

June 2013

Some Thoughts on Diversification Principles & Portfolio Performance

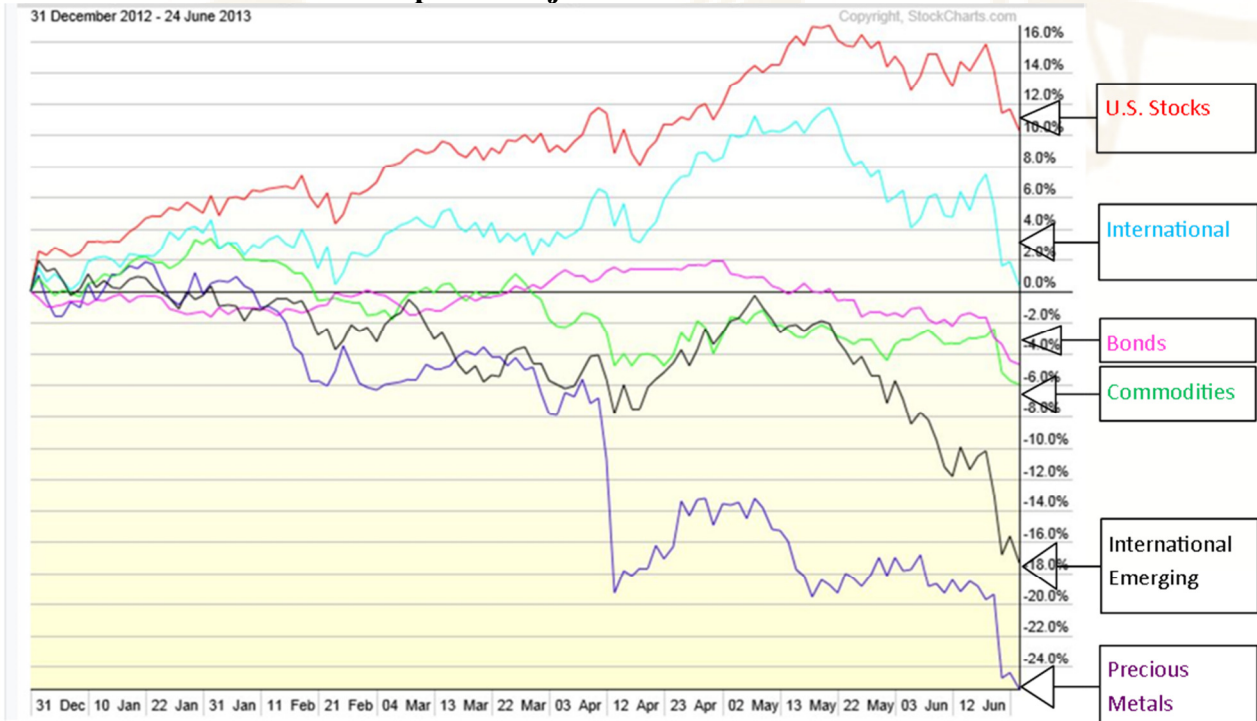
2013 has been a challenge for a diversified investment portfolio thus far.

The US stock market has done very well this year - however what has not been widely reported in the financial media is that the other components of a widely diversified and prudently allocated portfolio have struggled in 2013.

Long enduring principles of successful portfolio construction and diversification use multiple asset classes in an attempt to reduce risk and maintain or even increase return over time. Pension funds and other large professionally managed investment pools use these proven asset allocation principles, and several Nobel prizes have been awarded for and recognize these bedrock foundations and diversification rules for successful investing.

Over the long run these principles have laid the groundwork for success for investors. The major asset classes used to construct a properly diversified portfolio include; US stocks, international stocks, bonds, cash, and commodities and precious metals. Over the long haul each of these asset classes have been rewarding. However, as I write this article, bonds, international and emerging stocks, commodities, and precious metals are all negative so far this year, and only US stocks have prospered in 2013.

Performance Graph for major investment asset classes YTD 2013.



(Source: stockcharts.com. Investors cannot directly invest in an index.)

If your portfolio is only and completely allocated to US stocks, you probably are enjoying a fine year.

However, if your portfolio includes bonds, international stocks, or alternatives like precious metals and commodities, your portfolio returns may be suffering this year. This is a major departure from 2012, a year when most investors earned nice returns in each of those asset classes.

This may cause us to question our portfolios. Should we diversify? Does asset allocation work? Should we move all of our money to US stocks?

