AMM

AMERICAN MONEY MANAGEMENT, LLC

SEC Registered Investment Advisor

PO Box 675203, Rancho Santa Fe, CA 92067 | Tel 888-999-1395 | Fax 858-259-6906 | info@amminvest.com | www.amminvest.com

Risk & Reward ~ Building a Sustainable Portfolio

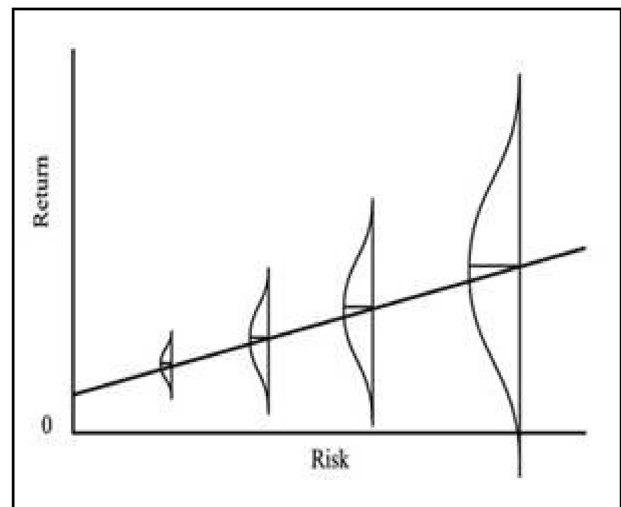
Risk, a seemingly simple concept, may be one of the most challenging and misunderstood areas of investing. Regular readers of our newsletters know that we define investment risk as the *likelihood of permanent capital loss, not volatility.* The word likelihood infers that with risk we are dealing with probability and odds, not certainties. At its very core, risk is always about making decisions about an uncertain and ultimately unknowable future.

Unfortunately, many investors make the mistake of equating risk and reward whereby simply taking more risk means receiving more reward. Exhibit A below is a textbook representation of this line of thinking: more risk = more return. This simplistic view can lead to terrible investment outcomes since the riskiest investments, using our definition of risk, will often result in permanent loss. To be fair, Chart A defines risk not as the likelihood of permanent capital loss but as volatility; but, even here, the idea that simply increasing portfolio volatility will generally result in higher returns is dangerous since it implies certainty about something that cannot be known (i.e. the future).

An improved version of the classic risk/reward tradeoff chart was developed by Howard Marks of Oaktree Capital (Exhibit B). Howard drew probability distributions (bell curves) over various points on the risk/reward curve to denote the probable range of outcomes that could be expected at various levels of risk taking. Note that as an investor takes on more risk, their range of potential outcomes increases, with the highest level of risk resulting in the possibility of permanent loss. More interestingly in our view is that the probability of earning a return above the average return line is the same as the probability of earning a return below this line. Market and portfolio returns are simply not predictable. The best we can do is provide a range of probable returns based on the past.

Exhibit A

Exhibit B



Compounding the problem of risk are numerous psychological limitations that investors face when making decisions about the future. These include:

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(Risk & Reward...cont.)

1. Hindsight bias: Risk tolerance is not static and tends to be related to a person's experiences in the recent past. In general, investors tend to be more risk averse when markets have done poorly and are pro-risk when markets have done well. This is evidenced by the famous Dalbar study which shows that flows into stock mutual funds were highest near market peaks and lowest at market troughs. This is completely at odds with the timeless logic of "buy low, sell high".

2. Overconfidence: A study by Robert Knox & James Inkster (1968) showed that people at the racetrack were much more confident of their horse's chance of winning after placing their bet than they were immediately before the wager. This is illogical since they held exactly the same information before and after the bet. The "ownership" of the ticket seems to have endowed it with a greater expected value to the holder than before it was purchased. How often do investors purchase stocks and have the same feeling, regardless of the underlying fundamental picture?

The above limitations are really just the tip of the iceberg when it comes to dealing with risk and investor psychology. If you are interested in a more in depth read on the subject, we highly recommend "Thinking, Fast and Slow" by Daniel Kahneman (Nobel prize winner in economics). The bottom line is that making decisions amid uncertainty and with uncertain outcomes will always be challenging. ***Our job is to take smart risks and to generate the best possible return for the level of risk that you are comfortable accepting.*** While we cannot remove risk, the below strategies should help us build a more sustainable portfolio over the long-run.

1. Diversification: Building portfolios of assets with low correlations to each other can help a portfolio hold up better during painful market downswings. For example, US Stocks (S&P 500) are negatively correlated to Bonds (Barclays Aggregate) and only modestly correlated to commodities (Bloomberg Commodity Index). Having exposure to all three assets increases diversification and should reduce downside relative to a pure stock portfolio.

