Investment Commentary: 9/2014

Risk was back on for U.S. stocks in the month of August. The S&P 500 rose 4%, the biggest one-month gain since February. Small cap stocks (Russell 2000) moved back into the black with a gain of 4.96% in August and are now up 1.75% YTD. Among positive economic news, second quarter U.S. GDP growth was revised slightly upward to 4.2%, as consumer spending, business investment, and exports rebounded after a weak first quarter. Other closely watched economic indicators include housing data, which continues to be mixed, but showed some improvement in homebuilding and home sales, based on August data releases.

The U.S. economic recovery has been tepid, but seems to be further along than other developed markets. Evidenced by the fact that the Federal Reserve continues to gradually reduce its support, while central banks in Japan and Europe are committed to maintaining or even expanding their stimulus efforts. Global central bankers made headlines in August as they met in Jackson Hole, Wyoming, for their annual gathering. Federal Reserve Board Chair Janet Yellen's speech reaffirmed the Fed's assessment that with economic growth and employment improving, and in the absence of worrisome inflation trends, the Fed is comfortable reducing its bond purchases even as it expects to keep interest rates low for the foreseeable future. This outlook was also covered in detail at the Fed's July meeting. The minutes (released in August) acknowledged that growth and employment have improved quicker than anticipated, which could at some point require a sooner-than-anticipated shift in interest-rate policy. The pace and timing of the Fed's decisions on rates remains an area of uncertainty, with the market currently not expecting a move to tighten policy before mid-2015.

Developed international stocks were slightly negative in August, with the MSCI EAFE down -0.15%. Worries re-emerged about deflation and faltering growth in the eurozone; however, investors seemed to take solace in European Central Bank President Mario Draghi's remarks at Jackson Hole, which affirmed the ECB's commitment to using "all available instruments" to fight deflation. Speculation was high that the ECB would announce additional policy actions during its September meeting, and European bond yields fell in anticipation. Japanese stocks declined slightly as a spate of short-term economic data disappointed. Emerging markets remained positive for the month, largely due to strong performances in Latin American markets Brazil and Mexico.

Continuing the year's trend, core bonds also rose for the month—the Vanguard Total Bond Market ETF was up 1.1%—as U.S. Treasury yields fell. The benchmark 10-year Treasury closed the month at 2.34%, down from 3% at the end of 2013. Global bond yields in other developed markets are very low, which may be one factor driving investors toward the relatively higher yields offered in the U.S. market. It is also the case that ongoing geopolitical tensions, which flared up in Ukraine during the month, may prompt flight-to-safety buying, with Treasuries as a beneficiary. After a weaker patch midyear, high-yield bonds have bounced back, rising 1.5% in August.

Research Highlights

Here is a quick rundown of some interesting research we reviewed during the month and thought was worth passing along to our readers.

Defining and Measuring Risk

We have a short-list of investors, that when they share their investment thoughts, we consider it a must-read and Howard Marks is definitely on that list. Marks is the Chairman of Oaktree, a firm that specializes in credit securities, and regularly writes an investment memo that is available on his website. His most recent memo focused on the topic of risk, some of the highlights are shared on the following page.

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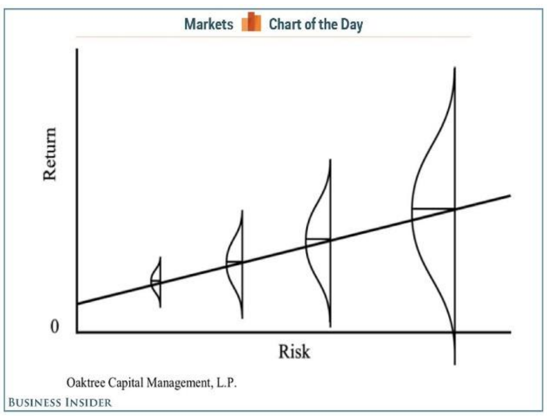
Volatility or standard deviation has become the widely accepted definition of risk in the industry, mainly because it is quantifiable and easily used in calculations. However, volatility (or fluctuations) really isn't a big problem for investors that can ride it out and come out the other side. The real concern for investors is (or should be) the permanent loss of capital. The challenge for investors becomes how to position a portfolio for future developments, when the future is unknowable. Traditional thinking suggests that if you want to get better returns you have to take more risk. But, of course, if riskier investments could be counted on to produce higher returns, they wouldn't be riskier. A better way to think about risky investments is shown in the chart below.

