


**AMERICAN MONEY MANAGEMENT, LLC**
*SEC Registered Investment Advisor*

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## THE BIG PICTURE ~ GROWTH & INCOME *INVESTING* FOR WEALTH CREATION

At its most basic definition, *investing* is laying out money now to get more money back in the future. Investors in common stocks take an *ownership* position in a public company with the idea that over time the underlying business will grow in value. As a business grows its revenues and profits, its book value should rise and ultimately build the shareholder's wealth both through dividends paid and share price appreciation. Unfortunately, the term investing is often mistakenly used to describe the act of *speculating*, which is an attempt to profit from short or medium term price fluctuations with little regard to a business's underlying financial attributes. In a sense, investors in stocks are owners of businesses, while speculators are merely trading pieces of paper.

We view speculation as akin to gambling since it requires making a short-term prediction about the future price direction of a stock, bond or other financial asset. While there may be a rare few who are able to consistently profit from speculation, we are certain that the odds are against the vast majority of market participants to do so. From a purely practical perspective, investing is a far superior way to growing one's wealth. Whereas successful speculation requires the ability to consistently predict the future, which is nearly impossible, investing rewards the virtues of discipline, patience, and taking the long view.

Historically, the long-term investment in stocks and other appreciating assets has been the best way to grow wealth over time. However, investing is not without risk. In fact, the risks are abundant: you could invest in a business that goes bankrupt or is at the start of a long decline, or you may pay too high a price for a security so that your long-term returns are poor, etc. Our role as your investment advisor is to manage this risk through research and security analysis of individual securities to estimate their growth prospects, underlying financial strength, and fair valuation, manager selection for clients invested primarily in mutual and/or exchange traded funds, and the construction of diversified portfolios that meet our client's specific objectives for income, growth, and risk tolerance levels.

### IS A STOCK MARKET CORRECTION ON THE HORIZON?

While trying to answer the question above would be, by definition, speculating, reminding ourselves that stock market declines are a natural part of investing is prudent, especially following a period of prolonged market upside and general tranquility. While investors cannot avoid periodic market declines, they can prepare for the inevitable by 1) recognizing the normalcy of market declines and 2) having a healthy set of principles for when to sell.

**Recognizing the Normalcy of Market Declines:** According to Capital Research and Management Co.'s historical analysis of market corrections from 1900-2012, the Dow Jones Industrial Average has experienced declines with the following frequency:

- 5% or more: About three times per year
- 10% or more: About once per year
- 15% or more: Approximately every other year
- 20% or more: About once every 3.5 years

From this data one might surmise that "we are due" for a decline of at least 10% since the market has not experienced a decline of this magnitude since 2012. While a speculator may want to "game" this data and "go to cash" essentially betting on a decline, investors should remember that even with relatively frequent declines, stocks have generated average annual returns of 9.7% over the long run.\* Choosing to speculate may work in the short run as it is a 50/50 proposition, but over the longer term, the odds are stacked in your favor as an owner or investor, not a trader or speculator.

\*S&P 500 Compound Annual Growth Rate 1900-2013.

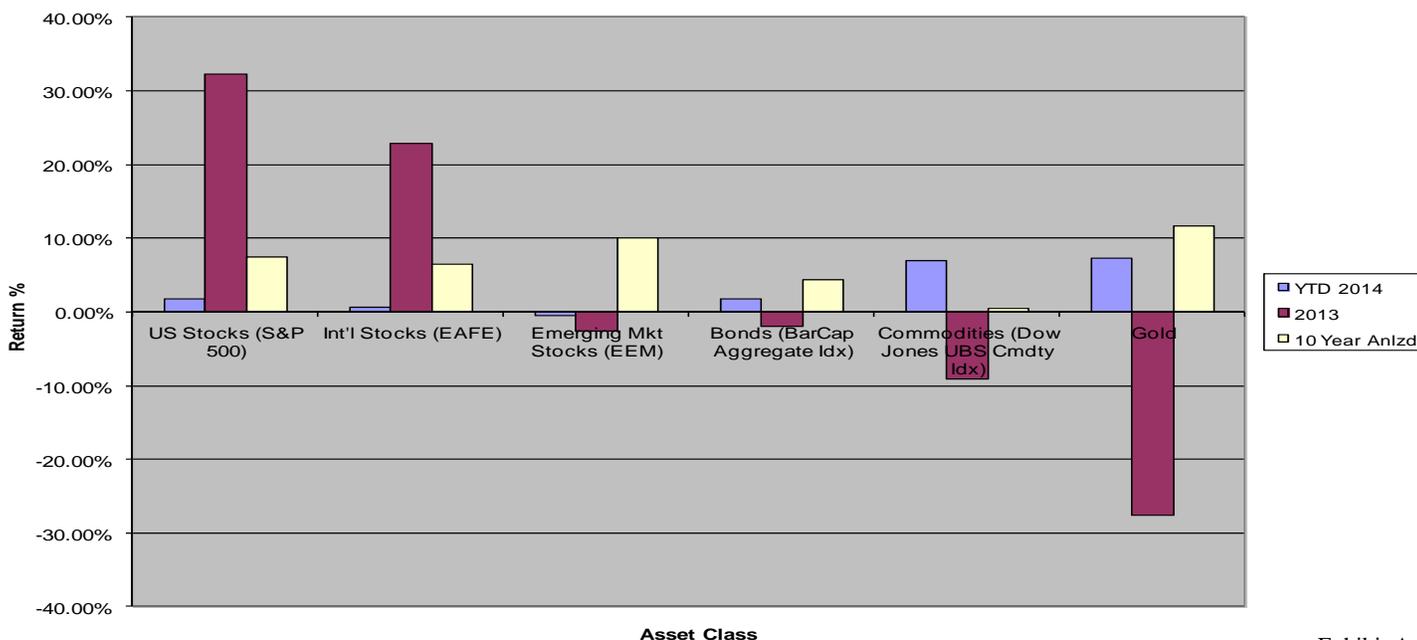
(Is a Stock Market Correction on the Horizon cont.)

**Healthy Reasons to Sell:** In our professional experience, more harm is done to long-term returns through indiscriminate selling decisions than just about anything else. Irrational reasons to sell include, among others, responding to market commentator warnings of a pending crash, fear of further declines, and the replacement of a current holding with an investment that has recently gone up more in price. All of these amount to speculative decisions and go against the grain of long-term wealth creation. Many of us look back with regret on how much we could have made hanging on to every good investment, from real estate to quality stocks, funds, bonds, or collectables. Reviewing the rational reasons to sell an investment should help an investor make better trading decisions in the event of a major correction. These include:

1. **Rebalancing:** An investor's asset allocation objective may be out of balance due to a rise/fall in asset prices and should be rebalanced back to the objective weighting to maintain proper diversification. For example an investor with an objective of 50% Stocks / 50% Bonds may find that their stock weighting has increased to 55% following a period of strong stock returns and should be rebalanced back to 50% by selling some stock. We review client portfolios on a regular basis for rebalancing opportunities.
2. **Fundamental Change:** In a perfect world, an investor could invest in a solid, growing company and hold forever to reap the benefit of compound returns. In reality, businesses change and evolve, for better or for worse. In the event of a material negative fundamental change in an investment, the investor should strongly consider selling regardless of market conditions.
3. **Raise Cash for a More Attractive Opportunity:** An investor may consider selling a position in order to replace it with a more attractive opportunity. For our common stock oriented strategies, we run periodic criteria screens to search for new investment ideas. If we need cash to invest in a new opportunity, we will seek to sell a less attractive holding, all else being equal.
4. **Overvaluation:** Overvaluation is the trickiest and, in our opinion, rarest reason to sell. All stock valuation estimates are subject to immense error and variability; so, even if you estimate that a current high quality stock holding is trading 10% or more above fair value, you may want to hold as the quality of the business should outweigh the marginal valuation differential. Nevertheless, in some circumstances valuations can become so overdone (most notably during the technology bubble of 1999-2000) that selling purely for valuation reasons makes sense.

