Understanding the

DYNAMIC CONTRARIAN PORTFOLIO STRATEGY

Executive summary:

The average mutual fund investor significantly under-performs the broad financial markets indexes.

Passive strategies based on indexing (owning securities designed to mimic the performance of stock or bond indexes like the S&P 500 stock index) offer a low-cost alternative to active management.

Most active investors would improve their long-term results, while saving both time and money, by adopting a passive index strategy.

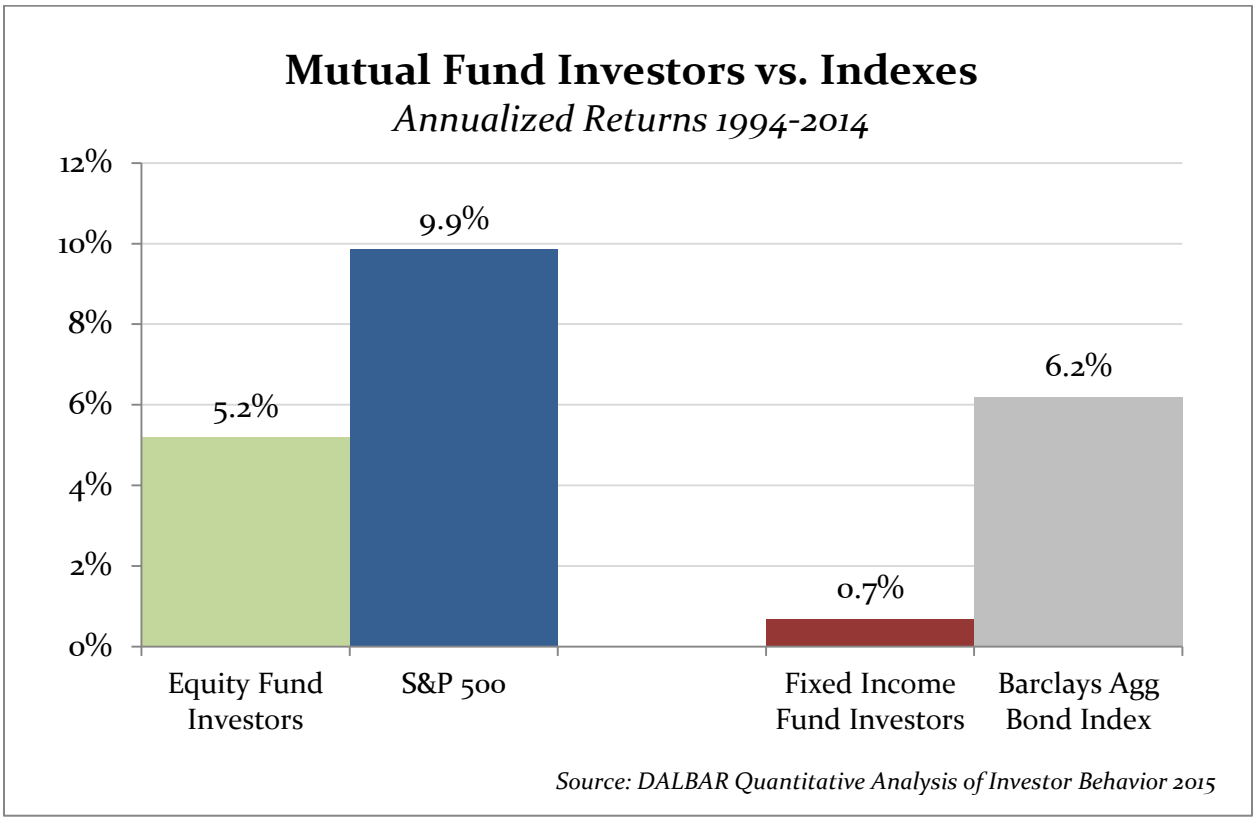
Index strategies have certain intrinsic challenges, especially at the asset allocation level.

The *Dynamic Contrarian Portfolio Strategy* offered by TGS Financial Advisors, which is designed to flow funds to under-priced asset classes at times of significant price divergence, offers a systematic framework for making asset allocation decisions.

Dynamic Contrarian investing is not for everyone.

Why do individual investors underperform?

Let's start with the bad news. Investment research demonstrates that the typical individual investor captures only a portion of the returns available in the financial markets. DALBAR, a mutual fund research firm in Boston, has for decades compiled data on the performance of investors in mutual funds. Here are the depressing results:



It is not the case that the average stock *mutual fund* underperformed the S&P 500 Stock index by more than 4.5% per year over twenty years. It is that the average *investor* in those funds underperformed by that huge margin. (It was worse, much worse, for investors in bond funds.)

Those investors were not careless. They did not buy bad mutual funds with stupid managers. In fact, they generally bought well-rated funds with smart, highly-trained portfolio managers. But they bought those funds at the wrong times. Consider some examples:

- The worst-ever single-month underperformance by mutual fund investors occurred in October of 2008. The stock market collapsed on October 10, and large numbers of mutual fund investors sold out. The market rallied, but those investors remained on the sidelines. During October 2008, the S&P 500 was down 16.8%, a terrible one-month decline. But the average equity mutual

fund investor was down 24.2%, more than 7.4% worse than the market. And all this in a single volatile month.

- Every year from 2008 to 2012, there were net outflows from equity funds and net inflows to bond funds. It was not until 2013 that investors found the courage to begin to invest new net dollars into equity funds. How did that work out? Badly. From March 2009 through year-end 2014, the S&P 500 returned 21.7% per year, but the Barclays Aggregate Bond Index returned only 5.1% per year. Those mutual fund investors missed the first four years of what has now been a six year bull market in U.S. stocks.

- From the low in March of 2009 through the end of 2014, the S&P 500 Stock Index was up well over 200%. Yet as of early 2015, more than 50% of Americans, including many with funds in employer retirement savings plans like 401ks, own no stocks at all.

- In 2014, the S&P 500 returned 13.7%. The average equity mutual fund investor earned only 5.5%.

Why do mutual fund investors do so poorly? The simplest answer is that investors *under-perform* by trying to *outperform*. Investors buy the funds that have done the best in the immediate past, and sell those that have disappointed. The result? The fund that was just sold usually provides higher returns than the one that was purchased.[1]

The reasons for poor performance are behavioral, not informational. The emerging discipline of behavioral economics demonstrates that our financial decisions suffer from deep-seated and systematic errors of thought and practice. Among the most damaging are trend-following and recency bias; human beings are hard-wired to believe what is happening now will continue in the future. Hence the decision to sell in October 2008, or the purchase of bond funds in 2009 through 2012.