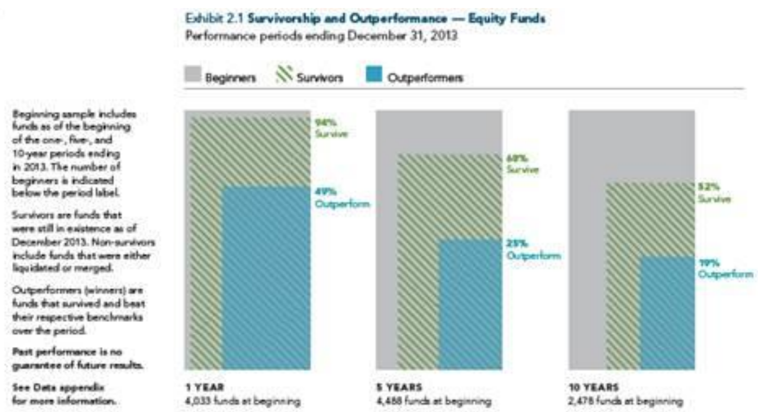


The chart illustrates that, yes, potential returns can increase with risk, but so does the range of potential outcomes. In other words, the greater the risk and reward potential, the greater the potential for actual returns to deviate from expectations. Meaning that expected returns may rise with risk, but so does the probability of lower returns, and even losses. Intelligent investors will pursue prospective returns that compensate them for taking the risk of negative future outcomes.

For those that want to read the whole memo (recommended) you can find it here: www.oaktreecapital.com/memo.aspx

A Case of Disappearing Funds

Dimensional Fund Advisors (DFA) recently published a study of mutual fund performance that had some eye-popping statistics. The chart below shows the number of equity mutual funds that outperformed their



respective benchmarks over multiple time-frames and the number of funds that survived over those same time-frames. The number of funds that outperformed their benchmarks over the different time-frames is astoundingly low, and progressively got worse the longer the time period. However, the "survivorship" numbers are even more surprising, with only 52% of funds surviving over the 10 year period ending 12/31/13. Both the low outperformance and survivorship statistics are damaging evidence that the mutual fund industry is more interested in churning out products than producing quality results for investors. For more information on the DFA study, click here http://goo.gl/lZW6Lo

The Average Investor

Lastly, the chart below was posted by Richard Bernstein and highlights the performance of the "average investor" over a 20 year period relative to the popular benchmarks and asset classes. The results are based on the buying and selling activity of mutual fund investors, and the conclusion is clearly marked on the chart (his words, ***not ours***!). Based on the study, the average investor has had terrible long-term investment results; mainly because they are too "emotional" when managing their investments, buying at the peaks and selling at the bottom.

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To help our readers avoid being the "average investor" we are sharing our list of investment rules to follow. These rules have been developed over decades of experience and are at the heart of our investment process, guiding the decisions we regularly make. Following these rules has helped us stay focused in our investment approach and deliver good results. We hope you find them useful as well.

AWM's rules for investing success

1. Focus on executing your process, not short-term results
2. Asset allocation is the most important decision
3. Markets will tend to mean revert over time
4. Volatility is a friend to the long-term investor
5. Contrarianism works when markets are at extremes
6. Don't be emotional investor, know your strengths & weaknesses, have a plan
7. Admit mistakes - sell your losers and let the winners grow
8. Valuation wins in the long-run
9. Costs matter
10. Risk cannot be avoided, be decisive when opportunities arise
11. Wall Street is not your friend - avoid hype and complexity
12. Avoid intellectual arrogance, it is the enemy of good decision making

We appreciate your confidence in us and we will continue striving to be good stewards of the capital we manage on behalf of clients. If you have any questions on this commentary or if we can be of service in any way, please don't hesitate to contact us.

—AWM Investment Team (9/14)