QUARTERLY NEWSLETTER

April 19, 2013

Market Commentary:
Global equity markets continued to rally during the first quarter of 2013, with US equities outperforming those based outside the US. The one exception is emerging markets which experienced a decline during the period.

The general equity rally is little to celebrate, however, since it now appears equities are fully priced, therefore return expectations going forward should be tempered. Investors who did not remain fully invested missed tremendous returns over the past several years, while those who stayed the course were once again rewarded for their discipline.

Now, as always, investors are left with what to do from here. Are equities fully priced? Yes. Should they now be avoided? No.

Current bond yields are a very good indicator of future bond returns. With bond yields continuing to hover at historic lows, the consensus return outlook for intermediate term bonds is about 2%. Given the historic US inflation rate of approximately 3%, bonds are almost sure to lose out to inflation over longer periods of time. Also recall the source of returns for bonds is two-fold: interest received +/- changes in principal value. If/when interest rates increase, that increase could easily cause the loss in bond principal values to exceed interest payments received.

What to do now?

Step 1: Turn off CNBC. News channels are paid according to the number of “eyeballs” they attract, and they attract them by appealing to our emotions. Emotionally driven investing is not a good strategy. For example, it’s been all over the media that the Dow has hit an historic high. So what? First of all, the Dow is a horrible benchmark given its constituents and equal-weighted methodology. Secondly, the Dow does not include dividend or inflation adjustments, thus the reported Dow ‘level’ is fairly useless. Finally, throughout your lifetime the market has and will continue hit new highs, therefore mentally anchoring on Dow highpoints is a rather useless and likely deleterious exercise.

Step 2: Develop a well thought out investment strategy which considers ALL risks alongside your time horizon and risk tolerance, and then implement the strategy.

Step 3: Stick to the strategy and sleep well knowing that you've done all you can to address *all* risks.

Below are the returns of major market indices as of March 29, 2013. Year-to-date returns are cumulative; 1, 3, and 5-year returns are annualized:

Benchmark	Year-to-date	1 Year	3 Year	5 Year
S&P 500 Index[1]	10.76%	13.97%	12.57%	5.95%
MSCI US Small Cap Value Index[1]	13.33%	20.05%	13.58%	8.87%
MSCI EAFE Index[1]	5.13%	11.25%	5.00%	-0.89%
MSCI EAFE Small Cap Index[2]	8.56%	13.43%	8.45%	2.06%
MSCI US REIT Index[1]	8.07%	14.94%	17.31%	7.15%
MSCI Emerging Markets Index[1]	-1.76%	1.81%	3.22%	1.06%
Barclays Capital US 3-7 Year Treasury Bond Index[2]	0.21%	2.90%	5.23%	4.58%
Barclays Capital US TIPS Index[2]	-0.36%	5.68%	8.57%	5.89%
Barclays Capital U.S. MBS Index[2]	-0.05%	1.97%	4.17%	5.15%
Barclays Capital U.S. 5-10 Year Corporate Index[1]	0.51%	8.79%	9.25%	n/a

1 Source: Vanguard. Visit **www.vanguard.com** for a description of each index.

2 Source: BlackRock. Visit **us.ishares.com** for a description of each index.

Vanguard Changes International Indexes: What it means for you.

On October 2, 2012 Vanguard announced that it would be transitioning the index of six international stock funds to FTSE benchmarks (as well as sixteen US Funds to CRSP benchmarks). As index providers charge funds for use of their index methodology, the switch was largely driven by cost considerations.

For Vanguard's foreign market equity funds, there are issues related to the index changes in addition to cost savings that you should be aware of:

1. MSCI EAFE Index did not include Canada, while the FTSE Developed Non-US Index does. Those using the MSCI EAFE Index would have needed to add an additional Canadian investment vehicle to complete a truly global equity portfolio or ignore investing in Canadian companies altogether.
2. The MSCI EAFE Index did not include South Korea while the FTSE Developed Non-US Index does.
3. The MSCI Emerging Markets Index includes South Korea while the FTSE Emerging Markets Index does not.

