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INVESTMENT ADVISORS

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OUR INVESTMENT PHILOSOPHY IN A NUTSHELL

With respect to the management of investment portfolios, we believe the following:

SOME BASIC PRINCIPLES

1. The most important principle upon which to premise an investment philosophy is recognition of the fact that "there is no free lunch." All investing involves trade-offs. For every perceived reward, there is some associated risk—whether perceived or not. Hence, it is incumbent upon every investor, tempted by the potential rewards of any investment, to ascertain the nature and magnitude of the risks involved. To assume that such risks do not exist, just because they are not readily apparent, may be an invitation to disaster.

2. A common characteristic of most <u>successful</u> investments, investment portfolios, and investment programs (as with insurance products and estate plans) is their <u>simplicity</u>. An investment product or program that is not easily understood is probably not one that is more desirable, but rather is one for which the risks and costs are merely less <u>visible</u> than the benefits.

INVESTMENT OBJECTIVES AND POLICIES

3. There are only three investment objectives capable of being achieved and, so, worthy of pursuit:

   A. Staying out of irretrievable trouble—which is most likely to be accomplished by owning high-quality securities and being broadly diversified.

   B. Participating in the markets or market sectors appropriate to the individual's investment time horizon and personal tolerance for risk and volatility.

   C. Accomplishing the foregoing in as efficient a manner as possible in terms of minimizing taxes and not paying for services which add little or no incremental value to the investment process.

4. High-quality and diversification in an investment portfolio serve a purpose similar to that of fire insurance on a house. We carry fire insurance, not because we "expect" our house to burn down. We carry it because, if we do not have it, and our house does burn down, we may not be able financially to recover from the catastrophe.

   Similarly, "high-quality" and "diversification" serve the purpose of "insurance" in an investment portfolio. They provide some degree of protection against an economic, monetary, or market calamity which we cannot foresee and do not expect, and which we might not otherwise withstand, or from which we might not otherwise recover, without the added protection, should such a calamity come to pass.

5. It is useful to draw a distinction between "risk" and "volatility" in the securities markets. If "risk" is defined as the possibility of experiencing a decline in the value of one's investments from which one cannot recover, it should probably be minimized for most people. If "volatility" is defined as the normal fluctuations to which all securities markets are subject, it must be endured, if the rewards bestowed by those markets are to be enjoyed.

6. For most people, the time horizon for their investment portfolio planning probably should be longer than they initially think. The attainment of retirement age is hardly a logical point at which to modify one's investment policy. At the very least, one should plan for a period covering one's life expectancy, and married couples should plan for a period covering their joint life expectancy. The life expectancy of an individual age 65 is 20 years, and the life expectancy of the second to die of a couple, each age 65, is 25 years. If one expects to bequeath a portfolio to one's children and hopes that they will pass it on to subsequent generations, the time horizon for investment planning, for all practical purposes, becomes infinite.

7. Investment objectives are meaningfully expressed only in terms of investment time horizon and tolerance for risk and volatility and not in terms of desired return. Everybody desires a maximum return but should expect to earn no more than what the markets in which they are invested bestow.

8. We feel that investment in common stocks can be justified if the individual believes that there is at least a 50% chance that the money so invested will not be withdrawn for other purposes over the subsequent 5 years. Historically, the probability of such an investor's realizing a positive return on his money over this investment time horizon, with even a randomly selected, unmanaged list of stocks, has exceeded 97%.

9. A good investment policy is one that never changes with changes in market conditions. An investment policy should change only with a major change in one's investment time horizon and/or a change in one's personal tolerance for risk and volatility, which tolerance, for most people, will probably not change throughout their lifetimes. In other words, a suitably formulated investment policy for a particular investor should probably never change throughout that investor's lifetime.

MARKET TIMING

10. We participate in markets; we do not try to outguess them. Market timing is a futile activity. The most successful investors, over time, are those who remain 100% invested at all times.

