Quarterly Newsletter

July 2015

CAPITAL MARKETS UPDATE | Troublesome headlines of potential debt defaults by Greece and Puerto Rico rattled markets at the end of the quarter. On average, equity markets declined 2% to 3% in June and largely offset handsome gains through May. The major equity markets finished the quarter with essentially break-even returns (U.S. Large Cap +0.3%, U.S. Small Cap +0.4%, International +0.6%, Emerging Markets +0.7%). Bond yields pushed higher across the globe as deflationary fears ebbed and investors anticipated the start of the Fed's rate hike cycle. Both the U.S. (-1.7%) and global bond markets (-1.2%) posted losses for the quarter. Interest rate sensitive Real Estate performed the worst (-10.0%) while Commodities rebounded (+4.7%).

BEHAVIORAL FINANCE REVIEW | This quarter's newsletter concludes a three part series focusing on behavioral finance and the implications and opportunities for investors. As review, behavioral finance theorists dispute that markets are efficient and that current prices fully reflect all relevant information (as the traditional text books purport). Numerous studies observe that cognitive and psychological biases contribute to emotional (a.k.a. irrational) financial decisions that produce inefficiencies in market pricing (periods when market prices differ from "fair value" based on the underlying fundamentals).

In January, we discussed the large impact investor emotion may have on asset prices and market cycles. How we feel about an asset often depends on how it has recently performed. The years 2013 and 2014 certainly tested our patience and discipline as U.S. Equities massively outperformed Foreign Equities (cumulative returns of 50.3% and 11.3%, respectively). History reminds us to stay diversified, especially when it seems we need it the least.

In April, we dug a bit deeper to examine the role of investor emotion in forming and perpetuating trends in asset prices. The resulting price inefficiencies from the sequence of initial anchoring and under-reaction to herding and over-reaction are an opportunity for disciplined investors. A managed futures strategy employs quantitative algorithms to profit from enduring price trends. The strategy tends to be an excellent diversifier given its ability to deliver positive returns in both rising and falling markets with historically low correlations to stocks and bonds.

This quarter, we complete the discussion with three additional strategies to exploit market inefficiencies and improve long-term risk-adjusted returns.

REBALANCING | While easy to execute, rebalancing is emotionally uncomfortable. The reason: it requires that we trim what has made us the happiest (done the best) and buy more of what has disappointed us the most (done the worst). It's much more comfortable to stay with or add to "what is working" and be a part of the crowd (herd). However, as prices change, so do asset valuations, which are a key driver of future returns. The dark side of bull markets is that extraordinary current returns tend to reduce future returns as relentless price increases overvalue the underlying fundamentals and create unrealistic expectations (this time is different). The bright side of bear markets is the mirror image as price declines tend to improve expected returns as despondent investors undervalue the asset. Accordingly, to benefit from the normalization (mean reversion) of asset valuations, it is sound strategy to reallocate dollars from assets with dimmer prospects to those with brighter prospects.

The current darling (S&P 500) and goat (Emerging Markets) of the global equity market offer valuable historical perspective on the prudence of diversification and rebalancing. Consider a robotic portfolio strategy that invested in a 50/50 mix of the S&P 500 and MSCI Emerging Markets indices at the beginning of 1988 (the earliest common data for both) and annually rebalanced to the 50/50 target no matter what happened along the way. The chart on the next page depicts the June 30, 2015 value of a one dollar initial investment. With perfect foresight, it would have been tempting to solely invest in Emerging Markets since it beat the S&P 500 by such a large amount. Note, however, that the diversified portfolio outperformed both of its component assets—rebalancing is the reason. Note also that the risk (standard deviation of returns) of the 50/50 mix is much lower than that of the Emerging Markets portfolio it beat.

