Quarterly Market Outlook & Strategy Letter

First Quarter of 2014

April 2014

Executive Summary

- As we wrote to clients last quarter, everything that goes around eventually comes around—often sooner, rather than later. The high-flying US stock market, which was the darling of investors last year, delivered only modest returns in the first quarter. Some very popular market segments (biotech, internet stocks, small cap names) have experienced a significant correction this year.

- By contrast, other neglected markets (US Treasury bonds, inflation-protected securities, commodities, emerging market debt and equity, US and foreign real estate) have enjoyed a rebound. Broad-based gains produced returns of 1-5% across most asset classes. Interest-sensitive sectors (bonds, utilities, dividend-paying stocks and real estate) performed especially well, as continued moderate growth and low inflation in the United States tempered fears of a sudden rise in interest rates.

- To be sure, asset valuations remain stretched in many market segments, including US equity, most fixed income sectors (especially corporate credit), and in private equity. However, there is no obvious or immediate catalyst for a reversion to fair value. Typically that catalyst is tightening liquidity. But, with inflation nowhere in sight, central banks are likely to continue supporting the economy and labor markets—with positive spillovers to financial markets.

- Last quarter we explained the importance of diversifying investment risk so as to improve long-term compound returns. Even more important is that a portfolio's risk profile fit its owner. Two primary considerations govern portfolio design: its owner's target rate of return (which entails a certain level of risk), and his or her willingness to tolerate volatility and potential losses in the portfolio.

- Matching a portfolio's risk profile to a client's risk tolerance is extremely important; the quality of the match determines whether the investment strategy remains "comfortable" through a range of market environments. A strategy that's not comfortable cannot be sustained long enough to achieve a client's goals: it is like an ill-fitting pair of shoes that is abandoned at the first opportunity or at the point of maximum pain.

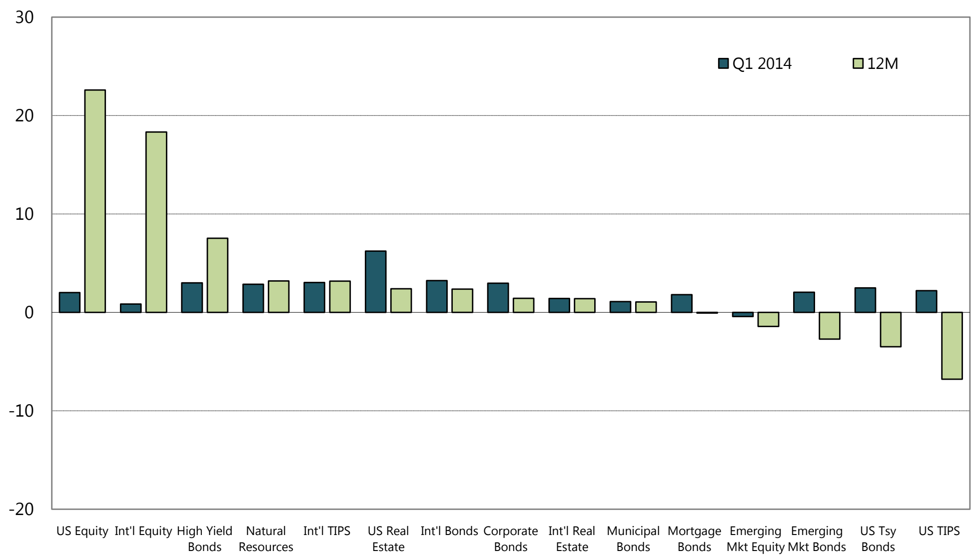
- We have road-tested a variety of surveys to enhance our understanding of our clients' investment risk tolerance. This information helps us to properly calibrate our clients' portfolio risk profiles. We learned that investment risk tolerance is (a) higher among men than women; (b) varies inversely with age and correlates positively with investment knowledge; and (c) has no connection with a client's wealth. Few people have a definite sense of their risk tolerance (and are liable to misjudge it). That's true in part because the willingness to take risk is conditional not only upon one's personal circumstances (which are liable to change) but upon the perceived value (opportunity) of an investment.

- People hate to be surveyed, but love knowing where they stand relative to others!

