

**AMM**

**AMERICAN MONEY MANAGEMENT, LLC**

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**THE BIG PICTURE ~ RISK**

One of our firm's core investment principles is *"volatility is not risk"*. We anoint this concept a core principal because the day to day movement of asset prices is often confused with real risk, which we define as the *"likelihood of a permanent loss of capital"*. Understanding the difference between volatility and real risk can make all the difference between achieving long-term investment success vs. investment mediocrity or failure. This is especially true for investors in financial assets like stocks, bonds and commodities for which there are daily quoted prices and the potential for wide price swings from one day to the next.

A permanent loss of capital can occur in many ways; notably, paying too high a price for an asset, investing in an asset of dubious quality, or attempting to time the market by selling an asset for a loss in order to "protect capital" from a further decline. While all of these approaches to investing are bad, we consider market timing to be one of the most dangerous because it is cloaked in the veil of risk management. We agree with Peter Lynch, the storied manager of the Fidelity Magellan Fund during its heyday, when he said *"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves"* (Businessweek, September 2014). Several studies appear to support this view:

- A Schwab study using Standard and Poor's data shows that between 1994-2013, missing the top ten days by trying to time the market would have resulted in a reduction from a 9.2% annualized return to 5.5%. For a portfolio with a starting value of \$100,000, this is the difference between having \$580,000 vs. \$275,000 at the end of the investment period.
- Richard Bernstein of Richard Bernstein Advisors ran a study over the same twenty year time frame comparing the returns of 42 asset classes (everything from US stocks to emerging market bonds) to the return achieved by the "average investor" over the same time frame. The average investor return was derived from the buying and selling activity of mutual fund investors. According to Bernstein, "The average investor under-performed every category except Asian emerging markets and Japanese equities. The average investor even under-performed cash... They bought high and sold low. When chaos occurred, investors ran away."
- Even "expert" market timers have trouble. According to research from Hulbert Financial Digest, a service that tracks the performance of stock and mutual fund newsletters, just 11 of the 81 stock market timers actually made money in the bear market that happened between 2000-02. Even more telling, however, is that the average annualized return for these timers over the last 15 years was *negative .8%* vs. +4.2% for a buy and hold investor.

**Exhibit A**

Juxtapose the above data with the experience of super-investor Warren Buffett. Buffet's Berkshire Hathaway recently hit an all time high over \$200,000 per share, and the company's book value has compounded at 19.7% over the last 49 years vs. 9.8% for the S&P 500. Berkshire's share price usually trades at a premium to book value, so we feel this is a reasonable comparison. Nevertheless, since 1980, the company's share price has declined by 19% or more at least five separate times, with two ~50% declines occurring in the last 15 years (Exhibit A). Buffett, arguably the greatest investor of our time, suffers stock market losses just like the rest of us. Part of his success is focusing on the long-term and riding out the downward swings.

Berkshire Hathaway (BRK-A) Largest Losses	
1981-1982	-19%
1987	-37%
1989-1990	-37%
1998-2000	-49%
2007-2009	-51%

*\*Largest losses since 1980*

*(The Big Picture—Risk cont.)*

We aren't suggesting that by simply buying and holding all stocks you will become the next Warren Buffet. Buffett is an exceptionally talented allocator of capital who leveraged these talents via one of the earliest hedge funds, The Buffet Partnership Ltd. After taking over one of the Partnership's failed investments, a textile company called Berkshire Hathaway, he used Berkshire's free cash flow for investment purposes. The rest, as they say, is history. *We are suggesting that investors heed his advice when making an investment in common stocks: "The more the market goes down, the more I like to buy"* Warren Buffett, CNBC 10/2/14.

