



## Year to Date 2013

Stock and bond markets sold off broadly in May and June, on speculation that the Fed would soon begin pulling back its stimulative quantitative easing policies. US stocks fared better than the rest of world. The widely followed S&P 500 index of large company US stocks actually gained 2.36% for the quarter and 13.82% since January 1. The broad-based EAFE index of larger foreign companies in developed countries is up 4.11% so far this year. The stocks across the Eurozone countries are up only 2.18%. Of the top twenty equity markets in the world, fifteen declined during the previous six months.

The news was much worse for emerging market countries that have been the world's growth engine for the past decade. They collectively plunged -8.08% during the second quarter and are now down -9.57% for the year. Almost all types of bonds both foreign and domestic also fell in value during the sell off. And despite the ongoing massive money printing and bond purchases by central banks around the world, gold lost its luster and plummeted -25.71%.

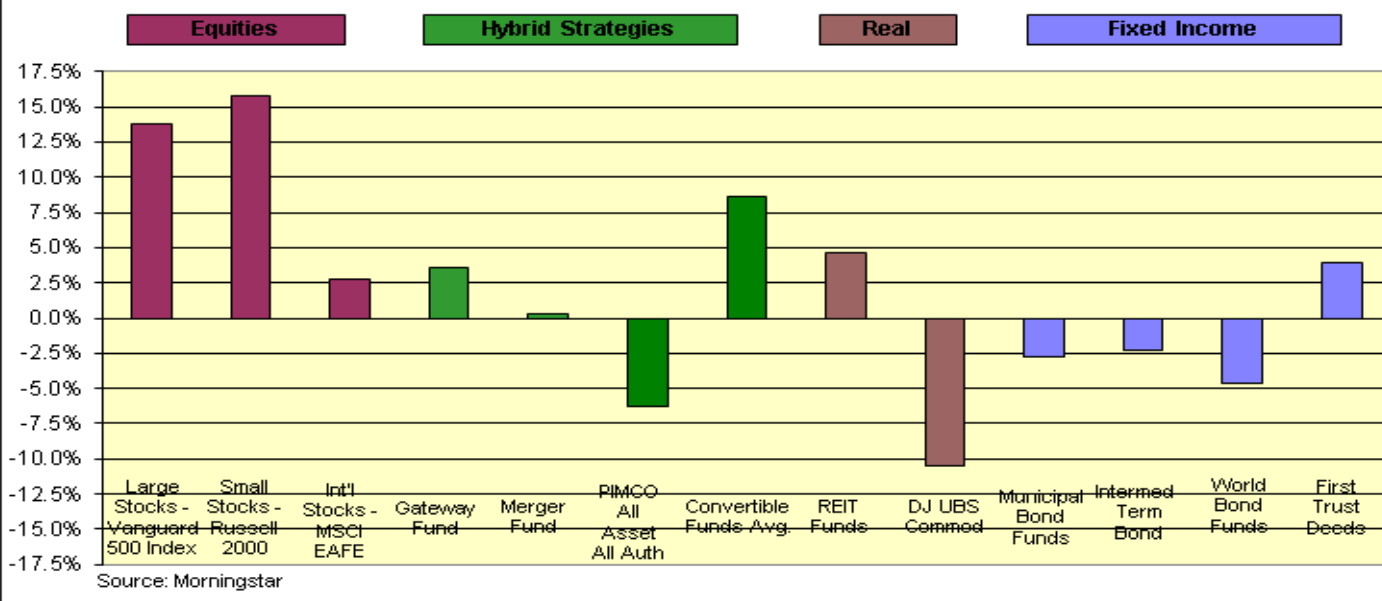
The graph below lists the YTD six month returns for various investment classes - notice the wide return dispersion between the various investments.

