KWAG June Update

Each and every week, we monitor and update the broader market averages; each one of the nine stock market style-indexes; and every one of our mutual fund manager's portfolios. Specifically, we examine the returns over various time periods, and we examine the actual stock holdings of each one of our managers. Basically, we're trying to get a sense of both the positive and negative trends in the stock and bond markets, which we use to pro-actively rebalance our portfolios.

For example, over the first quarter of 2014, the S&P500 and the Russell 2000 both increased approximately 1%. From a broader perspective, it looked - to the average investor - like not much had changed in the stock market from the beginning of the year. However, when you took a closer look at the actual nine stock market style-indexes, mid-value stocks increased more than 5%, while small growth was up only slightly. So, even though the broader averages looked about the same, there were some significant differences within the nine stock market style indexes.

In this specific case, there wasn't much of an opportunity to rebalance our portfolios, since the difference between mid-cap value and small growth was basically a reversion from the previous year. Over the previous year, small cap growth was up more than 27%, while mid-cap value was up 23%. Basically the stock market was self-correcting or reversing itself over the first quarter.

Second Quarter Opportunities

Over the last two months (April and May), some interesting trends have developed in our financial markets. Since March 31st, the S&P500 has increased more than 3%, and hit numerous all-time highs. The S&P500 is now up more than 4% for the calendar year through May. On the other hand, the Russell 2000 has lost more than 3% over the last two months and is now down more than -2% for the calendar year. In fact, the Russell 2000 took a (much needed and very healthy) 10% dip between March 4th and May 15th, 2014. To us, this makes small cap stocks very attractive over the long term.

When you examine each of the nine stock market style indexes, small cap growth is down more than -4%, while mid-value is up more than 6% for calendar year. If there was a time to rebalance away from large and mid-cap value stocks into small cap growth stocks…this would be the time.

Bond Market Opportunities

A similar trend is occurring in the bond market. At the beginning of the year, every economist (and their brother) was calling for an <u>increase</u> in interest rates. So, what have interest rates done this year? They've <u>decreased</u>…and in some cases, they have decreased significantly! The net result has been a broad-based rally in the bond market. In fact, our two largest bond holdings are up more than 5% through the end of May. The good news is, in both cases, these bonds will protect our clients if interest rates rise again, mostly because they have very little exposure to "interest" rate risk.

If you know of anyone who owns interest rate sensitive bonds, tell them they've been given a short-term reprieve. Now is the time to unload these overpriced bonds. They should use the proceeds from the sales to purchase non-interest rate sensitive bonds, and build well-diversified bond portfolios…much like all of our clients own.

Our Professional Managers

The primary reason we use active managers - versus index funds - is for periods just like this. Right now, there is a great opportunity to take advantage of the significant price difference in both the stock and bond markets. The good is…all of our stock and bond managers have been pro-actively rebalancing their portfolios, and every one of them have been doing so for a few months now. If you own an index fund - which by definition, does NOT pro-actively rebalance - there is no way to take advantage of this pricing gap, unless you do it yourself. Of course, that creates another significant problem. Exactly how do you rebalance your portfolio?

Most investors monitor their portfolios by only looking at the change in value from week-to-week or month-to-month. Performance is important, however it only tells you part of the story. Not only do you have to look at the underlying performance, but you also have to look at the underlying holdings of each mutual fund manager to see which holdings have changed, and to see what's driving your portfolios under or over-performance. This specific information also provides important clues as to how your overall portfolio diversification has changed over time.

Without this specific knowledge, there is no way to know which manager you should be buying or selling, and there is no way to know how many shares (of each fund) you should buy or sell. In essence you are rebalancing with blindfolds on…

KWAG Monitoring

On a regular ongoing basis, we consistently monitor the portfolio make-up (or stock holdings) of all of our pro-active managers. By doing so, we know exactly why our managers are under or over-performing, and we know exactly how well diversified our overall portfolios are. If you're ONLY following the change in value of the funds you own…how do you really know if it's done well (or poorly) versus an appropriate benchmark? How do you know if the manager is pro-actively rebalancing or not? How do you know if your portfolio is still well diversified across all nine style indexes or not? How would you know when to rebalance? How would you know how many shares to rebalance? The answer is you don't know any of these things. In fact, the illusion does not stop there.

Many investors are also under the impression that if they own a "mid-cap growth" manager, that managers stock holdings are 100% invested in only "mid-cap growth" stocks. This assumption is incorrect. The truth is the **largest percentage** of their money is invested in mid-cap growth stocks. However, in all likelihood they also have money invested in any number of other eight stock market style-indexes.

When a mid-cap growth manager originally purchases a new individual stock, it likely is a mid-cap growth stock…in the beginning. Over time, every stocks price/value will go up and down as the company grows, contracts, and/or evolves. Thus, the company may begin trading in the mid-cap growth style index…however, over time it could shrink into a small cap value stock…or grow into a large cap growth stock. Therefore, you have to examine the underlying holdings of each mutual fund manager on a regular basis to truly understand what you own. Otherwise, you're operating in the dark.

Over time, every stock manager's stock portfolio ultimately becomes a blend of many different stocks in many different style indexes. Our industry defines managers and mutual funds based on where the **majority** of their stock holdings lie. If most of their money is invested in mid-cap growth stocks, they are defined as a mid-cap growth manager. However, every manager owns a number of stocks that will always bleed into the other eight stock market style indexes.

This is why we have made the analogy of building a stock market portfolio to solving a complex Sudoku puzzle. If you don't monitor (and thus know) the exact holdings of each of your money managers (or mutual funds), there is absolutely no possible way to build a well-diversified portfolio…and there is no logical way to rebalance it.

The truth is monitoring is much more tedious (and difficult) than many investors realize. You have to love numbers! You have to love the daily challenge of balancing those numbers! And you have to love researching the percentages of money invested in each fund and style index! Did I mention you have to love numbers? Each and every week – over the last twenty plus years – our firm has pro-actively followed the financial markets; our managers; and our clients overall portfolios. If we see something out of balance, we pro-actively rebalance. This approach insures our portfolios remain well diversified (and un-clustered) over time.

Next month, (in our quarterly newsletter) we will discuss the exact process we go through each day, week and month to insure we stay on top of all our client's portfolios. In the meantime, you can be certain that we are pro-actively taking advantage of both the stock and bond market disconnects. In fact, many of you have probably noticed a number of buys and sells over the last few months. If done correctly, these little tweaks make a significant difference in your overall risk exposure and returns.

Vacation Time

This Friday - June 6th - Kellie and I will be leaving for a two-week educational trip to Spain. We will be travelling with some of my old friends and colleagues from Texas A&M…and a bunch of high school students. I have been asked to educate the students about the Euro, the European Central Bank (ECB) and the Spanish economy. I'm looking forward to the trip and getting a closer look at southern Spain - which took one of the biggest economic hits during the credit crisis of 2008. I will report my observations in next month's update. It should be an interesting report, as your economy is only as strong as you weakest link…right?

I will not be taking calls while I'm overseas, however I will be checking e-mails almost every day. Please feel free to e-mail me if you need something. It's funny…my employees and many of our clients always tell me to relax and get away. I try to explain to everyone that relaxing is stressful to me. I really like working and I love numbers (see the notes above)…so the idea of taking a day off from number crunching seems very stressful to me!! A good balance is the key…

In Closing

As usual, if you have any questions or concerns regarding our updates, our newsletter, your portfolio or any of our investment strategies, please feel free to contact us immediately. We always look forward to hearing from you and we appreciate all of your positive feedback and continued referrals.

Enjoy this great spring weather…

- ***Joe & The Gang at KWAG***

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