



COMMENCEMENT FINANCIAL PLANNING LLC

Q2

Quarterly Market Review

Second Quarter 2014

Quarterly Market Review

Second Quarter 2014

This report features topics of interest as well as world capital market performance and a timeline of events for the past quarter.

The world capital market performance discussion begins with a global overview, then features the returns of stock and bond asset classes in the US and international markets.

This report also illustrates the performance of globally diversified portfolios.

Overview:

Quarterly Topics: Connecting the Dots
Living off the Interest

Market Summary

US Stock Market Performance

World Asset Classes

US Stocks

International Developed Stocks

Emerging Markets Stocks

Select Country Performance

Real Estate Investment Trusts (REITs)

Fixed Income

Global Diversification

Connecting the Dots

Second Quarter 2014

Human beings love stories. But this innate tendency can lead us to imagine connections between events where none really exist. For financial journalists, this is a virtual job requirement. For investors, it can be a disaster.

“The Australian dollar rose today after Westpac Bank dropped its forecast of further central bank interest rate cuts this year,” read a recent lead story on Bloomberg.

Needing to create order from chaos, journalists often stick the word “after” between two events to imply causation. In this case, the implication is the currency rose because a bank had changed its forecast for official interest rates.

Perhaps it did. Or perhaps the currency was boosted by a large order from an exporter converting US dollar receipts to Australia or by an adjustment from speculators covering short positions. Markets can move for many reasons.

For individual investors, financial news can be distracting. All this linking of news events to very short-term stock price movements can lead us to think that if we study the news closely enough we

can work out which way the market will move.

But the jamming of often-unconnected events into a story can lead us to mix up causes and effects and focus on all the wrong things. The writer and academic Nassim Taleb came up with a name for this story-telling imperative: the narrative fallacy.¹

The narrative fallacy, which is linked to another behavior called confirmation bias, refers to our tendency to seize on vaguely coherent explanations for complex events and then to interpret every development in that light.

These self-deceptions can make us construct flimsy, if superficially logical, stories around what has happened in the markets and project it into the future.

The financial media does this because it has to. Journalists are professionally inclined to extrapolate the incidental and specific to the systematic and general. They will often derive universal patterns from what are really just random events.

Building neat and tidy stories out of short-term price changes might be a good way to win ratings and readership, but it is not a good way to approach investment.

Of course, this is not to deny that markets can be noisy and imperfect. But trying to second-guess these changes by constructing stories around them is a haphazard affair and can incur significant cost. Essentially, you are counting on finding a mistake before anyone else. And in highly competitive markets with millions of participants, that’s a tall order.

There is a saner approach, one that doesn’t require you spending half your life watching CNBC and checking Bloomberg. This approach is methodical and research-based, a world away from the financial news circus.

The alternative consists of looking at data over long time periods and across different countries and multiple markets. The aim is to find factors that explain differences in returns. These return “dimensions” must be persistent and pervasive. Most of all, they must be cost-effective to capture in real-world portfolios.

Admittedly, this isn’t a story that’s going to grab headlines. Using the research-based method and imposing a very high burden of proof, this approach resists generalization, simplification, and using one-off events to jump to conclusions.

But for most investors, it’s the right story.

1. Nassim Nicholas Taleb, *The Black Swan: The Impact of the Highly Improbable*, Penguin, 2008.

Adapted from “Connecting the Dots” by Jim Parker, *Outside the Flags* column on Dimensional’s website, April 2014. Dimensional Fund Advisors LP (“Dimensional”) is an investment advisor registered with the Securities and Exchange Commission. All expressions of opinion are subject to change without notice in reaction to shifting market conditions. This content is provided for informational purposes, and it is not to be construed as an offer, solicitation, recommendation or endorsement of any particular security, products, or services.

Living off the Interest

Second Quarter 2014

Most of us have heard or said, “If I had \$X I could live off the interest alone!”, but what does this actually mean and where did this line of thinking originate?

The foundation of United States law and culture undoubtedly comes from England, with the management and accounting of wealth being no exception.

The concept of trusts dates back to Roman times, but trust law as we know it originated in 12th century England during the time of the crusades. During that time land owning crusaders would often place their land holdings in trust where a trustee would watch over and account for all income and expenses of the trust, with the land being the principal. The result was that the land holdings would be preserved while the beneficiary would live off the “interest”.

As financial markets evolved and stocks and bonds came into being, trusts began to move away from owning just land. English law, however, was preoccupied with holding the nominal principal value constant. That is, according to English trust law at the time, trustees were required to hold steady the value of trust assets without regard to the after-inflation real value of those assets over time.

This peculiar view led to government bonds being the only allowable trust holding other than land (some argue that this stance also assured a market for

government bonds, thus easily gained governmental support) since land and government bonds were considered to be the only risk free assets which also produced “interest” for beneficiary.

The narrow view of English-based trust law held strongly until *Harvard College v. Amory* in 1830. To summarize, Harvard College was one of the remaindermen beneficiaries of a trust after the death of the income beneficiary. At the outset, the trust owned \$50k of bank, insurance, and industrial stock, but at the time of the income beneficiary’s death the original \$50k had shrunk by \$10k. Given English common law’s insistence on holding nominal value constant it would have seemed an easy win for Harvard College, but the Court recognized all investments have risk by stating, “Do what you will, the capital is at hazard.” Specifically, the Court questioned the real safety of governmental bonds by recognizing that government credit too can and has been impaired.

This recognition led to what is now known as the “prudent man” standard with the Court stating that trustees should, “observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of the capital to be invested.” For the next 110 years only eight other states adopted the prudent man standard, but of those Massachusetts remained almost alone with virtually all other states adopting a “legal list” of allowable trust investments.