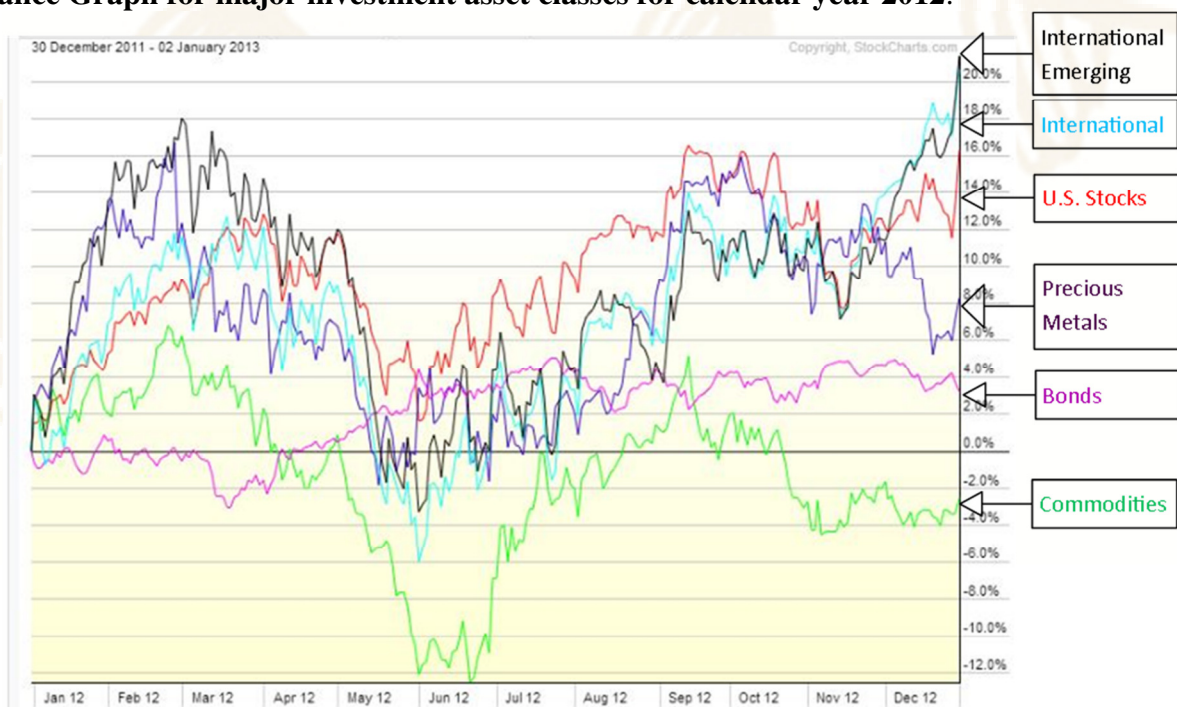
First let's acknowledge some truths:

- **Diversification has worked well in past years.**
- **Diversification may allow us to participate in the returns of multiple asset classes.**
- **We diversify because we don't know which asset classes will do well for any given period.**
- **Investors tend to have short memories, and are prone to chase returns**

Diversification has worked well in past years

Let's review 2012.

Performance Graph for major investment asset classes for calendar year 2012:



(Source: stockcharts.com. Investors cannot directly invest in an index.)

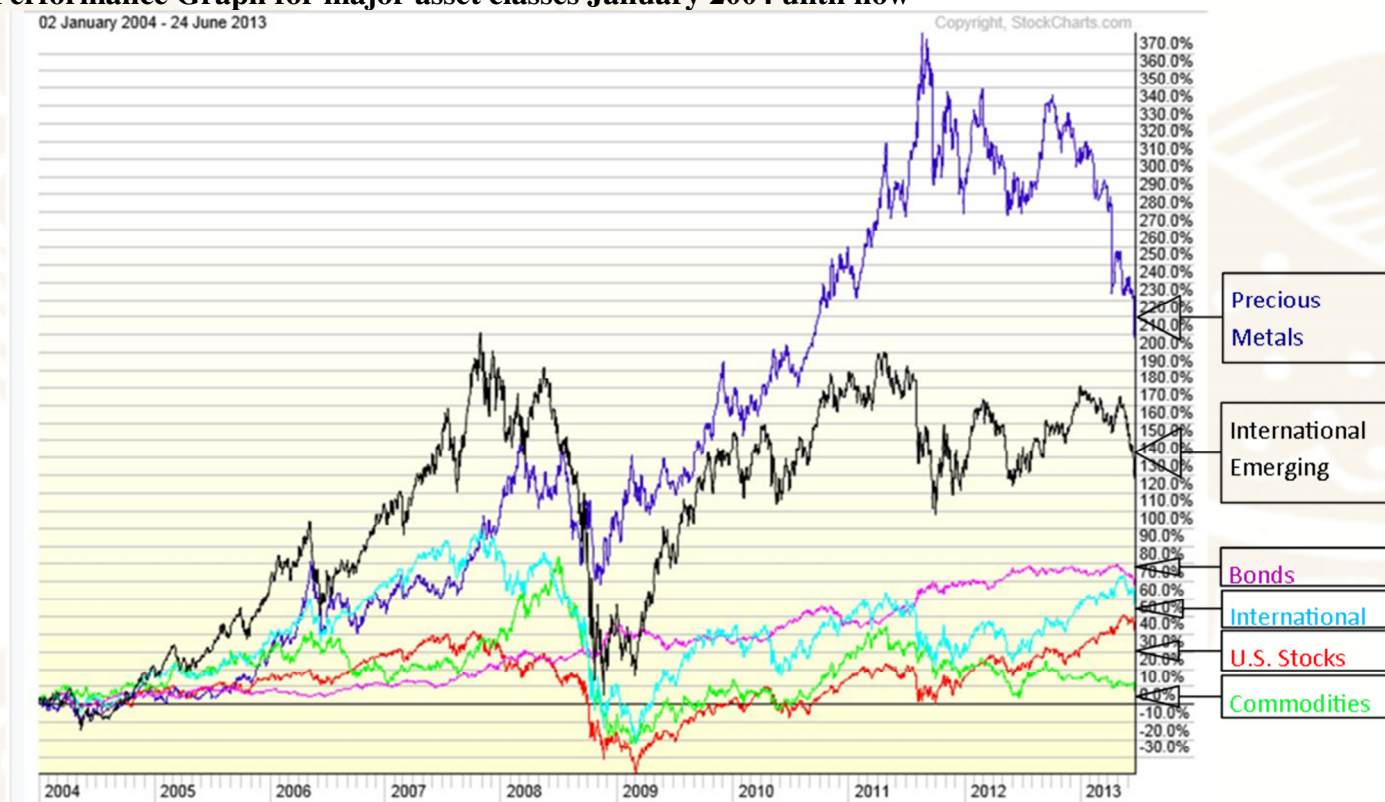
Note that every major asset class except for the commodity index had positive returns last year (*however our commodity investment did have a positive return in 2012.*) The US stock market did well, but was not the best performing area in 2012.