Due to the unusually wide dispersion of returns between foreign and domestic stocks as well as other asset

## Executive Summary

- The division of one's investment portfolio between stocks, bonds, cash and other asset classes is one of the most important decisions an investor has to make.
- Once this decision is made it is absolutely critical not to make an emotional decision to change it due to fear or greed.
- Asset class investment returns historically revert to the mean.
- Investors often chase outperforming investments and flee underperforming ones.
- US Stocks significantly outperformed international developed and international emerging stocks as well as bonds and other more conservative hybrid investments.
- Investors may be tempted to sell underperforming investments and buy US stocks.
- By sticking to a disciplined rebalancing strategy, investors can resist the temptation to chase top performing investments and flee underperforming ones.
- High quality first trust deed investments reduce interest rate risk and increase yield relative to high quality US bonds.
- The correction in emerging market bonds presents an opportunity to extend maturities and obtain higher yields.

2013 Short-term Returns (January 1 - June 30)



### Asset-Class Winners and Losers

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Highest return	28.6	29.8	21.5	22.8	17.8	60.7	20.7	14.0	26.9	11.6	25.9	32.5	31.3	28.2	18.2
	20.3	27.3	5.9	3.8	1.6	39.2	18.4	7.8	16.2	9.9	1.6	28.1	15.1	3.1	17.9
	13.1	21.0	0.6	3.7	-6.5	28.7	12.0	7.3	15.8	5.5	-20.7	26.5	13.6	2.1	16.0
	12.2	14.3	-3.6	-0.8	-13.3	24.8	10.9	5.7	12.9	5.4	-36.7	14.0	10.1	0.0	11.3
	4.9	4.7	-9.1	-11.9	-15.7	1.4	8.5	4.9	4.8	4.7	-37.0	0.1	8.2	-3.3	3.3
Lowest return	-7.3	-9.0	-14.0	-21.2	-22.1	1.0	1.2	3.0	1.2	-5.2	-43.1	-14.9	0.1	-11.7	0.1

■ Small stocks  
 ■ Large stocks  
 ■ International stocks  
 ■ Long-term government bonds  
 ■ Treasury bills  
 ■ Diversified portfolio

classes, we decided now is a good time to review some of the most important principles of asset allocation and diversification. It is during times like these that investors are prone to question the diversification in their portfolios and begin chasing investments with the best recent performance.

In addition, we'll briefly discuss bond returns and how they compare to the first trust deed investments that we prefer. And finally, we will describe a few adjustments we are currently making to most client portfolios.

### Asset Allocation – Diversification

A simple definition of asset allocation is the apportioning or diversifying of investment dollars among various asset classes, such as cash investments, bonds, stocks and other asset classes. This division of one's investment portfolio between stocks, bonds, cash and other asset classes is one of the most important decisions an investor has to make. Once this foundational decision is made, it is vitally important not to make changes to it due to the emotions of fear or greed.

Of course if one had a crystal ball and knew which asset classes or investments would outperform each year, diversification would be unnecessary. In spite of all the analysis and energy expended to identify the top performers each year, it is impossible to know in advance, which asset classes will

