The ACM Journal

Summer handicap

Ah summer, a time when a young parent's fancy lightly turns to thoughts of how to occupy the children when school gets out. Such was the scene at the Armbruster household a few weeks or so ago. Nipa and I realized, in abject terror, that we had no plans for the kids for the summer and they would be home all day every day.

Many camps had already filled up, many could not accommodate our eldest's gluten-free diet, and many just seemed too expensive (although the idea of all-summer boarding school did occur to us and money seemed no object). So, we leapt at the opportunity when the boys suggested they would like to try golf camp.

I've played golf, but only a few times. Nipa has never set foot on the links. So, the urchins' interest in the game comes as some surprise. Nevertheless, we quickly agreed to sign them up, mostly in the interest of self preservation. As a first outing, I took the boys to a driving range so they could see what golf was all about.

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Capital Markets Review

The second quarter of 2012 began on a sour note for stock investors. April was a month of ups and downs, but mostly downs. May was truly awful. June was still erratic, but it did provide some relief as global stock markets rallied into the close of the quarter. The S&P 500 fell as much as 10.0% during the quarter, but finished with a loss of 2.8%. As you can see on the nearby chart, all stock markets around the globe shared in the lousy performance. Real estate was the one bright spot for growth investors.

The culprits for the declines were the usual suspects: weak economic growth at home, uncertainty in the policy arena, and turmoil overseas. Reports of economic growth (whether GDP or Industrial Production) have been tepid lately. While still positive, government data shows a declining rate of growth, and previously-released numbers are being restated lower with some frequency. Employment reports have seen similar trends.

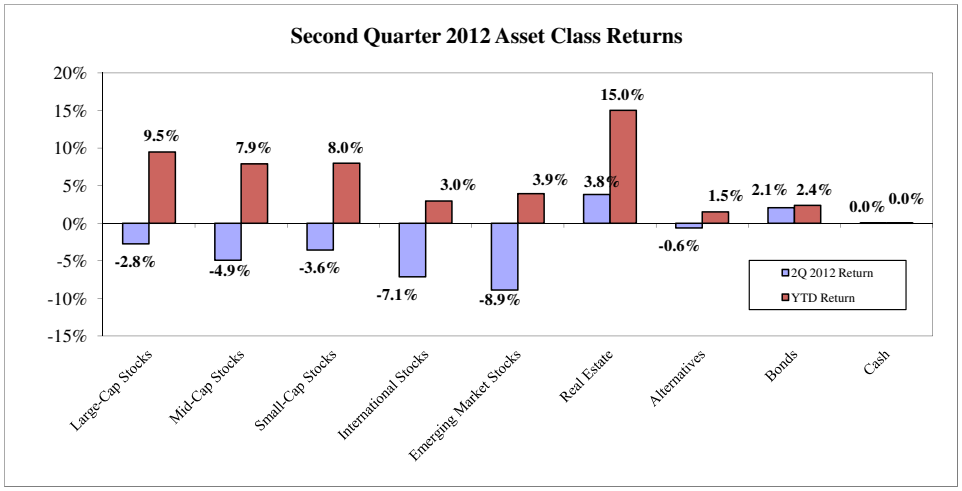
The debates over the "fiscal cliff" and "Obamacare" were also making headlines (and waves) during the second quarter. There is no way to accurately forecast the outcome of legislation, elections, or policy debates, but suffice it to say business confidence has not been high with all the uncertainty. Given that the election season is just heating up, I don't expect any relief on this front for a while. The impact on the capital markets will likely result in greater volatility at least through November. However, my favorite approach for weathering all the political advertising is to curl up in the fetal position, close my eyes, and put my hands over my ears. I strongly recommend it.

The one notable point, at least from an investment standpoint, now that Obamacare has been upheld by the Supreme Court is that taxes may be going up for some of you starting in January. For couples making over $250,000 ($200,000 if you are single) annually, there is a new 3.8% surtax on investment income. That means the tax rate on bond interest, stock dividends, and realized capital gains are all going to rise for "high earners". This makes strategies like "asset location," tax loss harvesting, and

others all the more important. If you are in this category and would like to discuss specific strategies to reduce taxable portfolio income, give us a shout.

Europe, of course, has been the largest driver of returns (both up and down) in the global capital markets. The Greeks have caused us plenty of anxiety, but it was Spain's turn to get in on the fun during the second quarter. Not wanting to be bested by its profligate neighbors, Spain announced it would be unable to meet its financial obligations without help from the greater European Union. However, stocks staged a strong rally on the last session of the quarter as the EU met and decided to allow banks to directly access money in the fund reserved for bailouts (the so called European Stabilization Fund). While this provides a short-term lifeline for the banks and possibly for European governments (notably Spain and Italy), the longer-term issues persist. Over-borrowing has been the biggest concern, and allowing banks to borrow even more hardly seems like the solution. Austerity has proven a controversial measure, but, in the end, you can't spend money you don't have, at least not forever.

Because of all the uncertainty and the significant issues global economies face, investors in the U.S. continued to pull money out of stocks in the second quarter. Specifically, investors pulled $44 billion out of stock mutual funds while investing $71 billion in new money into bond mutual funds, according to the Investment Company Institute. Interestingly, stock market valuations remain at reasonable levels for longer-term investors willing to ride out short-term volatility. Bonds, on the other hand, look historically expensive, trading at the highest level on record. A simple model for comparing stock and bond valuations became popular during Alan Greenspan's tenure as Fed Chairman. This so-called Fed Model compares the yields on bonds with the "earnings yield" on stocks (the inverse of the price/earnings ratio). Currently the gap is quite wide, a favorable omen for the stock market. Stocks may not rocket to new highs anytime soon, but there is hope for the future.



In praise of inaction

"One who sees inaction in action, and action in inaction, has understanding among men, disciplined in all he performs"

-Bhagavad Gita, Chapter 4, Verse 8

As you may have noticed, financial markets have been uncertain of late. The conventional response is to take some sort of action to better position your portfolio for the current environment. This might include trying to move in and out of different asset classes, trying to choose an investment manager who can pick the best stocks, or simply getting out of the markets altogether. However, there is ample evidence that the best course of action, in fact, is to take as little action as possible. Doing nothing in the face of changing markets may seem counterintuitive to most people. Nevertheless, when it comes to investing, inaction is often the best choice.

This is not to say that one should ignore portfolios entirely. Rather, the correct approach is to be highly disciplined and selective when making any and all changes to a portfolio. Reacting emotionally ito short-term market fluctuations should always be avoided.

Patience is a Virtue

History shows that high levels of portfolio activity are unlikely to improve long-term performance. Take Jeremy Grantham, a legendary investor who runs a multibillion dollar institutional investment firm. Mr. Grantham also manages his sister's retirement account, but not through his firm. He estimates that he trades his sister's account once or twice per year and produces returns that are one to two percentage points higher than the performance of his company's funds. Or, look at the ING Corporate Leaders Trust, which has outperformed the overall stock market over the past 10 years with no investment manager and a group of stocks descended from a portfolio set up in 1935 and not traded since. If you really need convincing, look to the Oracle of Omaha himself. Warren Buffett describes his investment time horizon for a stock as "somewhere between 10 years and forever." A more academic assessment of the costs of high activity comes from researchers Geoffrey Friesen of University of Nebraska-Lincoln and Travis Sapp of Iowa State. They calculated that between 1991 and 2004, "market timing" decisions reduced equity fund investor returns by 1.56% annually. In theory, taking action and making changes to your portfolio could be effective. It is certainly human nature to want to try. However, even smart investors are not particularly good at it, and the best investors avoid it almost entirely.

Manage the Tax Bite

Two other big reasons for inaction (better known to finance geeks as "low turnover") in a portfolio are taxes and costs. Taxes are generally either ignored or placed on the back burner by most investment managers, but they can be a huge drag on investment returns if not managed properly. Anytime you sell an investment at a profit, you have to pay capital gains taxes (15% for "long-term" gains and usually a higher ordinary income tax rate for "short-term" gains). So, frequent trading can significantly weigh on your returns after taxes are figured into the equation. In an influential paper some years ago, noted finance researchers Robert Arnott and Robert Jeffrey pointed out that very few investment managers actually outperform by enough to cover their capital gains taxes. In other words, their clients would have been better off, on an after-tax basis, if they hadn't traded at all. Therefore, it is best to avoid high turnover in your portfolio in order to avoid giving undue money to Uncle Sam.

The exception to this low turnover rule is realizing tax losses, which Arnott and Jeffrey point out "are like cash in the bank." This practice involves selling investments that have declined in value and immediately purchasing similar replacements so that your portfolio allocation does not change substantially. In this situation, you get a tax benefit from the capital loss you realized, which should help improve your investment results on an after-tax basis.

Reduce Costs

Higher investment costs are often a result of high portfolio turnover. Generally, investment managers who trade a lot are able to charge higher fees for all their activity, even if that activity does not produce better results. Additionally, there are higher costs embedded in the trading process. Brokerage commissions, the bid/ask spread, and market impact costs all serve to erode the returns of more active traders. Even if investment managers can improve returns marginally by trading aggressively, the evidence suggests they cannot improve returns enough to overcome the costs of their trades. Morningstar, the mutual fund research firm, has conducted studies on the impact of investment costs and concluded that the strongest determinant of future investment returns for mutual funds is the management fee. Lower cost funds tend to

outperform higher cost funds on average, which is fairly intuitive. Ultimately, turmoil in the markets can be difficult to endure, especially when the preferred strategy is to sit back and wait. However, our goal is to focus on time-tested strategies: maintain an appropriate long-term asset allocation plan, keep turnover low to minimize taxes, and invest in a low cost manner. As always, we will also rebalance between investments when necessary to keep your risk profile in line with what is appropriate. Rebalancing is one form of turnover that we believe is necessary. These are all things that, unlike the performance of capital markets, are within our control, and have historically proven the best strategies available for building and maintaining long-term wealth.

FIRM NEWS

Late in the second quarter our Portfolio Analyst, John Lyon, was quoted in an article for a Dow Jones News blog aimed at providing advice to other financial advisors nationally. John offered insight into various quantitative risk measures used (or often misused) by financial advisors. Let us know if you'd like to see a copy of the article.

As you all know, we have been running Armbruster Capital Management and Fulreader & Komma Management as two separate firms. We made a decision during the second quarter to consolidate the companies into a single entity. Armbruster Capital will be the surviving firm and we have been asking Fulreader & Komma clients to move their accounts over. So far the process is over half done and it has been going quite well. We anticipate the entire "merger" will be completed by the end of the year at the absolute latest. In the end, we will have a unified firm with streamlined processes, better reporting, a strong investment and operational team, and significant scale on which to build future growth.

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We pulled into the parking lot at the same time as one of Amer's friends from school. His family got out of their $60,000 SUV and were all decked out in appropriate golf clothing. We rolled up in a scratched pick-up truck. I was wearing work boots, ripped jeans, and a Cheerios t-shirt that I got free with a box of cereal. Clearly, I needed to learn what golf is all about.

In the end, the kids had a good time hitting balls and are now more excited than ever. I've committed to buying clubs for them that I'm sure will cost way more than I'm expecting. Still, perhaps it will turn out to be a good investment. Maybe they'll embrace the sport, hang out with the country club set, get good jobs, close many lucrative deals on the golf course, and be able to support their parents in our old age. Either that, or they'll lose interest in three weeks and their clubs will collect cob webs in the garage.

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