Market Overview

As we wrote to clients last quarter, everything that goes around eventually comes around—often sooner, rather than later. The high-flying US stock market, which was the darling of investors last year, delivered only modest returns in the first quarter. Some very popular market segment (biotech, internet stocks, small cap names) have experienced a significant correction this year. By contrast, other neglected markets (US Treasury bonds, inflation-protected securities, commodities, emerging market debt and equity, US and foreign real estate) have enjoyed a rebound. Broad-based gains produced returns of 1-5% across most asset classes.

Figure 1. Benchmark Asset Class Returns



Source: Bloomberg

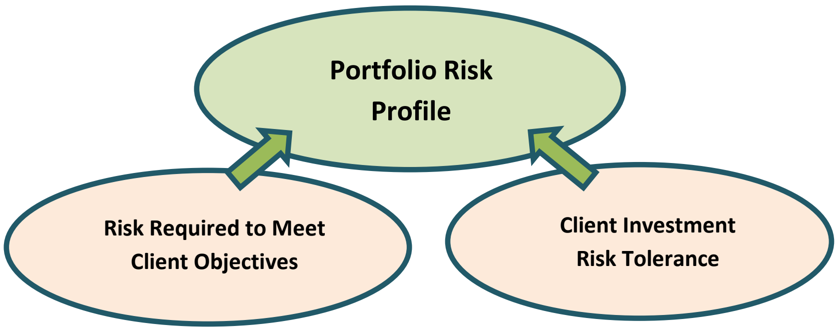
Given the strong performance of interest-sensitive sectors (bonds, real estate, utility stocks) perceptions of central bank policy again played a role in supporting markets. New Fed Chairman Janet Yellen reassured investors that the FOMC will maintain an accommodative policy for some time to come, tempering worries about the end of the Fed's bond-buying program. At the same time, Japanese and European officials hinted of additional easing steps, in response to sluggish growth in their economies. The emerging market "Fragile Five" took steps to stabilize their economies, raising interest rates, trimming budgetary outlays and allowing currency depreciation to improve competitiveness of their exports. Despite lingering worries about the slow pace of global growth, and ongoing geopolitical tension in the Ukraine and elsewhere, most investors view the global investment climate as relatively benign.

To be sure, asset valuations remain stretched in many market segments, including US equity, most fixed income sectors (especially corporate credit), and in private equity. However, there is no obvious or immediate catalyst for a reversion to fair value. Typically that catalyst is tightening liquidity. But, with inflation nowhere in sight, central banks will continue supporting the economy and labor market.

KPF GLOBAL INVESTMENT STRATEGIES LLC

Establishing a Portfolio's Investment Risk Profile

Last quarter we explained the importance of diversifying investment risk so as to improve long-term compound returns. Even more important is that a portfolio's risk profile fit its owner. Two primary considerations should govern portfolio design: its owner's long-term target rate of return (which entails a certain level of risk), and his or her willingness to tolerate volatility and potential losses in the portfolio.



Determining a retirement portfolio's return target is (relatively) easy. One creates a financial plan that projects income and spending into the future, in order to determine what draws from the portfolio may be needed to close the gap. Those draws must be compatible with the portfolio's long-term rate of return, to ensure that the investor does not run out of money during his or her lifetime. A client may have additional objectives—consistent investment income, a sizable cash cushion for business or personal contingencies, or socially-responsible investment priorities—that could also influence the portfolio's risk and return profile.

Understanding Investment Risk Tolerance

Determining a client's investment risk tolerance is considerably more difficult; the concept is imprecise, subjective and liable to be influenced both by a client's changing personal circumstances as well as fluctuating market conditions. Measuring a client's investment risk tolerance is difficult, in large part, because defining risk is difficult. The industry convention is to focus on fluctuations in a portfolio's value, but these fluctuations matter more, or less, depending on an investment's long-term prospects, and the portfolio's investment time horizon—both of which can be uncertain.

However ambiguous the task, matching a portfolio's risk profile to a client's risk tolerance is extremely important, for the quality of the match determines whether the investment strategy remains "comfortable" through a range of market environments. A strategy that's not comfortable cannot be sustained long enough to achieve a client's goals: it is like an ill-fitting pair of shoes that is abandoned at the first opportunity or at the point of maximum pain—entailing investment losses, foregone gains, and/or great inconvenience.

