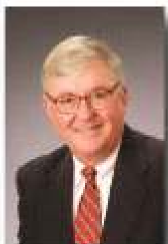
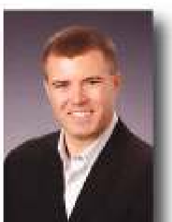
Second Quarter 2014

Investment Thoughts

This Issue





Dear Client,

Happy summer! We're just glad the weather finally decided to catch up to the calendar… Hopefully the slow start gave you plenty of time to compile your wish list of activities and the extra motivation not to waste a single sunny day.

Over the years we have often invoked the words of Warren Buffett while sharing nuggets of investing wisdom with you. So imagine our surprise to come across an article decrying the "Oracle of Omaha's" insights! In this quarter's featured selection (page 2), author Brian Portnoy criticizes Mr. Buffett's advice to his wife's future Trustee (from the 2013 Berkshire Hathaway annual letter) to invest primarily in a low-cost index fund. While we agree with almost all of Mr. Portnoy's comments and critiques of the strategy, overall this guidance is not at all controversial, and in fact is commonly accepted as sound strategy in the investment community. While the advice may not have been as "simple" as Warren claimed, did it really deserve the label of "bad" advice?

In the end, we concluded that the title of the piece was justified based on one simple standard: Warren Buffett doesn't follow it in his own life. This is a man who built his fame and fortune by "buying when others are fearful" and by "waiting for the fat pitch," not by blindly adhering to the index. In fact, Berkshire Hathaway has never paid a dividend to its shareholders because "it can put the money to better use" – in other words, beat the market. Warren's personal wealth is much more concentrated in Berkshire Hathaway than in the Vanguard 500 Index, so in essence he's recommending investors "do as I say, not as I do."

As your advisor, we just don't think that is right. How can we ask you to do something if we wouldn't be willing to do it ourselves? If you were to examine our personal portfolios, you'd notice a striking similarity to yours – the same active management mutual funds with the same emphasis on international and emerging markets equities. This willingness to "eat our own cooking" also holds true among our mutual fund managers, which is one of the many factors that gives us confidence in using their funds.

Perhaps most importantly, this strikes us as a "vote of no confidence" in Berkshire Hathaway's succession plan. We assume Mr. Buffett has devoted a great deal of time and energy toward finding a successor once he is gone, and yet he's instructing his own wife to direct her investments elsewhere? This is akin to Chris advising Peggy to use another advisor if anything were to happen to him. Let's just say Chris wouldn't be enjoying "Retirement Thursdays" as much as he is if that were remotely the case!

We realize that there is a lot of information out there, and that unfortunately much of it is more accurately categorized as "sales" rather than "advice." (See "Free Lunch" on page 3.) We do our best to be an objective source of information and expertise for you to turn to, and encourage you to do so whenever you have a question. And while the ultimate decision that is "right" for you depends on your individual goals and priorities ("do as I would do" doesn't always apply), we promise never to recommend a strategy/approach that we wouldn't be comfortable using ourselves if we were in your shoes.

Thank you for your continued trust,

Greg Rademacher, Chris Bugg and Jodie McLellan

"Buffet's Bad Advice
By: Brian Portnoy
Date: April 28, 2014

In the modern world of investing, complexity dominates. Thousands of difficult-to-assess choices present themselves, often with the perverse result of confounding us further rather than solving a problem. In response, the principle of "simplicity" is ascendant among advisors, fund managers, brokers, and authors.

But what counts as simple? Unfortunately (and ironically), the answer is elusive.

Having recently authored a book on why we have so much choice, why it's so overwhelming, and what to do about it, the most common response I've received from readers is along the lines of: Come on, just buy an index fund that tracks the market and be done with it!

Indeed, the vast majority of funds are actively managed and many show little sign of beating their bogeys for any meaningful period of time. So go passive and worry about something else in your life you actually have control over. Indeed, no less a luminary than Warren Buffett has frequently advised we do just that. In Berkshire Hathaway's 2013 annual letter, for example, Buffett wrote:

My advice … could not be more simple: Put 10% of the cash in short-term government bonds and 90% in a very low-cost S&P 500 index fund. (I suggest Vanguard's.) I believe the trust's long-term results from this policy will be superior to those attained by most investors – whether pension funds, institutions or individuals – who employ high-fee managers.

Clearly, investors have listened to Buffett, Vanguard founder John Bogle, and other indexing prophets. Morningstar recently highlighted the current "bull market" in passive investing, especially in equities. In the decade from 2003 to 2013, the percent of U.S. equity assets that were indexed doubled from 17% to 35%. That more than one-third U.S. equity fund investments sit in passive vehicles speaks volumes to the popularity of this approach.

The trend is clear. But the question remains: Is going passive the "simple" (and by implication, smart) approach?

Not necessarily.

In 2014, buying "the market" is not even close to the simple answer than many investors assume it is. Let me offer several reasons why.

To start, I'll deliberately pay short shrift to the conventional approach to this topic, which is the age-old debate over active vs. passive approaches. This is a rabbit hole of data and arguments from which it is sometimes difficult to emerge. Thus, briefly, even in passive management's most hallowed ground – large-cap US stocks – there is compelling evidence that managers with appropriate fee structures can win out over time. The evidence is even stronger in small-cap, non-US (especially emerging markets), and fixed income markets.

Still, *even if* we grant that many active managers cannot beat their bogey over the long run, there are still ample challenges to the idea that indexing is "simple."