Whether prompted by trusts piling into Massachusetts (since trusts there were outperforming “legal list” trusts by 100%) or for other reasons, by 1950 most states allowed at least some ownership of common stock by trusts, but the percentage of stock held by trusts was still quite small if any was held at all. This became very problematic after WWII given the low interest rate environment (sound familiar?) coupled with inflationary erosion of *real* value.

To make a long story short, by September 1995 38 states had finally abandoned traditional trust law in favor of the “prudent man rule” which allowed ownership of stock and for distributions to be made according to a total return policy instead of forcing beneficiaries to “live off the interest”.

Unfortunately, many individuals today still adhere to the seriously flawed “live off the interest” frame-of-reference rooted in English common law. Simply put, these individuals are often taking extreme long-term risk in favor of short-term stability and current “income”. How risky? As a simple example let’s assume a portfolio is worth a steady \$1m, net annual earnings are 5%, and annual inflation is 3%. Under this scenario the net annual distribution is \$50,000. The trouble is, however, that in 20 years time the *purchasing power* of that \$50k is worth barely over half what it was at the outset! This is a *real* risk for those depending on the “interest” to fund their retirements which can easily last for 20 years or more.

Living off the Interest (cont'd)

Second Quarter 2014

To overcome this flawed portfolio management approach one must first recognize that inflation is the greatest long-term risk and then structure our portfolio accordingly. This analysis generally helps us determine an appropriate mix of stocks and bonds.

Once an appropriate mix of stocks and bonds has been determined and instituted, the portfolio should be viewed as a whole without focusing on any particular part of it in isolation. This is because the performance of an investment portfolio is generally different than the sum of its parts due to its [covariance](#).

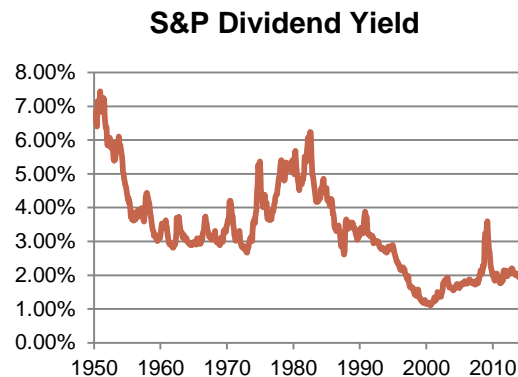
Then, when withdrawing from a portfolio, one should then do so without regard to its income production. This, in my opinion, is because portfolio “income” is rather meaningless. “Blasphemy!”, you say? Let me explain by way of a couple examples.

Over the past several years nontraded REITs have been pushed hard by financial salespeople onto unsuspecting customers. The main selling points for these products are “stability” (which is just an illusion since they are not priced every day) and high “dividend yields”. The trouble is that the dividend yields aren’t usually dividends at all, but instead are mainly a return of the investors original investment and/or made possible by the nontraded REIT taking on debt. In fact, FINRA released [this](#) investor alert on the matter.

So, all the retirees that were counting nontraded REIT distributions as income could have saved the sky-high

commissions and simply either spent the money they invested or went to the bank to get a loan. In other words, the “income” from nontraded REITs and other structured-type products is generally an illusion.

So what about real dividends from real profits? Below is a chart¹ that shows dividend yields since 1950 which have come down dramatically over time.



This decrease is partly due to increased stock prices relative to earnings, but also due to corporations now paying out only about one-third of their net income versus about one-half in 1950.

On one hand we have investments making payments that seem like income, but aren’t; and on the other we have investments that are earning income, but aren’t paying all of it out (for an extreme example of this see [Berkshire Hathaway](#), a very profitable company that has paid only one dividend....in 1967!). In the case of the former the payments are *decreasing* the

investment’s *value* while the retention of earnings in the latter are *increasing* it. A policy of “living off the interest” would take neither issues into account.

A much better approach is one called *total return*. A total return approach uses portfolio valuation to determine withdrawals instead of rather arbitrary portfolio income. A total return approach also affords the ability to better construct portfolios according to time horizon and risk tolerance instead of back-fitting to enhance a portfolio’s current cash flow by means of overloading bonds (and oftentimes high-yield low-quality bonds which tend to be a rather bad choice) and/or shady alternative products.

