The ACM Journal

Asset Protection

Having grown up in big cities, surrounded by people and constant noise, my wife Nipa was a little apprehensive about living in the country. She has repeatedly asked for an alarm system, especially now that I travel quasi-frequently for work. I finally caved, and invested in the latest in home security: a police dog.

Her name is Sara. She is almost three years old, and was an active-duty New York State Trooper. Her specialty is narcotics, but she is also trained in tracking. All police dogs are trained in suspect "apprehension".

Our security system is working hard for us, trying to prove her value. Unfortunately, that means that anyone who comes near the house, whether it be a friend, our babysitter, or even my daughter's pre-school buddy, is subject to incessant barking and growling. Fortunately, she hasn't "apprehended" anyone yet.

We are still working out a few kinks with our new system, and can't seem to turn off certain features, like alarm clock mode. Every morning, around 5:45, Sara stands at the base of the stairs and whines until I get up to take her for a walk. I wouldn't mind so much, had I not been woken up that early for the past eleven years by the whining of small children.

Maintenance has also proven to be more of a challenge than we expected. Cleaning up muddy paw tracks and hair, taking three walks a

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Capital Markets Review

The first quarter of 2014 was generally solid for most segments of the capital markets. Domestic stock returns were positive, but not stellar. This is not too surprising, given their massive run in 2013. Interestingly, mid-cap stocks provided the strongest returns among the domestic stock group. Small-caps were the worst, but they have been on quite a run for most of the past decade. We remain concerned about the valuation levels of mid-cap and small-cap stocks, but so far they have held firm.

International stock returns were not as strong, again. Stagnant economies in Europe, slowing economic growth in the emerging markets, and of course the situation with Russia and Ukraine have all weighed on international stock market returns. Still, we really like the longer-term outlook for international stocks, particularly the emerging markets. The valuation disparity between U.S. stocks and stocks in the rest of the world is significant. While the price/earnings ratio for U.S. stocks is around 17, it is only around 14 for developed world international stocks and 11 for the emerging markets. This seems like a bargain for those willing to ride out short-term volatility.

Interest rate sensitive investments, such as bonds and real estate performed quite well during the first quarter. Real estate investment trusts (REITs) rose 8.8%, which is a huge gain for a single quarter. REITs have lagged significantly the last year or two, so some of this may just be a "catch up" rally. We also continue to worry about the valuations for REITs, which have been extended, in our view. Investing for income has been in vogue the past few years, and REITs have generally benefited. We believe they, and all high-dividend-paying stocks benefited too much, resulting in overvaluation. We have consequently been underweighted in REITs recently. This worked against us in the quarter, but has been the right move over the past year.

Bonds also rebounded somewhat after a lousy 2013. A gain of 1.8% might not seem inspiring, but considering that bonds typically only earn around 5.0% in an average year, their gain in the first quarter is quite strong. We have been conservative with regard to bonds during the past year. In many portfolios, we've had significant amounts of cash, rather than investing in bonds. This was based on our belief that the opportunity cost for being out of bonds was not that high. In fact, we've side stepped some losses, and only recently missed out on a little bit of gain. However, we may be changing our view.

This is not in reaction to anything that is happening in the market, but rather to new research. A recent study in the *Financial Analysts Journal*, shows that rising interest rates historically have not been a problem for bond investors with a longer horizon. Typically, rising interest rates hurt the value of bonds, resulting in losses for bond investors.