Ill-timed course corrections are costly, so it's important to design and calibrate portfolio strategy to ensure that a good "fit." Understanding our clients' needs, aspirations and fears, so that we create portfolios that suit them, are the single most important task we perform—and our greatest fiduciary duty.

Various published surveys purport to measure investment risk tolerance. Not surprisingly given the murkiness of the subject, these surveys vary widely in terms of their focus, approach and scoring methods. We road-tested several highly regarded surveys, thanks to the gracious cooperation of our clients as well as members of our staff and external advisory board.[1] We compared individual client responses across the various surveys (including one that we developed and have been using for several years), and considered these in the light of other information we have about our clients. This multi-dimensional analysis helped us to assess the utility of various survey questions, and to understand better the underlying drivers of investment risk tolerance. Here is what we found:

Caution Favors the Fairer Sex

The single most reliable predictor of a person's investment risk tolerance is his or her gender: women tend to be more cautious than men when it comes to finances. This tendency has been identified in many industry surveys, and our clients are consistent with the societal norm. Caution is certainly not a bad thing—it implies selectivity and consistency, which are valuable traits in investing. Indeed, several recent studies have found that female investors earn higher absolute and risk-adjusted returns, on average, than do their male peers. That success may reflect a more discerning attitude toward investment risk, or the simple fact that women trade far less often, and therefore incur fewer fees.

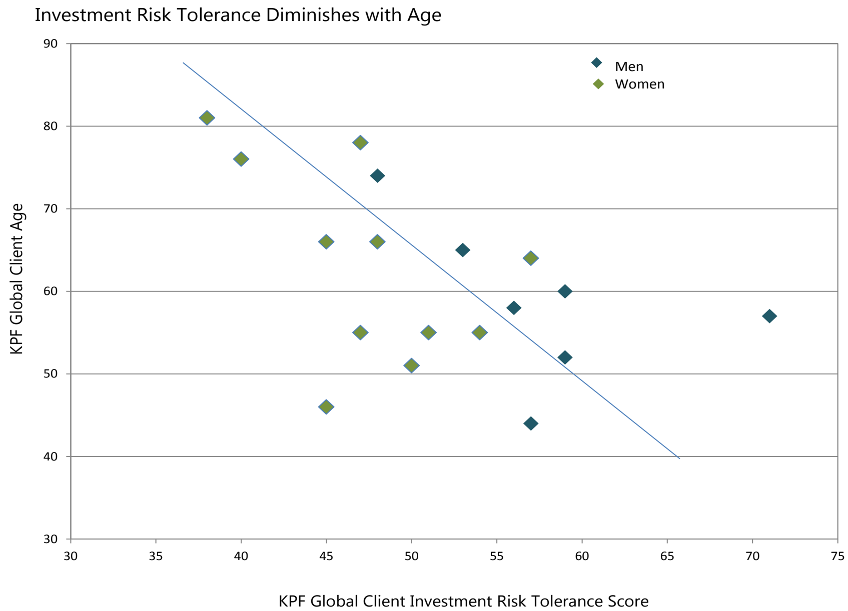
Although our female clients register as more risk averse on average, there are several notable exceptions among them—women who have considerably greater appetite for risk, and who are more knowledgeable about investments, than other clients—whether male or female. For this reason, one should avoid gender-based stereotypes in designing investment strategies.[2]

Age Trumps Wealth

The second most reliable predictor of a person's risk tolerance is his or her age: older individuals are generally more conservative when it comes to investing, and our clients are no exception. This is entirely logical: as people move into and through retirement, they rely increasingly on their portfolios to meet their spending needs. As a result, losses become more costly and anxiety-provoking.

[1] We focused, in particular, on FinaMetrica's risk profiling questionnaire (www.riskprofiling.com), and the Rutgers Risk Tolerance Quiz (http://njaes.rutgers.edu/money/riskquiz). Our own survey is attached to this letter.

[2] This author is among those with a high personal investment risk tolerance. However, she is cautious and protective of her clients' money.