Vanguard Changes International Indexes (cont'd):

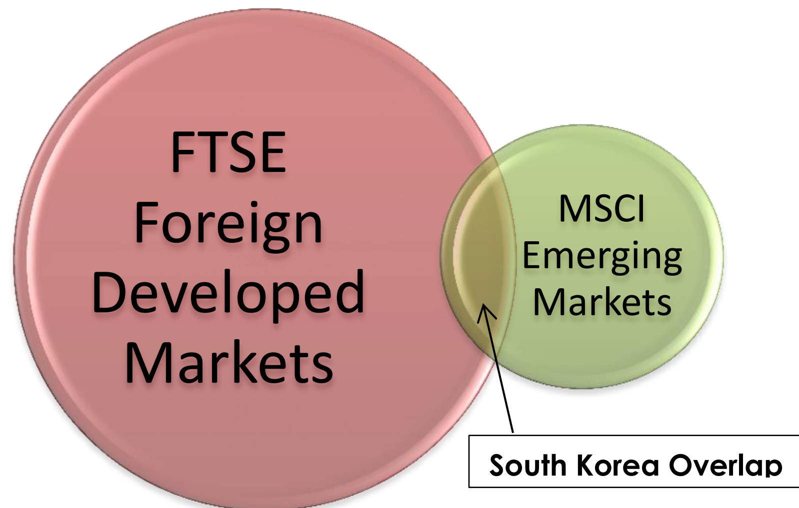
Several years ago I reached the conclusion that the FTSE Foreign Developed Market Index superior to MSCI EAFE largely due to its inclusion of Canada. Since Canada's economy is driven largely by trade (its import/export trade is worth more than two-thirds of its GDP) and the majority of that trade is with the US, it was widely accepted in the investment community that Canadian company exposure was unnecessary due to relatively strong correlation with US markets. The problem I saw with this conclusion wasn't that correlations weren't indeed strongly positive during good times, but what would happen during turbulent times? Would correlations remain strongly positive or are there structural differences in Canada that may cause less correlation? Since returns from foreign holdings come from both valuation changes in local currency +/- changes in currency exchange rate, I settled on the later theory. The fact the FTSE vehicle was less expensive for long term holders than the MSCI EAFE alternatives was an added bonus!

The challenge for advisors who recommended total foreign exposure while recommending MSCI EAFE investment vehicles was how to gain exposure to Canadian companies. Until fairly recently there was really only one option: to purchase an MSCI EAFE Index Fund and compliment it with a separate Canadian Index Fund. The trouble with this strategy, however, is added complexity and higher trading fees. Then Schwab introduced very low-cost ETFs designed to track the FTSE Developed Market Indices, which is why (after they had grown and sufficiently proved themselves) I recommend those.

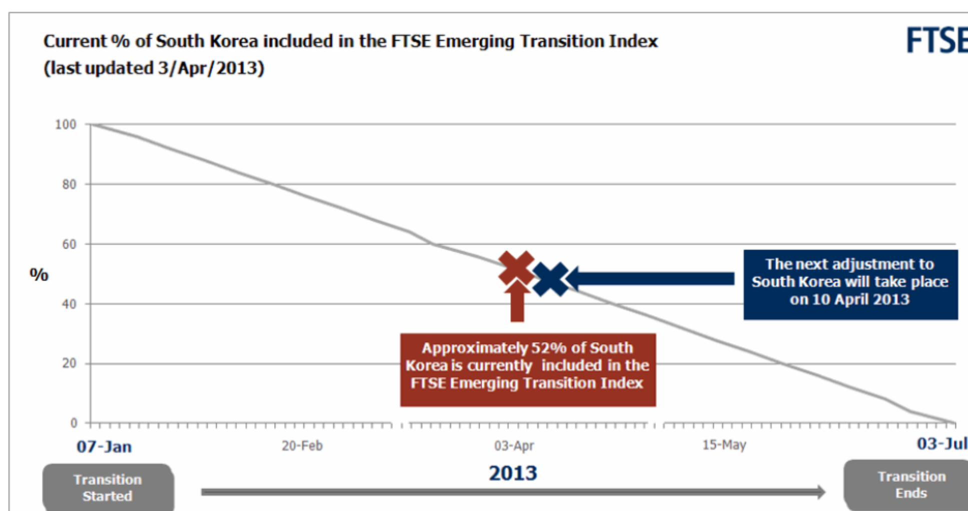
The Schwab Family of ETFs wasn't a panacea, though. In order to gain nearly full exposure to foreign markets one must not neglect emerging markets. Though volatile, emerging markets are not perfectly correlated with the developed world and are structurally different; the main qualities sought when constructing a diversified portfolio. Emerging market exposure is difficult for smaller investors to obtain efficiently, though, and the Schwab Emerging Market ETF is pretty tiny (though growing). Though not a perfect solution, this left a small handful of larger MSCI-based emerging markets funds as better options.