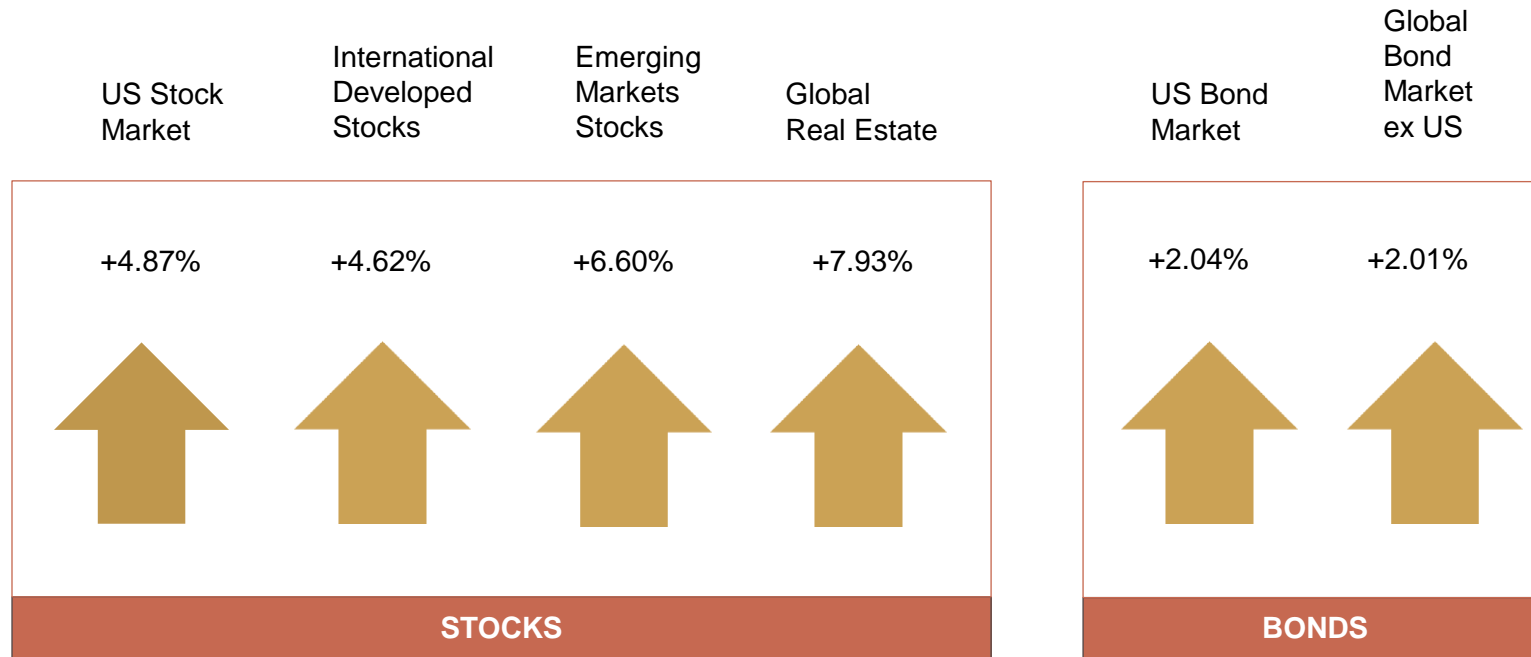
Under a total return approach an investor uses a valuation date or average of several valuation dates, and then applies a percentage (usually under 4% annually). They then withdraw the percentage in a tax efficient manner while rebalancing the portfolio back toward its targeted allocation.

To summarize, “living off the interest” can cause all sorts of issues including improper accounting, reaching for yield, over-allocating to bonds, tax inefficiency, being swayed into imprudent investments, and succumbing to inflation. A much better approach is to build a prudent portfolio according to your risk tolerance and time horizon, and then simply sell down a sustainable percentage of that portfolio each year to fund your cash needs.

¹ Source: [Online Data – Robert Shiller](#)