A key finding of research is that, among non-professionals, *more-active investors achieve worse results*. Investing, unlike most other human activities, does not reliably reward hard work and study with superior results. There is a profound and often costly difference between *information* and *insight*, and hence between *activity* and *advantage*.

Are there alternatives to these poor results? We believe there are.

[1] Even professional investors, running multi-billion dollar portfolios for institutions, suffer similar adverse results. When institutions replace one manager with another, the fired manager usually outperforms the hired manager. Charles D. Ellis, CFA, **"**Murder on the Orient Express: The Mystery of Underperformance," *Financial Analysts Journal,* Volume 68, no. 4 (2012): 14.

Index investing: A simple, low-cost and effective investment strategy.

The easiest way to avoid *underperforming* the market is to *own* the market. *Every investor's thinking should start with index strategies.*

The worldwide market for indexed investments, which totaled more than $9 trillion at the end of 2014, can be traced back to a research paper written by John Bogle in 1949, while he was a student at Princeton University. Examining the investment management industry centered in Boston, Bogle concluded that investors would be better served by an investment approach more committed to reducing costs and less focused on beating the market.

Bogle's insight was profound, and remains important more than sixty years later: *Don't waste time and effort trying to beat the market.* Instead, be content with simply capturing the return of the financial markets by owning an index fund that seeks to duplicate the return of the most representative and widely-followed equity index in the United States—the Standard & Poor's 500 Stock Index. In 1976, Bogle's Vanguard Group of mutual funds launched the First Index Investment Trust with an investor commitment of a mere $11.4 million. That fund is now called the Vanguard 500 Index fund, and it manages over $171 billion.

An index strategy offers several important advantages:

- **Low cost.** The typical expense ratio for index funds is much lower than for actively-managed funds. For example, the expense ratio for the Vanguard 500 Index fund was just 0.17% in 2014, and the cost of Vanguard's S&P 500 ETF (exchange-traded fund) was a mere 0.05%. By comparison, the cost for the average actively-managed U. S. stock fund was 1.25%.[2]

- **Tax-efficient.** Because shares within the fund are only bought and sold when companies are added to or removed from the index, portfolio turnover and the resulting taxable capital gains are kept very low, historically between 1% and 2% for Vanguard's 500 Index Fund. This makes an index fund an attractive investment in either a taxable or a tax-deferred account.

[2] A mutual fund with a 1.25% expense ratio (125 basis points) must earn returns 1.25% better than the market each year just to break even. Since all active mutual funds are competing with each other, buying and selling the same universe of stocks, by simple mathematics it is almost impossible for the average actively-managed fund to avoid underperforming the market in the long run. Russel Kinnel, "The Ever-Shrinking Expense Ratio: What's behind the persistent trend of declining mutual fund fees?" *Morningstar.com*. February 4, 2015, http://www.morningstar.com/advisor/t/101583441/the-ever-shrinking-expense-ratio.htm

- **Captures core returns.** Owning the S&P 500 gives you a share in the largest public companies in the United States. You own the commanding heights of the economy. In the long run, if the U. S. economy and the U. S. financial markets do well, you will surely participate.

- **No need to compare.** Since you already own the most widely-followed and representative equity index, you don't need to compare your performance to that index; there is no need to benchmark, evaluate, or second-guess your decisions.

- **Simplicity.** An index strategy can be "set and forget." Make your investment and hold it forever. This eliminates all of the time and trouble active investors spend managing their holdings—rarely with any predictable performance advantage to show for their efforts.

- **Accessibility.** Today, almost every employer-sponsored retirement savings plan offers the option to purchase a security that closely follows the performance of the S&P 500 Stock Index. Outside your retirement account, you can easily purchase a proxy for the S&P as a mutual fund or an exchange-traded fund (ETF).

Based on these straightforward advantages, we believe that index investing should be the default strategy for every prudent investor. As professional investors charged with running other people's portfolios, we pursue a more complex strategy, which we believe has potential benefits for a subset of investors with plenty of patience and an independent cast of mind. We'll address that strategy in the pages that follow, for those who have an interest.

But for most investors, our recommendation is the same as Warren Buffett's and John Bogle's: *Buy an S&P 500 Index Fund, hold it forever, and get on with your life.* It was good advice in 1976, and it remains a solid strategy today.

The limits of indexing.

All serious investors should start their thinking about investing with indexing, but we believe it need not always end there. While indexing should deliver better returns than the typical results earned by active amateur investors, a strategy built around the S&P 500 Stock Index suffers from several intrinsic limitations:

- **You will always own the most over-priced stocks.** The S&P 500 Stock Index is capitalization-weighted. This means that it owns stock in 500 companies in proportion to the value of those companies in the markets. Even the most casual market observer knows that sometimes markets go to irrational extremes. The most obvious example was the technology stock bubble of the late 1990s, when a small number of high tech stocks came to represent most of the value of the entire S&P 500 Index. When that bubble collapsed, many tech stocks declined by more than 80%, driving the entire S&P 500 Stock Index down by more than 45%. *Even though most of the 500 companies in the index actually appreciated during the three-year bear market from March 2000 to March 2003, S&P 500 Index investors lost money.*

- **Sometimes the S&P 500 delivers poor returns.** During the decade of the 1970s, the S&P 500 Index delivered returns more than 250 basis points per year below inflation, even before taxes. During the 2000s, investors in the S&P 500 actually *lost* money for the entire decade, even before inflation. In both cases, investors who relied solely on the S&P were unable to realize acceptable returns over a period of more than ten years.

- **You may miss important opportunities.** Consider the Callan chart on the next page, which documents the returns of a spectrum of asset classes, from investment-grade bonds to emerging markets stocks, on a year-by-year basis.[3] As you can see, the S&P 500 Index, shown as the army green boxes, has delivered superior returns only during a four-year period in the late 1990s, and in 2014. In 1977, for the first time, most of the capitalization of world equity markets was outside the United States. Since then, U.S. equities have represented anywhere from just under 30% of world market capitalization to just over 55%. *If you only own the S&P 500, you are excluding most of the world's investment opportunities.*

- **You have to stick with it.** While it is a sensible, low-cost strategy, and should be the default choice for every serious investor, it is vital to

[3] Inclusion of these indexes is for illustrative purposes only. Keep in mind that individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect actual investment performance. Individual investors' results will vary. Past performance does not guarantee future results.

remember that indexing is a strategy, and therefore a choice. Inevitably, just like every other prudent investment strategy, sometimes indexing will disappoint. Take a look at that Callan chart again. If you were following an S&P 500 Index strategy, how would you have been feeling in early 2003, after three years of sub-par returns? Might you have abandoned your S&P Index Fund to buy bonds, just in time for four years of lousy bond fund returns? Indexing is always sensible. That does not mean it is always profitable. Sometimes it can get really scary.