Vanguard Changes International Indexes (cont'd):

As illustrated below, though the larger MSCI-based emerging market vehicles appeared optimal in most every way, there was a South Korean overlap problem when using them alongside the FTSE Foreign Developed Index. I took this issue into account when recommending targeted allocations for each foreign developed and emerging markets.



So now that Vanguard has switched its international index provider to FTSE the overlap problem is solved, right? Not exactly. Though nominally large, South Korean companies are a relatively small portion of traded global equities. Any sudden portfolio shifts by large institutional investors such as Vanguard would likely result in market disruption, thereby harming shareholders. To help alleviate this problem, Vanguard has adopted the following rebalancing schedule to get its emerging market equity fund from 15% South Korean exposure down to 0%:



Source: www.ftse.com

Vanguard Changes International Indexes (cont'd):

Rodney Comegys, an executive in Vanguard's Investment Equity Group, had this to say in a recent interview for advisors (sorry, I wish I could share the actual interview with you in its entirety, but I'm prohibited from doing so!), "It would be speculative to put any sort of cost estimate on our migration other than to say it's expected to be modest. The transitions will be slow, they will be orderly, they will be measured to minimize costs, and they will be in the best interests of our shareholders. We successfully accomplished these goals in 2003 and will do the same in 2013." I'm confident Vanguard will achieve this goal during the emerging market benchmark transition.

By July 3, 2013 there will no longer be an overlap of South Korea between the FTSE-based foreign developed markets funds I recommend and Vanguard's Emerging Markets Fund. Therefore, I will be adjusting all target portfolio allocations slightly. Since emerging markets have recently experienced relative underperformance, this adjustment can generally be made without the need for active rebalancing, but should be reviewed on a case-by-case basis.

Now for something completely different:
Anatomy of a Speculative Bubble

Robert Shiller, Sterling Professor of Economics Yale University, defines a "speculative bubble" as:

> A situation in which news of price increases spurs investor enthusiasm, which spreads by psychological contagion from person to person, in the process amplifying stories that might justify the price increases and bringing in a larger and larger class of investors, who, despite doubts about the real value of an investment, are drawn to it partly through a gambler's excitement.[1]

I think this is a fairly good definition, but I would also add that around a bubble's peak most participating investors become insensitive to the actual risk they are taking on. I believe is subtly different from "gambler's excitement" because most don't realize they're gambling, and this is especially true during bubbles that persist for many years. As Charles Kindleberger wrote in *Manias, Panics, and Crashes*, "There is nothing so disturbing to one's well-being and judgment as to see a friend get rich." Simply put, it's hard to be the naysayer when everyone around you is profiting handsomely. It's not easy to keep from getting swept up in the collective mindset.

[1] Shiller, Robert J., *Irrational Exuberance*, Random House, 2005.