Market Summary

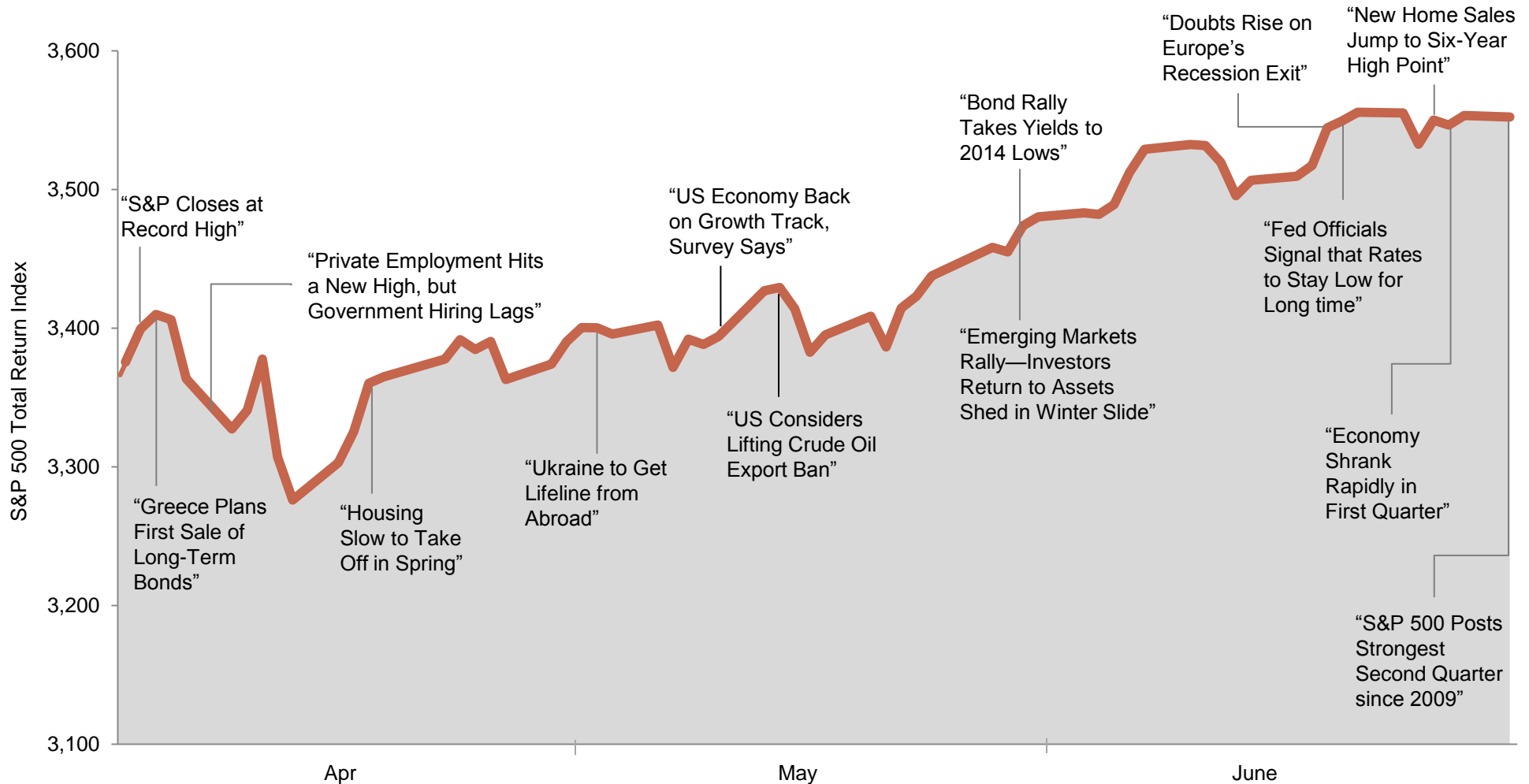
Second Quarter 2014 Index Returns



Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index), US Bond Market (Barclays US Aggregate Bond Index), and Global Bond ex US Market (Citigroup WGBI ex USA 1-30 Years [Hedged to USD]). The S&P data are provided by Standard & Poor's Index Services Group. Russell data © Russell Investment Group 1995-2014, all rights reserved. MSCI data © MSCI 2014, all rights reserved. Barclays data provided by Barclays Bank PLC. Citigroup bond indices © 2014 by Citigroup.

US Stock Market Performance

S&P 500 Index with Selected Headlines from Q2 2014



These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a longer-term perspective and avoid making investment decisions based solely on the news.

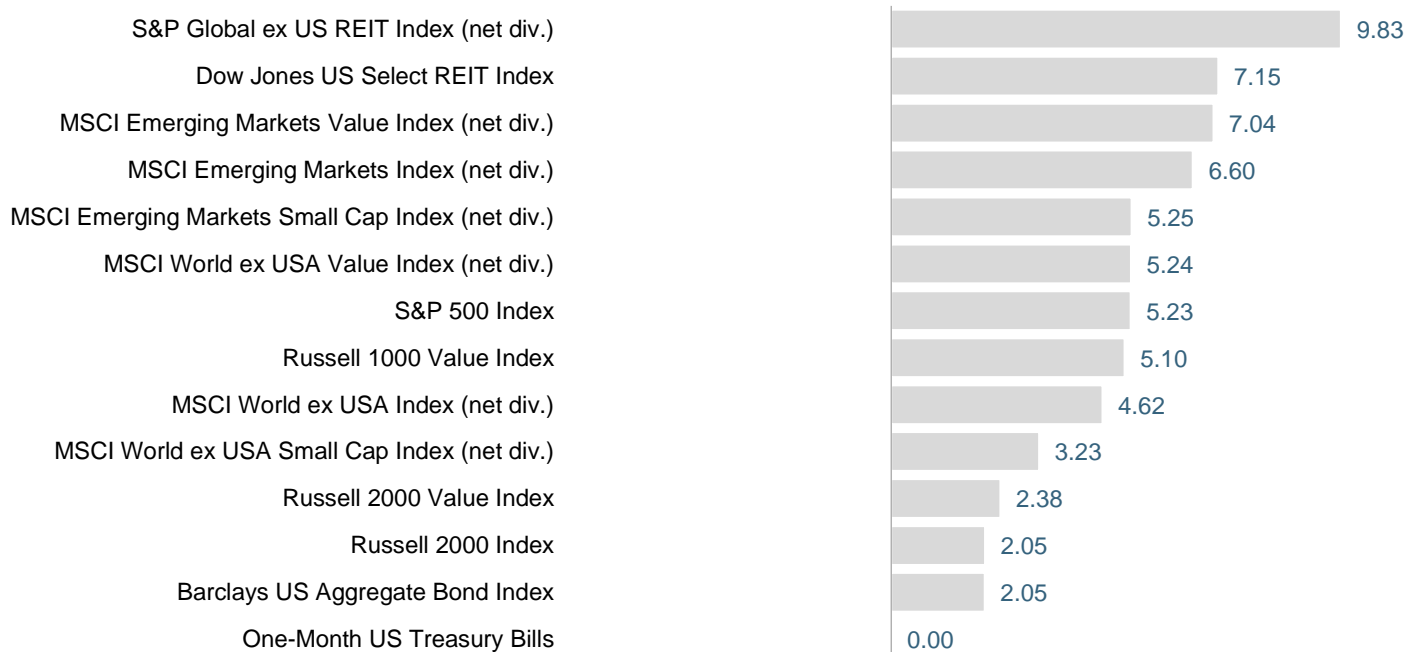
Returns in US dollars. Graph Source: The S&P data are provided by Standard & Poor's Index Services Group.

It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results.

World Asset Classes

Second Quarter 2014 Index Returns

Equity markets posted positive performance for the quarter, led by emerging markets. This was the first quarterly period in which emerging markets had outperformed developed markets since the third quarter of 2012. REITs both in the US and in developed non-US markets outperformed equities. Large cap indices outperformed small cap indices in the developed and emerging markets, including the US. In general, value outperformed growth indices, though performance was mixed within size ranges and regions.



US Stocks

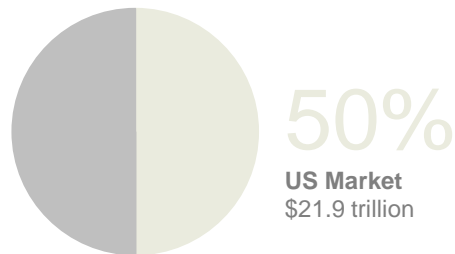
Second Quarter 2014 Index Returns

The US equity market recorded positive performance, with large caps outperforming small caps for the quarter.