The Callan Periodic Table of Investment Returns

Annual Returns for Key Indices Ranked in Order of Performance (1995–2014)

1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
S&P 500 Growth 38.13%	S&P 500 Growth 23.97%	S&P 500 Growth 36.52%	S&P 500 Growth 42.16%	MSCI Emerging Markets 66.42%	Russell 2000 Value 22.83%	Russell 2000 Value 14.02%	Barclays Agg 10.26%	MSCI Emerging Markets 56.28%	MSCI Emerging Markets 25.95%	MSCI Emerging Markets 34.54%	MSCI Emerging Markets 32.59%	MSCI Emerging Markets 39.78%	Barclays Agg 5.24%	MSCI Emerging Markets 79.02%	Russell 2000 Growth 29.09%	Barclays Agg 7.84%	MSCI Emerging Markets 18.63%	Russell 2000 Growth 43.30%	S&P 500 Growth 14.89%
S&P 500 37.58%	S&P 500 22.96%	S&P 500 33.36%	S&P 500 28.58%	Russell 2000 Growth 43.09%	Barclays Agg 11.63%	Barclays Agg 8.43%	Barclays Corp High Yield -1.41%	Russell 2000 Growth 48.54%	Russell 2000 Value 22.25%	MSCI EAFE 13.54%	MSCI EAFE 26.34%	MSCI EAFE 11.17%	Barclays Corp High Yield -26.16%	Barclays Corp High Yield 58.21%	Russell 2000 26.85%	Barclays Corp High Yield 4.98%	Russell 2000 Value 18.05%	Russell 2000 38.82%	S&P 500 13.69%
S&P 500 Value 36.99%	S&P 500 Value 22.00%	Russell 2000 Value 31.78%	MSCI EAFE 20.00%	S&P 500 Growth 28.24%	S&P 500 Value 6.08%	Barclays Corp High Yield 5.28%	MSCI Emerging Markets -6.00%	Russell 2000 47.25%	MSCI EAFE 20.25%	S&P 500 Value 5.82%	Russell 2000 Value 23.48%	S&P 500 Growth 9.13%	Russell 2000 Value -28.92%	Russell 2000 Growth 34.47%	Russell 2000 Value 24.50%	S&P 500 Growth 4.65%	S&P 500 Value 17.68%	Russell 2000 Value 34.52%	S&P 500 Value 12.36%
Russell 2000 Growth 31.04%	Russell 2000 Value 21.37%	S&P 500 Value 29.98%	S&P 500 Value 14.69%	MSCI EAFE 26.96%	Russell 2000 -3.02%	Russell 2000 2.49%	Russell 2000 Value -11.43%	Russell 2000 Value 46.03%	Russell 2000 18.33%	S&P 500 4.91%	S&P 500 Value 20.81%	Russell 2000 Growth 7.05%	Russell 2000 -33.79%	MSCI EAFE 31.78%	MSCI Emerging Markets 19.20%	S&P 500 2.11%	MSCI EAFE 17.32%	S&P 500 Growth 32.75%	Barclays Agg 5.97%
Russell 2000 28.45%	Russell 2000 16.49%	Russell 2000 22.36%	Barclays Agg 8.70%	Russell 2000 21.26%	Barclays Corp High Yield -5.86%	MSCI Emerging Markets -2.37%	MSCI EAFE -15.94%	MSCI EAFE 38.59%	S&P 500 Value 15.71%	Russell 2000 Value 4.71%	Russell 2000 18.37%	Barclays Agg 6.97%	S&P 500 Growth -34.92%	S&P 500 Growth 31.57%	Barclays Corp High Yield 15.12%	S&P 500 Value -0.48%	Russell 2000 16.35%	S&P 500 32.39%	Russell 2000 Growth 5.60%
Russell 2000 Value 25.75%	Barclays Corp High Yield 11.35%	Russell 2000 Growth 12.95%	Barclays Corp High Yield 1.87%	S&P 500 21.04%	S&P 500 -9.11%	Russell 2000 Growth -9.23%	Russell 2000 -20.48%	S&P 500 Value 31.79%	Russell 2000 Growth 14.31%	Russell 2000 4.55%	S&P 500 15.79%	S&P 500 5.49%	S&P 500 -37.00%	Russell 2000 27.17%	S&P 500 Value 15.10%	Russell 2000 Growth -2.91%	S&P 500 16.00%	S&P 500 Value 31.99%	Russell 2000 4.89%
Barclays Corp High Yield 19.18%	Russell 2000 Growth 11.26%	Barclays Corp High Yield 12.76%	Russell 2000 Growth 1.23%	S&P 500 Value 12.73%	MSCI EAFE -14.17%	S&P 500 Value -11.71%	S&P 500 Value -20.85%	Barclays Corp High Yield 28.97%	Barclays Corp High Yield 11.13%	Russell 2000 Growth 4.15%	Russell 2000 Growth 13.35%	S&P 500 Value 1.99%	Russell 2000 Growth -38.54%	S&P 500 26.47%	S&P 500 15.06%	Russell 2000 -4.18%	Barclays Corp High Yield 15.81%	MSCI EAFE 22.78%	Russell 2000 Value 4.22%
Barclays Agg 18.46%	MSCI EAFE 6.05%	Barclays Agg 9.64%	Russell 2000 -2.55%	Barclays Corp High Yield 2.39%	S&P 500 Growth -22.08%	S&P 500 -11.89%	S&P 500 -22.10%	S&P 500 28.68%	S&P 500 10.88%	S&P 500 Growth 4.00%	Barclays Corp High Yield 11.85%	Barclays Corp High Yield 1.87%	S&P 500 Value -39.22%	S&P 500 Value 21.17%	S&P 500 Growth 15.05%	Russell 2000 Value -5.50%	S&P 500 Growth 14.61%	Barclays Corp High Yield 7.44%	Barclays Corp High Yield 2.45%
MSCI EAFE 11.21%	MSCI Emerging Markets 6.03%	MSCI EAFE 1.78%	Russell 2000 Value -6.45%	Barclays Agg -0.82%	Russell 2000 Growth -22.43%	S&P 500 Growth -12.73%	S&P 500 Growth -23.59%	S&P 500 Growth 25.66%	S&P 500 Growth 6.13%	Barclays Corp High Yield 2.74%	S&P 500 Growth 11.01%	Russell 2000 -1.57%	MSCI EAFE -43.38%	Russell 2000 Value 20.58%	MSCI EAFE 7.75%	MSCI EAFE -12.14%	Russell 2000 Growth 14.59%	Barclays Agg -2.02%	MSCI Emerging Markets -1.82%
MSCI Emerging Markets -5.21%	Barclays Agg 3.64%	MSCI Emerging Markets -11.59%	MSCI Emerging Markets -25.34%	Russell 2000 Value -1.49%	MSCI Emerging Markets -30.61%	MSCI EAFE -21.44%	Russell 2000 Growth -30.26%	Barclays Agg 4.10%	Barclays Agg 4.34%	Barclays Agg 2.43%	Barclays Agg 4.33%	Russell 2000 Value -9.78%	MSCI Emerging Markets -53.18%	Barclays Agg 5.93%	Barclays Agg 6.54%	MSCI Emerging Markets -18.17%	Barclays Agg 4.21%	MSCI Emerging Markets -2.27%	MSCI EAFE -4.90%