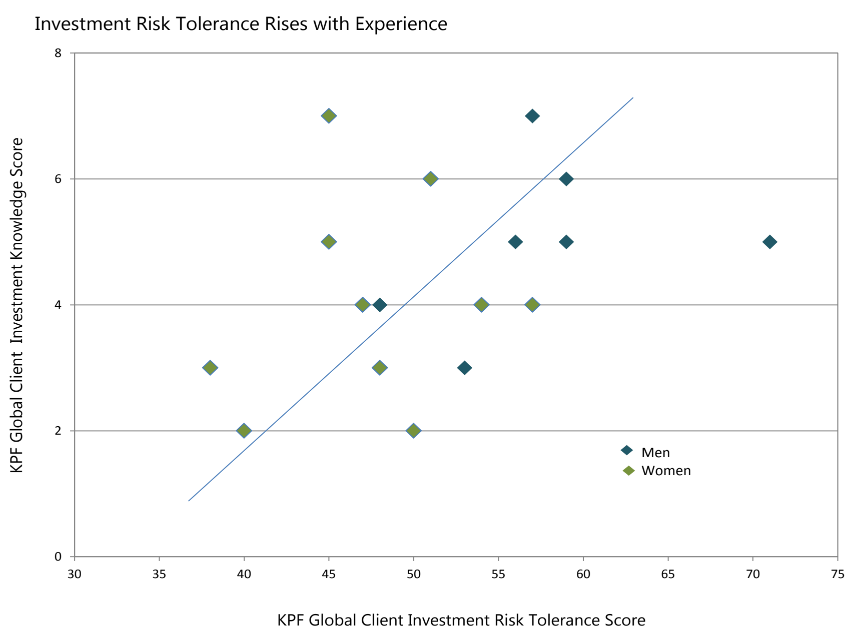
Even very wealthy older clients are less tolerant of risk than younger investors with far fewer assets—which suggests that risk aversion is not simply a fear of running out of money. Indeed—and in contrast with standard investment advice—we found *no* connection between the size of our clients' portfolios and their risk appetite. Many who can afford to take more risk choose not to do so—they don't need the money and don't want the worry. Older clients have seen more of the world, and a larger serving of human folly. They are aware of all that can go wrong in an economy, and in the financial markets. Sadly, this broader perspective is often accompanied by diminished short-term memory, which undermines a deserved confidence in their investment judgment. Not only do young people have longer horizons, they enjoy a sense of invulnerability that makes them more willing to take risks of all kinds, not just financial.

Knowledge is Power…but (some) Ignorance is Bliss

Those with greater investment knowledge tend to be more confident in their financial decisions, and those who are more confident are more tolerant of investment risk. This became readily apparent when we compared the survey responses of our staff and external advisory board members (who are very knowledgeable) with those of our clients. The average score of the professional investor group was 10 points higher than our average client score, which fell slightly below the survey's mean.

To evaluate our clients' investment knowledge, we relied on their self-assessments as well as our internal scoring system. While subjective, these signals proved surprisingly consistent, for our clients are open and self-aware. Educating clients about investment matters, in an atmosphere of mutual respect, yields a sizable peace dividend—peace of mind, that is. Our goal is not to increase our clients' portfolio risk profiles but rather to make them as comfortable as possible with the risks they have chosen to take in order to meet their retirement goals. Knowledge moves clients away from a state of paralyzing uncertainty toward habits of thought that make it easier to take considered risks.

Interestingly, knowledge boosts a person's risk tolerance…but only up to a point. Our results show that those with the greatest investment insight do not exhibit the highest risk tolerance scores. Indeed, the most knowledgeable investors are likely to *under*estimate their capacity to bear investment risk. As with older generations, the experienced know just how much can go wrong in the markets, and are correspondingly cautious.



Optimism Powers Capitalism

Winston Churchill observed that an optimist is one who sees the opportunity in every difficulty, whereas a pessimist sees the difficulty in every opportunity. Not surprisingly, those whose survey responses reveal an optimistic bent register as more tolerant of investment risk, whereas the pessimists (they would call themselves realists) are naturally cautious. The personality of the market is neither optimistic nor pessimistic; it suffers from bipolar disorder, swinging from greed to fear and back. Individuals who are optimistic by nature find it easier to look past the volatility, short-term risks, and lofty valuations; they are more inclined to get and stay invested. By contrast, pessimists can identify a seemingly endless list of (often legitimate) obstacles to market progress, to justify avoiding exposure.

