QUARTERLY NEWSLETTER

April 14, 2014

Market Commentary:

Although the first quarter of 2014 ended with most equity asset classes strongly positive, as of the writing of this letter only US REITs and now Emerging Markets, remain so.

On a fundamental basis US equities, appear to be fully priced. US Small Cap Growth stocks (which I do not generally recommend) appear especially heady as do US REITs. Foreign equities, on the other hand, continue to be relatively attractive on a fundamental basis.

Below are the returns of major market indices as of March 31, 2014. 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]	1.81%	21.86%	14.66%	21.16%
US Small Cap Value Index[1]	3.46%	24.70%	14.61%	26.26%
Foreign Developed Market Index[1]	0.54%	17.36%	7.15%	15.98%
MSCI EAFE Small Cap Index[2]	3.36%	23.10%	9.40%	21.70%
MSCI US REIT Index[1]	9.98%	4.28%	10.65%	28.67%
Emerging Markets Index[1]	-0.13%	-2.65%	-3.33%	14.15%
Barclays Capital US 3-7 Year Treasury Bond Index[2]	0.73%	-1.37%	3.02%	2.84%
Barclays Capital US TIPS Index[2]	1.95%	-6.49%	3.50%	4.91%
Barclays Capital U.S. MBS Index[2]	1.59%	0.02%	2.76%	3.57%
Barclays Capital U.S. 5-10 Year Corporate Index[1]	0.21%	-0.01%	0.03%	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.

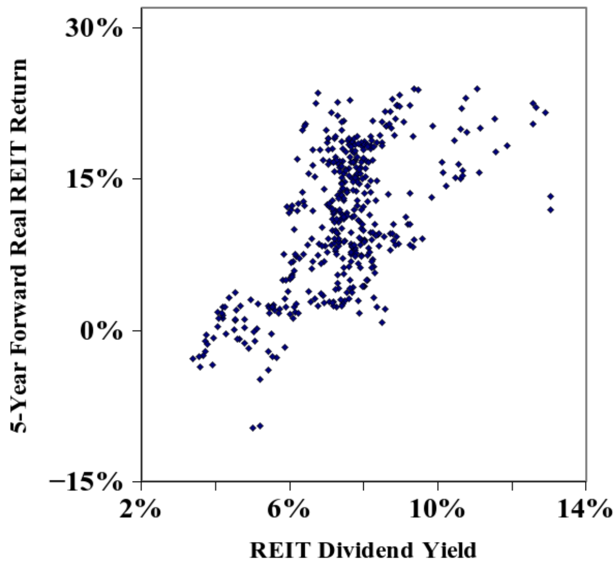
As you can see from the table above REITs have been on a tear this year, and remain so as of today. If we take a closer look, this may be cause for concern, however. In order to derive Expected Return (ER) going forward we can use the fairly simple formula:

ER = dividend yield +/- dividend growth +/- speculative return

The broad-based dividend yield of REITs is currently 2.8%, over the last 41 years real dividend growth has been a negative 1.6% (using NAREIT dividend and St Louis Fed inflation data), and to get back toward the historical dividend rate of 6% we'd need a negative annual return of approximately 7% over the next ten years. This leaves us with the fairly depressing expected return of:

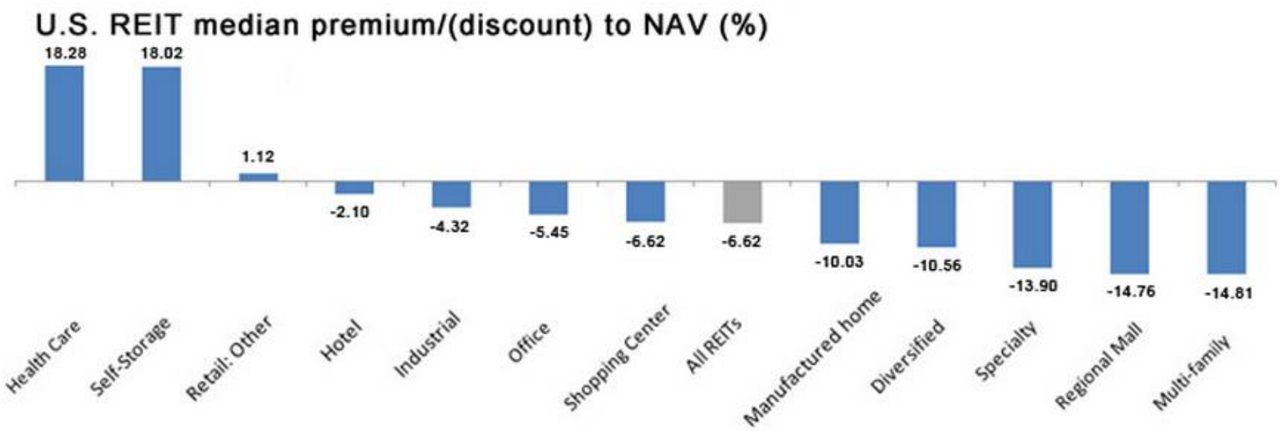
ER = 2.8% - 1.6% - 7% = $\boxed{-5.8\%}$