Conclusion: an investor enjoyed the benefit of a well-diversified portfolio in 2012.

Diversification allows us to participate in the returns of multiple asset classes.

Let's review a longer time span.

Performance Graph for major asset classes January 2004 until now



(Source: stockcharts.com. Investors cannot directly invest in an index.)

Note that US stocks lagged far behind many other asset class indexes during this time. International stocks, bonds, and precious metals all reported far higher returns.

Conclusion: Over the last 10 years, a well-diversified portfolio may have included assets that had better returns than the US stock market.

We Diversify because we don't know which asset classes will do well in any given period

It would be wonderful if we somehow had predictive powers so that we could know which investment would do well in any given year. There is an old joke on Wall Street, "He who is right predicting the market, will be right once in a row."

The periodic table of investments offers us a graphical year-by-year review of the major asset classes and their respective returns. Note how randomly the asset classes tend to trade places from year to year, and how some assets may be leaders for a period of time and then lag far behind for a period of time.

The Callan Periodic Table of Investment Returns

Annual Returns for Key Indices (1993–2012) Ranked in Order of Performance

1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
MSCI Emerging Markets 74.84%	MSCI EAFE 7.78%	S&P 500 Growth 38.13%	S&P 500 Growth 23.97%	S&P 500 Growth 36.52%	S&P 500 Growth 42.16%	MSCI Emerging Markets 66.42%	Russell 2000 Value 22.83%	Russell 2000 Value 14.02%	Barclays Agg 10.26%	MSCI Emerging Markets 56.28%	MSCI Emerging Markets 25.95%	MSCI Emerging Markets 34.54%	MSCI Emerging Markets 32.59%	MSCI Emerging Markets 39.78%	Barclays Agg 5.24%	MSCI Emerging Markets 79.02%	Russell 2000 Growth 29.09%	Barclays Agg 7.84%	MSCI Emerging Markets 18.63%
MSCI EAFE 32.57%	S&P 500 Growth 3.13%	S&P 500 37.58%	S&P 500 22.96%	S&P 500 33.36%	S&P 500 28.58%	Russell 2000 Growth 43.08%	Barclays Agg 11.63%	Barclays Agg 8.43%	MSCI Emerging Markets -6.00%	Russell 2000 Growth 43.54%	Russell 2000 Value 22.25%	MSCI EAFE 13.54%	MSCI EAFE 26.34%	MSCI EAFE 11.17%	Russell 2000 Value -28.92%	Russell 2000 Growth 34.47%	Russell 2000 26.65%	S&P 500 Growth 4.65%	Russell 2000 Value 18.05%
Russell 2000 Value 23.77%	S&P 500 Value 1.32%	S&P 500 Value 36.99%	S&P 500 Value 22.00%	Russell 2000 Value 31.78%	MSCI EAFE 20.00%	S&P 500 Growth 28.24%	S&P 500 Value 6.08%	Russell 2000 Value 2.49%	Russell 2000 Value -11.43%	Russell 2000 Value 47.25%	MSCI EAFE 20.25%	S&P 500 Value 5.82%	S&P 500 Value 23.48%	S&P 500 Value 9.13%	Russell 2000 Value -33.79%	MSCI EAFE 31.78%	Russell 2000 Value 24.50%	S&P 500 Value 2.11%	S&P 500 Value 17.68%
Russell 2000 18.88%	S&P 500 Value -0.64%	Russell 2000 Growth 31.84%	Russell 2000 Value 21.37%	S&P 500 Value 29.98%	S&P 500 Value 14.69%	MSCI EAFE 26.96%	Russell 2000 -3.02%	MSCI Emerging Markets -2.37%	MSCI EAFE -15.94%	Russell 2000 Value 46.03%	Russell 2000 18.33%	S&P 500 4.91%	S&P 500 Value 20.81%	Russell 2000 Growth 7.05%	S&P 500 Growth -34.92%	S&P 500 Growth 31.57%	MSCI Emerging Markets 19.20%	S&P 500 Value -0.48%	MSCI EAFE 17.32%
S&P 500 Value 18.61%	Russell 2000 Value -1.54%	Russell 2000 28.45%	Russell 2000 16.49%	Russell 2000 22.36%	Barclays Agg 8.70%	Russell 2000 21.26%	S&P 500 -9.11%	Russell 2000 Growth -9.33%	Russell 2000 -20.48%	MSCI EAFE 38.59%	S&P 500 Value 15.71%	Russell 2000 Value 4.71%	Russell 2000 18.37%	Barclays Agg 6.97%	S&P 500 -37.00%	Russell 2000 27.17%	S&P 500 Value 15.10%	Russell 2000 Growth -2.91%	Russell 2000 16.35%
Russell 2000 Growth 19.37%	Russell 2000 -1.82%	Russell 2000 25.75%	Russell 2000 11.26%	Russell 2000 12.95%	Russell 2000 1.23%	S&P 500 21.04%	MSCI EAFE -14.17%	S&P 500 Value -11.71%	S&P 500 Value -20.85%	S&P 500 Value 31.79%	Russell 2000 Growth 14.31%	Russell 2000 4.55%	S&P 500 15.79%	S&P 500 5.49%	Russell 2000 Growth -38.54%	S&P 500 26.47%	S&P 500 15.06%	Russell 2000 -4.18%	S&P 500 16.00%
S&P 500 10.08%	Russell 2000 Growth -2.43%	Barclays Agg 18.46%	MSCI EAFE 6.05%	Barclays Agg 9.64%	Russell 2000 -2.55%	S&P 500 Value 12.73%	S&P 500 Growth -22.08%	S&P 500 -11.89%	S&P 500 -22.10%	S&P 500 28.68%	S&P 500 10.88%	Russell 2000 Growth 4.15%	Russell 2000 Growth 13.35%	S&P 500 1.99%	S&P 500 Value -39.22%	S&P 500 Value 21.17%	S&P 500 Value 15.05%	S&P 500 Growth -5.50%	S&P 500 Growth 14.61%
Barclays Agg 9.75%	Barclays Agg -2.92%	MSCI EAFE 11.21%	MSCI Emerging Markets 6.93%	MSCI EAFE 1.78%	Russell 2000 Growth -6.45%	Barclays Agg -0.82%	Russell 2000 Growth -22.43%	S&P 500 Growth -12.73%	S&P 500 Growth -23.59%	S&P 500 Growth 25.66%	S&P 500 Growth 6.13%	S&P 500 Growth 4.00%	S&P 500 Growth 11.01%	Russell 2000 -1.57%	MSCI EAFE -43.38%	Russell 2000 Value 20.58%	MSCI EAFE 7.75%	MSCI EAFE -12.14%	Russell 2000 Growth 14.99%
S&P 500 Growth 1.68%	MSCI Emerging Markets -7.32%	Barclays Agg -5.21%	Barclays Agg 3.64%	MSCI Emerging Markets -11.59%	MSCI Emerging Markets -25.34%	Russell 2000 Value -1.49%	MSCI Emerging Markets -30.81%	MSCI EAFE -21.44%	Russell 2000 Growth -30.26%	Barclays Agg 4.10%	Barclays Agg 4.34%	Barclays Agg 2.43%	Barclays Agg 4.33%	Russell 2000 -9.78%	MSCI Emerging Markets -53.18%	Barclays Agg 5.93%	Barclays Agg 6.54%	MSCI Emerging Markets -18.17%	Barclays Agg 4.21%