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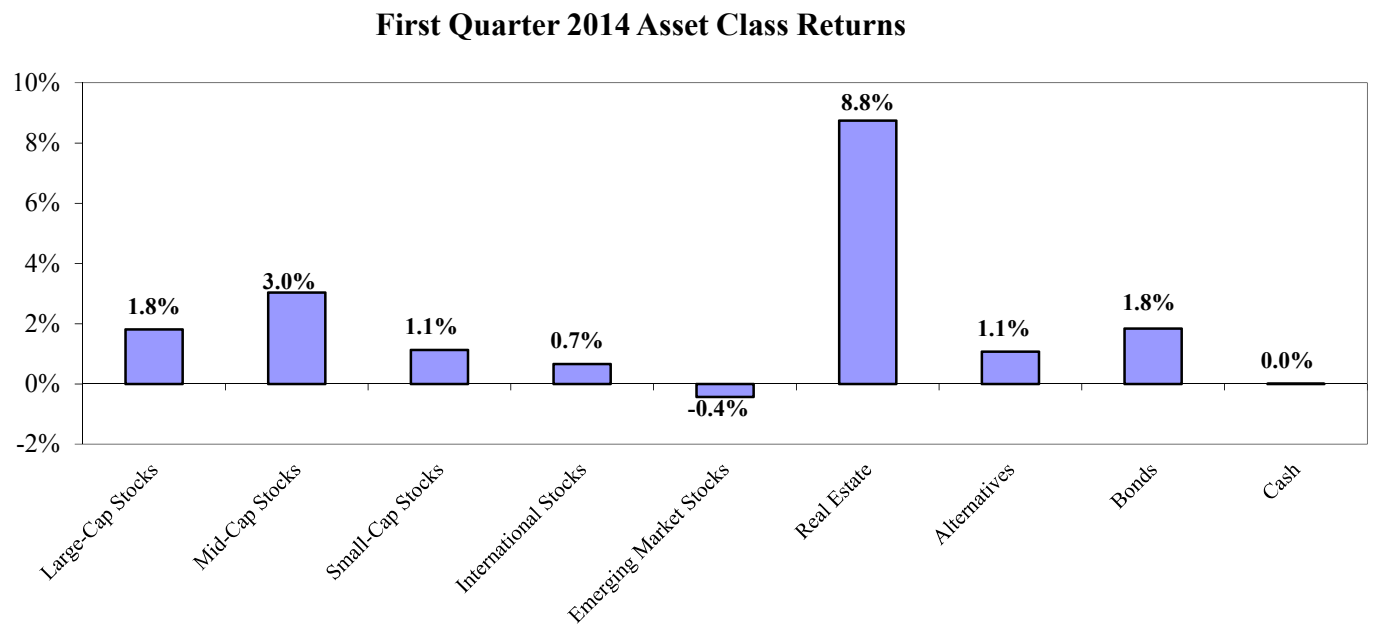

Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indcies. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Alternatives are represented by the HFRI Fund Weighted Composite Index. Bonds are the Barclays Aggregate Bond Index. Cash is the yield on the 30-day T-Bill.

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However, this recent study showed that for longer-term investors, returns for diversified bond portfolios converge back to the starting yield of the portfolio. The study indicates that for almost every six-year holding period from 1985 to 2013, the Barclays Aggregate Bond Index has provided returns that are within 1% of the starting yield. So, while there are a lot of alarming articles in the press about the impact rising interest rates can have on your bonds, the reality is that longer-term investors have typically fared well even in bad markets. We are doing some follow up work on this, and may make a few changes to our bond portfolios as a result.

Alternative investments continued to plod along in the first quarter. Returns have not been great, but they have reduced risk significantly in most portfolios. With the recent increase in stock market volatility, these investments may have an opportunity to shine in 2014.

So far we're off to a mediocre start to the New Year. We'll continue to monitor the portfolios we manage, and make changes as appropriate. However, our long-term strategy of staying invested, rebalancing, and managing costs and taxes has proven effective in the past, and we don't expect to deviate much, regardless of what surprises the stock market may have in store for us this year.

What is ACM?

Armbruster Capital Management, Inc. (ACM) is a boutique wealth management firm serving high-net-worth individual and institutional clients. The firm's innovative "Passive Quant" investment approach incorporates cutting edge financial research to help control risk and pursue superior returns. ACM uses index funds, exchange-traded funds (ETFs), and other investment vehicles to build portfolios designed to reduce investment-related costs and taxes in order to maximize net returns.