The graph below, using historical data from 1971-2012, tells a similar story. That is, when REIT dividend yields have been low, subsequent returns have been low and visa versa. This relationship should come as no surprise because the pattern is persitent across various equtity asset classes and reflects the fact that the market swings broadly around fundamental valutions.



Source: William Bernstein

Another way to look at valuations is to compare what the underlying assets are worth compared to the market price of the companies that own those assets. You'll notice from the graph below that "All REITs" are currently trading at a discount to the value of the property they own.



Source: SNL Financial

I believe that the answer is not to attempt to time markets, however. Asset classes such as REITs are introduced into portfolio to provide the benefits of diversification. Will rents and vacancies improve at rates higher than historical average? Is real estate currently overpriced when measured against the market price of owner companies? It's highly unlikely that any equity class will provide the same level of return as has been achieved over the past 5 years, so expectations going forward should be tempered, but even at current seemingly high valuations REITs should not be abandoned.

Dimensional
DIMENSIONAL FUND ADVISORS LTD.

Dimensional Fund Advisors

As I've mentioned in previous communications Dimensional Fund Advisors (DFA) recently approved me as an advisor with access to their funds pending my attendance at their Santa Monica conference at the end of this month. Given DFA's strict adherence to academic process and commitment to those that invest with them, I'm proud to be in the minority of advisors that are able to offer DFA Funds.

Over the next couple months I will develop more detailed communication, adjusted model portfolios, and client specific recommendations, but in this newsletter I will provide a broad overview. You may also find *New York Times* and *CNN Money* articles about DFA of interest.

DFA People – Board of Directors

Dimensional Fund Advisors LP (management company) –

- David Booth, Chairman & co-CEO
  - Co-founder of DFA in 1981
  - Namesake of The University of Chicago Booth School of Business
- Prof. Eugene Fama, Director & Investment Policy Committee
  - Professor of Finance at University of Chicago Booth School
  - Widely recognized as "father of modern finance"
  - Developed the efficient market hypothesis
  - Award Nobel Prize in Economic Sciences in 2013
  - With Prof. Ken French, won the 1992 Smith Breeden Prize for "The Cross-Section of Expected Stock Returns" in the *Journal of Finance*
  - Author of two books, published more than 100 articles in academic journals, and the winner of many awards in finance and economic sciences
- Prof. Kenneth French, Director and Director of Investment Policy
  - Professor of Finance at the Tuck School of Business at Dartmouth College
  - Expert on the behavior of security prices and investment strategies
  - Former faculty of MIT's Sloan School of Management, Yale School of Management, and University of Chicago Booth School of Business
- John McQuown, Director
  - Worked with David Booth to develop the first institutional index funds at Wells Fargo in the early 1970s
  - First Chairman of the Wells Fargo Investment Advisors (now Barclays Global Investors)
- Edwardo Repetto, Director, co-CEO & Chief Investment Officer
  - PhD in aeronautics from California Institute of Technology
  - MSc in engineering from Brown University
  - Brings statistical, scientific, and technological expertise to the science of portfolio management

DFA People – Board of Directors (cont'd)