(source: Callan Associates)

Conclusion: *Because we don't know which asset will do well in any given year, it makes sense to own a little bit of each in our portfolio.*

Investors tend to have short memories, and are prone to chase returns

Chasing investment returns in your portfolio can be a recipe for disaster. Following a process, and a disciplined diversification strategy is not always easy to do, but may result in long-term success.

Please review the Callan table again, and note that it is common for an asset to have great returns for a period and then immediately drop to the bottom. Large-cap growth, emerging markets, bonds, have all followed that pattern in recent years. An investor who tried to chase returns in these examples might have ended up with none of the gain, but all the pain.

Conclusion: *Don't try to chase returns, but keep some of your money in each asset.*

The current disparity in asset returns reminds me a little of the late 1990s, a period when large technology stocks dominated markets in returns and other asset classes lagged far behind.

I received a call from a doctor in late 1999 who asked if he could meet with me to review his retirement plan. His firm's plan lost money the previous two years at the end of the great '90s technology bull market. He and

his staff were upset and could not understand why their retirement plan had lost money during what looked like a great market.

When I reviewed the doctors' plan and how it was invested it was very clear what had happened. The investment manager he was using had made a binary choice of only one asset class and was not diversified. Unfortunately for the doctor that particular asset class, small-cap value, had done poorly for two years in a row. *(Please look at small-cap value - the light blue colored square – on the Callan chart for the years 1998 and 1999 and notice the returns were negative for both of those years.)*

I explained to him how he had made a binary choice and because of a lack of diversification his company's retirement money did not own investments that were doing well during the last two years.

Ironically, his small-cap value manager earned wonderful returns the next two years which he was quite pleased with. *(Please look at small-cap value – the light blue colored square – on the Callan chart for the years 2000 and 2001 and notice the returns were the best in the markets for those two years.)* Because their retirement plan was not diversified, they endured two poor years, followed by two very good years.

If the doctors' plan had been properly diversified to begin with, they might have endured less volatility in both the good years and bad years, earned a decent return, and spent less time worrying about their investments.

So, what then should we do? Should we move all of our money to US stocks to chase the great returns of the last few months?

Let's not lose sight of bedrock asset allocation principles, and our investment discipline and process. Let's also remember that if we were to move our portfolio completely to US stocks, we would also increase our risk level a great deal.

I welcome the opportunity to review investment philosophy, discipline, and process. A faith shaking period like this offers us an excellent opportunity to retest and review strategies.

That being said, I do acknowledge that the last few months have been disappointing for our non-US investments. We have encouraged and implemented increases in US dividend paying stocks over the last year and a half, and also slight reductions in our bond allocations, which has helped.

We can discuss allocations and diversification plans at our next review meeting, or of course please feel free to call us if you'd like to discuss this before we next meet.

The Federal Reserve and the Markets

Investment markets worldwide have taken a sharp tumble recently as a result of Federal Reserve announcements. What exactly did the Federal Reserve say, and what does it mean to the investment markets?