11. The evidence is overwhelming and incontrovertible that even the highest paid professionals are unable to predict with an accuracy of better than 50% such factors as short-term moves in the market, onsets of recessions or recoveries, changes in the direction of interest rates or foreign exchange rates, or changes in the rates of inflation. Therefore, such considerations should remain irrelevant to both the formulation of an investment strategy and the timing of investments or disinvestments. One should put money in the market when one has it to put, and withdraw it from the market when one wants to use it for something else. There should be no other timing considerations.

12. Because, for all practical purposes, the securities markets are efficient, the concept of employing a "professional money manager" to try to time the markets, rotate from market to market, or sector to sector, or to buy individual securities when they are undervalued and to sell them when they are overpriced is an exercise in futility. In this sense, there are no such "professional" money managers and, so, paying for such a service is counterproductive, serving only to reduce one's overall total return.

ASSET ALLOCATION

13. Except in cases where prohibited by law (as with certain trusts where income beneficiary and remainderman interests conflict), investors should utilize the "total return" concept of investing. This means that, for investment selection, performance evaluation, and spending purposes, they should draw little distinction between income derived from interest and dividends and income derived from growth of principal.

14. The best estimates anybody can make about future rates of inflation and future rates of total return are simple extrapolations of past long-term rates of inflation and long-term rates of total return. In this regard, the best historical measures we have cover the 90-year period 1926 through 2015 and are as follows: inflation, 2.9%; cash, 3.4%; U. S. Government bonds, 5.6%; corporate bonds, 6.0%; large capitalization common stocks, 10.0%; and small capitalization common stocks, 12.0%.[1]

15. The differences between historical rates of return among the various asset classes are not random events. They are based upon a fundamental principle of capitalism that, for the system to attract investment capital, the greater the uncertainty of the <u>timing</u> of one's rewards, the greater must be the <u>magnitude</u> of those rewards. For this reason, it seems reasonable to extrapolate historical differentials into the future.

16. The most successful investors are those who maintain broadly-diversified portfolios of the common stocks of high-quality, growth-oriented companies in unregulated (non-utility) industries.

SECURITY SELECTION

17. A good investment is one that represents the simple direct ownership of man-made, value-added, productive resources (plant, equipment, organization, patents, copyrights, trademarks, franchises, and human talent) as opposed to claims on mere commodities (precious metals, the commodities futures markets) or artificially created and/or leveraged risks (derivative securities such as common stock and interest rate options).[2]

18. If, when, and as possible, it is far more efficient to own securities outright, rather than indirectly through the mediums of so-called "packaged products" such as mutual funds, exchange traded funds, or variable annuities.

    Over the 25 years ending in 2014, the average owner of equity mutual funds earned 7.71% less per year than the average shareholder invested directly in a randomly selected and unmanaged list of U. S. stocks. For the average owner of a mutual fund invested in long-term U. S. Government bonds, the shortfall over the past 25 years, relative to a randomly selected, unmanaged list of long-term U. S. Government bonds, has been 2.50% per year. For the average owner of a mutual fund invested in foreign stocks, relative to the U. S. stock market, the sacrifice has been 9.83% per year over the past 25 years.[3]

19. Above-average current yields on investments are indicators of less desirable investments. High current yields indicate low-quality and a likelihood that the current yield is unsustainable, a low-likelihood of any significant improvement in future performance, or both.

20. <u>Foreign</u> investing is best accomplished, and real estate investing is effectively achieved, through the ownership of the common stocks of <u>domestic</u>, operating companies. A typical portfolio of high-quality, growth-oriented U. S. companies derives about 40% of its sales and profits from overseas operations, and about 40% of U. S. corporate assets consist of real estate. The ownership of foreign securities or real estate investment trusts to participate in these two market sectors is both unnecessary and inefficient.[4]

21. Initial public offerings (IPOs) should be avoided. Those that turn out well are generally unavailable or in very limited supply; while those that turn out poorly are generally marketed aggressively because of otherwise inadequate demand. The result is that the investor who participates in the IPO market ends up with little of the former but much of the latter and, so, below-average market performance with IPOs in general.

