Third Quarter 2015

Indexing & Market Timing:

Much has been written lately about simply buying and holding index funds. They are inexpensive and some pundits argue that active management doesn't outperform, so why pay for it? For those who are banging the drum of "index investing" and "buy and hold" without risk mitigation strategies, the following chart (from Carter Worth of Cornerstone Macro) is rather revealing.

Since the S&P 500 highs back at the beginning of 2000 through September of 2015, a $100,000 investment in an index fund that exactly tracked the S&P 500 Index would have "*grown"* to $98,090 inflation-adjusted dollars including dividends. That means that over 15.75 years, the index investor's purchasing power was *eroded* by -1.91%. Just a small measure of risk mitigation to avoid parts of the Dot-com crash and the Great Recession would have led to much better results and positive investment returns.

We like and use index funds because they provide diversified exposure to an asset class or sector and they are inexpensive and tax-efficient. However, we believe that there are times when it makes sense to own index funds (or other stocks or funds) and times when it does not make

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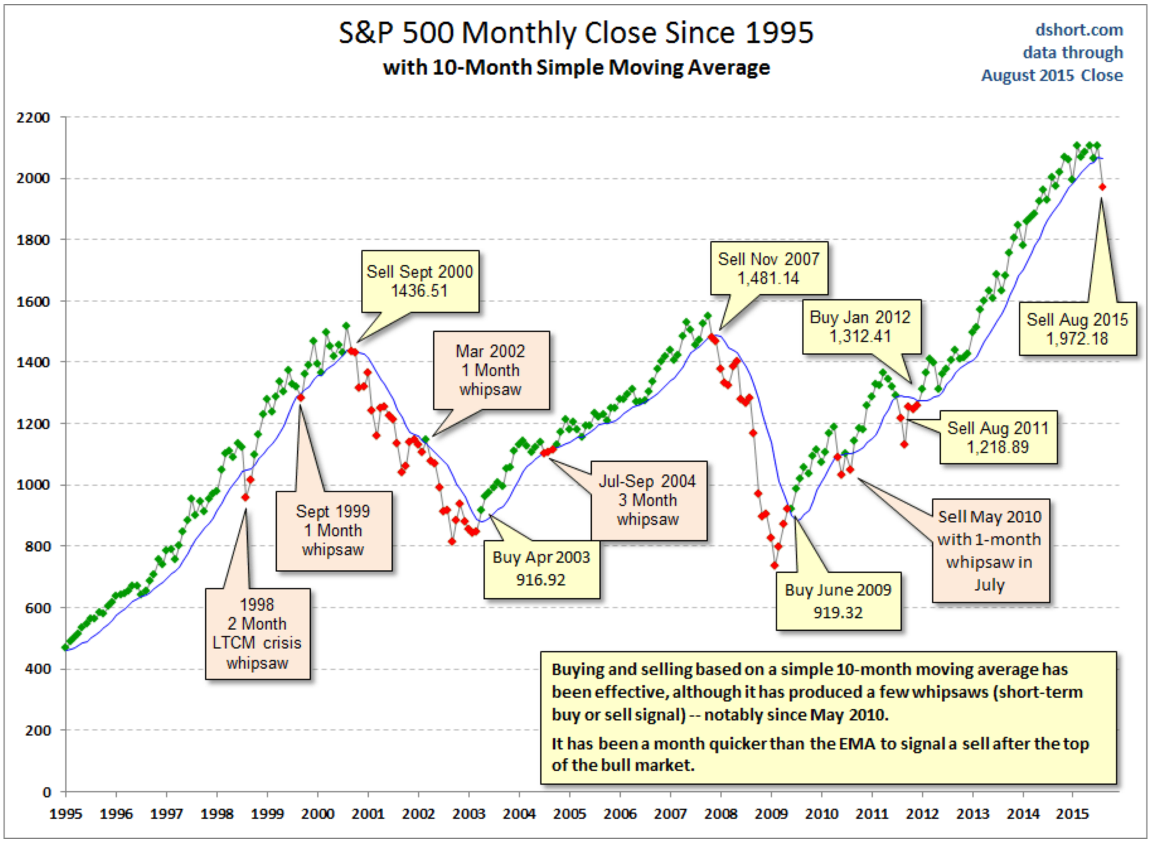
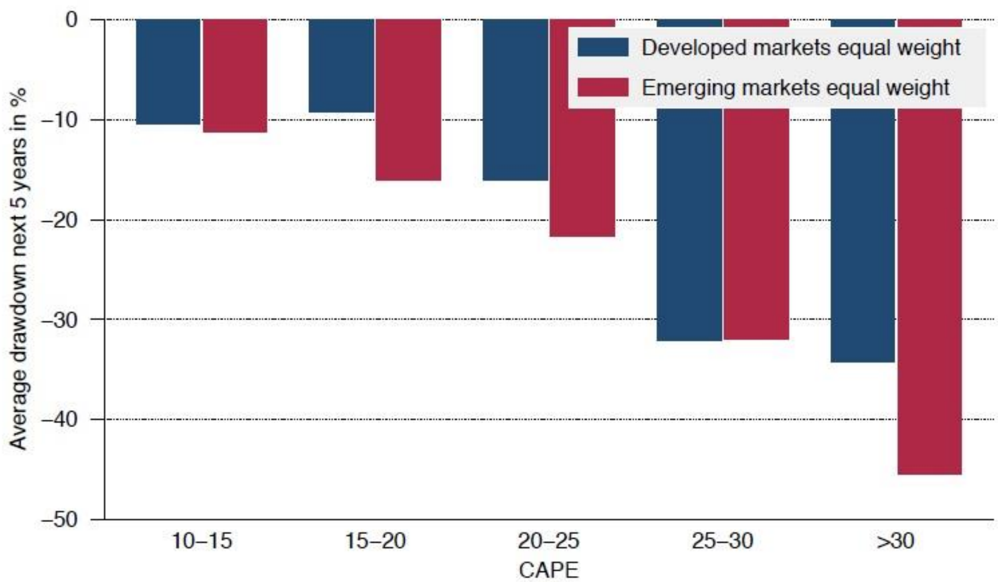
sense to own them. A simple moving average can be helpful in determining when to be "in the market" and when to be "out". As you can see from the chart below, this simple timing tool has historically been very effective in helping an investor avoid catastrophic losses during major stock market declines.



We use market timing techniques, not to try to pick market tops and bottoms, but rather to help us mitigate risk of loss. Over long periods of time, the stock market will go up in price, but there are times when the odds are against an investor, such as now. Currently the Shiller Cyclically Adjusted PE ratio (CAPE) of the S&P 500 is 25. The following chart illustrates that the downside risk for a CAPE value such as we have now is an average of more than -30%.

Exhibit : Relationship between CAPE and future drawdowns in developed and emerging markets



Source: Wellershoff & Partners

We suggest that now might be an opportune time to reduce your portfolio exposure to risk assets like stocks and high-yield bonds. The current CAPE value suggests that market losses of > -30% should be expected sometime in the next 5 years. Currently, the market trend is down and the 10-Month simple moving average says "sell stocks" or hedge stock positions. When valuation and trend are flashing "caution" we believe it is prudent to take action and mitigate risk of capital loss.

Safe investing!

Steve Small

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