Dimensional US Mutual Funds[1] –

- David Booth, Chairman
- Prof. George Constantinides, Independent Director
    - Professor of Finance at University of Chicago
    - Has been a Marvin Bower Fellow at Harvard University and taught at Carnegie Mellon University
- Prof. John Gould, Independent Director
    - Professor of Economics at University of Chicago
    - Member of the faculty of the University of Chicago Booth School of Business since 1965 & dean of the school from 1983-1993
- Prof. Roger Ibbotson, Independent Director
    - Professor in the Practice of Finance at Yale University
    - Founder of Ibbotson Associates, now a Morningstar Inc. company
    - Chairman & CIO of Zebra Capital Management, LLC
    - Co-author of the annually updated book *Stocks, Bonds, Bills, and Inflation*, which serves as the standard reference for information on investment market returns
- Prof. Edward Lazear, Independent Director
    - Professor of HR Management and Economics at Stanford Graduate School of Business
    - Recognized as labor economist and founder of a field known as personnel economics
    - Served as chairman of the President's Council of Economic Advisers and worked for the White House from 2006-2009
    - Senior fellow at Hoover Institution from 1985-2002
    - Former Professor of Urban and Labor Economics at University of Chicago
- Prof. Myron Scholes, Independent Director
    - Professor Emeritus of Finance at the Stanford University Graduate School of Business
    - Co-originator of the Black-Scholes options pricing model
    - Received the Alfred Nobel Memorial Prize in Economic Sciences in 1997
    - Chairman of Oak Hill Platinum Partners and a managing partner in investment groups of the Robert M. Bass organization
    - Former Professor of Finance at the University of Chicago
    - Has taught at MIT Sloan School of Management
- Edwardo Repetto, Director
- Prof. Abbie Smith, Independent Director
    - Professor Emeritus of Accounting at University of Chicago
    - Coeditor of the *Journal of Accounting Research*

DFA Philosophy –

- Driven by research, process, and data; forward looking and [ready to adapt] as new objective evidence arises
- Markets work – a complex network of information, expectations, and human behavior drive security prices to fair value
- Management that strives to beat the market by taking advantage of pricing "mistakes" and attempting to predict the future too often proves expensive and futile
- The futility of speculation means that security prices are fair and that persistent differences in average returns are explained by differences in average risk
- Returns are explained by risk factors
    - Equity factors
        - Market – stocks have higher expected returns than fixed income
        - Size – small company stocks have higher expected returns than large company stocks
        - Price – lower-priced "value" stocks have higher expected returns than higher-priced "growth" stocks
    - Fixed income factors
        - Term – longer term instruments are riskier than shorter-term instruments
        - Credit – instruments of lower credit quality are riskier than instruments of higher credit quality
- Diversification is an essential tool available to investors
- Asset mix determines most of the performance in a diversified portfolio
    - Investors choose asset classes to play different roles in a portfolio
    - Appetite for risk guides asset allocation
    - In general, the greater the proportion of stocks a portfolio holds, especially small cap and value stocks, the more "aggressive" is its risk and the greater is its expected return

DFA Process –

- Believes that, in liquid markets, prices reflect all available information
- Focuses strategies on dimensions of higher expected returns
- Seeks to add value through portfolio design and implementation
- Portfolios are based on rigorous academic market research
- Equity inclusion according to DFA eligibility rules
    - Market capitalization
    - Price-to-book ratio
    - Must exhibit general characteristics of the defined asset class
    - Must have sufficient liquidity for cost-effective trading
- Once an equity is included, places priority on efficiently managing portfolio turnover and keeping internal trading costs low

Why DFA and what might it replace?
DFA is driven by academic research and sound process. DFA has a long and proven track record of adhering to philosophy, adjusting processes when new convincing objective data comes to light, and looking out for the people and institutions that invest with them. Taken together, these are the fundamental attributes I look for in an investment manager.

I see DFA's main strength being their ability to successfully and efficiently gain exposure to two dimensions of equity investing: *small* cap *value* stocks. Funds like the Vanguard Small Cap Value Fund ETF (VBR) are fine, but they must follow a strict mandate set by their commercial benchmark which reduces flexibility. This leads to a peculiar set of problems which I hope to remedy with a particular set of DFA Funds.