One of the key insights of Modern Portfolio Theory is that diversification can deliver measurable advantages. By owning a more diverse selection of investments, an investor may be able to earn acceptable returns in a broader range of market environments than would be possible with a portfolio confined to any one asset class—including the large-capitalization U.S. stocks represented by the S&P.

But understand that all of the limitations discussed here are arguments against *concentration* and for *diversification*. They are *not* arguments against indexing itself. In fact, there are now index options for many markets besides the S&P 500. Today it is possible to diversify both globally, and across asset classes, while still benefiting from the low costs of index mutual funds and ETFs.

This brings us to two key questions for every serious investor who is committed to a diversified investment approach:

- How should you allocate capital across the range of global investment opportunities, from stocks to bonds to real estate to cash? Looking at the style boxes in the Callan chart on the last page, which of the colored boxes are you going to feature in your portfolio strategy, and how many dollars are you going to allocate to each?

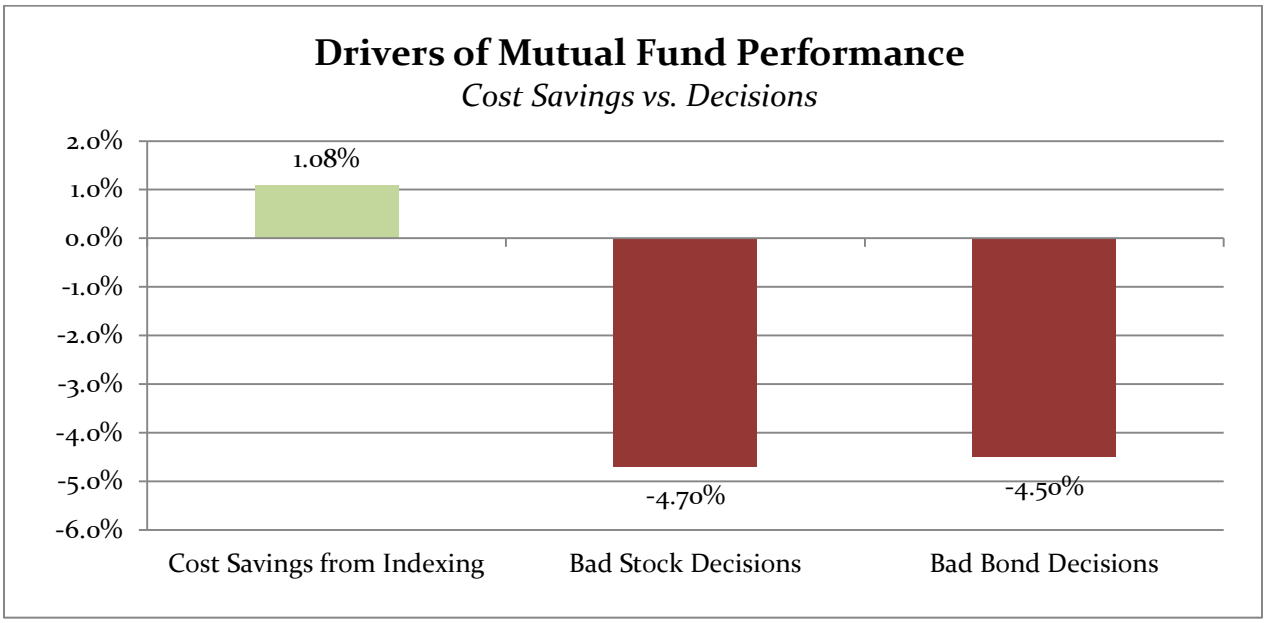
- How will you adjust those allocations as the current prices and prospective returns of those various asset class change over time, especially when markets go to extremes of valuation, driven by the fear or greed of millions of individuals and institutions?

At TGS Financial Advisors, we devote most of our research time and attention to answering those questions.

The Dynamic Contrarian Portfolio Strategy™
Taking advantage of opportunities created by irrational investor behavior

Once you decide to diversify beyond an S&P 500 Index Fund, you are in the asset allocation business, whether you realize it or not. How will you approach solving the key challenges of portfolio diversification?

The costs of getting it wrong are high. Remember the DALBAR graph on the second page, and consider the performance deficit suffered by the typical mutual fund investor, as shown below.[4]



We draw three conclusions from these data:

1) The most powerful investment decisions occur at the asset allocation level, not at the security selection level. In other words, it is more important to decide correctly whether to own stocks or bonds, large or small companies, U.S. or foreign equities, than it is to decide on a specific stock, bond or mutual fund. *This is exactly where the typical mutual fund investor gets it wrong, again and again.*

[4] Index cost advantage calculated as the difference between the average actively-managed fund at year-end 2013 (125 bps), per *Morningstar.com*, and the year-end 2014 cost of the Vanguard Index 500 Stock mutual fund (17 bps). Mutual fund investor performance disadvantages from the DALBAR *Quantitative Analysis of Investor Behavior 2015*.

2) Once an investor commits to a diversified portfolio approach, the range of possible portfolios expands, and the asset allocation decision becomes primary. The cost-savings advantages of an index strategy remain, and can be significant over time, but the effects of asset allocation decisions, which may be positive or negative, will dominate the structural cost savings from indexing.

3) Investors lose about four times more potential return to bad decision-making than they do to fees and expenses.