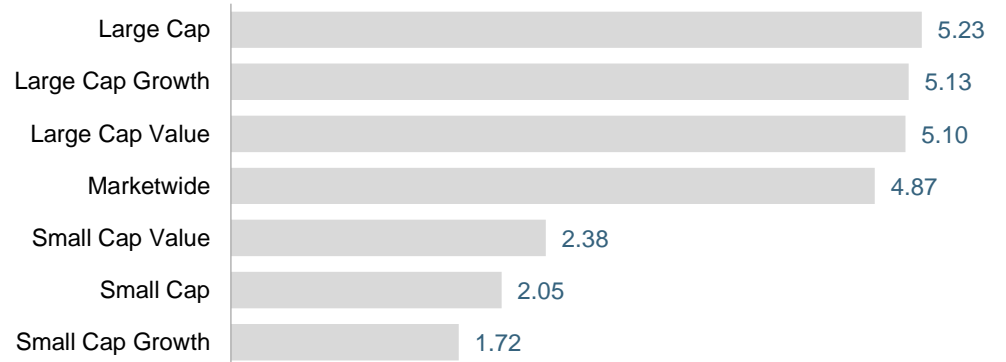
Value outperformed growth within small cap and mid cap indices.

Within large caps, value and growth indices recorded similar performance.

World Market Capitalization—US



Ranked Returns (%)



Period Returns (%)

Asset Class	YTD	1 Year	* Annualized		
			3 Years*	5 Years*	10 Years*
Marketwide	6.94	25.22	16.46	19.33	8.23
Large Cap	7.14	24.61	16.58	18.83	7.78
Large Cap Value	8.28	23.81	16.92	19.23	8.02
Large Cap Growth	6.31	26.92	16.26	19.24	8.20
Small Cap	3.19	23.64	14.57	20.21	8.70
Small Cap Value	4.20	22.54	14.65	19.88	8.24
Small Cap Growth	2.22	24.73	14.49	20.50	9.04

Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Market segment (index representation) as follows: Marketwide (Russell 3000 Index), Large Cap (S&P 500 Index), Large Cap Value (Russell 1000 Value Index), Large Cap Growth (Russell 1000 Growth Index), Small Cap (Russell 2000 Index), Small Cap Value (Russell 2000 Value Index), and Small Cap Growth (Russell 2000 Growth Index). World Market Cap represented by Russell 3000 Index, MSCI World ex USA IMI Index, and MSCI Emerging Markets IMI Index. Russell 3000 Index is used as the proxy for the US market. Russell data © Russell Investment Group 1995–2014, all rights reserved. The S&P data are provided by Standard & Poor's Index Services Group.

International Developed Stocks

Second Quarter 2014 Index Returns

International developed markets indices recorded similar performance to the US, with large caps outperforming small cap indices.

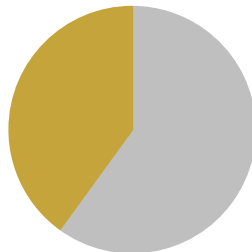
Value indices outperformed growth indices across all size segments.

The US dollar depreciated relative to many of the major international developed currencies.

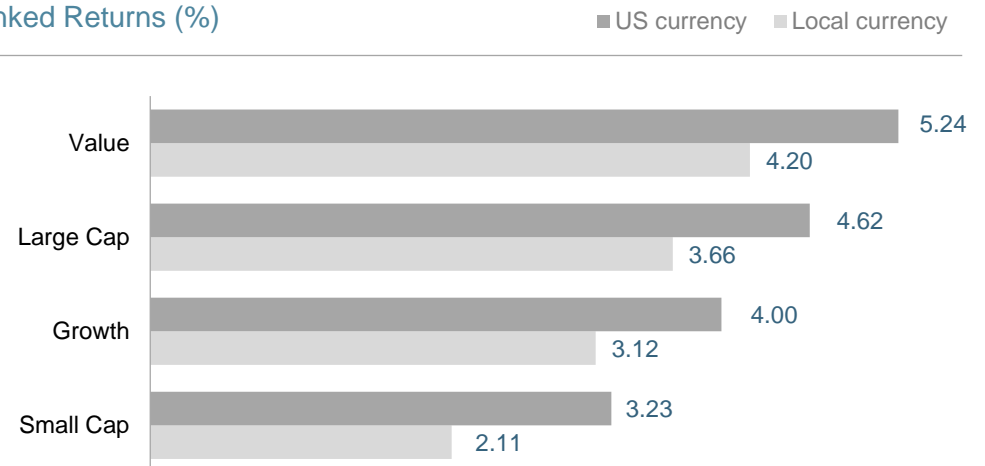
World Market Capitalization—International Developed

39%

International
Developed
Market
\$17.4 trillion



Ranked Returns (%)



Period Returns (%)

Asset Class	YTD	1 Year	* Annualized		
			3 Years*	5 Years*	10 Years*
Large Cap	5.40	23.83	7.58	11.67	7.18
Small Cap	6.79	29.55	8.75	15.32	8.73
Value	6.39	26.91	8.22	11.54	7.09
Growth	4.41	20.79	6.90	11.74	7.20

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Emerging Markets Stocks

Second Quarter 2014 Index Returns

In a reversal from the previous quarter, emerging markets led equity returns versus developed markets, including the US.

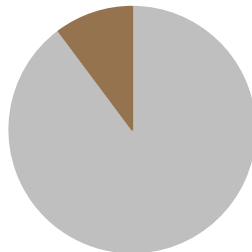
As with developed markets, large caps outperformed small cap indices for the quarter. Value indices outperformed growth indices across all size segments with the exception of mid caps.

The US dollar depreciated relative to many of the major emerging markets currencies.

