August 2014

Dear Friends and Family,

The first half of 2014 was a productive period for your investments. Global concerns such as the Russian annexation of Crimea, an aggressive extremist Sunni insurgency in Iraq, economic troubles in China, and an extremely cold and snowy winter in the U.S. did little to slow down the now five-year-old bull market in U.S. equities. The S&P 500 index recently broke 1,000 days without a 10 percent correction, the 5th longest streak in history. With this low volatility backdrop, US stock indices rose between 3 percent and 7 percent. Bond investments benefited from a benign inflation environment and lower interest rates spurred by central bank actions around the world.

Despite this ongoing strength in stocks, recent surveys show that the surge has bypassed many investors. According to Bloomberg National Poll, more than 75 percent of Americans say the bull market in U.S. stocks has had little or no effect on their financial well-being. This poll is consistent with investment fund flows, which show that approximately $600 billion have left equities since 2008. Thus, the data suggests that most investors have missed one of the greatest stock rallies in history. As a result, a number of pundits have dubbed the current rise in equity prices “the most hated stock rally of all time.”

The typical investor’s shortcomings are a result of the lack of a long-term financial plan and an overemphasis on emotion in decision making. In this letter, we will review some of the most important principles of managing a long-term investment program.

CRASH DIETS & CRASH INVESTING

“I want to lose weight by eating nothing but moon pies, which have significantly less gravity than earthier foods such as fruits and vegetables.” -Jarod Kintz, Author

It’s long been joked that losing weight is a true American pastime, since about 30% of the population claims to be on a diet at any given time. Many dieters vainly go from one fad to the next. Although a substantial change in a nutritional regimen may be effective in the short-term, it is estimated that only about five percent of people are able to keep the extra weight off over time.

The inability to achieve long-term weight loss through quick fixes lies in the way our bodies are biologically wired to adapt to different kinds of stresses. On July 4, 1936, endocrinologist Dr. Hans Selye published a paper in the journal *Nature* titled “A Syndrome Produced by Diverse Nocuous Agents.” This paper provided the biological framework for athletic training and conditioning as we know it today.

Selye’s theory suggests that radical changes to dietary routines can overwhelm the body, causing it to adapt in unexpected ways. By way of example, many crash diets suddenly restrict caloric intake. The body senses that there are fewer calories being ingested, kicking it into “starvation mode” by taking those fewer calories and turning them into fat. When a dieter starts eating

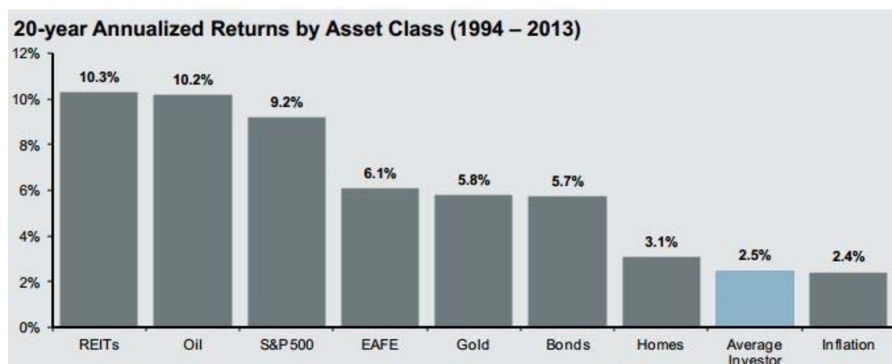
"normally" again, the body has already set itself to a lower level of calorie burning, and weight is gained back faster than it was taken off.

This wiring has implications for the way we approach investing and think about managing money. Many investors take a crash diet approach to their financial planning. They jump from fad to fad looking for a quick return, instead of establishing a thoughtful and long-term plan to build financial assets. We all know people who take action after hearing about a "hot stock tip" or make major portfolio decisions because "they saw something on television."

Crash dieting seldom works, and neither does crash investing.

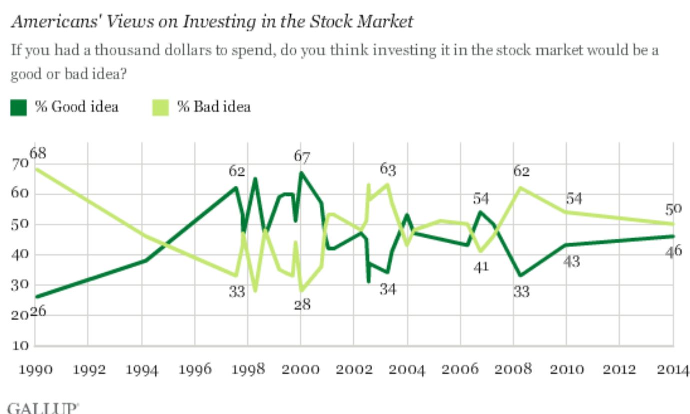
Research has indeed shown that the average investor has a dismal record when it comes to investing. Dalbar, a financial market research firm, analyzed mutual fund purchases and sales over the past twenty years and computed that the average investor's annualized return from 1994-2013 was 2.5% - a return that barely beat inflation over the same period.