Anatomy of a Speculative Bubble (cont'd)

Speculative bubbles have consistently occurred in the past and they will continue to show up in the future, so we have to deal with them. The best place to start is to understand the general lifecycle common across all speculative bubbles. A bubble's lifecycle generally goes something like this (in chronological order):

1. Valuations inexplicably begin to rise, but this increase generally goes unnoticed. In the early stage of bubble environments, however, the rate of increase eventually begins to accelerate, and more investors do eventually begin to take notice. No single trigger for the accelerated increase is ever identified. Shiller describes this phenomenon as a sort of "feedback loop"[1] in that the resulting "sound" is so different from the trigger that the trigger can no longer be discerned.
2. A few investors begin to make outsized returns, but the majority believes the opportunity has been missed and future returns will normalize.
3. Existing investors continue to make outsized returns and more investors enter the market which further increases demand, thus price. At this point theories begin to develop in order to justify the current price and prospects for future increases.
4. Retail investors begin to enter in mass with little knowledge other than the fact others are making a lot of money. They perform no analysis of their own, but readily accept simple stories. Historically, these stories have included justification such as:
    - **South Sea:** company had developed a strategy to earn enormous profits in the south sea (although no one knew exactly what that strategy was!)
    - **Mississippi Land:** controlled trade with China and East Indies, excited about possibility of finding gold and silver in the Mississippi territory
    - **Panic of 1796-97:** wary of currency, land speculation became the investment of choice
    - **Roaring '20s:** prohibition of alcohol will increase productivity
    - **Tronics Boom of '59-'62:** space age has ushered in a new economic era
    - **The Nifty Fifty of the 1970s:** nothing is as safe and certain as a blue chip stock
    - **'79-'80 Gold:** runaway inflation will persist and the fiat monetary systems of the developed world are doomed
    - **1980s Japan:** Japan will become the world's leading industrial powerhouse
    - **1990s Tech:** the internet will increase productivity
    - **2000s Housing:** increasing population, low unemployment, "they aren't making any more of it", real estate is safe because it's tangible

Anatomy of a Speculative Bubble (cont'd)

5. Economists begin to debate the validity of competing theories and current prices, but it's difficult to argue about a "true value" when the market is actually paying high prices.
6. Leverage continues to increase as the last investors enter. Some investors betting against the bubble cannot afford to maintain their short positions and fail (recall that "short selling" is a bet that valuations will fall, but until a short sale is closed there will be interest charges as well as collateral calls if valuations continue to rise.) The financial failure of "doomsayers" and their seemingly false predictions further bolster bubble investor confidence.
7. The media marches out "experts" that have made unbelievable returns. Ads will target even the smallest of investors. Most everyone is euphoric and not able to comprehend the possibility of a decline.
8. Suddenly and inexplicably prices begin to fall. A few very lucky investors manage to sell. The rest are left with the proverbial falling knife. Some hold onto optimism for quite some time, but ultimately capitulate. Others that borrowed to invest are forced to sell by their creditors (or simply walk away from their investment).
9. Panic ensues and the market crashes well below its true value. Patient investors are faced with opportunity, but most everyone is fearful and reluctant to invest. This fear causes many to lock in their losses toward the market bottom by moving to cash.
10. Markets begin to recover, but retail investors are skeptical and most remain on the sidelines.
11. Markets "normalize" and many retail investors eventually re-enter with their locked-in loss amount after the market has rebounded handsomely. Some investors never return.
12. Eventually, most everyone seems to have an explanation on why the bubble should have been obvious. With this newfound knowledge and wisdom they will surely never fall victim again.
13. Repeat

We must accept the fact that bubbles will happen in the future and we will not be able to detect them while they are happening. Everyone around us will be making money, the future will look gloriously bright, and economists will be arguing theories.

So what to do? Develop a sound portfolio management process and do not become distracted. Most investors invest according to intuition, thus largely emotion. They tend to shun recent losers and buy recent winners (essentially a buy-high sell-low strategy). Instead, a portfolio should be constructed with asset class targets designed to address all risks in a way that's commensurate with the investor's risk tolerance and time horizon. Disciplined rebalancing to those targets will cause the investor to rebalance down rapidly increasing areas where bubbles might be forming.