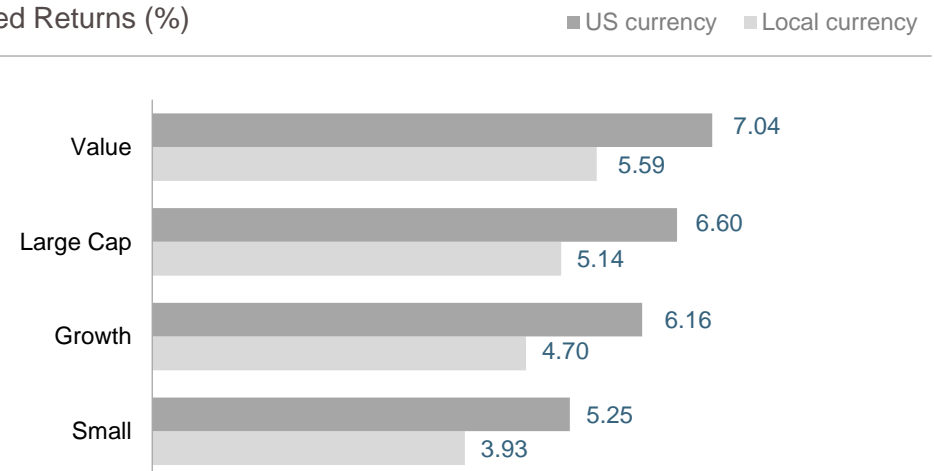
World Market Capitalization—Emerging Markets

11%

Emerging Markets
\$4.7 trillion



Ranked Returns (%)



Period Returns (%)

Asset Class	YTD	1 Year	* Annualized		
			3 Years*	5 Years*	10 Years*
Large Cap	6.14	14.31	-0.39	9.24	11.94
Small Cap	8.98	14.20	0.58	11.48	13.37
Value	6.16	14.43	-1.63	8.30	12.59
Growth	6.11	14.18	0.79	10.13	11.25

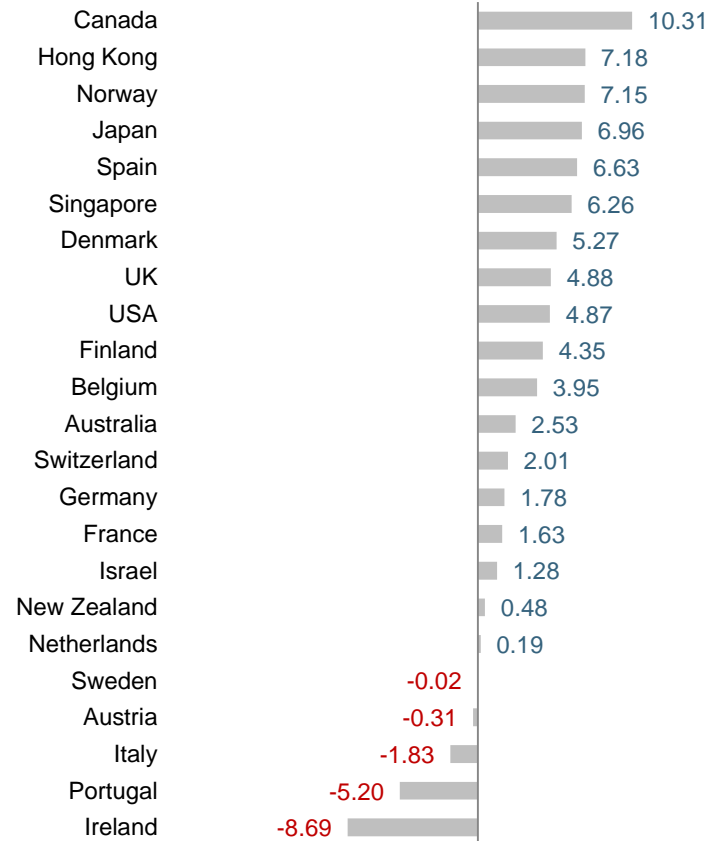
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Select Country Performance

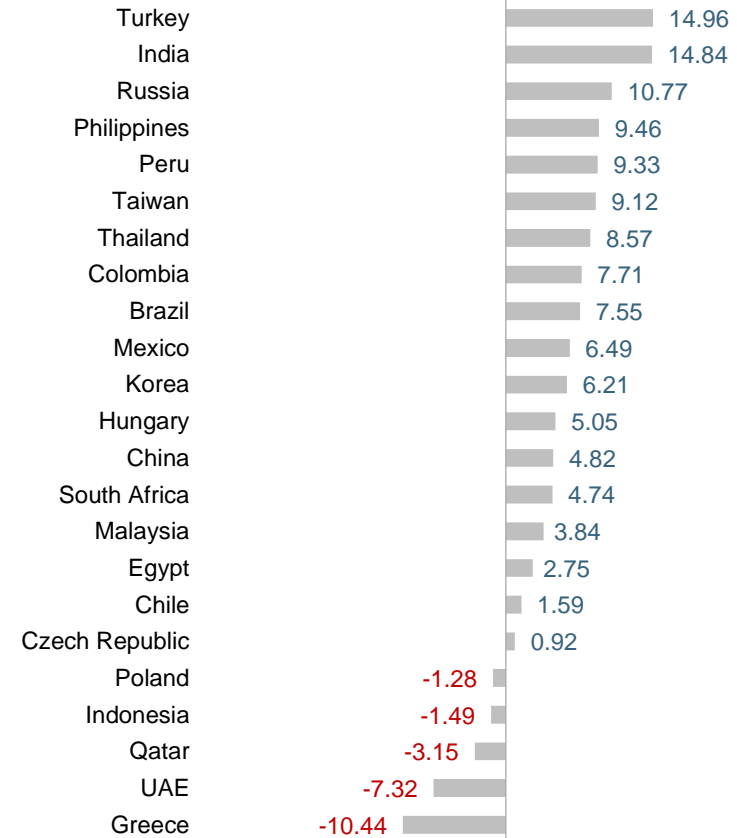
Second Quarter 2014 Index Returns

Canada recorded the highest performance in developed markets, followed by Hong Kong. In a reversal from the previous quarter, Italy and Ireland recorded some of the lowest returns in developed markets. Turkey and India led performance in emerging markets. Qatar and the UAE, recently reclassified by MSCI to the Emerging Markets IMI Index, were among the lowest performing emerging markets.