First, Buffett's advice flies in the face of the most basic principle in investing, which is diversification. While perhaps intended as shorthand for "go passive" rather than a prescription for parking most of your assets in large-cap U.S. stocks, the one-size-fits all solution hardly resonates as sound financial planning advice. As is well-understood and well-evidenced, exposure to lower-correlated assets produces more optimal portfolios, so venturing away from U.S. large caps to any number of other equity, bond, real estate, and alternative asset classes makes sense.

Second, index investors often assume that because they've bought "the market," they have necessarily diversified their holdings and thus mitigated portfolio risk. But that's clearly not true. A powerful example of this is that leading up to the 2000 bear market, around 29 percent of the S&P 500 was in technology companies, many of them overvalued. The numbers for the NASDAQ market at the time were even more extreme, and that market hasn't come close to recapturing its early 2000 highs. Likewise, leading into the 2008 crisis, a meaningful percentage of the S&P 500 was exposed to finance, housing, and mortgage related stocks – many of which contributed to a 37% drop in the overall market that year. Don't think that owning "the market" protects you from serious losses. It never has.

Third, the right way to define and invest in "the market" is evolving, rendering claims about simplicity tenuous. Keep in mind that the first index fund wasn't launched until 1971, and like any invented product, it has deliberate design features and potential flaws. Historically, most index funds have been market-cap weighted (i.e., the bigger companies have a bigger role in the portfolio), but that's not always a good thing, as the bear market losses over the last decade-and-a-half demonstrate. In fact, there are newer indexing approaches – sometimes described as "fundamental" or "smart" beta – which weight certain stocks or risk factors differently. There is evidence to suggest that these newer approaches are better. It may appear, years in retrospect, that we were indexing incorrectly for decades.

Finally, none of this indexing strategy immunizes an investor from its greatest risk: himself. Investors tend to buy high and sell low – exactly the opposite of a wise approach. As a result, it's painfully clear that the listed returns for funds far exceeds what investors actually earn. Index funds, just like actively managed funds, are highly volatile, which means they can induce just the same level of suboptimal behavior, which belies the somewhat folksy impression that indexing is simple. Those who believe the latter might sacrifice vigilance for complacency.

Are there worse paths to follow than just buying the Vanguard 500 Fund, or something like it? Of course there are. There are terribly overpriced and mismanaged funds that lard up too many portfolios. And it is hardly Buffett's or Bogle's fault that the marketplace has been inundated with choices, or that we are our own worst enemy when it comes to investing. That said, there is really nothing passive about "passive" investing. It involves a series of choices, some much more complicated in both financial and behavioral terms than the casual observer might recognize.

Free Lunch?

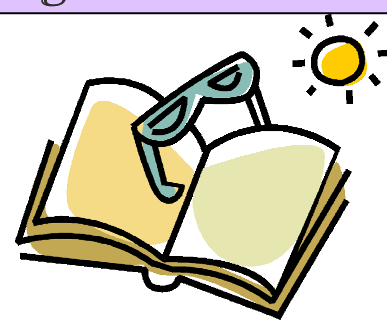
A couple of weeks ago, I received a flyer in the mail for a "complimentary dinner" – read "free lunch" – to discuss *Retirement Readiness* at Ruth's Chris Steakhouse. The invitation was quite formal, and the topics to be discussed sounded reasonable enough. They included:

1. Will your retirement income last as long as you do?
2. How will tax laws affect you?
3. What will be the impact of Obamacare now and in the future? (Red Herring alert!)
4. What steps can you take now to avoid future taxes?

But the more I thought about it, the more I realized this wasn't an educational seminar, this was going to be a sales pitch for an annuity. To test my hypothesis I brought the flyer to the office and offered it to Greg and Jodie. "Do you really want to go to an annuity talk?" they both asked.

The fact that I'm receiving these flyers means many of you likely are, too. And while we had enough experience (and cynicism) to see through the marketing this time, we have to admit a lot of what's out there catches even our attention. So by all means, go enjoy a steak dinner if you'd like; you may even be fortunate enough to learn a few things in the process. But if any of you have ever experienced the "free weekend getaway" offered by a vacation rental property (timeshare), you know the sales pitch that's more than likely waiting for you before you can go home. After all, you know what they say about that "free lunch"…

Summer Reading/Viewing



- Thomas Piketty - Capital in the Twenty-First Century
- Brian Portnoy - The Investor's Paradox
- Tim Geithner - Stress Test
- J. Brown and J. Macke - Clash of the Financial Pundits
- Michael Lewis - Flash Boys

Franklin Templeton Video on Loss Aversion:

https://www.franklintempleton.com/retail/pages/generic_content/home/splash_PUB/loss_aversion_and_golf.jsf

Yahoo Finance Video on Take Control of your Investing Destiny:

http://finance.yahoo.com/blogs/breakout/don-t-be-a-victim--3-ways-to-control-your-investing-destiny-195111753.html

If you have difficulty accessing the sites, please email linda@btnwd.com

Send Your Statements

You may have noticed you haven't received the latest Social Security Statement by mail.

They are now available online at SSA.gov/myaccount.

Please send us a copy when you have a chance to check it out online.

Also - State Employees: Please remember to send us your retirement plan statement when you receive it.

Care to save a tree?

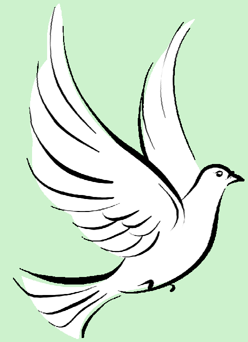
If you would prefer to receive our newsletter electronically, just let us know and we will send it via email each quarter.

Email linda@btnwd.com or call 608-827-6415.

Please also contact us if you would like information about online account access and/or receiving your statements electronically.

"I believe that through knowledge and discipline, financial peace is possible for all of us."

- Dave Ramsey



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