Portfolio Construction Principles I Employ When Investing Your Money

> *My primary goal is to build wealth for each client. Whatever income I receive in pursuit of that goal is a secondary consideration.*

The basic model I employ for managing your investments strategically places me between you and the market. Since I cannot control the market, I focus instead on your objectives that, in turn, define your risk tolerance. My background is deep in understanding how the market works although that background does not in any way suggest I know what the market will do the next minute, the next day, the next week or the next month. Over longer periods of time like 3-5 years, I have confidence that it will behave more like it has in the past, which is up. The following discussion presents a few important concepts I employ when investing your money. Keep in mind that portfolio construction is more of an art than a science.

Market timing. If you think about it, trying to time the market by buying at the top and selling at the bottom makes no sense. If it were so easy, everybody would be filthy rich. Well, that is hardly the case. Beyond a shadow of doubt, market timing is nothing more than a myth promoted by someone pursuing his or her own best interest as opposed to your best interest. It's like shooting at a moving target in the dark. Nobody has the ability to time the market. Nobody!

CIM Model. My job is to match your risk tolerance with appropriate market securities. The CIM model is a planning model, not a market prediction model. My purpose is to help you maintain balance; that is, to encourage you when it appears the sky is falling and to discourage you when euphoria has apparently taken control of everybody's brain. Objectivity is the non-emotional feature of the CIM model that I consider quite important. Removing emotion from the investment decision-making process and replacing it with discipline is the key to building wealth. I do this by rebalancing your portfolio quarterly to a consistent, pre-determined level of risk. I developed this model after studying the market for over 50 years. It has stood the test of time. While I can't promise to make you wealthy, I can promise you a professional, unbiased, independent, and objective approach to managing your money. As a CFA, I bring you the highest standard of ethical conduct available in the market. One last thing: every client is unique and, thus, his/her portfolio is unique. No two clients have the same portfolio composition. I do not use a cookie cutter approach to investing. This approach is time-consuming for me but I consider it important. While my clients may not see much going on during the quarter, I can assure you that much is taking place behind the curtain.

Fiduciary. CIM is a fiduciary, a Registered Investment Advisor (RIA) fiduciary. This means I work for a fee, which is based on the market value of the portfolio. I am independent and I accept no commissions or rebates. As a fiduciary, I place your well being ahead of my own. Brokers are not fiduciaries. They accept commissions and work under a non-fiduciary "suitability" standard of conduct. This standard legally allows a broker to sell a product that is suitable but not in your best interest. Some advisers are licensed as both brokers and RIAs, which is called a dual registration model. With this model, a broker can call himself/herself a fiduciary and, thus, independent but that is only true when wearing their RIA hat. When they don their broker hat, they are not fiduciaries and are not independent. The dual registration model is confusing to the investing public and some dually registered advisers take advantage of the confusion by advertising they are independent fiduciaries. That is not totally true. Unknowledgeable investors fall prey to this type of half-truth. The simplest way to check whether an advisor is a fiduciary is to look at a trade confirmation slip to see if you are paying the advisor (not the custodian) a commission on the trade. Be careful, however, because mutual fund trades may show no commission and hide a 12b-1-rebate fee paid to the broker, which is really a commission.

Schwab's Role. Schwab is a custodian and a bank. As custodian, Schwab holds securities, collects dividends and interest, performs a variety of administrative duties in maintaining client accounts, and executes trades according to my instructions. As a bank, Schwab operates FDIC-insured checking accounts. Transaction fees, when they apply, are the lowest in the industry and go directly to Schwab. Nothing goes to CIM. A Limited Power of Attorney (LPOA) allows me to make trades on your behalf but not to remove money from your accounts without your permission. Schwab sends monthly statements and I send a performance review along with a letter and article like this one every quarter. My professional assistants, June and Kim, maintain constant contact with Schwab in conducting administrative duties such as transferring funds, opening accounts, and changing beneficiaries. The ladies copy me on all email traffic. They are quite good at what they do. I often hear reports of how much my clients love them.