2. Price: Overpaying for any investment is detrimental to wealth creation. Even a growing profitable company or beautiful piece of real estate can become a horrible *investment* if you overpay. For example, Cisco Systems (CSCO) has grown their earnings more than sevenfold since the year 2000 through December 2014; however, the price is down more than 40% over that time frame. While the company has had strong earnings growth over this period, the stock is down because it was simply too expensive in 2000 to reward long-term shareholders. The price you pay for any investment matters immensely.

3. Dividends: Since 1926, dividends have represented approximately 40% of the annual total returns achieved by owning stocks (with capital appreciation accounting for the remaining 60%). For investors in stocks, dividends provide both an immediate cash return to the shareholder regardless of day to day price fluctuations and, in the case of dividend growth stocks, the ability to earn a pay raise every time the company raises their dividend.

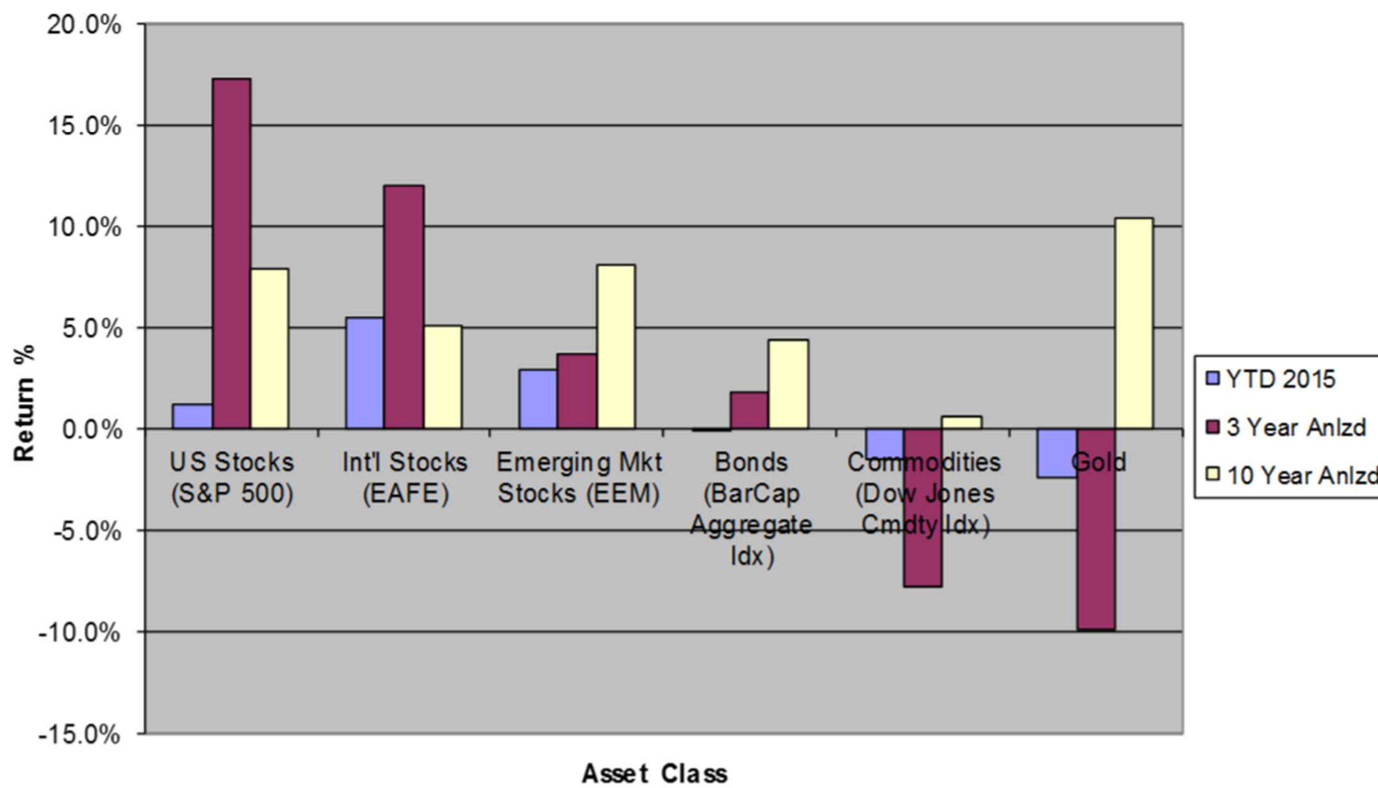
4. Matching Time Horizon to Strategy: Due to the inherent volatility in markets, it is possible to permanently lose capital in a great investment bought at the "right" price if you are forced to sell at an inopportune time. For this reason, large endowments and institutional pension plans match their investment allocation to their obligations (i.e. invest in significant shorter term investments to service current and near-term cash needs, along with longer term investments for growth). If you are at or nearing retirement and are planning to withdraw funds from your investment account for living expenses, it is important that you have an asset mix that matches your time frame and distribution needs.