VBR follows the CSRP Small Cap Value Index. Though not horrible, the index simply defines small cap equities according to size, then splits them down the middle with one-half being growth and the other being value (VBR is the value side). The result of this splitting is VBR having a rather large median market cap ($3.0 billion versus $1.3 billion for the DFA Small Cap Value Fund I), it being rather "growthy" (price/book and price/earnings of 2.0x and 22.0x, respectively versus DFA Small Cap Value Fund I's of 1.4x and 16.5x, respectively), and it owns an overlapping positions of Real Estate Investment Trusts (REITs) which have been shown to have attributes unique enough to necessitate their own separate asset allocation target (Currently, I must adjust for the overlapping "problem" as best as I can).

Index funds must also fully replicate their index and rebalance as dictated by the index provider. This can be quite expensive, especially when dealing in small cap stocks because they are less liquid than large cap ones. Since DFA is not mandated to follow an index they have greater flexibility when trading. For instance, DFA believes that it's more important to capture the systematic performance of broad market dimensions than the random fluctuations of any single security. This provides DFA with the ability to be flexible and patient when adding and removing securities from portfolios. In other words, a small cap manager following an index accepts increased trading costs in favor of tracking while DFA does not.

Finally, the DFA US Small Cap Value Fund I (DFSVX) actually has more individual securities than VBR (1,239 versus 799), it does not add initial public offerings (IPOs) as are generally mandated by indexes (note that IPOs have historically been a losing proposition when taken as a whole, even when including the likes of Microsoft and Google), and DFA now takes into account the dimensions of momentum and profitability so they won't eject a stock from a portfolio just because a company's market cap begin to exceed a certain size.

I will also likely recommend the DFA International Small Cap Value Portfolio I (DISVX) as a replacement for the Schwab International Developed Small Cap ETF (SCHC). The reasons here are largely the same as with replacing VBR, but SCHC has also been somewhat of a disappointment. In spite of Schwab's record of generally tracking mandated indices, they've failed to adequately do so with SCHC. This is likely due to faulty sampling methodology since the SCHC does not follow a full replication strategy. DISVX, on the other hand, has a proven track record of following their mandate back to December 29, 1994.

The final DFA Fund that I might eventually recommend is the DFA Emerging Markets Portfolio I (DFEMX), though the reasoning is somewhat different. Yes, the fund is dimensionally more "valuey" and "smaller" than the Vanguard Emerging Markets Index (VWO), but it also limits the amount of exposure to any one country. In emerging markets land I find this fairly compelling in and of itself.

Through my due diligence process I did consider other alternatives to DFA. The potential alternatives I considered include Schwab's Fundamental Funds, Invesco Poweshares FTSE RAFI portfolios, and various WisdomTree, Guggenheim, and Bridgeway Funds. I was unable to settle in with any other them due to a variety of reasons including concerns over fund size, expenses, processes, philosophies, and track records. These fund families do remain on my watch list, however.

The DFA Funds are not without potential downsides. These include:

- DFA Funds do have higher expense ratios than the Vanguard and Schwab ETFs, but these expenses are offset by securities lending income of which DFA returns all to the funds (which is rare in the mutual fund world). Therefore, when looking at the expense ratio know that it's actually lower than stated due to the securities lending revenue offset which tends to be rather high when dealing in less liquid small cap stocks.
- The Small Cap Value premium may not persist into the future. There is an economic theory which says that once a "free lunch" is found, it goes away. Though I have no way of knowing whether or not the small cap value premium will persist, I believe it's a risk story and not a "free lunch" story. I also know that the premium has been found around the globe, and was not only found as described in the 1992 Fama and French *Journal of Finance* paper, but was also found in real-world performance after DFA implemented. One must also realize that taking on risk means taking on risk, however, so adherence to the small cap value risk story can and often does take patience.
- It is expensive to trade in DFA Funds. For many clients the cost of trading in DFA Funds will be prohibitive. Since Schwab (and most other custodians except 401k plans) charge approximately $50/trade, the minimum trade I will likely recommend will be north of $25k.

Taken as a whole I anticipate that the addition of DFA Funds (where it makes sense) will improve the risk/return characteristics of portfolios. DFA follows sound processes rooted in stringent academic research and is overseen by some of the most respected academics in the industry. Though you may decide that DFA is not right for you, I will tell you that I will personally be one of the first ones to invest once DFA funds become available to me and my clients. Looking forward, access to DFA Funds will become available to me early May 2014, with specific client recommendations to be delivered during late May-June 2014 timeframe.