Anatomy of a Speculative Bubble (cont'd)

Measurement helps greatly, but thorough and objective analysis is very difficult. Therefore most people tend to make financial decisions based on emotion and/or intuition (for more on this see: *Thinking Fast and Slow*, Kahneman).

An objective analysis may look something like this:

1. Does the potential investment have characteristics anticipated to improve the risk/return profile of my portfolio as a whole?
2. Does the potential investment have current earnings which justify its current price or must earnings improve?
3. If earnings must improve to justify the current price, how much must they improve? Is the rate of necessary future growth a realistic expectation?
4. Has the analysis objectively considered all risks? Have I injected emotional or intuitive biases into the analysis?
5. Has the analysis considered relevant historical data?

So, are there any speculative bubbles currently? I don't know, but as with several other newsletters I will once again turn to gold. Related directly to the steps listed above I provide a brief example analysis:

1. Does the potential investment have characteristics anticipated to improve the risk/return profile of my portfolio as a whole?
   Possibly. When currencies and civilizations have collapsed in the past, gold has held value. Gold has also managed to keep up with inflation over very long periods of time, but not consistently over shorter periods of time. The correlation of gold to other asset classes is erratic at best.
2. Does the potential investment have current earnings which justify its current price or must earnings improve?
   No, gold earns nothing and for all intents and purposes has no industrial use. Its price is based on what someone else will pay for it, nothing else. Historically it's always been worth something, though.
3. If earnings must improve to justify the current price, how much must they improve? Is the rate of necessary future growth within prudent expectations?
   Since gold does not produce income, a modified analysis is needed. The question becomes: How much does gold cost to produce? The all-in average cost to produce an ounce of gold is about $1,000 which includes recent spikes in exploration and mine development costs made possible by miners' recent excess profits (See: Barrick's 2012 Annual Report, for example). Thus the cost of producing gold is still well below its current market price.

Anatomy of a Speculative Bubble (cont'd)

4. Has the analysis objectively considered all risks? Have I injected emotional or intuitive biases into the analysis?

   The risk of currency and civilization collapse during our lifetime, though possible, is slight. A gold position would likely stand up well in such an event, but if that unlikely event does not occur, then there should be a backup plan (i.e., diversification). Further, governments around the world can enact policies that could affect gold demand, but such policies are not predictable. For instance, India, the world's largest consumer of gold demanding approximately 25% of world supply, recently increased taxes on gold imports (and they are considering a second round of tax increases) to curb domestic demand for imported gold. What happens to the US gold price should the Indian government be successful in stalling demand for gold imports? A lot of people have recently profited handsomely from gold, but some have suffered catastrophic losses. Many have held gold for decades, and only recently begun to see positive real appreciation of their investment. Gold is alluring to me, but I am aware of its history, speculative nature, and cost of production; and I will base my investment decisions on those objective measures, not emotions.

5. Has the analysis considered relevant historical data?

   From the time Sir Isaac Newton set the gold price in 1717, gold prices remained virtually unchanged until 1914 when many industrialized nations relaxed the "gold standard" to pay for WWI. Starting in 1934 and ending in 1974 the US government fixed the price of gold at $35/oz. For much of this time the Bretton Woods system was also in place. Simply put, there really isn't good historical gold price data until 1974. For the post 1974 period, however, gold has remained largely flat and has not served well as an inflation hedge until its recent price run up. Since 1974 gold underwent what appears to have been a speculative bubble during its incredible run up from 1978 until its peak during 1980. From the 1980 peak to the 1982 trough, a dramatic loss of approximately 56% occurred. If a dramatic loss has happened before, it can certainly happen again. If catastrophic global financial calamity does not ensue, one would expect the price of gold to retrench toward or below its cost of production, which would be a dramatic loss.

This exercise should show there's no easy answer here. Speculation about civilization collapse, currency collapse, government debt, money printing, who will be president, etc. all appeal to our emotional brains. We've got to constantly pull ourselves back to objective analysis using the facts we *know*. Otherwise you'll likely get fooled into participating in the next speculative bubble.