Located in Pittsford, New York, ACM is employee owned, independent, and free of conflicts of interest. Acting as a fiduciary, the firm creates truly customized investment portfolios tailored to each client's unique objectives.

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New Reinsurance Fund

We recently added a new fund to our alternative investment portfolio, The Stone Ridge Risk Premium Interval Fund. The ticker symbol is SRRIX. This fund buys reinsurance investments, which is unlike anything else we own. This is why we like it.

The fund invests in two types of securities. The first is catastrophe bonds. Catastrophe bonds are a way for municipalities to take out additional insurance against events like hurricanes, floods, earthquakes, and other risks. For example, no insurance company will write additional insurance on hurricanes in Florida. The entire insurance industry believes that it has enough exposure to hurricane risk, and hurricanes are inevitable in Florida.

However, many municipalities would like to take out additional insurance to reduce their expense when the next hurricane comes. The solution is that these municipalities effectively issue bonds to outside investors. The investors collectively pay into a pool of say $100 million. This money sits on deposit with a third party custodian bank and earns interest. The municipality pays a premium of around 8% every year for access to this pool of money if a hurricane occurs. The investors collect this premium as a sort of coupon payment for the bonds they purchased.

If there are no hurricanes during the term of the bond, usually three years, then the investors get their principal dollars back. They have effectively earned an 8% return. If there is a hurricane, and one severe enough to meet the specifications of the bond contract, some portion, or possibly all of the principal is used by the municipality to pay for hurricane damage.

Clearly, this can be a risky proposition. If you were to buy catastrophe bonds to insure Naples, Florida against hurricanes, you would make around 8% each year until a bad hurricane occurred. Then you would potentially lose everything. That doesn't sound so good. However, by diversifying the exposure to hundreds of uncorrelated risks around the world, it is possible to build a portfolio of catastrophe bonds with very little risk.

You can minimize the "idiosyncratic risk" of a single natural disaster by having only a little exposure to hurricanes in Florida. The rest of the portfolio might be invested in bonds that insure earthquakes in California, or tsunamis in South Asia, and hundreds of other events around the globe. Thus, when one investment doesn't work out, the premiums collected from all the others can offset that loss. Because there is no correlation among natural disasters in different parts of the world, it is fairly easy to create a very diversified portfolio with little overall risk.

The other investments our new fund use are called "quota shares". These are similar to catastrophe bonds, except they effectively give exposure to the balance sheets of several large reinsurance companies. This is a bit esoteric, but instead of getting exposure to one risk at a time, as with catastrophe bonds, quota shares allow the fund to get exposure to hundreds of risks all at once. Again, the idea is to diversify as broadly as possible.

While we like the idea of this fund on its own merits, we really like it as part of an overall portfolio. The reason is because it is complementary to both stocks and bonds. Natural disasters have no economic sensitivity. A bear market for stocks will not cause an earthquake or flood, and natural disasters usually do not have a negative impact on the broader national economy. So, while the fund itself is broadly diversified, it actually brings a large degree of diversification to the overall portfolio as well.

The statistical properties of the fund are intriguing. Along with very low correlation with stocks and bonds, the year-to-year volatility is very low for these investments. Because natural disasters don't occur all the time, and because the fund is broadly diversified, most years there is not a lot of fluctuation in price beyond the increase in value from collected premiums. There is also a nice expected return. With a combination of catastrophe bonds and quota shares, the fund expects to earn double-digit returns, on average over time.

In numbers, the Swiss Re Global Catastrophe Bond Index has returned 8.5% from early 2002 through the end of 2013. The annual standard deviation (a measure of risk) was 2.4%. By way of comparison, stocks earned 6.0% with standard deviation of 17.2% over the same time period. The Stone Ridge fund also invests in quota shares, which are not included in the Swiss Re index. This will make the fund a bit riskier, but should also result in higher returns over time. Using modeled data, the expectation for the portfolio of catastrophe bonds and quota shares is mid double-digit returns, and still low year-to-year volatility.