"In considering whether a recalibration of the pace of its purchases is warranted, the [Federal Open Market] committee will continue to assess the degree of progress made toward its objectives in light of incoming information."

"A premature tightening of monetary policy could lead interest rates to rise temporarily but would also carry a substantial risk of slowing or ending the economic recovery and causing inflation to fall further."

"A reduction in stimulus would not happen in an "automatic, mechanistic program. Any change would depend on the incoming data."
Federal Reserve Chairman Ben Bernanke

(Source: Bloomberg.com)

Wall Street is quite concerned that the Fed is going to slow down the rate of money creation or money printing. To put the Fed's actions into a historical context; the US money supply grew to \$800 billion, or .8 Trillion from 1900 until 2008. This calendar year alone, the Federal Reserve will print one Trillion dollars – more money will be created in 2013 than was created in all of the last century!

Wall Street is hyper focused and inebriated on all of this new money creation, and believes, and probably rightly so, that much of the new money created will flow into the investment markets. If money printing slows down, the prevailing wisdom is that the investment markets may suffer also.

Federal Reserve money printing is a double-edged sword; it may be great for investments while it is occurring however no one really knows what will happen when they decide to turn off the printing presses.

As investors, we want to try and discern what Fed policy will be, and try to adjust our investment strategies accordingly. By the way, this is not something that I like, or think that is good for our country, and certainly not the way I would have given investment advice 20 years ago.

Nevertheless, we are living in highly unusual and unique economic times and therefore need to plan accordingly.

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A couple of observations:

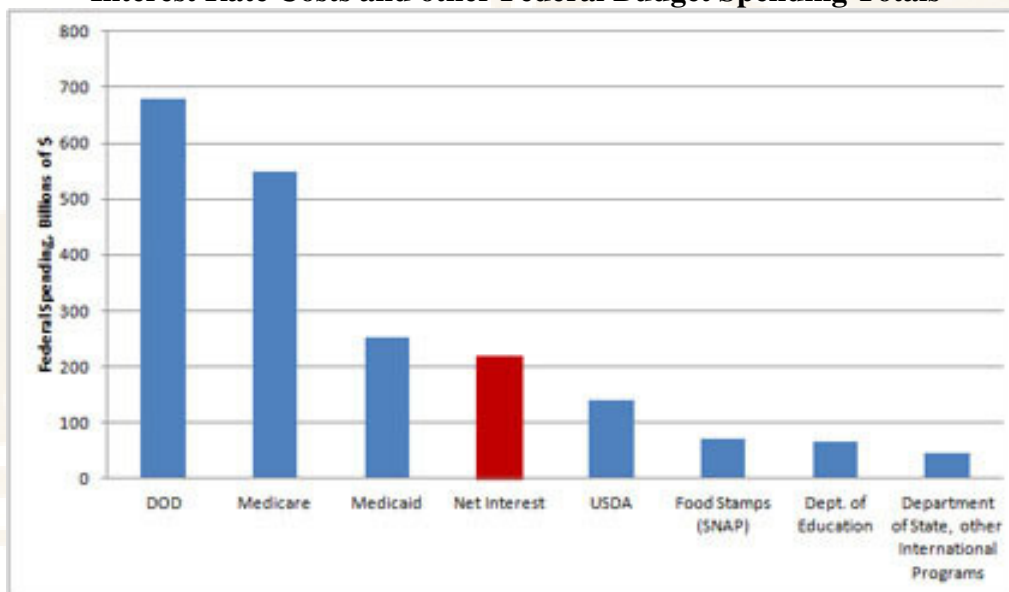
First – Mr. Bernanke never implicitly stated that the Federal Reserve was definitely going to reduce the current money printing policy. He did say that they would consider it if the economic data supported it (which it has not so far.) It is interesting and a little startling that the investment markets had such an adverse reaction to his rather vague pronouncements.

Second – if the Fed does slow down or stop money printing, interest rates will immediately rise. (Please review our prior client letters discussing quantitative easing (money printing) for an in-depth explanation of this.)

Interest rates on government bonds is the cost of the US government's debt. Right now that interest cost is still very low; this morning the rate on a five-year government bond is a little over 1%. In 2000 the rate was over 6.5%, many times higher than today.

If interest rates were five times higher than they are today, like they were in the year 2000, it is possible that the interest cost on the federal debt would exceed every other budget item in the federal budget. Even with today's unusually low interest rates, only the cost of Medicare/SS and Defense are higher than the federal debt interest costs.

Interest Rate Costs and other Federal Budget Spending Totals



(Sources: 2011 actual spending totals from President's FY 2013 budget, Congressional Budget Office, USDA. All figures are for 2011 except Medicare, Medicaid, and interest spending, which are estimates for 2012)

In fact many of our government leaders have pointed out how precarious the US interest cost situation really is. Erskine Bowles, a co-chair of the president's bipartisan deficit-reduction commission known as "Simpson-Bowles," has called the nation's compound interest burden one of the biggest long-term challenges facing the United States.

"We'll be spending over \$1 trillion a year on interest by 2020. That's \$1 trillion we can't spend to educate our kids or to replace our badly worn-out infrastructure."

This fact is important in understanding Fed policy. If the Fed does stop money printing (QE) then interest rates will rise, the federal deficit will become worse, and the interest cost on the federal debt will consume more and more of federal spending.



The Fed is in the proverbial spot between a rock and a hard place, and may find it very difficult to allow interest rates to rise because of the suffering that might ensue.

Understand that is just the impact of rising rates on the federal debt. There is also a lot of potential pain for the \$1 trillion in outstanding credit card debt, and the \$1 trillion dollars in outstanding student loans, and the several trillion dollars in municipal government debt. All those debtors might also be squeezed by rising rates, giving the Fed even more incentive to maintain low rates through money printing/QE.

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How will this all turn out? I have stated before that we are living through a gigantic financial experiment unlike anything the world has ever seen. Even Mr. Bernanke, the head of the Federal Reserve himself, has no idea how this will turn out nor does he have any historical precedence to guide him in his decision-making. I am hoping that his decisions will be the best for our economy and nation and our children and grandchildren.

The great economic uncertainty we face today emphasizes the need for a well-diversified investment strategy.

I appreciate your relationship and trust, and we remain completely committed to your financial well-being.

Warm Regards,

William R. Gevers
Financial Advisor

PS: We have been repeatedly asked by clients if they could share these e-mail notes with their friends or neighbors. Please feel free to forward this with the stipulation that it may only be forwarded if done so in its entirety with no portions omitted. We would be delighted to share our comments and opinions with your friends, and welcome your comments and feedback. If you received this and would like to be included on our newsletter list, please email us at wgevers@geverswealth.com

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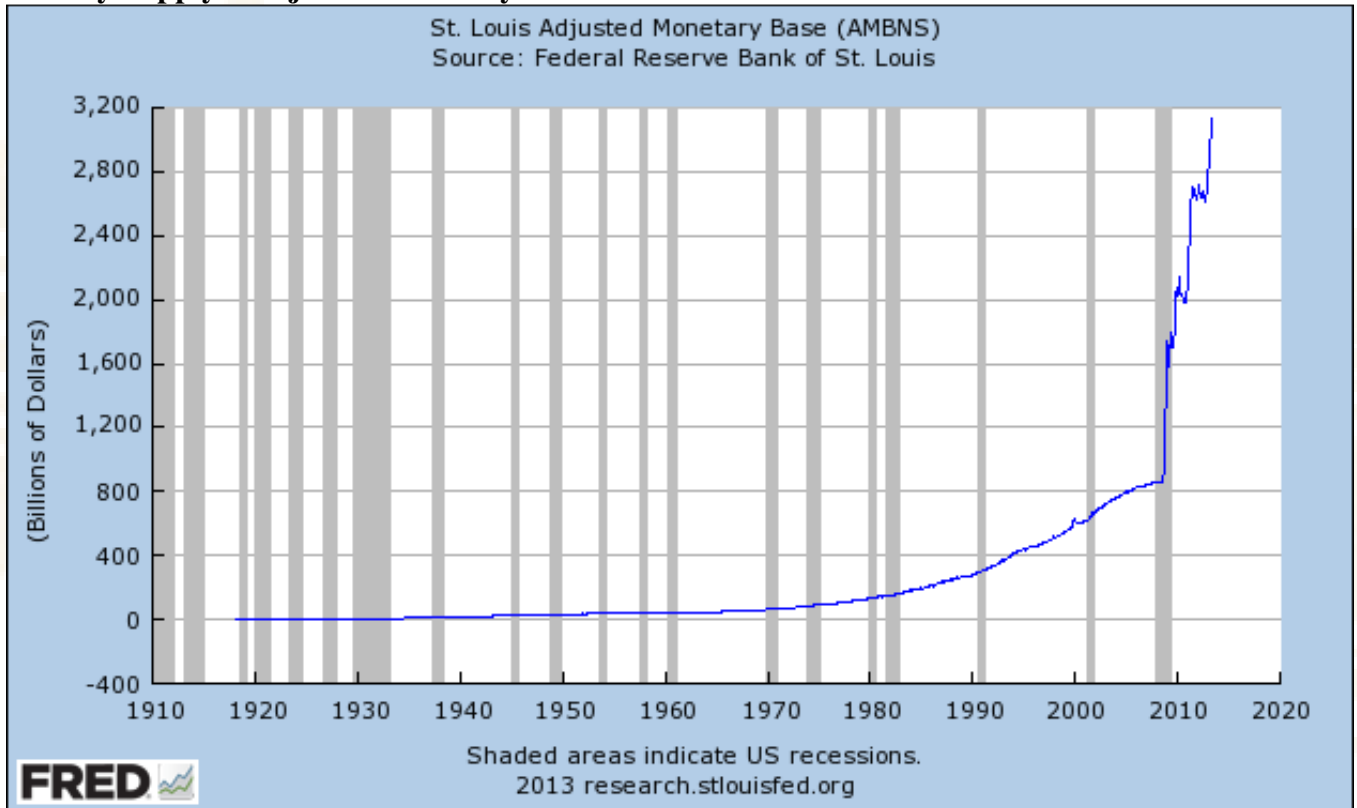
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US Money Supply, US Dollar, and Inflation/Deflation Watch