Anatomy of a Speculative Bubble (cont'd)

All this said, if you want to invest in gold, *just do it,* but do it knowing you may lose big. Gold, after all, hasn't always gone up, and it's not out of the realm of possibilities for it to come crashing down from current levels. As with all investing, it is and had always been wise to diversify.

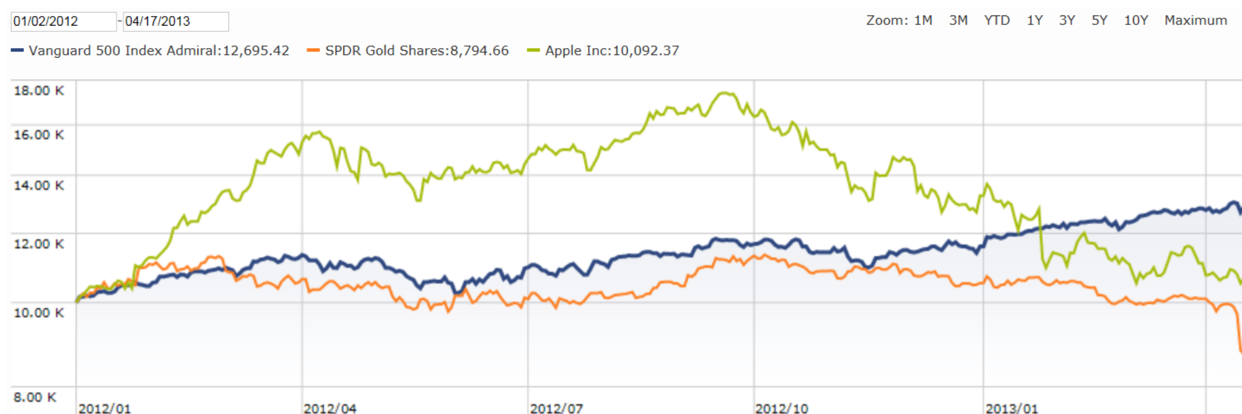
Believe me, no. I thank my fortune for it,
My ventures are not in one bottom trusted,
Nor to one place; nor is my whole estate
Upon the fortune of this present year:
Therefore my merchandise makes me not sad. (1.1.41-45)
~ Shakespeare, *Merchant of Venice*

A final note on speculative bubbles: Even if you do detect a *real* speculative bubble, it's unwise to try to profit from it. Speculative bubbles can last for many years, sometimes decades. In the meantime, those betting against a bubble have ongoing carrying costs that can cause them to go broke well before the bubble bursts. After John Maynard Keynes was wiped out betting against what he believed to be a bubble, he famously said, "The market can stay irrational longer than you can stay solvent."

A Tale of Two (bubble-ish) Investments

Throughout 2012 it was a struggle for me to keep several people from becoming overly distracted by gold and Apple (AAPL). Both were trading at historic highs, and this caused many investors to discount the true risks involved with investing too much in either. I was successful in most cases, but the few that proceeded with investing imprudent amounts now find themselves wanting.

Here is a chart of S&P500 (as measured by VFIAX), gold (as measured by GLD), and AAPL from 1.2.2012 through 4.17.2013:



Source: www.morningstar.com

A Tale of Two (bubble-ish) Investments (cont'd)

Other than diversifying risk, my reasoning for not loading up on gold & AAPL was quite different for each. Fundamentally, gold appeared to be trading at bubble prices. In mass, gold investors seemed to forget that the price of gold *can* fall dramatically as it has in the past. AAPL, however, was trading at prices that seemed justified by its then current fundamentals. The problem with current fundamentals, however, is they're *current*. If AAPL failed to generate consistently high revenues, its fundamentals would quickly fall apart. Given AAPL's intense competition and the fact that consumers are so darn finicky, the likelihood of AAPL maintaining and growing market share is slim. When the price of an investment is persistently high (as it was with gold and AAPL), though, these arguments sound flimsy to those relying on their emotions and intuition. It's not easy to argue for prudent investing while everyone around us is getting rich!