Optimists who overestimate their risk tolerance tend to be relatively knowledgeable about investments (affirming the old adage that a little knowledge can be a dangerous thing!) However, some people's confidence exceeds their expertise—and prudent investment boundaries. Occasionally we meet people who are eager to take risk but have no real understanding of what they are getting themselves into. These are the ones who are most in need of financial advice, and least likely to seek it.

*Minding Their **P'**ennie**s** & **Q'**uarter**s***

We have identified one reliable marker of a person's risk tolerance that is not captured in most surveys—frugality. That thriftiness and investment caution go hand-in-hand should come as no surprise. People who manage their expenses carefully tend to save and invest more, achieving compound gains in wealth over the course of a lifetime. Those who have marshaled and multiplied their assets over a lifetime of prudent choices and careful planning are unlikely to approach the investment markets with abandon. These individuals view portfolio fluctuations not in terms of abstract concepts or vague percentages, but in actual dollars saved and lost. The thriftier they are, and the more money they have saved, the larger is their investment portfolio—and so are the corresponding fluctuations in its dollar value. It can be startling for these cautious individuals to witness a $20,000 change in a portfolio's value, given the effort that went into earning and saving that much money. However, such fluctuations are the norm for those who have created a comfortable nest egg—if they are invested in the equity markets.

Paradoxically, the effort and attention that goes into saving for retirement leaves such individuals ill-suited to oversee their own portfolios. Planning and self-discipline are helpful, but otherwise, less is more when it comes to "managing" investments. The best long-term results accrue to investors who pay less attention to market news and chatter, do less checking of their investment results, trade less (apart from periodic rebalancing), and therefore incur less tax liability and less expense. Doing less means better results with less stress. However, it can be exceedingly difficult for accomplished and attentive individuals to accept that the best investment advice often is: "Don't Just Do Something—Sit There!"

Survey That!

Most people are unsure of their risk appetite and misjudge their survey scores—often by quite a lot. However, they are quite sure they don't want to be typecast—least of all by simplistic, multiple-choice questions. Many clients resisted filling out our surveys, until they realized that we don't evaluate them narrowly, etch their responses in stone, or calibrate their investment strategy according to a single numeric score. This is no box-checking, CYA exercise for us; understanding our clients' investment attitudes and perceptions is the most important work we do. Surveys are a useful place to start, but none capture all the interesting and important nuances that shape one's investment personality. Fortunately (and most enjoyably) there is no substitute for getting to know our clients well by working together over time.

Although they resist being classified, our clients are fascinated to know how their investment attitudes stack up to others. They are surprised to learn that most people underestimate their risk tolerance—because just about everyone thinks others are wiser, braver, and more patient than they are. Few clients have any idea how to characterize a portfolio's risk profile, or what kind of return they can reasonably expect theirs to produce. Most say they want relatively safe portfolios—but they also want relatively high returns. Fortunately, our clients do have a clear sense of how large a loss they can tolerate, having experienced several investment traumas as a result of market collapses over the past two decades.

Although many of our clients are unsure how much investment risk they should take (or indeed, are taking), it turns out that the average portfolio share that they say they are willing to invest in assets of medium to high risk (66%) is precisely the share that such assets represent in our adult clients' portfolios. That may be true on average, but what about individual clients? The chart above shows that the realized (actual) volatility of our clients' portfolios generally aligns with their risk tolerance. There are a few outliers, including two portfolios that were too conservatively invested.[3] The other outlier portfolios are either in a gradual transition due to tax considerations, or represent only a portion of a broader set of investments whose risk profile more closely matches their owners' preferences.

[3] Of course, the jury is out until we go through a major market correction. Many who believe themselves to be very tolerant of market risk prove to be considerably less so when the chips are down.

Value Investors All

People may hedge their preferences because their willingness to take risk depends on a variety of changing circumstances, many of which cannot be captured in a survey. Chief among these is an investment's long-term prospects. Many of our clients will tolerate considerable price volatility and risk of loss *provided* they believe an asset is attractively valued. They understand, intuitively, that an investment's future prospects are, all else equal, inversely related to its current price. Yet they also recognize that all else *never is* equal, and that judgments of an asset's intrinsic value are difficult to make. It's not surprising, therefore, that those with greater investment knowledge tend to score higher on measures of risk tolerance.