Our ***Dynamic Contrarian Portfolio Strategy™*** is designed to provide a disciplined, forward-looking investment process that anticipates market moves, making decisions based on historical price and yield relationships, instead of reacting to market moves by chasing performance after the fact. Our approach has five basic elements:

- **Diversification:** We diversify systematically across up to fourteen different asset classes. Our baseline portfolios are adjusted to reflect five levels of risk tolerance.

- **Value tilt:** We over-weight value-oriented investment disciplines, and under-weight growth-oriented disciplines.

- **Contrarian asset allocation:** We use historical price and yield data to determine the relative value of paired asset classes. When one asset class is meaningfully overvalued, we flow funds from the overpriced to the undervalued asset class.

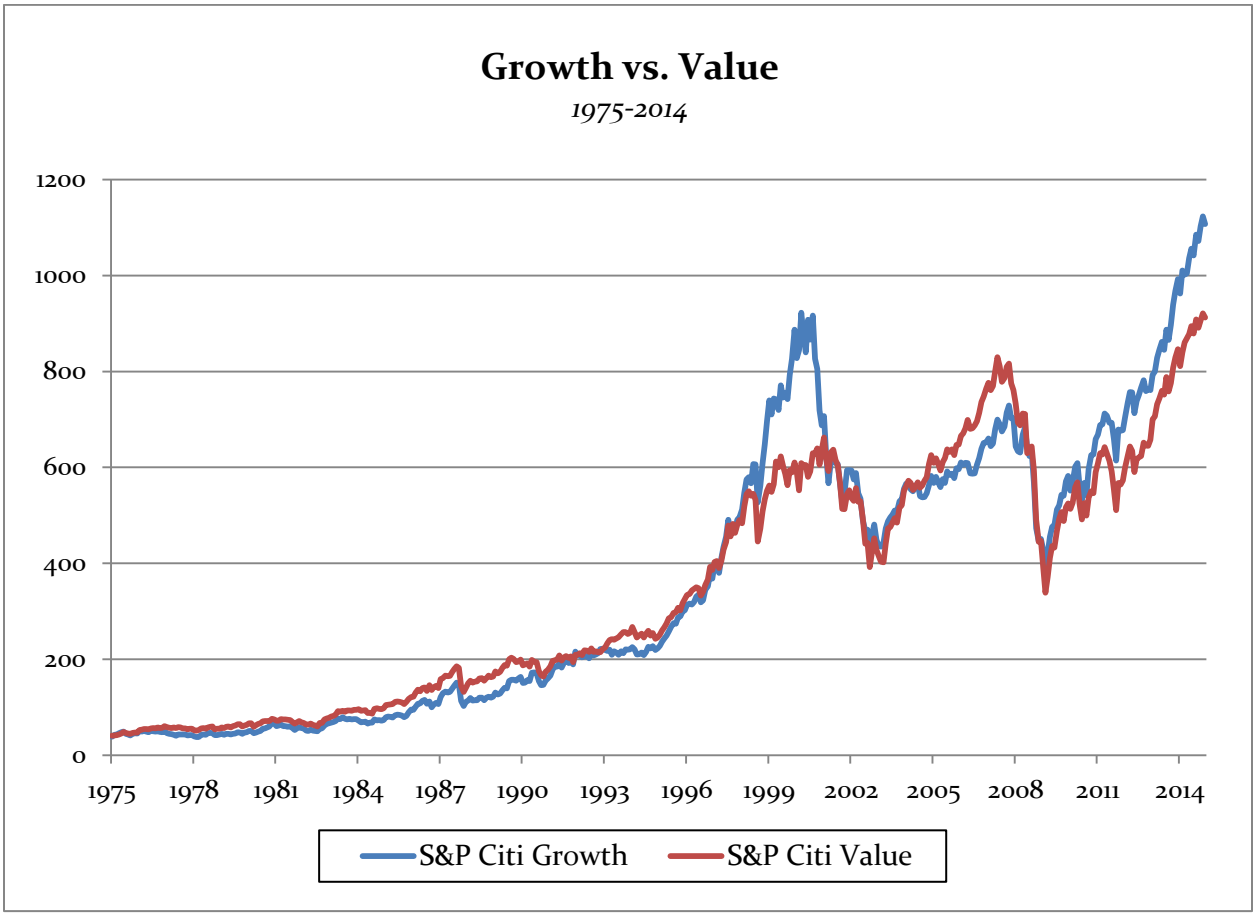
- **Focus on costs:** In many of the asset categories in our model, we use index funds, ETFs or institutional-class shares to drive down costs.

- **Discretionary portfolio management:** To make sure our strategy is implemented consistently and on a timely basis, we manage all investments on a discretionary basis.

In the next section, we will examine the implementation of this strategy, using real-world examples.

The Dynamic Contrarian Portfolio Strategy™
Case studies from periods of market excess.

The graph below compares the prices of the Citigroup S&P 500 Growth Index to the Citigroup S&P 500 Value Index, starting when these measures were created in 1975.

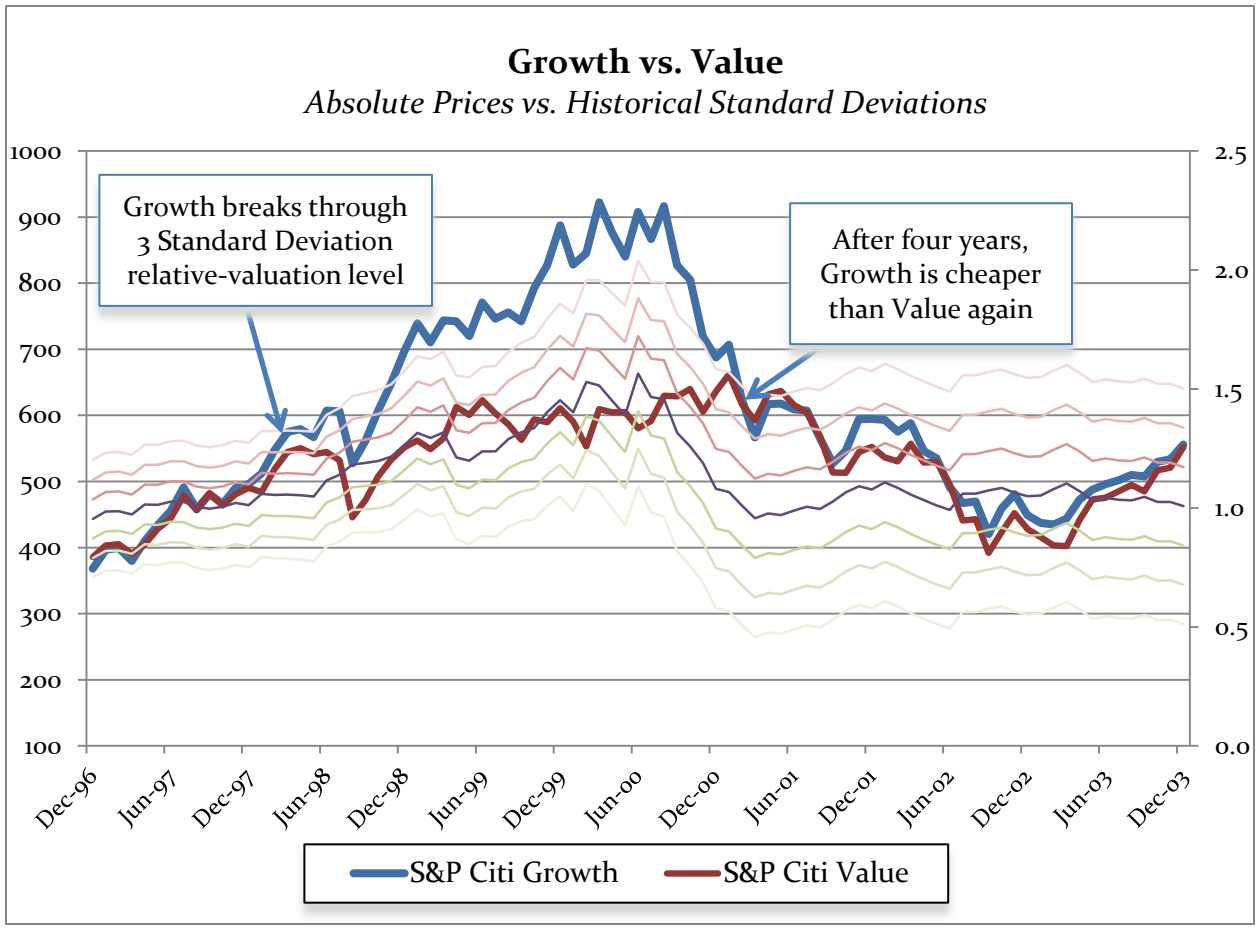


As you can see, from 1975 until the mid-1990s, the two indexes were closely linked. There were periods when growth outperformed and periods when value outperformed, but the paired strategies appeared to have a strong relationship. Performance advantages were relatively small, neither index outperformed for more than four years, and their prices always converged.

Until 1997, when growth took off. This was the period when the Internet went from an electronic messaging and file transfer protocol, of interest only to a few scientists, to a worldwide phenomenon of profound social and economic importance. As use of the World Wide Web expanded, companies involved in online connectivity or services exploded in value, whether or not that company was profitable. In the last crazy year of the technology bubble, ending on March 24 of 2000, the tech-heavy NASDAQ Stock Index went up more than 80%.

This was the greatest investment bubble in human history, and it drove profoundly irrational decisions and expectations.[5]

Let's drill down further, to see what drives our actual decision-making. We track prices of paired asset classes, using standard deviation as a measure to assess how far out-of-balance one asset class is from another; in this case, we were tracking growth and value.



By the first half of 1998, when the relative price of growth over value breached the three-standard deviation line, growth had reached a position of profound over-valuation. Reacting to this price anomaly, by early 1998 we were significantly over-weight value. [6]

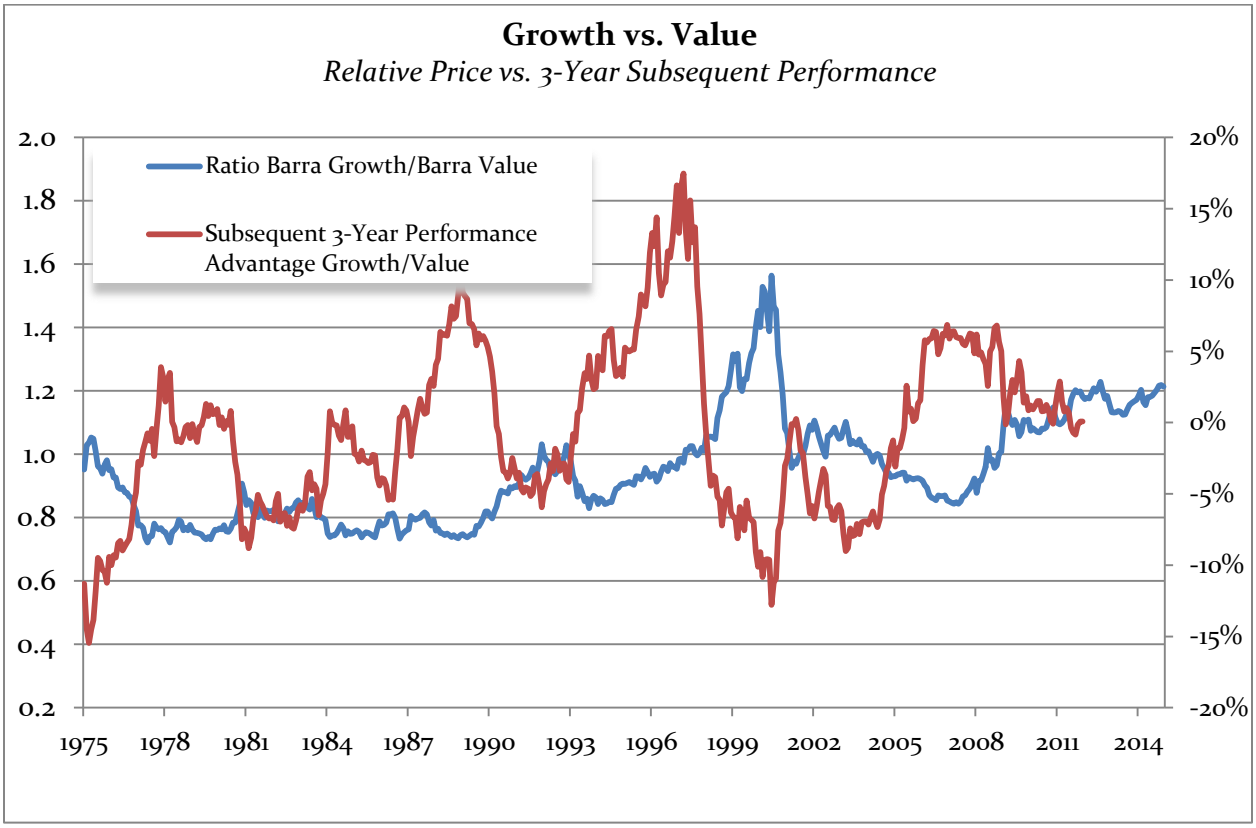
[5] In late 1999, a *USA Today* survey found that Americans expected stocks to earn an average return of over 27% per year over the next decade. The return on the S&P 500 in the 2000s was actually slightly negative.