The arguments for overweighting gold and AAPL consistently went like this:

- <u>Gold:</u> Governments around the world are printing more fiat money and going deeper into debt. This will cause currency collapse and inflation. The only true hedge against such a financial Armageddon is gold, and even if that doesn't happen (which it will) gold is the only asset that has consistently held its value.
- <u>AAPL:</u> I own Apple products and so do most of my friends. We love AAPL! AAPL dominates the market and will continue to grow their market share. They're the most innovative tech company in the world. AAPL also has an "ecosystem" while their competitors don't. Once in, customers will find it hard to leave (but they won't because everyone will love AAPL products just like I do!).

These are compelling stories. Especially so when gold and AAPL were trading at all-time highs. The trouble is that they are very simple stories aimed at explaining an extremely complex set of interrelationships. As humans we are wired to gravitate toward these stories because actually analyzing an enormous data set is *physically* exhausting and the inevitable ambiguities analyses reveal are quite *emotionally* unsettling.

A Tale of Two (bubble-ish) Investments (cont'd)

By way of example I present two fictional companies: Greatco & Lameco, which have the following attributes:

Greatco	Lameco
mature company	mature company
household name	private label firm that few have heard of
innovative	hasn't produced a new product in decades
consistent earnings and growing	consistent, but relatively flat earnings
many competitors, but has consistently led the pack	very few competitors
pays dividends	pays dividends
regularly talked about in the media as a "star"	only spoke of in specialized trade journals
1-year return: **27.8%**	1-year return: **1.3%**

Given a choice, which is the more attractive investment? Be honest.

Here we have easy-to-understand simple stories about two companies, but little more than a starting point for actual analysis. The fact is most retail investors base their financial decisions on simple stories, and most financial advisors have learned to prey on that weakness. You should be smarter than that. I've learned to keep the following *facts* in mind while actually analyzing *any* company:

- Simple stories *never* suffice
- A great company can be a lousy investment
- A lousy company can be a great investment
- All value is eventually derived from current and future net earnings
- What we don't know can hurt us
- The future is always uncertain
- Diversification is always prudent

Is it possible to pay too much for Greatco even though its simple story is quite compelling? Yes. Is it possible to purchase Lameco at a bargain price even though its simple story is pretty lame? Yes. Would any real-world investors make important financial decisions based on having as little information as provided for these two fictional companies? Yes, most actually make their decisions with even *less* information. Be smarter and remember that simple stories *never* suffice!

Where gold and AAPL go from here is anyone's guess. The current price of gold is still well above the cost to produce it, so if financial Armageddon does not occur, I would expect the price to continue its fall back toward the cost of producing it. If AAPL is able to leapfrog its competition once again, I'd expect its value to increase from here. If competition remains fierce and AAPL continues to stall out, expect further declines. As always, the only prudent solution to these vast unknowns is *diversification*.

In Closing

On a fundamental basis, equities around the globe now appear fully priced. This does not mean that they should be abandoned, however. Given the low interest rate environment, bonds are fraught with interest rate risk so thinking of them as a panacea would be misled. The dividend yield on global large cap equities remains a bit higher than the general interest rate on intermediate term investment grade bonds, and continued global economic improvement would improve corporate earnings, thus fundamentals. The combined effects of corporate dividends and continued economic improvement would cause stocks to have a higher anticipated long term return than bonds, though volatility in the short term will no doubt persist. Therefore, investors should continue to maintain an appropriate mix of stocks and bonds even though bonds will likely produce flat or negative real returns over the next several years.

Remember: *Develop a financial plan according to your unique situation and manage your investment portfolio according to a well thought out and documented investment policy. Doing so will greatly increase the probability you will actually meet your financial goals.*

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This letter is intended to address broadly defined financial planning issues. If you need assistance developing a wealth management program tailored to your unique situation, then seek the assistance of a fee-only NAPFA registered financial advisor who is also a CERTIFIED FINANCIAL PLANNER™ professional having the proper education and experience. Consult with your tax advisor before implementing a particular tax strategy.