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## MANAGING RISK

The great irony here is that as volatility increases and prices decline, real risk decreases (all else being equal). Another of our core principles is *"the price you pay determines your return"*. The lower the price paid for an investment, the lower the risk (i.e. there is less downside), and the higher your expected return. Investors unprepared for inevitable market declines and, by extension, lower prices tend to view them as high risk events, when in fact they should be viewed opportunistically. This is one of the hardest things about investing in financial assets with daily price quotes. In an attempt to avoid making costly trading decisions during market corrections, we recommend and employ the following risk management techniques:

- **Diversification:** First and foremost, accept that stocks are volatile and prices may swing widely over time. An investor with a long time horizon for their assets should be able to accept these swings in exchange for higher expected returns relative to more conservative assets. Still, investors should be reasonably diversified within their stock investments. Investors with shorter time horizons, or those not wanting to stomach the volatility associated with a pure stock portfolio, should diversify a portion of their portfolio into less volatile investments like investment grade bonds. Additionally, the inclusion of assets with a low correlation to stocks (commodities, real estate, etc) will provide even further diversification and should allow for "smoother" albeit lower returns over time.
- **Rebalancing:** An investor's asset allocation objective may be out of balance due to a rise or fall in market prices. For example an investor with an objective of 50% stocks / 50% bonds may find their stock weighting has increased to 55% following a period of strong market returns and should be rebalanced back to 50% by selling some stock. We review client portfolios on a regular basis for rebalancing opportunities.

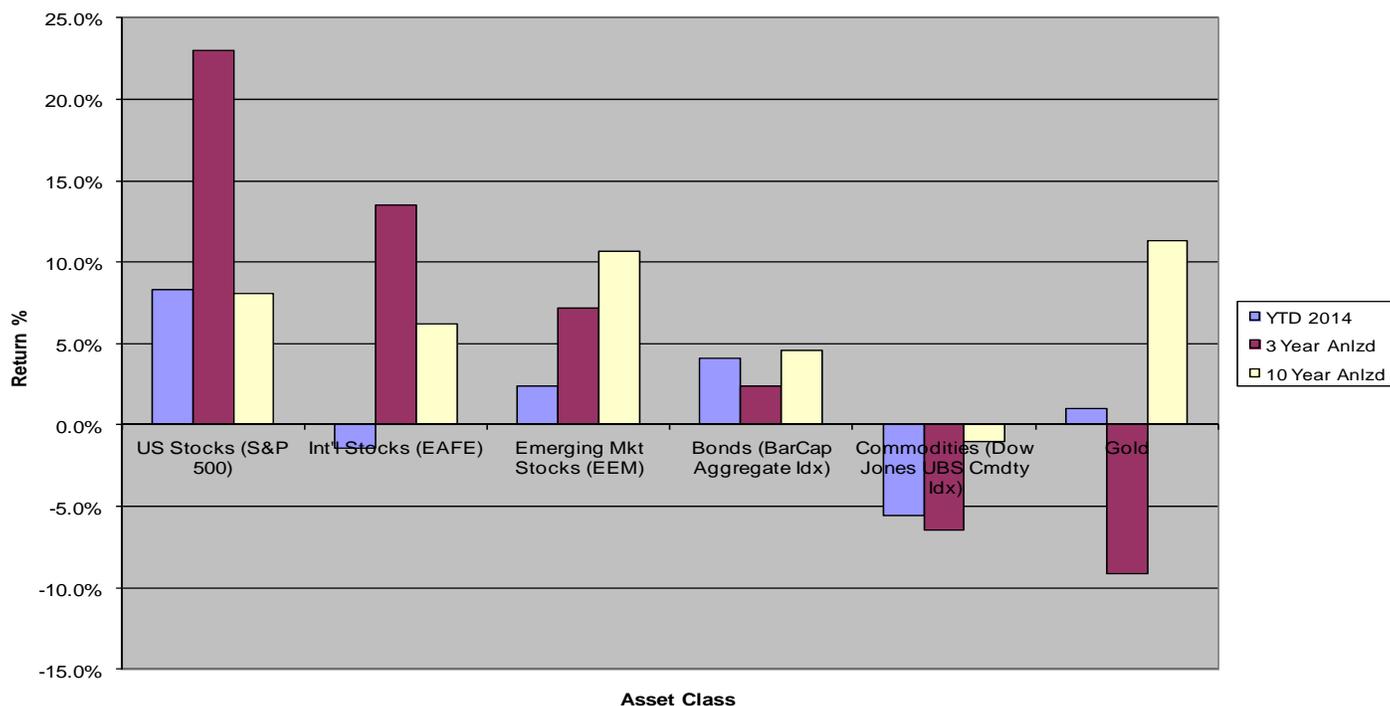
The last 14 years included the unwinding of the great technology bubble, a huge "out of the blue" market shock in 9/11, two wars, a market boom that led to the housing bubble, and the greatest economic downturn since the Great Depression. The next 14 years are certain to provide their own unique set of risks, challenges and opportunities. We will continue to follow our core investment principles to navigate the markets going forward and to help you achieve your investment goals.