Developed Markets Returns (%)



Emerging Markets Returns (%)

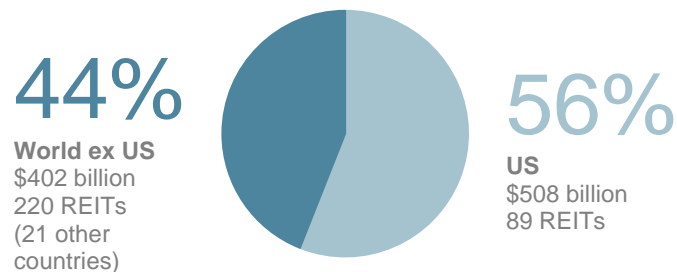


Real Estate Investment Trusts (REITs)

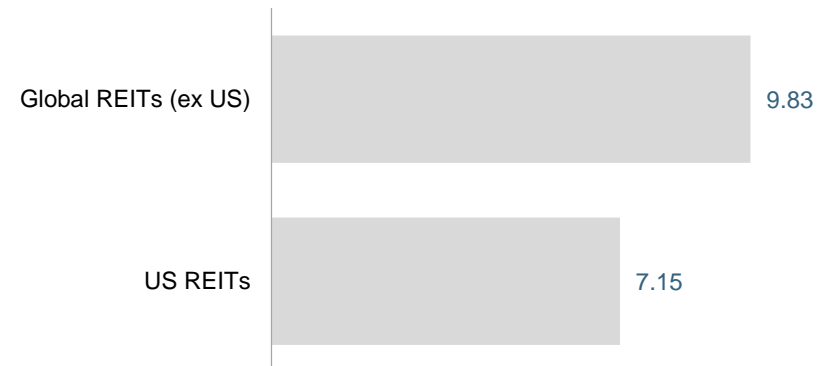
Second Quarter 2014 Index Returns

REITs again returned positive performance, outperforming broad market equity indices in the US and developed non-US markets.

Total Value of REIT Stocks



Ranked Returns (%)



Period Returns (%)

Asset Class	YTD	1 Year	* Annualized		
			3 Years*	5 Years*	10 Years*
US REITs	18.24	13.27	11.38	23.76	9.41
Global REITs (ex US)	13.42	17.86	8.67	16.43	7.28

Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Number of REIT stocks and total value based on the two indices. All index returns are net of withholding tax on dividends. Total value of REIT stocks represented by Dow Jones US Select REIT Index and the S&P Global ex US REIT Index. Dow Jones US Select REIT Index used as proxy for the US market and S&P Global ex US REIT Index used as proxy for the World ex US market. Dow Jones US Select REIT Index data provided by Dow Jones ©. S&P Global ex US REIT Index data provided by Standard and Poor's © 2014.

Fixed Income

Second Quarter 2014 Index Returns

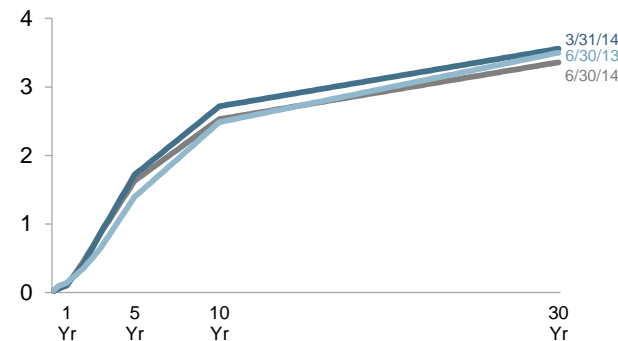
Interest rates across all US fixed income markets declined during the second quarter. The 10-year Treasury note ended the quarter at 2.53%, a decline of 20 basis points over the period. The 30-year Treasury bond finished with a yield of 3.34%, a decline of 22 basis points. The decline in intermediate- and long-term rates, coupled with relatively unchanged short-term rates, led to a flattening of the US Treasury yield curve.

The 30-year Treasury bond returned 5.20% and continued to outpace all fixed income markets with a 13.80% return for the year.

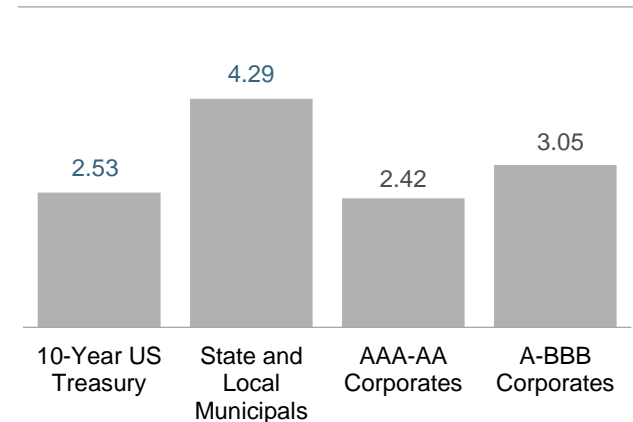
Long-term corporate bonds returned 4.40% for the quarter and 10.42% for the year, beating intermediate-term corporate bonds, which returned 1.77% and 3.49%, respectively.