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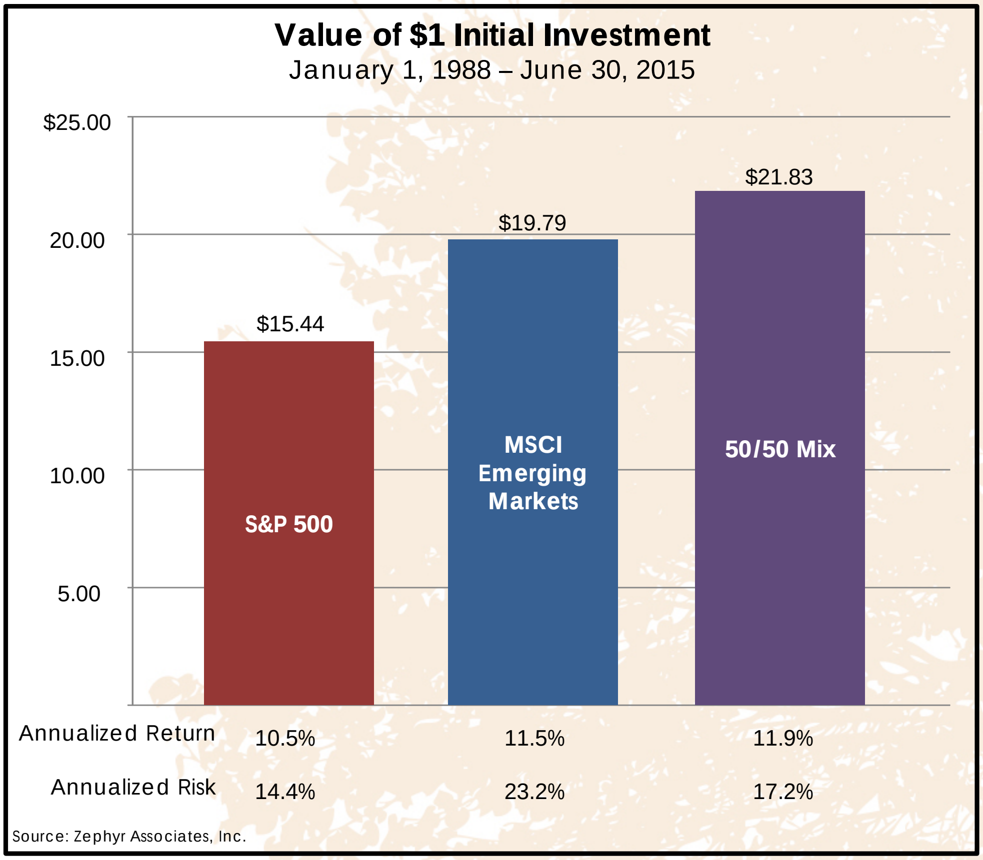
FUNDAMENTAL INDEXING | Rebalancing across asset classes is a widely accepted and time tested discipline—what about rebalancing within an asset class? Robert Arnott and his colleagues at Research Affiliates delivered groundbreaking research in 2005 that proposed an alternative approach to cap-weighted indexing. Rather than link a stock's weight in the index with its price (which swings with the emotions of investor sentiment), base it on fundamental factors like sales, cash flow, dividends and book value...and rebalance annually. The intuition is straightforward: only increase (decrease) a company's weighting if its fundamentals have strengthened (weakened) relative to those of its peers.



Fundamental indexing trades against the episodic swing of investor emotion—it systematically rebalances away from the fads and bubbles and embraces the most feared and loathed industry sectors/ companies when sentiment reaches extremes. The rational anchor in volatile markets is the fundamental scale of each company in the index. Since traditional cap-weighted indices (S&P 500, Russell 1000, etc.) only weight each company based on its market value and have no rebalancing mechanism, the composition of the index inevitably drifts with the relative popularity of each stock.

Arnott's research concluded that U.S. investors in the Research Affiliates Fundamental Index (RAFI) index have an opportunity to beat the cap-weighted index by 2% per annum over the long haul. Early critics claimed that RAFI was just another value index that captured the historical outperformance of value stocks vs. growth stocks (over the 35 ½ year history of the indices, Russell 1000 Value beat Russell 1000 Growth by an annualized 1.2%). The first ten years of live data suggest otherwise. As summarized in the chart on the next page, the FTSE RAFI US 1000 outperformed the Russell 1000 and Russell 1000 Value and matched the performance of the Russell 1000 Growth during a period when growth beat value by 2% per year.

How did RAFI do so well when growth dominated value? It rebalanced! While a fundamental index typically favors value stocks, the value tilt is dynamic over time due to annual rebalancing. In 2005-2008, the value tilt was small since the index rebalanced out of value stocks that had outperformed since 2000. After value stocks were savaged in the 2008/2009 market collapse, the index aggressively rebalanced into these out of favor companies and established a much deeper value tilt. The market handsomely rewarded these uncomfortable rebalancing trades. Looking out the windshield, it is reasonable to expect RAFI to outperform even more in a decade when value beats growth given its inherent value tilt and dynamic rebalancing.

