Perspective

August 2013 By Davis Riemer

DHR Investment Counsel, Ltd.
The Fine Art of Wealth Management

In this *Perspective*, we briefly review broad investment results in 2013, discuss more extensively an important comparison of two portfolios, touch on the need for care when using historical data, and then wrap it up with comments about an objective that is important to us at DHR - the continuing education of clients and their families about financial success.

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Pick a number, lay your money down and spin the wheel! Wow! Fun! One can say this unless the game involves serious money. The game is even less appealing when it is played with *your* money. Typically, most of us don't feel comfortable about such a form of gambling. Many view the financial markets as a gamble and in an ultimate sense, that view contains an element of truth. That truth emanates from the inherent uncertainty that shrouds our future. However, although we cannot make the future certain with financial planning, we can reduce the risk of making the "wrong decisions." Three things help us to do that: 1) Self-knowledge, as gained through an understanding of human tendencies when making decisions in the face of uncertainty; 2) Historical, empirical evidence, garnered through research; and 3) Finance theory and statistics, with which we can more correctly understand historical data.

These ideas are part of several sections of this issue of Perspective.

Reviewing investment results in 2013 through June 30.

One signal event, or non-event if you will, dominated the markets in the second quarter. Late in May, addressing Congress, Federal Reserve Chairman Ben Bernanke referred to the possibility that, in the future, the Fed might want to increase interest rates. However, other than words about a possibility in the future, there was no event. The identity of the speaker made it an event. Nevertheless, hyper-anxious market participants jumped into action. Market interest rates rose, bond prices fell and stock prices fluctuated more widely.

The S&P500 closed higher each month of the year through May. It fell 6% from the mid-May high to the mid-June low and then rose somewhat, closing down for the month, but up for the year. Influenced both by events in the U.S. and Europe, the EAFE index wobbled through mid-April, but rose sharply until late May. Then, following Bernanke's testimony, it plummeted in June to finish far below it's 2013 high.

The domestic equity portion of our portfolios performed well through this period. Our bias to value and small cap fell less and rose more than the broad market. However, our international funds, also emphasizing value, reflected the difference in concerns between the Europeans and us. Value did not do as well there. All in all, given the economic "event," market outcomes have occurred pretty much as expected.

Whether as a result of an event or only the perception of a possible future event, a moment we have waited for has arrived. Interest rates have moved up. What does that mean for your portfolios and what, if anything, should we do about it?

We can say that the "meaning" differs when separated between short and long term outcomes. For a long term investor, such fluctuations smooth out and fade away. An investor overly concerned with short term experience has little choice but to resort to anticipation and timing. No evidence demonstrates the reliability of those strategies. Frankly, this economy in general, as well as savers and investors in particular, need interest rates to rise above recent levels.

Investment Returns in 2013 through June 30 **Market Benchmarks and Sampled Funds**	**Fund Symbol**	**Total Return**
Investment Market Benchmark		
U.S. Stocks: Russell 3000	R3000	14.06
Investment Fund		
Vanguard Total Stock Market (US)	VTSMX	14.03
Vanguard S&P500 Fund	VFINX	13.74
DFA Large Cap Value Fund	DFLVX	18.00
DFA Small Cap Value Fund	DFSVX	17.73
DFA Core II (US)	DFTCX	16.13
Investment Market Benchmark		
Foreign Stocks: Europe, Australia, Far East	EAFE	4.47
Investment Fund		
DFA International Value	DFIVX	1.77
Investment Market Benchmark		
U.S. Bonds: Barclays Capital Gov't/Credit	B/C 1-3	0.02
Investment Fund		
DFA Two Year Global Bond	DFGFX	0.1
Vanguard Short Term Investment Grade	VFSUX	-0.5
DFA Five Year Global Bond	DFGBX	-1.2

Generating Income and Preserving Value: A Retirement Income Example

Many of our clients ask about income in retirement. How much can they safely develop from their portfolio? What role does investment allocation and selection play? What impact do costs have?

I recently received a study of two retirement income portfolios, one invested exclusively in Vanguard funds and one exclusively in DFA funds. The study was done by a professional colleague, Jeff Troutner, to whom we are indebted for both careful work and willingness to share. Both portfolios distribute income at 4% of starting principal, adjusted annually for 3% inflation over the 13 year period 2000 – 2012. Given the frequency and importance of questions from clients about this, it seemed like we should make the conclusions of this research available to you.

We did not anticipate the degree of difference that might be available to our clients, resulting from utilization of DFA funds. Our clients know that DHR invests in "passively managed" funds, with a "bias" towards value and small cap, and many know that both Vanguard and DFA meet those criteria. DHR manages portfolio costs diligently, yet generally, the DFA funds cost more than their Vanguard "equivalent." Do clients receive value commensurate with their costs? Setting aside for now the substantial value of the full range of advice and service that DHR delivers, let's look just at portfolio dollar value, through the perspective of a direct comparison study.

The comparison begins with the classic Vanguard "No Bet" portfolio of market cap weighted funds, divided 35% to bonds and 65% to stocks, with the latter divided 70% to domestic and 30% to international, with the domestic equity in the Vanguard Total Stock Market Fund and the international equity in the Vanguard Total International Fund. There is no advisory fee involved. Therefore, the only cost to the portfolio is the weighted average of the expense ratios of the funds, which is seven basis points, or 0.07%.

This was then set side by side with a portfolio invested 100% in DFA funds. Instead of "pure index" (market cap weighted) it emphasizes, although not exclusively, value and small cap stocks, to a greater extent than the market itself. Instead of three funds, it uses six. The domestic/foreign ratio is very similar. Last, the weighted average expense ratio for DFA is 35 basis points with an advisory fee of 100 basis points. Thus, the total expense comparison is 0.07% to 1.35%.

Here is the chart for the first comparison, to the "pure index," market cap weighted funds.

Comparing Two Retirement Income Portfolio Models
Both Distribute Income of 4% of Starting Principal
Adjusted Annually for 3% Inflation
Over the Priod 2000 - 2012

	Vanguard	**DFA**
Beginning Value	$500,000	$500,000
Total Income Withdrawals	$312,354	$312,354
Highest Value During Period	$499,346	$698,542
Lowest Value During Period	$344,211	$435,393
Number of Years Below Initial Value	13	4
Ending Value	$393,076	$604,659
Ending Dollar Advantage	n/a	$211,583

The foregoing discussion and chart, valid in many ways, needs to be accompanied by another. The superiority of the results of the DFA portfolio can be attributed to several things, one of which is the long-term higher expected returns from value and small cap, both of which have higher representation in the DFA portfolio. However, Vanguard also offers passively managed value and small cap style funds. The following chart displays both the Vanguard and DFA portfolios with the same "style bias."

There are numerous points that should be kept in mind as one studies the comparisons. The terms "value" and "small cap" – and even the term "passive" mean different things for the funds of the two companies. For DFA, "passive" does not apply to trading strategies, although it does apply to selection methods. The companies include different universes of small and value issues, relying on both theoretical and practical influences. While those distinctions probably do not matter to most of our clients, who rely on DHR to understand them, the differences in outcomes do matter. Rarely have we had a chance to see those differences displayed in this kind of context.

Comparing Two Retirement Income Portfolio Models
Both Distribute Income of 4% of Starting Principal
Adjusted Annually for 3% Inflation
Both Portfolios with Style Bias
Over the Period 2000 - 2012

	Vanguard	DFA
Beginning Value	$500,000	$500,000
Total Income Withdrawals	$312,354	$312,354
Ending Value	$536,956	$604,659
Ending Dollar Advantage	n/a	$67,703

However, even the similarity in "style bias" does not get at all the major differences. A critical difference results from the advisor's role – and the execution of rebalancing.

Since the small cap and value funds had more volatility during the thirteen year period, the DFA funds required more rebalancing, a function that was performed four times. When small cap and value funds were used in the Vanguard portfolio, the rebalancing increased from one time to three. Of all the incidents of rebalancing, the most critical came at the end of 2008, when the stock market had fallen over 37%. The following chart, "Illustrating the Effect of Rebalancing," shows the impact of rebalancing at that point in time.

In an earlier Perspective, we discussed some of the lessons we feel we learned when we re-examined those years. At one moment late in 2008, I felt truly as though I was staring into the void, facing a future black with uncertainty and risk. DHR evaluated re-balancing several times during those months but, all things considered, we chose not to do it. The stock market had fallen almost 40% in just a few weeks. Major manufacturers, brokerage firms, banks and insurance companies were failing with equal suddenness and the very ground upon which we rested trembled. When we sought to estimate the cost of being right and of being wrong in the action of rebalancing, we opted to forego the opportunity to seek profit and instead chose not to increase the capital at risk. We neither sold nor bought equity in a broad way. The accompanying chart on the impact of rebalancing is hypothetical, but it promotes good questions about investment objectives and execution. In partnership with each of our clients, we are constantly searching for the right balance between adaptivity and discipline. We do not regret our choices in this matter, but we value the education given us by consideration of the numbers shown here.