However, as with any investment, there are risks. Stone Ridge, again using modeled data, believes the fund could lose as much as 30% in a very severe downturn. That sounds like a lot, but it is far less than stocks have lost in their worst periods.

We have invested small percentages of many of our clients' portfolios in this fund. It is not appropriate for everyone, but we have used it where we believe it is a good fit. If you are concerned about your portfolio, either because of the inclusion or exclusion of this fund, feel free to give us call. We'd be happy to discuss this or any other investment with you in greater detail.

Firm News

We have continued to grow, and currently manage just shy of $150 million. While we remain smaller than many of our peers, this is significant growth over the past five years.

Of course we are thrilled to be growing. Larger scale provides us additional financial resources, but we believe it is also good for our clients. For example, scale provides us with investment opportunities we might not otherwise have. The Stone Ridge fund (see related article) that we recently invested in would not have been available to us if we were a smaller advisor. We also are able to invest in enhanced technology that improves security and brings efficiencies to our work day, thus allowing us to spend more time on portfolio management and client service.

That said, growth can also bring challenges. Frequently firms grow too fast and are not able to keep up from an operational and service perspective. Also, firms can become too focused on growth, and take existing clients for granted. We pledge to not allow this to happen.

Our firm is committed, first and foremost, to investment innovation and client service. Too often companies reach a "good enough" stage with their products or services, then just push that product or service through their sales channels. We will never get to this stage. Staying current with the latest research and continually searching for ways to improve our portfolios is part of our DNA.

Client service is also a cornerstone of what we do. We set goals for client service, search for ways to go "above and beyond", and meet regularly to discuss how we are doing in this area. Without happy clients, we would not be growing, and in fact, would not exist at all. We will be doing a client satisfaction survey later this year to further assess our efforts. I ask that everyone participate and give us your candid feedback. Of course you don't have to wait for the survey; if there is anything you need, feel free to call us anytime.

Rather than relying on my assurances that we take these issues seriously, I think you will see by our actions that this is the case. We have been aggressively expanding our team the past couple years to ensure the quality of our efforts remains high.

In our last newsletter, I wrote about some staff turnover we have experienced over the past six months. We received some concerned phone calls as a result. Accordingly, I'd like to spend a few paragraphs discussing our professional team and what we have done recently to build it out.

In March, Bill Skuse joined our team to focus on business development and client service. Bill is going to help us find new client relationships, but he also brings a wealth of financial experience that will be helpful to our existing clients. Bill is a CPA by training, but has also worked in the financial planning industry for a couple decades. He understands risk management, comprehensive financial planning, and the tax impact of financial strategies at a very deep level. He will be invaluable when creating and assessing financial plans for our clients.

We also have hired Julie Song to help with investment research and trading. Julie starts on May first. She has a background in international business, investments, and trading. She also has a strong academic pedigree and a solid knowledge of statistical and quantitative methods. Julie will be able to help us research new ideas, conduct rigorous analysis on new investments, and help us better craft our portfolios. We're very excited to welcome her aboard.

Adding Bill and Julie to our already strong team will bring our headcount to seven. We'll have two people who either hold the CFA or are in the process of obtaining it, two CPAs, an MBA, three former business owners, and decades of professional experience. I can't tell you how excited I am about what we are building.

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day, and keeping all food out of nose's reach has been time consuming. Just a week after we picked Sara up, she had a run in with a skunk, and required an emergency trip to the dog spa for a special (and expensive) bath. Vet bills, food, a new crate, and a bed have all increased the installation costs significantly. At least we haven't required very many toys for when she is "off-duty"; she is quite content to steal our daughter's dolls, socks, and snacks.

In the end, I'm not sure we made the most cost-effective or practical choice. After all, a proper alarm system doesn't drink out of the toilet. However, we have grown quite fond of our more peculiar alarm system, and know she will continue to protect our household for many years to come.

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