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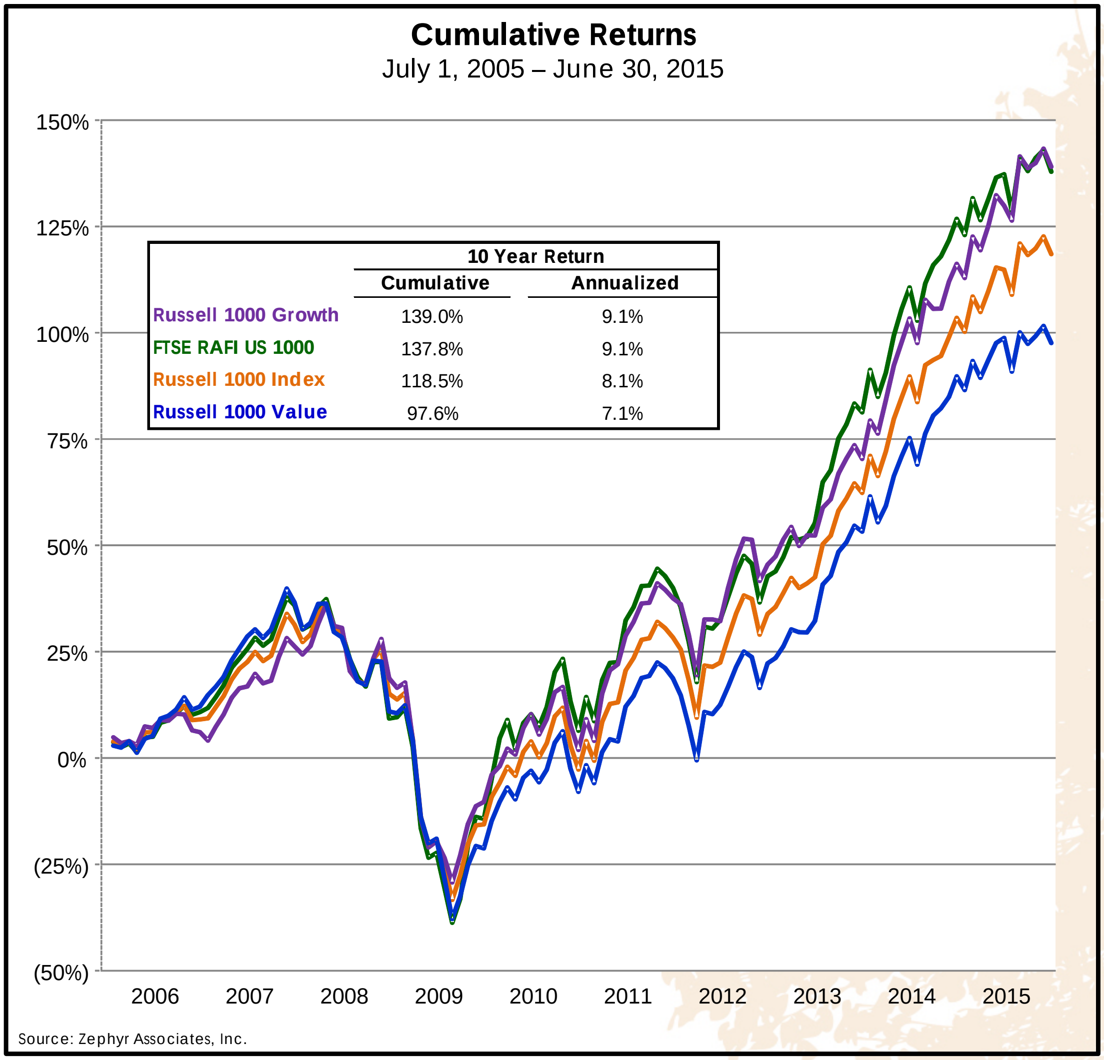

	10 Year Return	
	Cumulative	Annualized
Russell 1000 Growth	139.0%	9.1%
FTSE RAFI US 1000	137.8%	9.1%
Russell 1000 Index	118.5%	8.1%
Russell 1000 Value	97.6%	7.1%

MARKET NEUTRAL STRATEGIES | Market neutral strategies are another compelling way to exploit pricing inefficiencies. These strategies are attractive alternative investments and valuable diversifiers as returns do not depend on broad equity markets moving higher or lower. By design, the investor's net exposure to equities is zero, i.e., a "neutral" stance relative to the market.

As discussed above, over the long haul RAFI expects to earn an annualized return premium of approximately 2% in the U.S. vs. the cap-weighted index. Historical studies suggest the opportunity is substantially greater in foreign markets—the greater the pricing noise (volatility around fair value) the higher the return premium. A market neutral strategy, also known as "Long-Short," seeks to capture this net return advantage by investing in the highest conviction stocks in RAFI (Long) and neutralizing the overall equity market risk with an equal offsetting position in that country's cap-weighted index (Short). The investor's return is the net result of the RAFI portfolio return minus the cap-weighted index return. One may then diversify across a number of countries with a market neutral position in each country. As a truly alternative investment, the expected return has little to no correlation with global equities.

CONCLUDING THOUGHTS | By being students of behavioral finance, we may better recognize and temper the inevitable emotional swings that accompany our journey through volatile, cyclical markets. History reminds us that maintaining discipline has rewarded long-term investors at the expense of market timers and performance chasers. Indeed, we have opportunities to profit from the emotional biases of the crowd through rebalancing, fundamental indexing, managed futures (trend following) and market neutral strategies. As legendary value investor Benjamin Graham observed in his book The Intelligent Investor in 1949, "Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal."