The ACM Journal

Race Time

At the beginning of the summer, Nipa and I overheard the kids' plans to while away their vacation parked in front of the Xbox, to master their video gaming skills. Panic stricken, we called a family meeting in which we set numerous constructive goals, including getting into better shape. Though Nipa and the kids have been practicing martial arts for many years, and some of us attend the occasional yoga class, we felt that only running would take our athletic prowess to the next level.

Our biggest concern was our oldest son, Omar, who is most likely to succumb to the siren song of the mystical, magical box. His interest in video games goes beyond normal attachment, veering into gluttony, lust, or any of the seven deadly sins.

Also, Omar had expressed an interest in playing soccer at school in the coming fall season. Because he hadn't played before, and was now twelve years old, we knew he would have to build his speed and endurance in order to hold his own with the other more experienced kids.

At first, we gave him instructions to run in the yard, and left him to his own devices. We set time and distance requirements for him most days, and expected him to adhere to the plan. Since adherence was

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As evidenced by the chart below, the third quarter was nothing short of awful for investors. Practically every segment of the global stock market was down significantly. There were a number of events that contributed to the carnage.

Poster Boys for Profligacy

Early in the quarter, perennial troublemakers Greece and Puerto Rico caused unease by declaring their need for further financial aid. Greece went to the brink, but ultimately did win a third bailout from its European peers. Puerto Rico also announced that it would be unable to meet its debt obligations. There is a lot of legal wrangling about how Puerto Rico will ultimately get out from under its debt burden, which will take years. In the meantime, Puerto Rico represents one more corner of the globe with an uncertain economic situation.

The stock market generally weathered this news without too much impact. However, when China unexpectedly devalued its currency in mid-August, and the Chinese stock market lost over a third of its value in just a couple months, the U.S. market also finally threw in the towel.

More Bad News

The volatility continued in the quarter as the U.S. dollar strengthened, the oil market plunged, and the Fed threatened to raise short-term interest rates.

Money fled international markets, pushing up the value of the U.S. dollar. That makes it more expensive for U.S. manufacturers to sell their goods overseas, and can weigh on domestic economic growth.

Oil continued its slide, and was down over 50% from a year ago. The U.S. is awash in oil currently, thanks to incremental production from shale producers in recent years. In the face of this, OPEC nations have continued to pump oil, hoping to drive down prices, and push U.S. producers out of business. This battle of the competitive wills is good for us at the gas pump, but because oil company earnings are such a big part of the stock market, declining oil prices are not always a good thing for stock market returns.

Right up until the end of the third quarter, the Fed continued to suggest it would raise short-term interest rates. Such a move has the potential to slow economic growth, as the cost of financing corporate growth rises. However, in the end the Fed remained on the sidelines. Interestingly, the market took this as an even bigger negative, believing that the Fed had so little faith in the strength of the U.S. economy, that it couldn't boost interest rates. This added even more uncertainty to an already shaky stock market.

The S&P 500 Index fell 12% from its high on July 17th through the low point on August 25th. Things weren't

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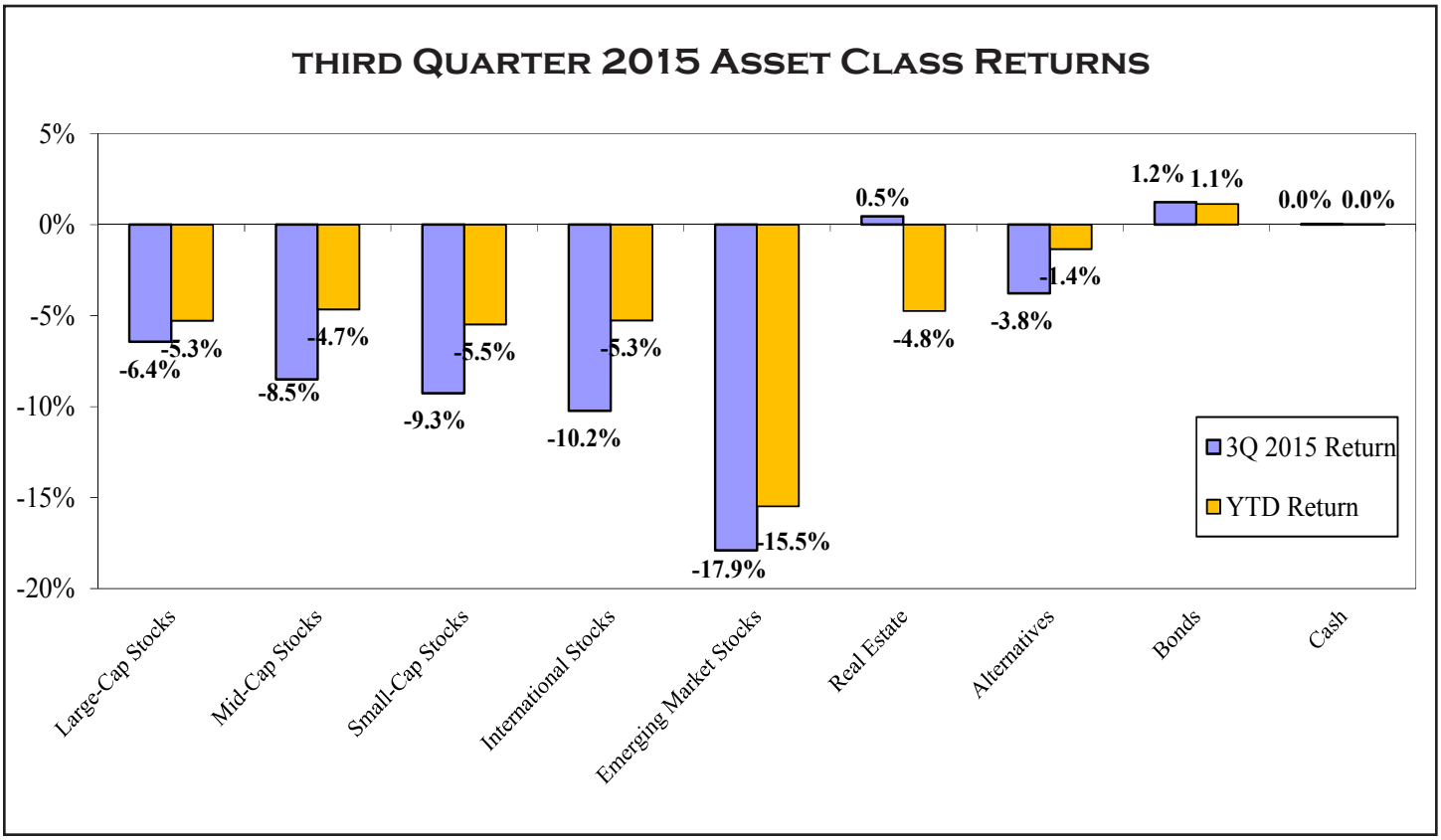

Portfolio Review

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quite so bad for the full quarter, but U.S. large-cap stocks still lost 6.4%. Diversifying across the various segments of the stock market wouldn't have helped buffer the downside, as smaller stocks and international markets lost even more.

Diversification

During periods of market pessimism is when we need diversification the most, but also when it is least likely to work. Investors flock to the largest, most liquid stocks, shunning the riskier parts of the market. So while it makes sense to try to capture the higher potential returns of smaller stocks, value stocks, and international stocks, this exposure can actually exacerbate market downturns. This may sound like a poor strategy, but we believe it is actually the proper strategy for long-term investors. Those willing and able to stay invested during short periods of market volatility can potentially earn higher long-term returns by taking on the risk of these sectors.

That doesn't mean that investors need to accept high levels of risk. It just means that if you have a portion of your portfolio invested for growth, and you truly have a long time horizon, then we believe you ought to invest for the most growth you can get. We hedge the risk of that growth by using other asset classes to help diversify our portfolios.

Bonds Offer Protection

High quality bonds are the best source of diversification. They tend to go up when stocks slide, as they did in the third quarter. The Barclays Aggregate Bond Index rose 1.2% in the quarter as stocks declined. Most portfolios should have some allocation to bonds for just this reason. The problem is that the outlook for bonds isn't very bright.

With interest rates at historic low levels, and the Federal Reserve threatening to raise interest rates imminently, bonds likely will see lower returns than they have in the past. Bond prices fall as interest rates rise, and by most accounts, interest rates will be moving up in the future. Of course no one can predict the timing or magnitude of these interest rate increases, but it seems clear that rates will have to move at least a little higher before too long.

An orderly rise in interest rates is not a horrible scenario for bonds. It also isn't great. However, the ability of bonds to protect portfolios during times of stock market turmoil make them a must in most portfolios, despite their mediocre outlook.

An Alternative Approach

Another approach to hedging the volatility of the stock market is to use alternative investments. This includes investing in things such as commodities, currencies, hedge fund strategies, catastrophe bonds, and others. While these all sound fairly risky, we use them to reduce the risk of more traditional stock and bond portfolios. These investments all offer returns with low correlation to stock market returns, so like bonds, they can help offer protection when stocks falter. On the nearby graph, you will see that alternative investments fell almost 4.0% in the quarter. However, that is the return for the overall hedge fund industry, which isn't necessarily representative of the way we invest in alternative investments. A basic, equally-weighted model of the alternative funds we use was up roughly 2.0% when the stock market was down over 10.0% in the past couple months.

That doesn't mean our funds will always outperform, but it does show that there are ways to alleviate some of the risk of the stock market. We also like the fact that the expected return of alternative investments is higher than that of bonds. Ideally we'd be able to get long-term returns that approach those of the stock market, but with significantly less overall volatility. This approach is not appropriate for a large portion of your portfolio, but with a 10% or 20% allocation, alternatives have been a nice compliment to stocks and bonds.

A Silver Lining?

The good news about market declines is that they allow us the opportunity to fix and tweak portfolios without adverse tax implications. When the market declines, we can sell stocks that are trading below their cost basis. We realize these losses, but immediately reinvest in similar funds so that the portfolio exposure effectively remains the same. For example, we might sell an international fund for a 5% loss, but then use the proceeds to buy a different international fund. The value here is that you can use these losses to offset current year capital gains. If you don't have current year gains, the losses can be carried forward indefinitely to offset future capital gains. We therefore like to "bankroll" losses during these periods so we can rebalance in the future in a tax-efficient manner.

We also use down markets as an opportunity to buy stocks. It sometimes seems counterintuitive to buy investments that are declining, but we like to buy assets at low prices. So, we'll sell bonds, which generally rise when the stock market is falling, and purchase more stocks at low levels. When the market eventually rebounds, our portfolios will have more shares of stock to participate in the rebound. There are numerous studies that show rebalancing can add incremental performance, and we want to capture as much of it as we can.

Volatile markets therefore result in a lot more trading of our portfolios. They keep us busy, and you have likely noticed some incremental trading in your accounts. Feel free to give us a call if you have questions about any activity you've seen.

Where do we go Now?

In the first week or two of the fourth quarter, the markets are already starting to behave a little better. We certainly don't know if there will be more downside from here, but our expectation is that the markets will not experience a large decline like in 2008. We have been warning about volatility for the past six or nine months, and it has certainly arrived. After six years of the stock market effectively moving straight up, what we just experienced is not surprising.

The best approach is to not get too excited. Unfortunately, there isn't much action anyone can take to make the volatility go away. Market ups and downs are part of the investment experience. For long-term investors, staying the course, managing taxes, and rebalancing when necessary are the recipe for long-term success.

Firm News

Our biggest news this quarter is that I have a new partner: Chris Cebula. Chris is our CFO, but also wears a lot of other hats, and generally keeps our business running. I used to feel quite comfortable that I could perform all the necessary functions to keep the company going. However, as we've grown, I realize this is no longer the case. Chris has taken over, and improved upon, many of our essential duties, including finances, technology, general operations, human resources, and others. He effectively runs our firm, which frees me up to spend more time on research and client service. Chris has been a good friend for many years, and will now be an invaluable partner.

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shaky, and not without a healthy dose of complaining, Nipa decided to start running with him. Within days, Omar's barrage of whining and protesting left Nipa feeling defeated, so I stepped in.

In my youth, my lack of coordination, and inability to throw, kick, or dribble anything resembling a ball, left me with no choice but to pursue individual sports, such as cross-country running and Nordic skiing. I wasn't fast, but I built up endurance, and went on to long events such as marathons, triathlons, and 20-mile Nordic ski races.

Along the way, I picked up a competitive streak, and was known to push myself, and those I coached, a little too hard. Having traumatized poor Omar at an early age by putting him on skis at age three, and having further distressed him by losing our way during a four hour hike in Vermont, I decided to start with a gentler, more cautious approach. We started by running around the neighborhood, with the goal of doing a 5K race at the end of the summer.

I tried to be encouraging and enthusiastic, but may have occasionally barked orders to keep up the pace, breathe more steadily, or refrain from throwing in the towel all together. Between work and family activities, we didn't get out as often as I would have liked, but we signed up for the 5K anyway.

On race day I explained to Omar that we were going to have to run a little harder than we normally do. We generally trained around ten-minute-mile pace, so I suggested we shoot for nine-minute miles or twenty seven minutes for the whole race.

When the race started, the whole field started out slowly (perhaps because the really good runners had opted for the 12K on the same day). Being able to see the front of the crowd triggered my competitive spirit, and I know I pushed Omar harder than he would have liked. He was a trooper though, and managed to run a better-than-expected pace of eight-and-a-half minute miles. We both finished second place in our respective age groups, and we managed to do it without collapsing or losing our lunch on the finish line (ask me about that story some time).

I was proud of Omar, and was excited at the prospect of future races together. I started thinking maybe Omar would get the "race bug," and we could do a bunch more of these. I asked him if he had fun, and he sort of mumbled "I don't know" the way preteens do. Then he asked if we could go home so he could play video games.

Firm News

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Also, we've brought on some much needed administrative help. Tarryn Rozen worked for us briefly a couple years ago, and has returned now that our needs are greater and her schedule is a little more flexible. Nipa Armbruster has also signed on to help us keep the office organized. In order to prevent unfortunate side effects of spouses working together, Nipa will be reporting to Chris Cebula.

We continue to make progress on strengthening our firm. Last year was our year to upgrade our technology, particularly to ensure that our data is safeguarded. This year we're working on a formal succession plan to ensure the continuity of the business in the event that Mark has an unfortunate run in with the proverbial bus. This plan will be finalized in the next week or two. Finally, we're doing a lot of research on new ways to streamline our work. The first item we're addressing is a trading system. This will allow us to review accounts in a fraction of the time it currently takes, and to enter trades in a more timely fashion. While we're not aggressive traders, we do want to make sure that we can be responsive to market fluctuations as soon as they happen.

It is our first priority to ensure we stay ahead of the curve with respect to investment research, portfolio management, efficient operations, and client service. We've added staff, technological prowess, and new procedures in that pursuit. We take our responsibilities seriously, and will continue to make investments that strengthen the firm over time.

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