### WHERE WE ARE INVESTING CAPITAL NOW\*\*

Asset Class Returns



*(Where We Are Investing Capital Now\*\* cont.)*

We have updated our asset class return chart (Exhibit A) to reflect Year to Date 2014, Calendar Year 2013 and 10 Year annualized returns. Interestingly, but not surprisingly, the best performing assets year to date through March 31st were gold up +7.2% and commodities up +7.0%. Domestic stocks (S&P 500) and bonds (Bar Cap Agg Idx) were both up +1.8%, while international stocks (EAFE) increased +.6%. Emerging market stocks posted the only decline of the major assets that we follow declining -.4%.

**Fixed Income (Bonds):** In a low interest rate environment like today, long-term investors must be extremely vigilant about the potential risks of rising rates. Nevertheless, we recognize the importance of the asset class in a diversified portfolio and have developed a bond strategy that we feel adequately addresses the challenges bond investors face in the current environment. This strategy includes: 1) Keeping maturities relatively short (< 5 years). Shorter maturity bonds are exposed to less interest rate risk than long-term bonds; 2) Investing in alternative fixed income sectors including floating rate bank notes and absolute return bond funds. Both investments should do better than traditional bonds in a rising rate environment; and 3) "Hedging" a portion of our bond exposure via an exchange traded fund (TBF) that shorts treasury bonds (i.e. as interest rates rise, this security should rise in value).

In the first quarter, we added a fourth "leg" to our fixed income strategy by adding the Merger Fund (MERFX) to accounts with balanced or income oriented investment allocations, where applicable. The Merger Fund follows a merger arbitrage strategy by investing in the targets of announced merger or buyout deals. Most buyout targets typically trade at a modest discount to the buyout price until the deal closes. The discount compensates the shareholder for the risk that the deal falls through. Since the spreads are typically small, funds deploying these strategies generally aim to generate long-term returns in the mid-single digits with both low volatility and low correlation to the equity and bond markets. At first glance, this stock oriented strategy may seem out of place in a fixed income allocation; however, the historical volatility and return profile is much more similar to that of bonds than stocks. As such, we view this position as a nice complement to the more traditional fixed income positions held by our clients.

**Diversifying Assets:** After declining more than -27% in 2013, gold is the best performing major asset class that we follow so far in 2014. This performance differential highlights the benefit of maintaining some position in holdings with a low historical correlation to traditional assets like stocks and bonds (i.e. gold and commodities). While gold will never match stocks as a wealth creator, it has acted as a preserver of wealth and a store of value for thousands of years. Additionally, while inflation has remained tame over the last few years, positions in gold and commodities should provide a hedge in the event of an inflation surprise in the years to come.

**Stocks:** We continue to tilt domestic stock exposure towards large cap dividend paying holdings and smaller growth oriented funds, where applicable. Yields on investment grade bonds remain at historically low levels which we feel has caused many investors to seek the higher yields provided by select dividend paying stocks. Dividends provide a cash return to investors while they wait for price appreciation. Additionally, we continue to favor exposure to financial and technology oriented issues. The former group should, on par, benefit from a more normal interest rate environment, while the latter should benefit from higher corporate investment and capital spending.

Internationally, we are currently weighting most asset allocation portfolios with a roughly even mix of emerging market and developed market stocks. Concerns related to the negative effects rising interest rates in the US may have on emerging economies (higher domestic rates could cause capital to flee emerging markets) as well as a slowdown in China have caused these markets to underperform in recent years. The three year annualized rate of return for the EEM index was *negative* -2.8% vs. +14.7% and +7.2% for US and Int'l developed stocks respectively. While we cannot know when the tide here will turn, we believe that the recent underperformance in EM assets provides a strong value opportunity for long-term investors.

*\*Individual accounts will vary based on the client's stated objectives, risk tolerance, and time frame. We manage several different portfolio strategies, so not every client has exposure to the securities listed above. In addition to growth and/or income oriented asset allocation strategies, we also manage more concentrated equity portfolios that generally carry a higher degree of risk and volatility. Please contact us if you want to discuss your portfolio strategy in greater detail.*

Should you have any questions regarding your investment account(s) or, if there have been any recent changes to your investment and/or retirement objectives, please do not hesitate to contact our office. We can also provide you with a current copy of our SEC Form ADV Part II, at your request.

As always, it is a great privilege to be entrusted with the stewardship of your retirement and investment assets.

*Your Portfolio Management Team*

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