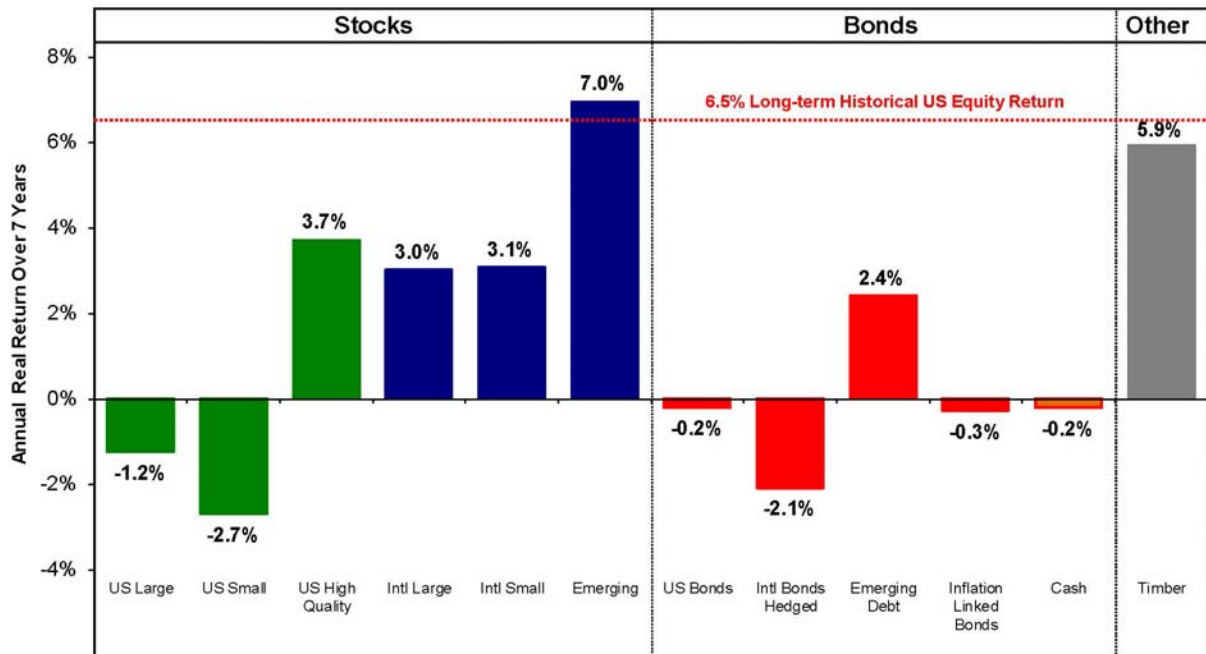
provide the highest returns. Because of this, it is essential to diversify one's portfolio and then to do everything possible to avoid chasing the best performing investments and selling the worst performing investments.

A disciplined rebalancing strategy helps to prevent investors from doing this. Also it is essential for investors to have a clear understanding and awareness of the fact that as an asset class falls in value or experiences below average returns versus other asset classes, the cheaper it becomes and the higher the expected future returns will likely be. The reverse is also true. The higher the returns are for an asset class the more expensive it becomes and the lower the expected future returns will likely be. This is exactly what happened during the technology stock bubble in the late 1990s. It is human nature to want to sell investments that have poor recent performance and buy investments that have strong recent performance.

Currently US stocks are outperforming international developed and international emerging markets and one may be tempted to sell international and emerging stocks and buy better performing US stocks. US stocks are also outperforming bonds and lower risk hybrid investments and investors may be tempted to sell their fixed income investments and other lower risk investments to buy US

## GMO 7-Year Asset Class Real Return Forecasts\*

As of June 30, 2013



\*The chart represents real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward-looking statements. US inflation is assumed to mean revert to long-term inflation of 2.2% over 15 years.

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stocks.

Invariably this trend will reverse itself. Experienced investors know that investment returns almost always revert to the mean. Essentially all this means is that investments that have recently experienced strong performance eventually revert back to more average or below average returns and those that have underperformed tend to eventually have stronger performance. This is often caused by people chasing top performing investments and selling under performing investments until at some point a top and bottom is reached and things begin to reverse.

You see this reversion to the mean phenomenon playing itself out in the Asset-Class Winners and Losers graph on page 2. Let's take the most extreme example during this time period which was international stocks. From 2000 – 2003 international stocks were at the bottom or near the bottom of the performance chart. And then from 2003 – 2007 they move to either near the top or at the top. Then in 2008 they once again dropped to the bottom and then they jumped right back to the top the next year in 2009 and then back down again in 2010 and 2011 only to jump back up to the second best performer in 2012.

If you look closely at small US stocks, large US stocks and even long-term government bonds and treasury bills you'll see the same phenomenon occurring just not quite as extreme. The only investment you see that is consistently in the middle (which means it is much less volatile) is a diversified portfolio that is rebalanced annually.

It is absolutely critical not to chase the most recent winning asset classes just as it is critical not to flee the worst performing asset classes. A consistent, disciplined rebalancing strategy will enable you do this.