2015 Mid-Year Review ~ Asset Class Outlook*

Through 6/30/15, domestic stocks (S&P 500) increased 1.2%, developed international stocks (EAFE) increased 5.5%, and emerging market stocks (EM) increased 2.9%. Bonds (Bar Cap Agg Idx) were down -.1%, commodities (DJ Commodity Idx) were down -1.5%, and gold was down -2.4%. We have updated our asset class return chart (Exhibit C) to reflect YTD 2015 along with three and ten year annualized returns for the aforementioned asset classes.

(2015 Mid-Year Review...cont.)

Exhibit C



Fixed Income (Bonds): The expected increase in interest rates by the Federal Reserve has been one of the most talked about and forecasted "macro" events in recent memory. Since bond prices move inversely to interest rates (i.e. as interest rates go up bonds generally go down), investors have rightfully questioned the place of bonds and/or bond funds in a portfolio. For investors with long time horizons or those with a healthy risk tolerance, we feel bonds should be underweighted. However, for investors with short-term time frames or those who have expressed a very low tolerance for risk, bonds remain a critical part of their investment allocation.

For more conservative investors, the virtues of bonds include the following: 1) government bonds act as a flight to safety/quality during periods of market stress. U.S. treasury bonds were one of the few asset classes to produce positive returns in the market crash of 2008; 2) corporate bonds are higher on the capital structure than stocks, which means that in the event of a bankruptcy, the bond holder would get paid first; 3) bonds provide a steady stream of cash flow; 4) if held until maturity, bond returns can be predicted with more precision than stocks since the maturity price (par) is known as well as the interest rate at time of purchase.

Unfortunately, none of the above bond "virtues" changes the current bond market reality: rates are very low and an eventual rise will likely depress prices. For this reason, we continue to position the majority of a client bond allocation in short to intermediate term bond holdings which are less sensitive to a rise in rates relative to longer term bonds, floating rate notes with adjustable rates so as rates rise the interest paid on the note will rise, and strategic income funds which provide flexibility to the fund manager to "go anywhere" for return including shorting bonds.

Stocks: By almost every valuation measure, stocks in the U.S. appear to be fully valued and in some cases overvalued. Price to earnings ratios, whether using forward or trailing earnings, show a market trading modestly above the long-term average while the Shiller cyclically adjusted P/E shows a market trading well above its long term average. Some may even use the term bubble to describe the current valuation environment, though we do not think this is helpful as it would imply that investors are good at predicting bubbles (spoiler alert – they are not).

(OVER)

(Where We Are Investing Now cont.)

Over the long-run, the U.S. equity markets are fairly resilient with only 7 down years in the last 34 calendar years, which would imply approximately 80% odds of upside in any given year. In every single one of these years, there were risks and reasons to worry about a downturn. But, had one acted on these concerns, it is almost certain that their long-term returns would have suffered immensely. Yes, from time to time the "crash call" may prove correct, but even a broken clock is right twice a day. This is no way to invest. The simple reality of the above average valuations is that future returns will likely be lower to compensate for the period of above average returns that we have recently experienced. ***This is another reason for stock investors to focus not just on capital appreciation but on dividends which provide a cash return to investors in both good and bad markets.***

Our approach to the fully valued market described above has been to increase exposure to International (developed and emerging markets), which appear to offer better values and/or to focus on individual stocks that we feel are attractively priced regardless of the overall market.

Diversifying Assets: The ongoing weakness of gold and commodity investments, which are generally considered good inflation hedges, underscores the difficulty in estimating the future. Many investors would have expected higher inflation over the last several years following the actions of the federal reserve to essentially print money and debase the currency; but, in fact, core inflation has remained muted in part due to significant slack in the jobs market. Additionally, ongoing concerns about slowing growth in China, a massive consumer of commodities, could mean that a major source of demand has been reduced. Too much supply and not enough demand equals lower prices.

As discussed above, in addition to being an inflation hedge these assets also provide a portfolio with exposure to assets that have a low or even negative correlation to other portfolio holdings. Over the long run, we feel these diversification benefits should smooth portfolio returns; however, in the short run, it is very difficult to estimate where prices are headed. Many suggest commodities face too many headwinds to post positive returns for some time. Our view is that the biggest macro risks are the ones that no one is paying attention to and that inflation could rear its head when market participants least expect it. For this reason, we think a modest exposure to inflation hedged assets in a diversified asset allocation portfolio still makes sense.

**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, we thank you for entrusting AMM to help you achieve your investment and retirement objectives.

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*
Mike Green, *Portfolio Manager*
Adele Canetti, *Portfolio Manager*
Robert Frazier, *Investment Advisor*
John Nyaradi, *Investment Advisor*
Bryan Case, *Investment Advisor*

AMERICAN MONEY MANAGEMENT, LLC

Tel: (888) 999-1395 Fax: (858) 259-6906 E-mail: info@amminvest.com www.amminvest.com