PORTFOLIO MONITORING

22. Except to accommodate a particular income tax or diversification objective, the decision of whether a specific security in a portfolio should be held or sold generally should not be predicated upon the behavior of its "price" while it has been in the portfolio. If the securities markets are "efficient," which for all practical purposes we believe they are, the "current" price is the only "correct" price. The decision to hold or sell should, then, be based upon an assessment of whether or not the company's quality and potential for earnings growth continue to conform to the standards established for the portfolio, irrespective of the price of the stock.

23. Most high-quality companies that stumble eventually pick themselves up and get back on track again. For such companies, the question of whether to hold or sell becomes one of whether or not one wants to wait out the "turnaround time." If the turnaround time is apt to be too long, it is probably better to trade the stock for one that appears currently to have its act together and to be able to keep it that way for a while.

24. Though an important consideration, the tax on a gain, if realized, should not necessarily be a barrier to the sale of that security. Historically, just a randomly selected, unmanaged list of common stocks has accrued capital gains at an average rate of 7.9% per year; for growth portfolios, the rate has been considerably higher. If, on average, one realizes gains at a rate less than the rate at which one accrues gains, securities become "locked in," and it becomes increasingly difficult to adapt the portfolio to the standards of diversification, quality, and potential for growth that optimize the investor's longer-term interests.

PORTFOLIO ADVISORS

25. Legitimate roles for a portfolio advisor are the following:

    A. To help the client view his investment portfolio in the broad context of his overall individual circumstances and aspirations, with special consideration being given to appropriate income tax, retirement, and estate planning objectives.

    B. To help the client (1) identify an appropriate investment time horizon over which to plan; (2) assess his personal tolerance for risk and volatility; (3) become acquainted with the rates of return historically available with alternative investment policies, and the degree of risk and volatility historically associated with each; and (4) structure a diversified portfolio of securities that conforms to his personal investment time horizon and tolerance for risk and volatility.

C. To help the client monitor his portfolio over time to make sure that the individual securities in it continue to conform to the client's standards of quality and potential for growth and that the portfolio as a whole remains reasonably well-diversified.

D. To provide the client with a perspective with which to assess his ongoing performance which, for any short period of time, may differ dramatically from expected longer-term results. Though disparagingly referred to as "handholding," this function is vitally important for most clients, if they are going to continue to be successful investors. On a cruise ship, in the middle of the ocean in a violent storm, even the most experienced traveler, if he is to travel that way again, may need reassurance from the captain that the vessel is not leaking, that the engines are still running, and that the ship is, in fact, still on course.

CONCLUSION

The foregoing statements are more <u>what</u> we believe than <u>why</u> we believe it. We attempt to explain the bases for many of these beliefs in other, more detailed dissertations, which we shall be happy to make available upon request.

Clifford G. Dow, ***CFA, ChFC, CFP®***
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[1] Sources: Ibbotson Associates, *Stocks, Bonds, Bills and Inflation* and Thomson Reuters, *Investment View*

[2] The *Wilshire 5000 Total Market Index* is regarded as the most compressive index measuring the performance of the entire U. S. stock market and the "equal weight" version of this index is used here as a proxy for a randomly selected, broadly diversified, and unmanaged portfolio of U. S. stocks. Over the 25 years ending 12/31/15 the average annual rate of total return, as measured by this index (16.38% per year), has exceeded the average return on gold (3.96%) by 12.42% per year and it has exceeded the return on silver (4.92%) by 11.46% per year. Sources: www.wilshire.com and *Thomson-Reuters Investment View*.

[3] The *Barclays Long Government Bond Index* is used here as a proxy for a randomly selected and unmanaged list of long-term U. S. Government bonds. The measures of mutual fund performance used here are the *Thomson Financial* "All Equity Mutual Funds," and "All Non-U. S. Equity Mutual Funds."

[4] Over the past 25 years, the average annual total return on the U. S. stock market (16.38% per year) has exceeded that of the *Morgan Stanley World Equity Index ex the USA* (5.99%) by 10.39% per year, and has exceeded that of the *Wilshire Real Estate Investment Trust Index* (11.73%) by 4.65% per year.