Cautious Cathy vs. Freewheeling Ferris

Catherine, our stereotypically risk-averse investor, is an older woman who has managed her money carefully over the course of a lifetime. She has amassed a large nest egg from which she draws little; her husband has passed away and her children are grown. Given her low spending rate and long investment horizon (these assets are destined for her children) Cathy can afford to take some investment risk. However, she is reluctant to put money in the stock market because she is alarmed by the volatility. She doesn't have a lot of investment experience, but watches the financial news to try to learn more. Catherine has heard that US stocks are overvalued, earnings are stagnant, and there are numerous obstacles to growth abroad—especially in the emerging markets. China is slowing, so commodities aren't as attractive as they used to be. The US housing market remains sluggish, so real estate doesn't seem like a good idea. Cathy would be comfortable investing in bonds, but can't believe how low bond yields have gotten. Stuck between a rock and a hard place, she decides to spread her sizable cash holdings across several banks that offer a "high" rate of interest on deposits—about 1% annually. Even as she reads about the stock market's historic gains, Catherine remains paralyzed by ambivalence: she regrets having stayed out of the market, but is sure that it's too late to invest now.

Ferris, our stereotypically risk-seeking investor, is a young man who graduated recently from college with a degree in business administration. He has always been fascinated by the stock market, and has been running his own portfolio with a bit of money he managed to earn from internships and summer jobs—plus whatever family members were willing to lend him to get started. Although he doesn't have a lot to work with (and has student loans to pay off), Ferris is confident that he'll be able to grow his portfolio by posting strong returns and attracting new clients over time. His aspiration is to be a successful hedge fund manager one day. Ferris monitors his portfolio's performance frequently, adjusts his investment selections in response to changing market conditions, and reads several investment blogs that keep him informed of emerging investment trends, economic data releases, and various measures of investor sentiment, flows and price technicals. Too clever by half, Ferris overtrades his portfolio, racking up expenses. Confident in his judgment, his investments turn out to be highly correlated with one another and suffer large declines during the ensuing market correction.

From the standpoint of investment risk tolerance, Cathy and Ferris might as well be from different planets.[4] Neither has adapted to the messy realities of investment life on Earth. Investment success is hampered by seeing the world in black and white—shades of gray are the colors of the financial rainbow. Learning to walk the middle road produces better investment results and less drama.

A financial advisor is not unlike a personal trainer (although "Zen Master" might be a better metaphor). Everyone knows what he or she needs to do to stay healthy: exercise, eat more vegetables, avoid sugar, alcohol and processed foods, get more sleep, and avoid stress. In investing, the recipe for success is equally simple: save as much as you can, don't put all of your eggs in one basket, take the long view, be mindful of valuations, trade infrequently, and keep expenses low.

However, the sorry state of human health—and of real-world investment portfolios—suggests that most of us need some help in order to be our physical and financial best. Often, that help comes from respecting the homeostasis (natural healing potential) that exists in the economy and investment markets, just as it does in the human body. Less is more. Simplicity is rewarded. First, do no harm. Everything in moderation. Seek serenity.

KPF Global Portfolio Strategy

We have made no major changes in portfolio strategy over the past few months. We allowed our client's US equity exposure to drift higher along with the market's appreciation, but are beginning the process of rebalancing exposures back to target. We have trimmed investments in smaller-capitalization names, in favor of large-cap and value sectors which are more attractively priced. We continue to emphasize less volatile, dividend-paying stocks, which performed well during the market's Q1 soft patch. We maintain a tilt toward the international markets, and especially the emerging equity and debt markets, which are attractively valued and which are benefiting from the gradual recovery in the global economy.

In keeping with the benign cyclical environment, we have put a bit more money to work in international real estate and maintain a healthy allocation to commodity-related investments. Within the fixed income markets, we have trimmed our clients' investments in mortgage-backed securities in favor of larger allocations to municipal bonds and cash equivalents. Our clients' maintain a sizable cash (and cash equivalents) cushion, equivalent to 5-10% of portfolio value.

[4] Neither represents an actual KPF Global client, but they represent realistic composites of personal attributes and attitudes that we have seen over the years.