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## WHERE WE ARE INVESTING CAPITAL NOW

We have updated our asset class return chart (Exhibit B) to reflect Year to Date 2014, 3 year annualized and 10 Year annualized returns. Year to date through September 30th, domestic stocks (S&P 500) increased 8.3%, international stocks (EAFE) declined -1.4% and emerging market stocks (EM) increased 2.4%. Fixed income bonds (Bar Cap Agg Idx) were up 4.1%. After a strong start to the year, both commodities (DJ Commodity Idx) and gold *sold off in the third quarter* and are now down -5.6% and up 1% respectively.

## Asset Class Returns (as of 9-30-14)



**Fixed Income (Bonds):** Bonds have been one of the surprising performers year to date. With interest rates at historically low levels and a Federal Reserve that has indicated they will halt their quantitative easing program in the fourth quarter and begin hiking rates in 2015, we are surprised that there hasn't been a bigger sell off in bonds. One explanation may be the ongoing malaise in Europe along with the myriad geopolitical issues that have sprung up from Ukraine to the Middle East, which could cause a flight to safe assets like treasury bonds. Perhaps most importantly, the demand for income securities, including bonds, seems to be outweighing the supply for the time being.

Nevertheless, we still feel the appropriate positioning of client fixed income allocations is to position for rising interest rates. This four pronged 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; 3) "Hedging" a portion of our bond exposure via an exchange traded fund (ETF) that shorts treasury bonds (i.e. as interest rates rise, this security should rise in value); 4) Investment in Merger Arbitrage strategies that offer bond like returns without the associated interest rate risk.

**Diversifying Assets:** Diversifying assets encompass all assets that do not fit into a traditional stock or bond category. These assets, by definition, do not have a strong correlation with stocks or bonds and, therefore, increase portfolio diversification. Recently, both commodities and gold have suffered in this period of low inflation and slowly improving economic growth. Add to this the recent dollar strength, and the demand for gold (a hard "currency") drops even further. For these reasons, our typical position size in both of these assets remains modest. Still, we view these positions as providing a hedge against the possibility of an inflation surprise in the years to come.

**Stocks:** Following a multi-year rally, domestic stocks do not necessarily look cheap; however, we do NOT think most stocks are in bubble territory either. We continue to tilt domestic stock exposure towards large cap dividend paying holdings and growth oriented positions, 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 oriented issues which should benefit from a more normal interest rate environment.

*(Where We Are Investing Now cont.)*

Relative to US stocks, we continue to see better overall value in International and Emerging Market (EM) stocks. 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 EM index was 7% vs. 23% and 13% 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 or asset classes 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*

Gabriel Wisdom  
*Managing Director*

Michael Moore  
*Chief Investment Officer*

Glenn Busch  
*Portfolio Manager*

Vicki Ohara  
*Operations Manager*

Jim Rhodes, CFA  
*Executive Director*

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