Comparing Two Retirement Income Portfolio Models
Both Distribute Income of 4% of Starting Principal
Adjusted Annually for 3% Inflation
Over the Period 2000 - 2012
Both with Value and Small Cap
Illustrating the Effect of Rebalancing

	Vanguard	DFA
Beginning Value	$500,000	$500,000
Vanguard Market Weight	$393,076	$604,659
Both with Style Bias	$536,956	$604,659
Style Bias WITHOUT 2008 Rebalancing	$506,000	$582,012

Mind Your P's and A's

When looking at historical data, one can often perceive correlation between events, such as, for example, between economic events and prices in the investment markets. It might seem that, when one event appears, so will the other. One might think that such correlation can be useful in making investment decisions. Indeed, so it might. Or not. Here's why: There are very clear correlations, such as interest rates and bond prices. Those relate by causation, not just correlation. However, another feature of data can mislead us. We can think we see such patterns in the data, when in fact they do not exist as persistent or repeating patterns. They exist as fleeting anomalies - mirage like, to the investor thirsty for predictive signals.

In a recent finance blog, I found a description of work done by a well respected financial researcher, who discovered that, using correlation statistics, he could predict prices on the stock market using only three variables. They were: 1) Cheese production in the U.S.; 2) Butter production in the U.S. and Bangladesh; and 3) Sheep populations in the U.S. and Bangladesh. Statistically speaking, he saw that these three variables had correlated with (and therefore "predicted") 99% of the U.S. stock market's movement. (His observations were apparently correct; his conclusion was intended as a joke).

We all know that correlation is not causation. I would add: correlation can be random. I would further add: Don't believe everything you think. As humans, we seek to identify patterns in our environment. Sometimes, this is survival oriented behavior, thus hard to resist. When an occurrence in our environment, or a configuration in the data looks like it did the last time we were wounded or hurt, we might, out of the desire for safety, tend to see correlation or even causation, even though it can be – like the above – mere accidental association.

If we see that certain historical events occurred in an associated way, we must ask: Is this a snapshot of an historical "moment," in which these events occurred randomly – even in a repetitive way? Or, is this an example of a repeating pattern of events, that we can reliably expect will recur, even if not constantly? The former is anomaly, the latter pattern.

Many investment strategies, and even more "market calls" (for rises or falls), emanate from an observation that a "pattern" has emerged. Whenever such an observation is published, researchers go to work to test its validity, by attempting to replicate the results in other settings. A strong profit motive accompanies the search. To date, very few have survived the tests of research or continued observation; we must therefore regard them as anomalies. Consequently, if you see an example of a currently circulating "pattern," remember to "Mind Your P's and A's."

On the other hand, here is a pattern one can identify and use to manage towards success –

the pattern of one's own behavior and decision making. Focus on the long term and on the reasons for doing so, follow neither fear nor greed, diversify with quality instruments and remain patient.

We recently created and examined a report of the age demographics of DHR clients. We found the range goes from seventeen to ninety-four. It encompasses students, grads, early employed, newly married, family raising, empty nesters, career-peakers, approaching retirement, retired, late retired – even those planning for their last days. It encompasses those who have children, those "sandwiched" between their children and their own parents, those caring for their elders, handling bereavement, and even handling estate asset distribution. Life is rich in variety. This way of understanding our clientele prompted us to think of the phrase "Seasonal Wealth Management." We want to analogize to processes that help one navigate through changing times, evolving needs, sudden occurrences and unexpected outcomes. The seasons of the weather bring such changes to us, in ever-ongoing ways. By analogy, we want to provide financial counsel and guidance through all the "seasons" of our clients' financial lives. Importantly, at DHR, we are working to develop our understanding of and thoughts about each of these times of life. Currently, as has been mentioned before in the *Perspective*, we are finding success bringing two or even three generations together to discuss various matters pertaining to finances. These matters are both financial and non-financial, e.g. values, purposes, hopes. We have found that parents often harbor deep feelings about their children's approach to money. At some point, however, the children will be in charge.

Two things have significant influence on us and on the next generation, regarding one's use of money. One is the matter of personal values and one is that of intellectual understanding. The former belongs primarily, though not exclusively, to family, but the latter can be promoted by outside influences. Certainly reading can help, but so also can dialog, particularly with informed parties.

We have touched on a number of matters in this Perspective that are important to a good understanding of how to handle money, once saved. Those matters include the importance of careful analysis, separation of variables, discernment of differences between patterns and anomalies in bodies of data, self-knowledge, the role of heuristic bias in otherwise rational decisions, the long-term value of discipline, etc. As we, purportedly rational adults, age through the seasons of our lives, we face these questions and matters in evolving ways. Furthermore, the next generation will begin anew, but not where we began. "No man can step into the same river twice." (Heraclitus)

At DHR, we seek to help our client families develop a constantly increasing understanding of personal, financial values as well as knowledge of finance.

DHR Investment Counsel, Ltd.
A Registered Investment Advisor

5435 College Avenue, Suite 200 • Oakland, California 94618 • 510.596.2580 • www.dhrcounsel.com