, both learning and participating, has fielded a voluminous number and variety of client requests, has handled a number of clients directly and has become the principal "master" of our financial planning software, Money Guide Pro. In 2015, we will continue to guide and advance her experience. Shannon will attend more meetings, with more to do and say. In 2016, she will assume the role of primary contact for a number of clients and DHR will have three full-time Advisors. Shannon's dedication, diligence and determination indicate her strong desire to be successful and warrant this advancement.

DHR is pleased to bring an increase in our resources, service and value to our clients. In December, we increased our intellectual resources and strengthened our ability to help in an area that is becoming increasingly relevant to our clientele.

In recent years, more and more clients have been asking questions about Social Security, Medicare and Long Term Care (LTC). We have been able to field the questions about Social Security, but have long felt that Medicare and Long Term Care – the need, the service and the insurance – are areas of DHR's financial planning knowledge which we want to improve. However, acquiring such knowledge takes a significant amount of time and energy. In December, we contracted with a firm and its founder to join us in this effort. Allen Hamm, who founded Superior LTC, has signed an exclusive arrangement with DHR. Superior will provide information and advice on both Medicare and LTC to all of our clients who wish to receive it. As an example of why we think this is a good idea, I point out one aspect of Allen's work with people on LTC coverage. Most people will buy it if they think it will be needed. Few would do so if they think not. But – how can one know? Although one cannot "know," one can assess probabilities. Allen will ask for personal and family medical history, which information he will compare to medical statistics to determine the degree to which one's personal history increases or decreases the risk of needing long term care. He can speak more specifically about the probabilities of using the coverage. Although Allen does sell LTC insurance when asked, we have asked him not to do so with our clients. There will be no attempt to "sell" anything, or even consider a DHR client as a prospect for a policy. This service

will simply provide information and analysis, from an expert source. If you are interested, we can provide you with a free copy of the book Allen has written: “How to Plan for Long Term Care.”

Anyone out there confused about Medicare issues? “Oh, yes!” we frequently hear. Allen can help with those questions, as well. DHR will soon start to recommend and arrange conferences between Allen Hamm and those of our clients who are approaching 65, but also for younger ones who perhaps should consider LTC coverage.

There will be no cost to our clients for this service. DHR pays Superior’s fees with a retainer.

Clients may receive the information and advice in a variety of ways, which will usually begin with a teleconference. DHR will hold a webinar with Allen on March 5, for all who wish to attend, at which point we will discuss the arrangement and the range of questions that typically arises, answer a few questions and generally acquaint people with the service. All are invited. Please send an e-mail to Lyn Jung (Lyn@DHRCounsel.com) for details of time and site.

Space changes are coming at DHR. We had hoped to see the renovations complete within the month of January, but no – it will be mid-March instead. Nevertheless, it is not too early to tell you what’s coming. DHR has leased additional space adjacent to our existing conference room. We will move our conference room to the new space, which will have a number of advantages. That room is removed from traffic and noise. It will be tranquil and faces a garden outside. One will not have to walk through the rain in winter to go from reception to conference. The existing conference room will become the reception room, which also has a number of advantages. No more stairs to climb, for one. No barking Pepa! (She will be frustrated by the demotion from being watchdog for all comers). We are excited about completing the renovation and decoration of the rooms and welcoming you here to see them.

All of us at DHR look forward to the challenges and inspirations coming in 2015. We remain committed to meeting the needs and serving the interests of our clients, in an even better way. We invite your thoughts, questions and suggestions. Also, with our expanded capacity, we will be delighted to welcome new clients to our fold. If you know of anyone who might have an interest in a conversation with us, please do let us know, or give them our contact information.

With that – *Happy New Year!*