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PORTFOLIO COMMENTARY

Spring, 2015

—Russell B. Dow, J.D.
Private Account Portfolio Manager

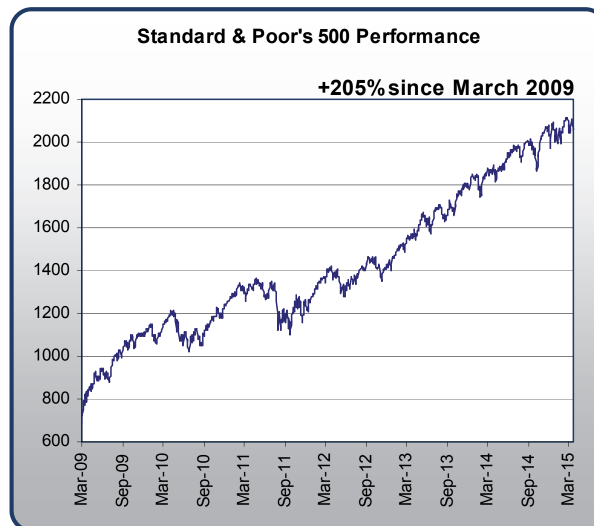
Financial Fort Investment Portfolios

Dear Client:

The Federal Reserve appears to be nearing an interest rate increase for the first time in a decade. This changing tide comes with some risk. If rates rise too quickly, the Fed inadvertently may derail the economy which has been uncommonly weak for a post-recessionary recovery. Yet, if raised too timidly, then the enormous money supply expansion of recent years could unleash an inflationary spiral.

The heightened volatility in the stock market over the fall and winter—which may well persist—appears to reflect the uncertainty of the timing and likely success of this new economic phase.

Now, then, might be a good time to review the investment philosophy that we prescribe.



Avoidance of an Irrecoverable Portfolio Loss

Although it is essential and tautological that a sound investment strategy must seek to avoid an irrecoverable portfolio loss, time and again, many investors fail to do so for easily avoided missteps. Stories of ill-fated strategies are not hard to find.

Our first goal, then, is to construct a "Financial Fort" for our clients' investment portfolios. Because it is impossible to know the nature of the next economic crisis, or even when it is apt to strike, like insurance, the principles for a fundamentally sound portfolio need to be in place *at all times*. One cannot rely on anyone's claimed, though surely specious, ability to predict the markets so as to steer around the next challenging period. The page following this letter highlights those protective measures we advocate for our client portfolios and which we rigorously follow for those that we manage.

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A portfolio that adheres to all five guidelines seems to provide a robust defense against catastrophe. In fact, if we were to ask the question, "*How might a portfolio be better fortified?*", I am not sure what else could be done. I suppose that we think of bomb shelters and canned food as the next lines of personal defense.

Investing for Total Return

For most investors, loss avoidance is only a first goal. Earning a respectable return is a near-equal priority.

It is worthwhile to understand *why* investors might expect to earn a return on investment. What do we get paid *for*? Essentially, investors are paid to endure a discomfort with which others are unwilling to cope. If we are not suffering some unpleasantry, then no appreciable return is apt to be earned. Investor discomfort comes in a variety forms:

- The ***inaccessibility*** of one's savings—*e.g.,* buying a 5-year CD versus keeping funds in a readily available passbook savings account that earns a low rate of interest… or none at all;
- Subjecting one's savings to ***risk***—defined for our purposes as the possibility of a permanent loss; and
- Subjecting one's savings to ***volatility***—the uncertainty of not knowing *when* a return will be received or even *how much* it will be.

Not all investments expose us to all three demands. In fact, we can largely choose which type of irritant we find most tolerable.
Dow Wealth Management's goal is to avoid the first two, while being willing to accept the third.

- By owning publicly traded stocks and bonds, our capital is *immediately accessible*. Stocks may be sold for same-day settlement and the funds wired to the client's checking account just hours later.

> As an aside, many investors in recent years have purchased "non-traded real estate investment trusts (REITs)" for the high dividends they often pay. Many are now discovering that they cannot sell these investments except at fire-sale prices back to the issuers and, furthermore, that much of the dividend paid was merely a return of the investor's own principal.
>
> The "accessible" character of an investment frequently has proven itself to be a critical component for success: It acts as a qualifying test to help avoid the worst investment types. In other words, if a security is illiquid, we may not be able to ascertain just how badly other investors tellingly *don't* want to own it until we try to sell it.

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- By maintaining a portfolio that adheres to the Financial Fort principles discussed below, *our risk of an irrecoverable portfolio loss appears to be remote*.

Consequently, *if we are not enduring either of the first two discomforts* of having inaccessible capital or of having it at any meaningful risk, then the only other basis for which we should expect to earn a return is for subjecting our investments to market volatility.

Volatility, of course, is the pain in the arse that our investment methodology delivers in spades.