[1] The “Dimensional US Mutual Funds” refer to The DFA Investment Trust Company, DFA Investment Dimensions Group Inc., Dimensional Investment Group Inc. and Dimensional Emerging Markets Value Fund Inc.

Recent Improvements

Over the past several months I have allocated significant resources toward enhanced security and reporting of client financial data. What follows is a summary of those improvements.

<u>Physical Security of Office Space</u> - During March 2014 I significantly enhanced the physical security of my office space. Up until March my office space was secured by a security system that would detect a breach of structure either by doorway or window. That security system has now been fully integrated with property perimeter surveillance so that:

- Any movement on exterior property is detected and immediately reported via phone messaging as well as audible alert within the office space
- All exterior space is monitored and continually recorded by a state of the art video surveillance system
- Video surveillance can be monitored either in-space or remotely via phone or iPad
- Potential intruders can be viewed and spoken to remotely via phone or iPad
- External alarm and emergency light can be triggered remotely via phone or iPad
- Any breach of the structure is reported via phone messaging and audible in-space alarm
- Any breach of the structure is now reported via phone messaging as well as audible in-space alarm

As chance has it, two days after the new video surveillance system was installed an officer from the Tacoma Police Department specializing in the recovery of crime scene video came into my office space to review the new system. The officer informed me that my system was among the best she has seen. This feedback obviously gave me comfort in my decision-making process. Though the cost of implementation was high, I believe the additional layer of deterrent and security was worth the price.

Citrix ShareFile Service – During July 2013 I subscribed to ShareFile so that:

- Sensitive electronic documents can be shared securely over the internet
- Clients can also share sensitive electronic documents with other service providers such as their tax preparers
- Clients can securely store copies of sensitive documents such as Wills, Powers of Attorney, and Health Care Directives
- Documents such as Health Care Directives can be securely retrieved from anywhere in the world at any time
- The power holders of clients can contact me in case of emergency so that I can retrieve their health care documents and/or powers for them, if needed
- Clients can securely retrieve sensitive data from anywhere in the world at any time using mobile ShareFile applications

For more information, explore the full capability of ShareFile by clicking here.

Blueleaf Data, Reporting, & Client Interaction Service – During February 2014 I subscribed to Blueleaf's client portal so that:

- Client investment accounts can be consolidated and viewed in one convenient place by logging on here
- Web-based live reporting portal that includes balances, performance, allocation, and detailed holdings information is made possible
- Clients can collaborate with family members and other advisors as they wish (settings allow clients to control what others have access to and control over)

For more information about Blueleaf's features click here.

Blueleaf has not been without its challenges, however. The first issue has been with security questions. That is, after adding an account to Blueleaf the client must resubmit the answers to security questions as prompted over time. Then, once every security question has eventually been answered, Blueleaf should be able to access the account data without further action by the client.

The second issue is that of a "connection failed" message. If you receive this message then:

1. Try re-entering your credentials – remember that the username and password you enter should be that of the account you are attempting to link and not your Blueleaf credentials
2. If re-entering your credentials does not work you should email Blueleaf support at: vipsupport@blueleaf.com or call them at 877.882.5287
3. If neither #1 nor #2 above work, you should contact me ASAP. Blueleaf is expensive and still on a trial basis, so if they do not adequately deliver I will not hesitate to cancel the contract if problems cannot be resolved.

In Closing

The world of remains an inherently risky place: The Federal Reserve seems to be waffling on their guidance and indicators; the U.S. and European allies have perhaps the most strained relations with Russia since the Cold War; once shining emerging markets countries like Turkey and India have again shown how inherently risky emerging markets can be; bond yields, though increasing at the longer end of the yield curve, still remain very low; and let's not forget about other challenges like the ones facing Greece, Cyprus, and the Euro-zone, in general.

Patient and disciplined investors have been rewarded handsomely over the past several years, and even though returns going forward will likely be much less than we've experienced recently, there's no evidence that prudent and thoughtful portfolio management will underperform market timing and speculation going forward.

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.*

Troy

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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.