Chart 1



What has driven the poor performance? Investors may only have themselves to blame, as demonstrated by an annual Gallup poll that measures investor sentiment. In 2000, for example, when stock prices were high and valuations were stretched, 67 percent of Americans thought it was "A good time to invest in the stock market." In contrast, during the market turmoil of 2008-2009, when stocks were at their cheapest since the Great Depression, only 33 percent of Americans thought it was a good time to invest.

Chart 2



A BETTER APPROACH

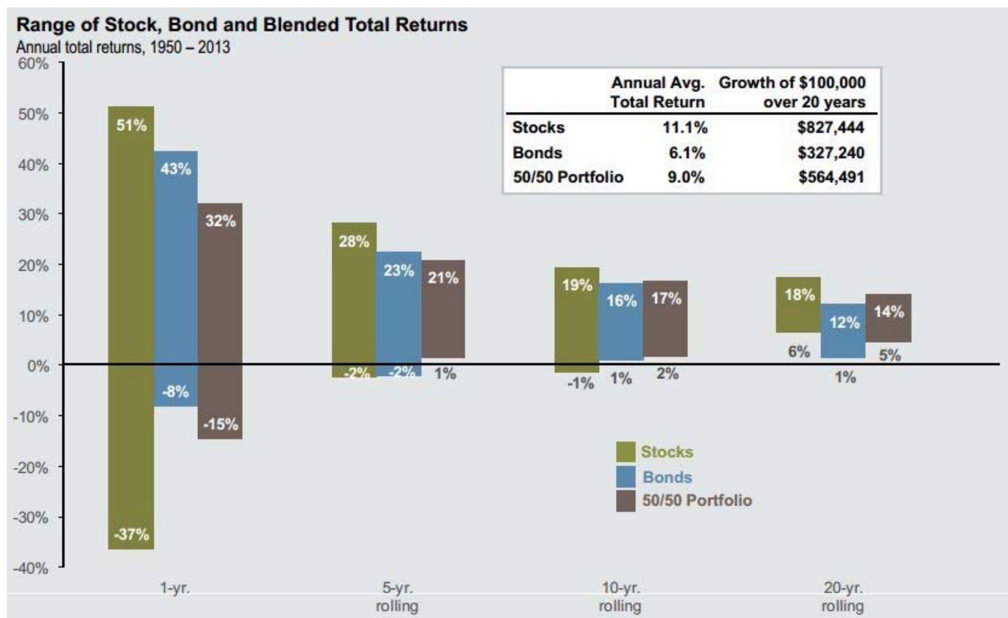
"True discipline is really just self-remembering; no forcing or fighting is necessary."
-Charles Eisenstein, Author

Common sense and academic research both suggest that the key to sustainable weight loss is a balanced approach of exercise and healthy nutrition. The greatest challenge is in the execution, which few would argue is easy.

Similarly, with investing, the key to success over time is the execution of a rational, long-term financial plan. Yet, our emotional response to market ongoings and price volatility has the potential to derail even our most well thought-out intentions.

For example, as demonstrated in Chart 3, going back to 1950, stocks have fallen as much as 37% in one calendar year. Even a balanced portfolio of 50% stocks and 50% bonds suffered as much as a 15% depreciation during the 2008-2009 financial crisis.

Chart 3



Yet, the numbers also demonstrate that over a longer time horizon, for those willing to tolerate volatility, investing in stocks can also be very rewarding. The average annual return for equities (including dividends) since 1950 is 11.1%. Furthermore, downside risk over a longer time period is dramatically reduced. In the absolute worst 10-year period, the most unfavorable return was just -1% per year. Thus, even if one invested at the very height of the dot-com technology bubble in the fall of 2000, losses were mitigated by the subsequent recovery in stock prices.

CONCLUSION

While there are no magic formulas that lead to investing success, your Advisor frequently reflects on what has proved helpful over the past two-plus decades of managing money. We summarize three particularly important principles below.

1. A rational evaluation of long-term business values, not an emphasis on current emotion, should be the primary driver of investment decisions.

2. Investment gains cannot be achieved without a willingness to tolerate volatility. Since 1980, the average intra-year decline of stock prices was -14.4%, compared to more mild declines of -6.0% in the past two years. Short-term price declines in the future are not only possible, but also extremely likely.

3. An investment program should be fully integrated with holistic financial planning.

To the latter point of emphasis, we welcome the opportunity to review your family's financial planning with you, especially if there have been any changes to your financial circumstances. As always, we appreciate your trust, confidence, and partnership over the years.

A copy of our Firm Brochure (Form ADV filed with the SEC) is available upon request.

Very truly yours,

Howard Alter Stephen Shueh Andrew Lieu Matthew Wallack