[6] A 3-σ (three sigma) event should happen only 0.3% of the time, so the growth spike was genuinely unusual. Standard deviation (also called sigma and represented by σ) is generally applicable to phenomena that are normally distributed, like coin tosses, intelligence quotients, heights of people, or blood pressure readings. Investment returns are not normally distributed, because they are not the random outcome of a natural phenomenon; rather, they are the result of the combined decisions of millions of human beings, who are prone to herd behavior at the extremes. So freakish high prices (the tech bubble of the late 1990s) or low prices (the market crash from fall 2008 to spring 2009) occur much more often than we would anticipate. What we observe is a bell curve with "fat tails."

This illustrates the fundamental challenge of *Dynamic Contrarian* investing. Just when markets are most exciting, or most scary, our client portfolios will be most out-of-sync with investor psychology. When markets are up, we will leave possible returns on the table. When markets are down, we will be buying when everyone else is selling. Our hope is always that our decisions will help us avoid losses, and enhance returns, when market trends reverse. But those potential benefits can never be certain.

As you can see, eventually the trend did reverse, and quite dramatically. By mid-2001 the Citigroup Growth index was actually *below* the Value Index, just as it had been in early 1997. All of the superior returns of growth during the three year tech bubble had been erased. Over the full cycle, our decisions to under-weight growth, while over-weighting value, bonds and Real Estate Investment Trusts (REITs), paid off for our clients.

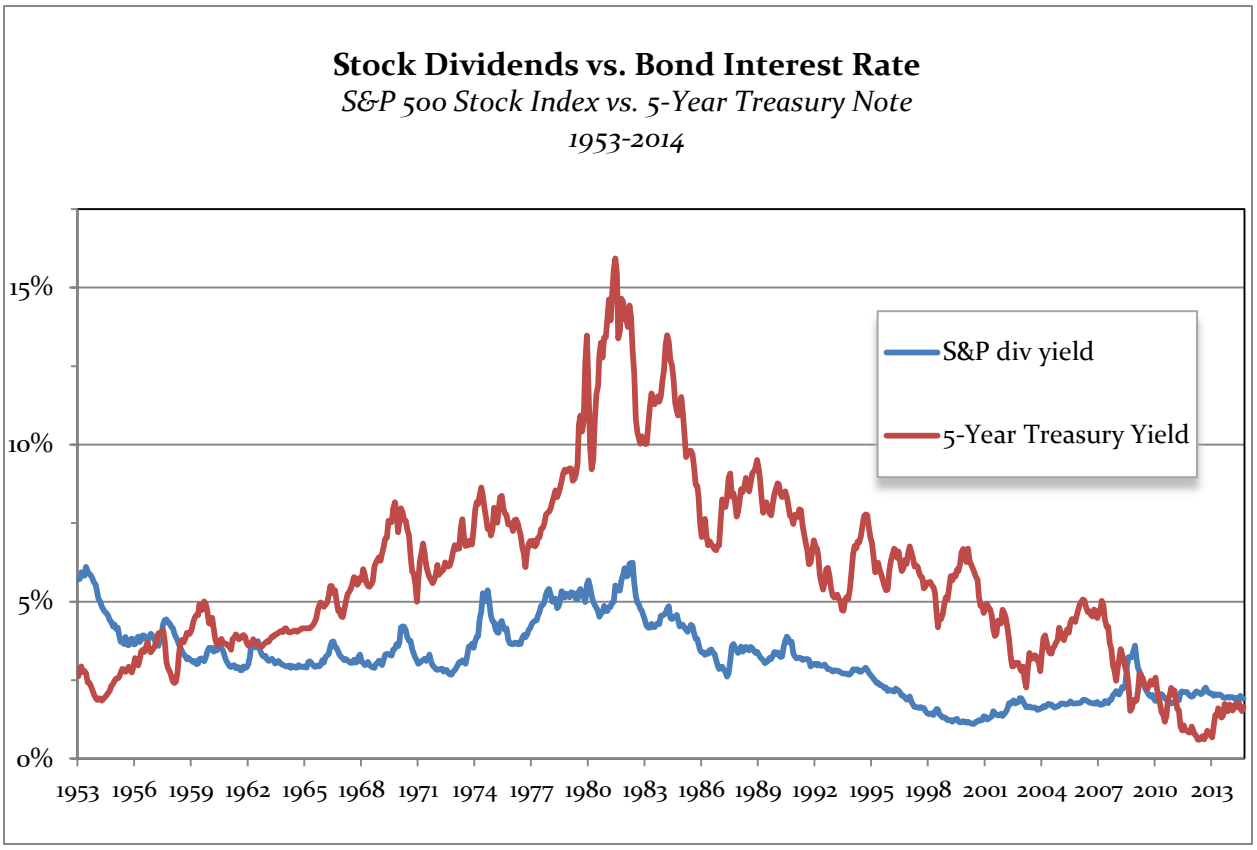
The graph below connects the historical relative valuations of large-cap growth and value stocks directly to subsequent episodes of outperformance and underperformance:



The blue line represents the relative price of growth to value. When the blue line is high, growth is expensive. When the blue line is low, growth is cheap and value expensive. The red line represents the average annual performance divergence over the next three years. To see the result of any price anomaly, simply look directly above or below. For example, if you look at the 1999 growth spike (the highest point on the blue line), you can see that, over the next three years, value outperformed growth by more than 11% per year.