Diversification. Diversification is not just important, it's imperative. The concept of diversification can be workably simple or incredibly complex. To keep it workable, I view the market as comprised of equities (domestic and foreign), bonds (domestic and foreign), real estate/natural resources, and cash. If growth is your objective, which it is to some degree for everyone, the investment of choice is equities. Investing in equities gives you an ownership interest in the business sector while diversification within the equities market spreads out that interest across many different types of businesses. Investing in equities requires a strong belief in capitalism and democracy, both of which the US is the clear global leader. Bonds, on the other hand, are defensive and provide no growth but do provide a source of income and diversification in a portfolio comprised of multiple asset classes. Real estate and natural resources are also defensive and, for that reason, provide the portfolio with an additional measure of diversification.

E**xchange Traded Funds (ETFs).** ETFs are passively diversified index securities that do not rely on a manager picking winners and losers. ETFs are similar to mutual funds but continually trade throughout the day as opposed to only at the end of the day like a mutual fund. ETFs come in a wide variety of different sizes and shapes. They can be stocks, bonds, real estate, gold, or almost any other asset investors demand. I use ETFs extensively. Without going into the details, ETFs are actually swaps. Quite creative, indeed! They fit a long-term, diversification strategy, are cost efficient, and are flexible for constructing portfolios requiring diverse levels of risk. A well-diversified portfolio should be built on ETFs. Individual equities can be included in an otherwise diverse ETF portfolio depending on my client's risk tolerance. Younger investors may have a portfolio comprised of all individual stocks if they can tolerate the volatility and are not counting on that money any time soon. Investing in individual stocks is a difficult game to play and should only be attempted with relatively small amounts of money and with an objective of aggressive growth. I have found many fundamentally attractive stocks that the market has not embraced. No explanation for this other than the fact that the market simply does not agree with my assessment. Maybe over time, the market will come around to my way of thinking, but that is risk.

Risk. Risk is a slippery term and risk-avoidance is not possible. It's another illogical idea proposed by someone whose interest is not aligned with your interest. For example, some advisers advise investing in T-bills until the market settles down. This is a market timing strategy that gives the adviser an opportunity to trade in and out of stocks in order to generate a high level of commissions. Such a timing strategy is senseless because the market will never settle down. Chaos is the inherent nature of financial markets. Always has been; always will be. New information, whether expected or unexpected, continually arrives to the market every nanosecond and it's new information that causes chaos. Even if the information is expected, different analysts interpret it in conflicting ways. By investing in cash, you incur the risk of foregoing a return available in the market. Investing in T-bills or other money market instruments is also not a good idea because the yield is so low--you lose to inflation and taxes over time. The only time you should invest in cash is when you need to use the money soon.

Loss in Market Value. What is a loss? This question confuses most investors who think a decline in the value of their portfolio represents a real loss. That is not the case. A loss occurs only when you sell; otherwise, it is just a paper illusion. Actually, a decline in value may represent a buying opportunity. A highly temperamental market is prone to over-react on both the downside and upside, often for no apparent reason. A great story involves a $6.2 billion "loss" Warren Buffet incurred in mid-1998 in the value of his Berkshire Hathaway stock. Did he actually lose that huge amount? No! It occurred only on paper. He did not need the money and was mentally prepared for the decline so when it occurred, he took it in stride and held his position. This attitude along with a long-term positive view of the market allowed him to see his holding hit a new high by the end of the year. Sometimes the best course of action is to do nothing, but that takes discipline and usually seems counter-intuitive (remember Cool Hand Luke saying something similar!). The lesson here is not to panic, view market downturns as a potential buying opportunity, and to be mentally prepared for inevitable volatility. Above all, don't let the market make decisions for you. We know downturns will occur. We just don't know when they will occur or how long they will last.

My business partner, Justin Burgess (JB), is fully on board with my thinking. Please don't hesitate to let me know if you have any questions or concerns. Would love to hear from you. REC