### GMO 7-Year Forecasts

As you can see from the GMO 7-year return forecast graph, GMO expects international and emerging market stocks to offer higher returns than US stocks over the next seven years. This makes sense given that US stocks have outperformed international and emerging market stocks. This is also consistent with our earlier discussion of asset class returns reverting to the mean whereby top performing asset classes swing to bottom performing asset classes and back again.

## First Trust Deeds vs Bonds

The GMO 7-year return forecast graph also shows the expected real return for various types of bonds over the next seven years to be very low indeed and in most cases negative. Remember the real return is the total return minus an assumed inflation of 2.2%.

The math on bonds is relatively simple. Let's use the Vanguard Total Bond Index fund (VBTLX) as an example. This is an intermediate bond fund. Right now the yield to maturity of this portfolio is roughly 2%. So if you take this 2% and subtract 2.2% inflation you end up with a negative return of -.2%.

In addition, bond prices drop as interest rates rise so the negative real returns will likely be larger if and when interest rates rise. We don't know anybody who thinks that current interest rates are going to remain this low forever. In fact interest rates did rise at the end of the quarter and right now this fund has experienced a negative YTD return as of 7/5/13 of -3.46%. Most long-term high quality bond funds have experienced losses of roughly -10% YTD (the longer the maturity of the bond, the greater the drop in value as interest rates rise).

Due to prevailing historically low interest rates and correspondingly low expected bond returns, for our larger clients, we invest a large portion of their fixed income allocation into a very high quality, short term, first trust deed investment which is currently paying between 7% and 8%.

This pool of first trust deeds has an average loan to value of roughly 50% and it weathered the recent real estate crisis and financial crisis without a loss. The main reason it came through the crisis unscathed is because it has no leverage and it only makes conservative, short term, low loan-to-value loans. If and when interest rates rise, which they surely will, this first trust deed pool is unlikely to decline in value. In fact if rates rise enough, they will be able to raise the rate they charge on their first trust deeds and the yield on the investment will rise.

Year to date, these first trust deeds have returned almost 4% vs. -3% to -10% for high quality bond investments. This is a difference of 7% to 14%!

## Swapping Pimco Emerging Currency Bond for Pimco Emerging Local Bond

For several years we have been looking for an opportunity to swap the Pimco Emerging Currency Bond fund for the Pimco Emerging Local Bond fund. The yield on the Local Bond fund is almost 3% higher due to its longer duration. The Local Bond fund has been outperforming the Emerging Currency fund but we did not want to make this change until we experienced a correction.

In the last month we had a correction in this area of the bond market, and as we write this newsletter the Local Bond fund is down roughly -10% YTD and the Local Currency fund is down -4%. We will now swap these two funds and continue to hold the Local Bond fund for the long-term.

The purpose of this fund in client portfolios is to provide a small amount of non-dollar denominated bond exposure to emerging markets in the belief that over the next 5-7 years these currencies may appreciate vs. the dollar. These assets will be much more volatile than high quality US bonds but their yields are over twice as high and if held for the long-term, should end up providing decent returns compared to the high quality US bond market.

## Summary Perspective

A sound asset allocation and rebalancing strategy will keep you from chasing top performing asset classes after they have outperformed and are poised for a period of underperformance; and it will help keep you from fleeing underperforming asset classes just as they are poised for a period of outperformance.

In this low interest rate environment, we prefer high quality first trust deed investments to high quality bond investments for our larger clients. For smaller clients we will continue to keep their bond allocations diversified mostly across high quality intermediate bonds with a smaller percentage in multi sector bonds and emerging market bonds.

Due to the large correction in emerging market bonds we will move to a more aggressive emerging market bond investment with a longer duration and a higher yield and hold this for the long-term.

## Thank You for the Referrals

As always we want to thank those of you who continue to refer your friends and family to us. Most of our clients have been referred to us by other clients and related professionals. If you know anybody looking for an objective advisor, feel free to give them our number and if we are not a good fit for them, we will be sure to refer them to another fee-only advisor.

Please don't hesitate to call us if you would like to discuss anything you read in this newsletter in greater detail. We hope you are enjoying your summer.

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