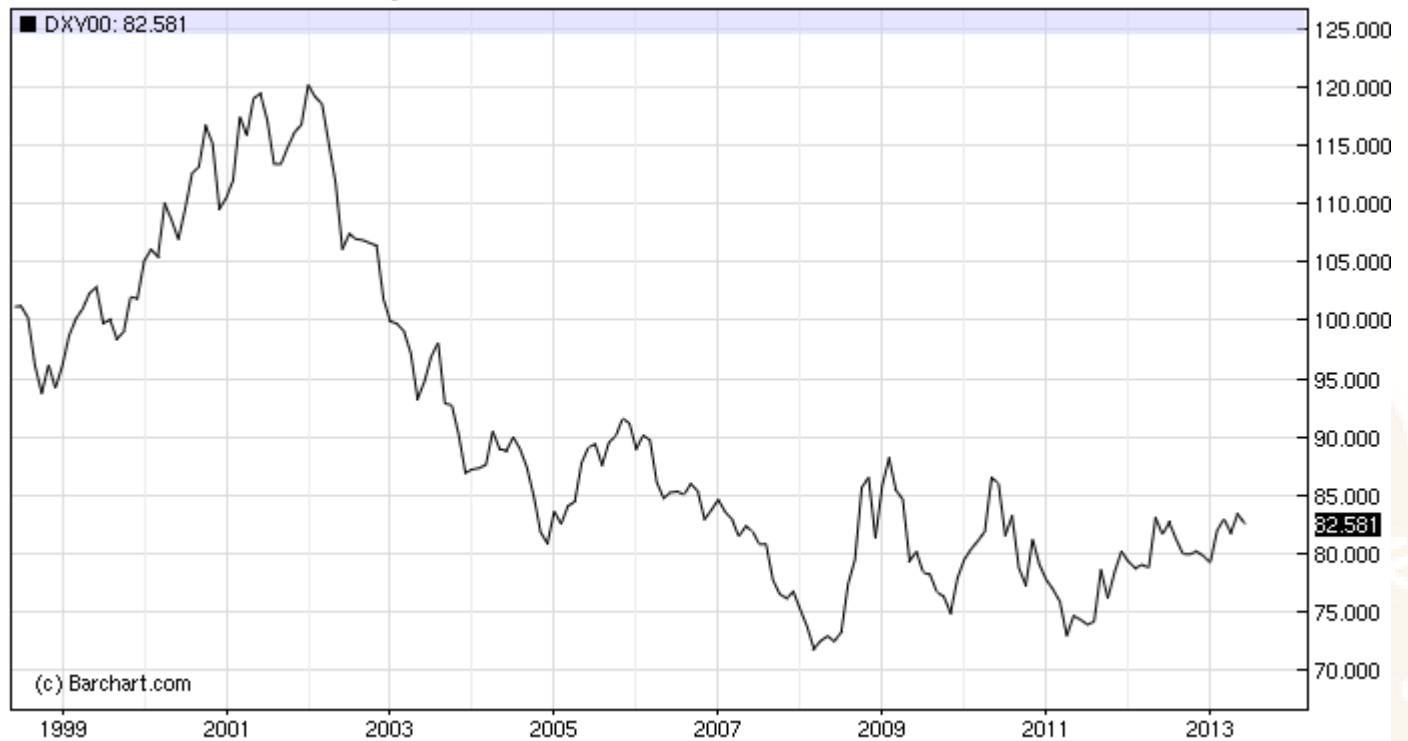
US Money Supply – Adjusted Monetary Base



(<http://research.stlouisfed.org/fred2/graph/?s%5B1%5D%5Bid%5D=AMBNS#>)

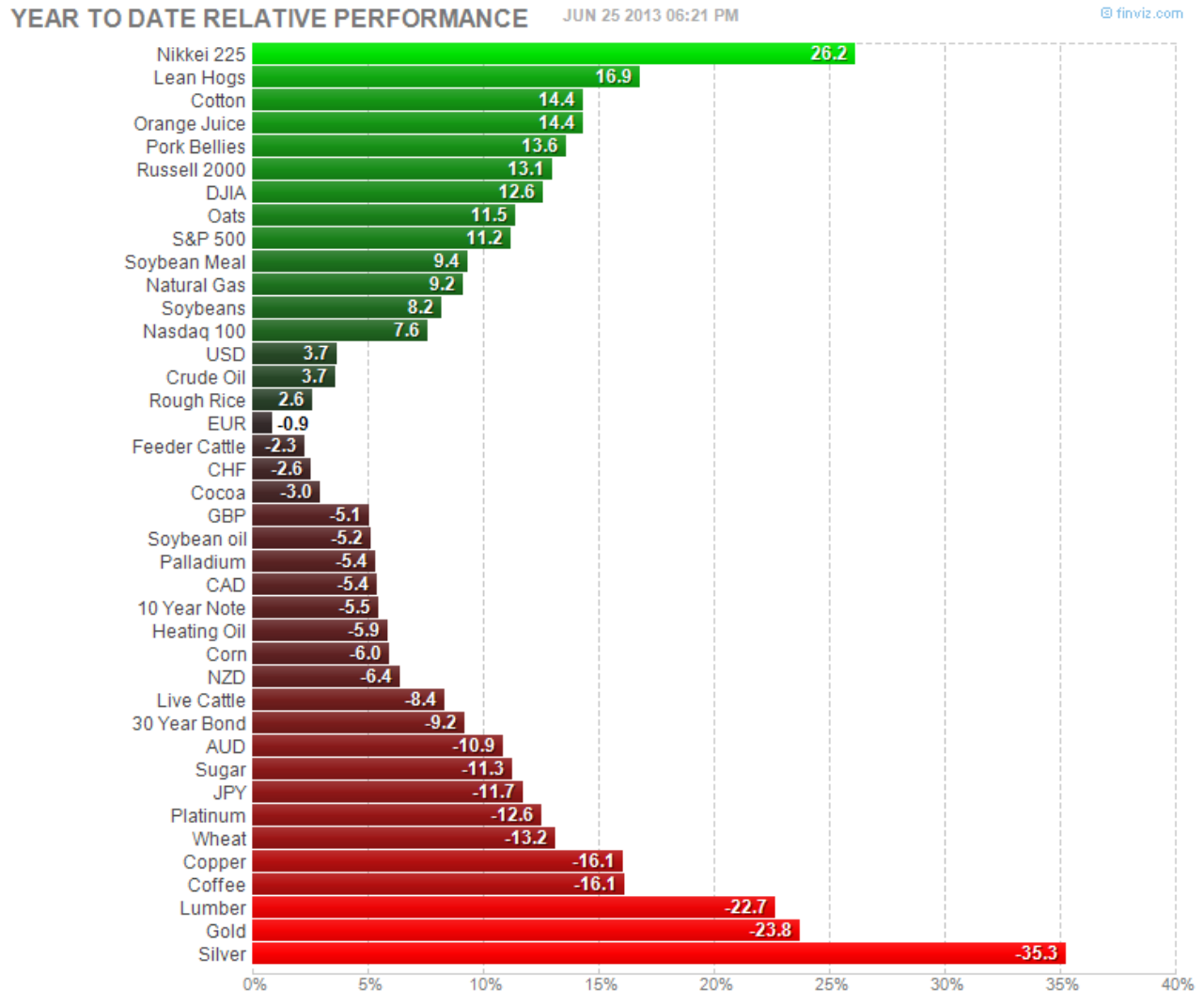
US Dollar Price – (DXY) USD Index Measured against Other Currencies

DX - U.S. Dollar Index - Monthly Continuation Line Chart

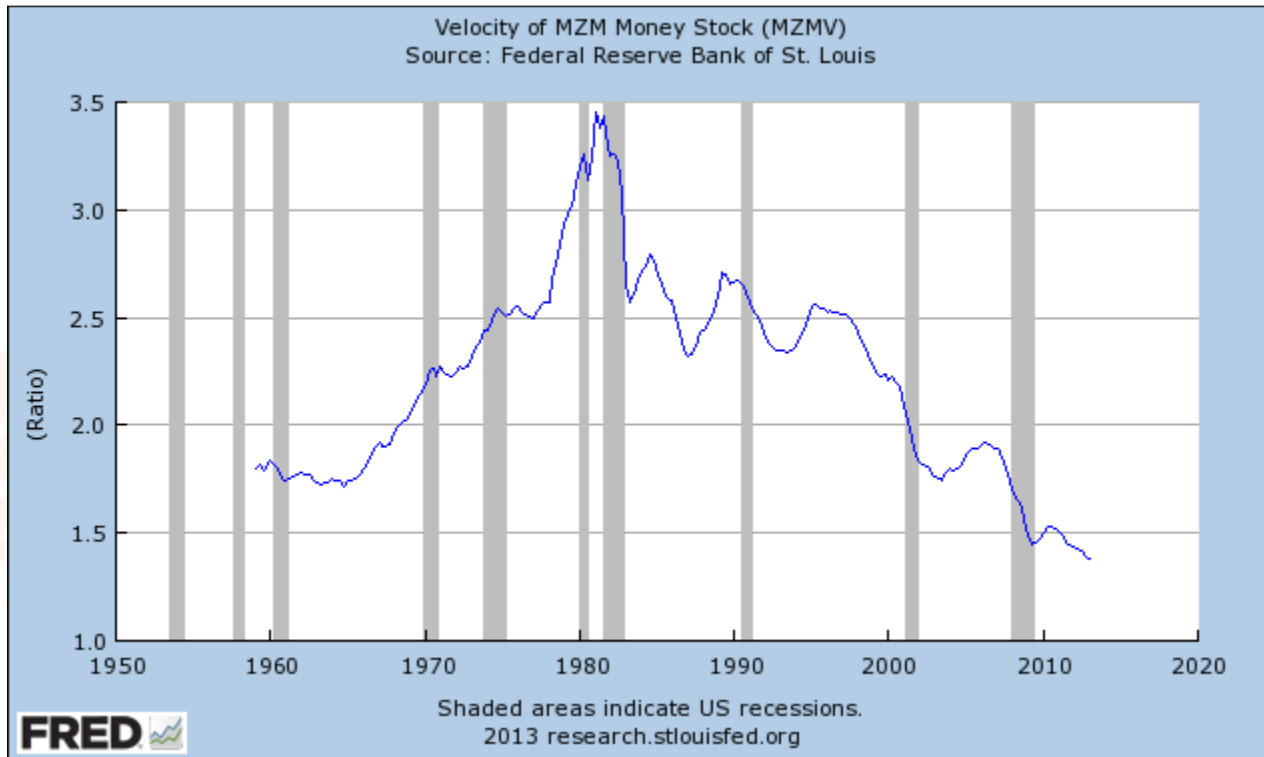


(<http://barchart.com/chart.php?sym=DXY00&style=technical&template=&p=MC&d=H&sd=01%2F01%2F2000&ed=&size=M&log=0&t=LINE&v=1&g=1&evnt=1&late=1&o1=&o2=&o3=&sh=100&indicators=&addindicator=&submitted=1&fpage=&txtDate=#jump>)

Inflation/Deflation -Year to Date Price Increase in Commodities and Basics as Measured by Futures



(http://www.finviz.com/futures_performance.ashx?v=17)



Velocity is a measure of how quickly money is spent. High velocity is typically a precondition for inflation.

(<http://research.stlouisfed.org/fred2/series/MZMV>)