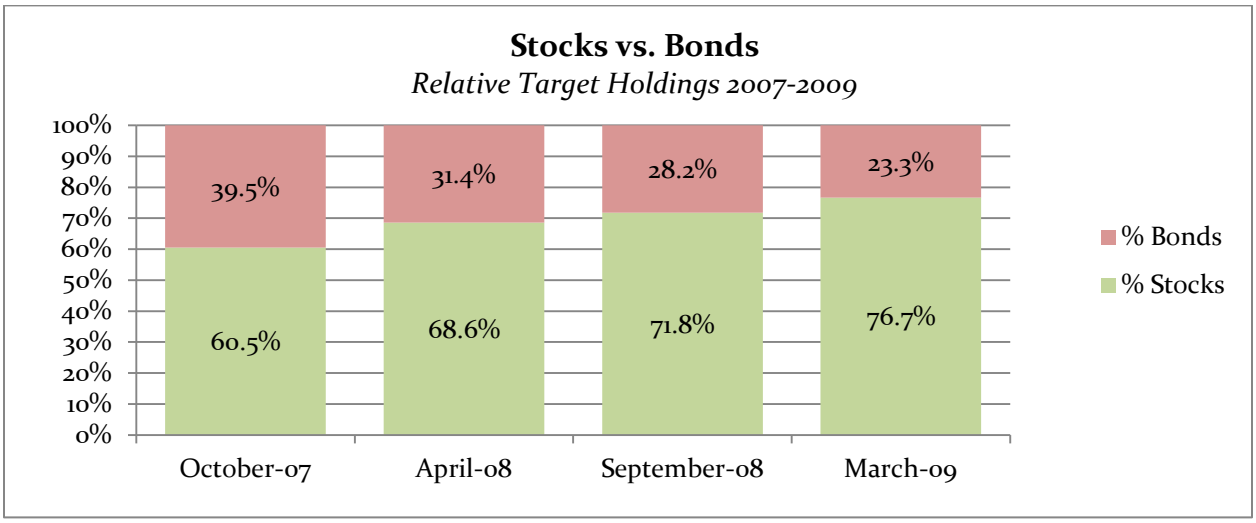
What does this prove about future performance? *Nothing.* We can't *know* the future. We can observe that, in the past, certain price relationships appear robustly connected to each other, and conclude that those prices will ultimately mean-revert. This has been a powerful—and profitable—insight over the years. We make our portfolio decisions based on measurable criteria that we believe will offer us an economic advantage in the future, but we remain (like every other investor, all of the time) hostages to that always-uncertain future.

Let's examine another real-world example of *Dynamic Contrarian* investing. One of the paired asset classes we track is the S&P 500 against the 5-year Treasury note. In this case, we track on a yield basis, not a price basis.



For more than half a century, starting in 1957, bond interest rates were higher than stock dividend yields. Until 2008-2009, when the financial sector collapsed and worldwide stock markets crashed. From market peak in October 2007 to the trough in March of 2009, the S&P 500 declined by more than 60%, and investors abandoned stocks and bought Treasury bonds, in a classic "flight to safety." For the first time since the 1950s—an entire investment lifetime—stock dividends were higher than bond yields. We saw this as an opportunity, and bought stocks aggressively.

The graph below shows the relative holdings of stocks and bonds in our target portfolios from 2007 to 2009.[7]



Understand what this graphic illustrates: For this entire period, stock prices were going down, and for much of it, bond prices were going up. We kept buying more stock from early 2008 through early 2009, in the middle of the most severe stock market decline since the Great Depression, and we were wrong again and again.

But in the end we were right. The relationship between the yields of stocks and bonds turned out to be quite robust. Since the market low in March of 2009, through March of 2015, the U. S. stock market is up more than 200%, far more than the bond market. We can now see clearly that the stock market panic of 2008-2009 represented a buying opportunity for stocks, and a selling opportunity for bonds.

Every investment decision is made in the context of uncertainty about the future. We are always hostages to the unknown. As we seek a rational basis for portfolio construction, we believe that the relative-value and relative-yield scenarios we have described in this section present a compelling framework for our investment decisions.

[7] The graph shows the holdings of two components of our investment target portfolio at the *Moderate Risk* level. It is not a complete picture of our target portfolio, and does not include every asset class included in a typical client portfolio. It does not precisely represent the actual allocation in the portfolio of any specific client at any point in time.

Is *Dynamic Contrarian* investing right for you?

In this white paper, we have very intentionally avoided discussions of the performance results we have earned for individual clients over specific periods. After all, past performance is always what someone else got, and is a notoriously unreliable predictor of future results.

What we have tried to do, in this quite detailed discussion of several of our portfolio decisions, is to communicate three things:

- Our conviction that historical price and/or yield relationships provide a rational basis for making decisions at the asset allocation level, and the possibility those decisions may provide a performance advantage when trends reverse.

- The inherent impossibility of timing such decisions precisely at the inflection point, immediately before the trends reverse, and hence the certainty of periods of underperformance.

- The psychological challenges created by the stress of being out-of-sync with both the financial markets and other individual investors.

Every investment strategy, even the most sensible, will deliver poor results during some part of the market cycle. Even the most expert and insightful portfolio manager will suffer through periods when he appears to have lost his touch. The challenge for every individual investor is to decide on a sensible strategy, and then to stick with it through thick and thin, both when it is working well and (even more urgently) during those periods when it is underperforming and out of favor. Following the crowd and changing direction in response to recent trends is an almost guaranteed way to fail as an investor.

As professional investors, we believe long-term investment performance is a client-selection challenge. From time to time, markets will go to extremes, creating opportunities to reduce economic risks and enhance long-term portfolio returns. Without exception, taking advantage of those opportunities will require us to make decisions different from those of the mass of individual investors. To have the chance to add value for our clients over time, we must depend on them to do three things:

- Not panic during down markets.

- Not get greedy and chase performance during market bubbles.

- Accept that their portfolio returns may diverge significantly from those of their peers, for periods as long as several years.

Do you believe that the crowd will get it wrong at the extremes of investment cycles, and that the mass decisions of millions of emotional knuckle-heads may provide you with profitable opportunities? Does the chance of buying something on sale, amid the kind of disorder that causes most individuals and institutions to lose their bearings, genuinely excite you? Are you willing to turn your back on apparently easy profits, when those same knuckle-heads are bidding suspect assets up to absurd heights of over-valuation?

If so, you may be a good match with our strategy.

Summary:

In this white paper, we have outlined three possible strategies for investors to pursue:

- **An unsystematic, performance-following strategy using mutual funds or individual securities.** This is the default strategy for most individual investors, and research by DALBAR suggests it is likely to result in long-term underperformance.

- **A passive investment strategy using index funds.** We believe such a strategy is simple, low-cost, and should capture much of the core return available in the financial markets. A move toward indexing would lead to improved performance for most active investors. While index strategies have certain inherent limitations, indexing should be the default strategy for prudent long-term investors.

- **Our *Dynamic Contrarian Portfolio Strategy (DYCOPS)***, which combines systematic diversification with a deliberate policy of over-weighting underperforming assets at times of significant price or yield divergence. This strategy offers the certainty of tracking error, with the possibility of higher risk-adjusted performance. We believe it can be a prudent alternative for a minority of disciplined, value-oriented long-term investors.

We hope this white paper has been helpful to your thinking about the challenges of long-term investment strategy. If our approach resonates, we would welcome the opportunity to meet with you and learn more about your finances.

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