A High-Quality Stock Corollary

A significant benefit of Dow Wealth Management's focus on high-quality common stocks is the possibility of allocating a greater portion of a portfolio to high-return-potential equities than what might otherwise be desirable.

The ability to own a portfolio allocated 100% to high-quality stocks, rather than just 50% to average-quality stocks (as is typical for many investors with the remainder in cash and fixed-income securities) can be a powerful driver of portfolio returns.

This is especially true today with interest rates on fixed-income portfolios near historic lows.

In other words, if we do not own high-quality stocks, then we probably should not make a large commitment to them—which, by itself, seems apt to dampen results significantly.

Preferred Volatility?

Let's consider volatility a bit further. As indicated above, volatility is one of those discomforts for which the market tends to reward investors for incurring because many people find it so intolerable. Investors must be paid or no one would ever subject his money to the ups and downs. Therefore, it stands to reason that, if we increase the volatility of our portfolio, then we potentially might earn higher returns.

That is the rationale for making a distinction between high-quality Growth stocks and high-quality Income stocks.

- Growth stocks generally offer low dividend yields. Most all investor return, therefore, comes in the form of capital appreciation. The uncertainty attendant to such returns naturally leads to more dynamic stock price movements.

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- Income stocks, on the other hand, offer significantly higher yields. For that dividend portion of the total return, investors know with some assurance *when* and *how much* they will be paid. Income stocks, therefore, generally tend to be less volatile than Growth stocks.

Consequently, we would expect that, over time, more volatile Growth stocks might provide higher total returns than likely tamer Income stocks.

Although it may sound counter-intuitive, volatility in a portfolio that is otherwise sound is an indicator that it may be well positioned to appreciate. If a portfolio does not fluctuate in value, the odds are exceedingly good that its returns are not much to write home about.

Portfolio Indexing

Once we have controlled for portfolio Risk and Volatility, we essentially **index** the portfolio to the appropriate market sector by broadly diversifying among the stocks within it. That broad diversification helps ensure that a possible setback in any single holding will not badly compromise the portfolio.

Conclusion

The Fed's potential rate increase is reason for optimism. It would signal an expectation that the employment situation may continue to strengthen and that businesses are expanding in sustainable ways. That has been the turn of events for which we have long waited.

So, should the stock market enter another turbulent period as the world transitions to a new phase, we should remember that it is neither unexpected nor likely compromising to a soundly constructed portfolio. It is the very cost for which we have bargained to justify our ongoing investment returns. Our willingness to persevere through such periods is why stock investors have greatly outperformed most other investors…and wildly so since 2008.

If we have built our portfolio to the specifications of a Financial Fort, we might have peace of mind that it will likely continue to withstand successfully the trials through the ages and thrive along the way.

Thank you, and we wish you only the "up kind" of volatility this spring.

Most sincerely,

Russell B. Dow, J.D.
President & Senior Portfolio Manager

This paper represents the general economic overviews of Russell Dow, Dow Wealth Management, LLC, and does not constitute investment advice, nor should it be considered predictive of any future market performance. Any securities mentioned are for illustrative purposes only and are not recommendations to buy, sell, or hold such issues.

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Building a Financial Fort

Investors who have followed just a few rules for sound investing may have avoided irrecoverable portfolio losses during turbulent times.

Elements for building a Dow Wealth Management Financial Fort include:

- **Protection against severe economic/ business cycle downturns:**
  Ownership of predominantly ***high-quality*** securities defined by S&P A+, A, A- ratings for stocks and S&P AAA, AA, A ratings for bonds. Such underlying companies and issuers seem unlikely to be fundamentally compromised even during the worst of recessions.

- **Protection against rising inflation and interest rates:**
  Ownership of ***equity*** (*e.g.*, common stocks) and, if they are held, fixed-income securities with ***very short*** maturities. Stocks have tended to be a good hedge against inflation and short-maturity debt may be rolled over quickly into higher-paying securities as rates rise.

- **Protection against isolated destructive economic and corporate events:**
  The use of ***broad diversification*** among companies and industries. Such a well-diversified portfolio of high-quality securities seems apt to recover easily from the unlikely calamity in even several of its holdings.

- **Protection against investor emotion:**
  The use of a strict ***investment discipline*** to avoid the risk of converting *temporary* market downturns into *permanent* losses by selling at inopportune times.

- **Protection against investment firm failure:**
  The use of one of the world's most financially sound and largest custodians to hold and service your account. **Bank of New York Mellon** carries credit ratings that are among the highest in the financial services industry. Pershing, wholly owned by Bank of New York Mellon, has approximately $1.5 trillion in global client assets (Pershing LLC and global affiliates) and its parent company, BNY Mellon has $28.5 trillion in assets under custody and/or administration.*

  *All figures as of December 31, 2014

  The foregoing guidelines seek to lessen the probability for a portfolio to incur an irrecoverable loss of principal and/or its purchasing power. These guidelines do not protect against market declines. It must be understood that all investments and strategies are at risk for causing permanent portfolio loss, even if seemingly remote.

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