Municipal revenue bonds slightly outpaced municipal GO bonds by 2.83% vs. 2.19% for the quarter. Long-term municipal bonds outperformed all other areas of the curve by returning 4.11% for the period and 10.05% for the year.

US Treasury Yield Curve



Bond Yields across Issuers



Period Returns (%)

Asset Class	YTD	1 Year	3 Years*	5 Years*	10 Years*
BofA Merrill Lynch Three-Month US Treasury Bill Index	0.02	0.06	0.07	0.11	1.63
BofA Merrill Lynch 1-Year US Treasury Note Index	0.15	0.29	0.29	0.50	2.07
Citigroup WGBI 1-5 Years (hedged to USD)	1.13	1.84	1.85	1.89	3.25
Long-Term Government Bonds	10.90	6.81	8.02	7.17	7.15
Barclays US Aggregate Bond Index	3.93	4.37	3.67	4.85	4.94
Barclays US Corporate High Yield Index	5.46	11.73	9.48	13.98	9.05
Barclays Municipal Bond Index	6.00	6.14	5.35	5.81	4.97
Barclays US TIPS Index	5.83	4.44	3.55	5.55	5.25

* Annualized

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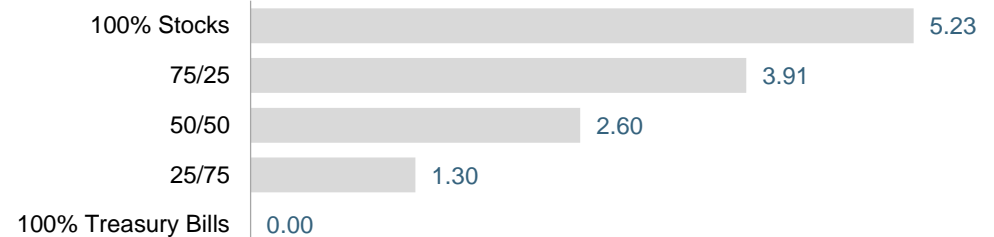
Global Diversification

Second Quarter 2014 Index Returns

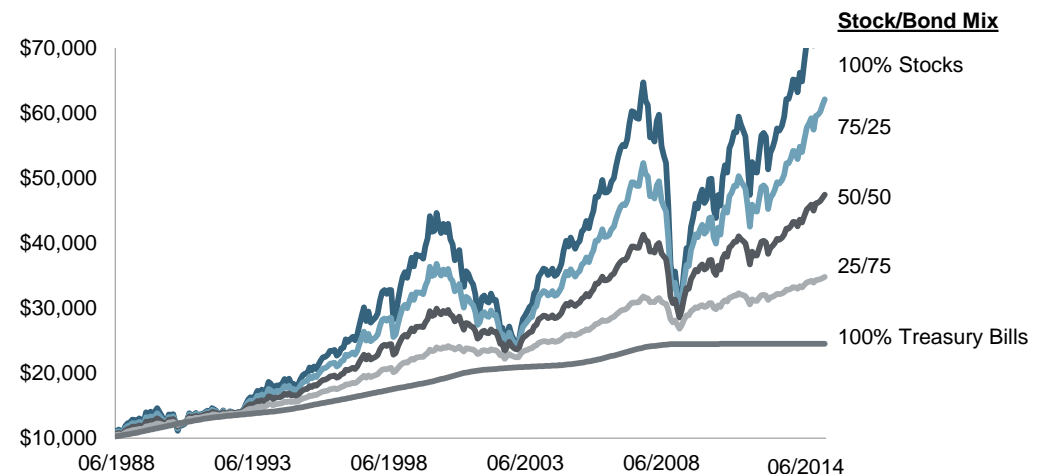
These portfolios illustrate the performance of different global stock/bond mixes and highlight the benefits of diversification. Mixes with larger allocations to stocks are considered riskier but have higher expected returns over time.

Period Returns (%)		* Annualized				
Asset Class	YTD	1 Year	3 Years*	5 Years*	10 Years*	
100% Stocks	6.50	23.58	10.85	14.88	8.02	
75/25	4.89	17.35	8.25	11.22	6.64	
50/50	3.27	11.35	5.58	7.53	5.09	
25/75	1.64	5.57	2.84	3.81	3.37	
100% Treasury Bills	0.01	0.02	0.03	0.06	1.50	

Ranked Returns (%)



Growth of Wealth: The Relationship between Risk and Return



Diversification does not eliminate the risk of market loss. Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect expenses associated with the management an actual portfolio. Asset allocations and the hypothetical index portfolio returns are for illustrative purposes only and do not represent actual performance. Global Stocks represented by MSCI All Country World Index (gross div.) and Treasury Bills represented by US One-Month Treasury Bills. Globally diversified allocations rebalanced monthly, no withdrawals. Data © MSCI 2014, all rights reserved. Treasury bills © Stocks, Bonds, Bills, and Inflation Yearbook™, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefeld).

In Closing

Second Quarter 2014

Remember: *Develop a financial plan according to your unique situation and manage your investment portfolio according to a well thought out and documented investment policy. Doing so will greatly increase the probability you will actually meet your financial goals.*

Troy Sapp, CFP®
Commencement Financial Planning LLC
www.commencefp.com

This letter is intended to address broadly defined financial planning issues. If you need assistance developing a wealth management program tailored to your unique situation, then seek the assistance of a fee-only NAPFA registered financial advisor who is also a CERTIFIED FINANCIAL PLANNER™ professional having the proper education and experience. Consult with your tax advisor before implementing a particular tax strategy.