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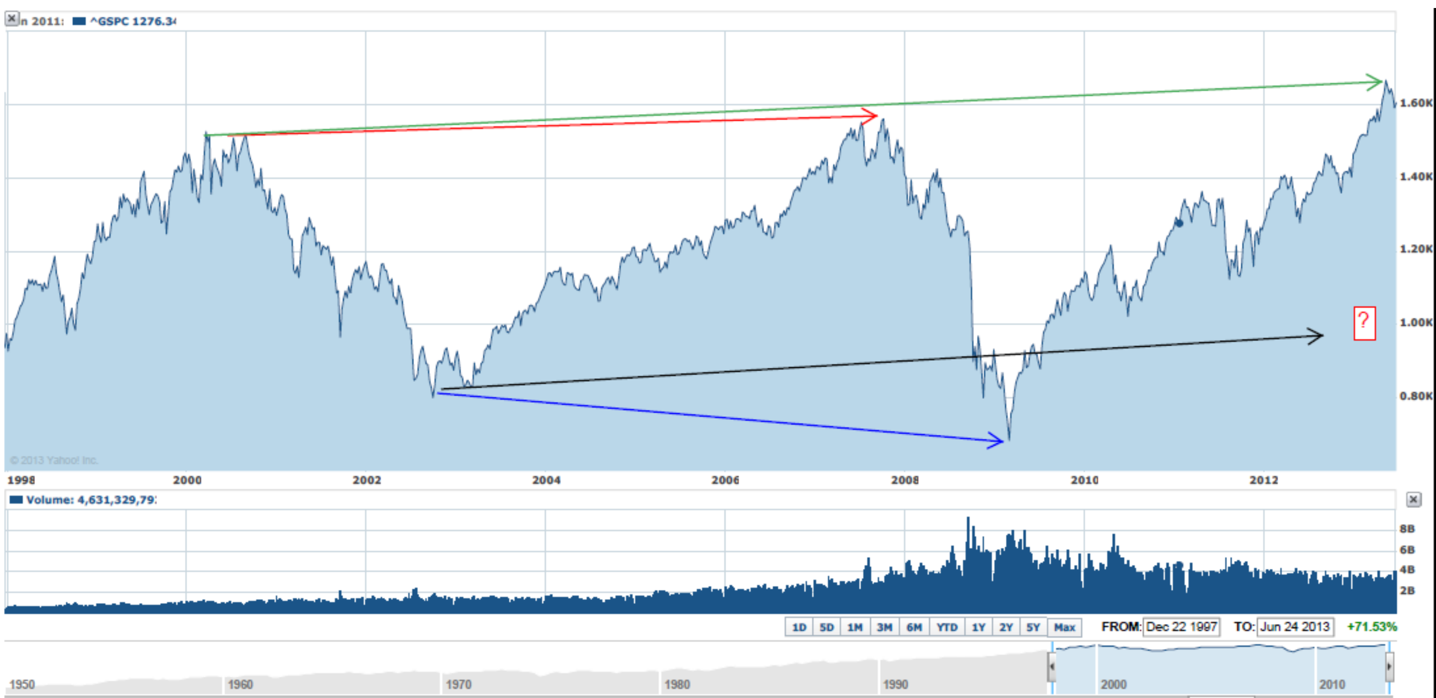
"***The superior man is distressed by the limitations of his ability; he is not distressed by the fact that men do not recognize the ability he has.***" **-Confucius**

Performance Measurement

One of the biggest challenges we face as investors is to define our goals and then map out a course for achieving them. Part of this is knowing our own risk appetites and constructing a portfolio that will allow us to remain largely invested even when times are difficult. For those less adventuresome, that may mean a much more conservative approach than, say, someone with few obligations and a sizeable penchant for risk**.** Either way, it is important to properly construct a portfolio with your own profile as a guide and then *select an appropriate benchmark* that will allow an objective review of your performance over time relative to both the benchmark *and* your goals**.** Selecting an appropriate benchmark is a topic many professionals in the investment community have shown great passion about. For our purposes (and since we are not generally dealing with institutions where these issues have broader implications) a benchmark should at least come close to tracking the broad asset classes represented in your portfolio. That is to say if your portfolio is 40% in bonds and 60% in stocks, the benchmark should have similar weightings. Also, if the stock portion is 50% domestic and 50% foreign, then so should your benchmark. We could do a more thorough treatment of appropriate benchmarks in a whole letter, but for now this description should suffice.

Up to this point most readers will probably feel that all of this sounds reasonable and logical. It is, however, a good leaping off point for a study in human behavior. Often times the logical and pragmatic get replaced by human emotion. This is particularly acute in the capital markets where a myriad of financial assets trade every day, giving an investor an up to the minute reading on the status of their financial well being. There is the always human tendency to alter a set of well defined goals in favor of the vogue. Missing out is a truly human emotion. It is this emotion that is the bane to most successful investment plans. One of the big errors that investors make in the hurricane of emotion is proper perspective. For example, in today's news you may very well find articles of how well the general stock market is doing and how far it has gone up in the last four years(150%!). What you will not likely find is the peak to peak returns *over a full market cycle.* This is important because the peak to peak returns (or trough to trough returns) represent the real returns investors can likely achieve by assembling a portfolio similar to the benchmark without trading in and out of the assets in question at all the right times (a feat few, if any, professionals have perfected).

In the graph below we examine the S&P500 Index's price performance over more than a decade. The return from August 2000 through October 2007 (red arrow) was **0.29%** per year. With dividends the compounded annual rate was close to **2.46%**. From August 2000 through July 2013 (green arrow) the price return was **0.81%** per year and with dividends was close to **2.92%.** These numbers are a far cry from the historical returns from stocks over the last century (closer to 9+% with



dividends). The historical long term returns may not rejoin us until the excessive debt burdens the world has accumulated over the last two decades show signs of being resolved to something much more sustainable and manageable. A big reason for this lies in the *observed* historical record that suggests that large debt burdens are deflationary precisely because more and more productive output goes to service the debt rather than for productive purposes. This brings us back to full cycle returns and their measurement. Since we have completed roughly 2 full peak to peak market cycles since the 2000 market peak, the question becomes, "what will the full 2-cycle trough to trough returns look like?". Without having significantly reduced our overall debt burdens since the 2008 financial crisis, my suspicion is that the 2.50 to 3.00% peak to peak total return is still valid and likely for the trough to trough returns. This is also validated by long-term explanatory variables like S&P500 revenues and Shiller 10-year smoothed earnings. If this proves to be the case a price correction of 45% is not out of the question. To punctuate this possibility consider that we've had two similar episodes (each with over 45% declines) since 2000. Why point this out in a piece about performance measurement? The simple fact is that human nature forces us to change our perspective based on the most recent past rather than on accumulated facts. By nature we have a great capacity to forget those things that caused us the most pain in our past. By doing this, it is tempting to judge the performance of our own portfolios against those that have performed best in the recent past, ignoring important facts like 1) Is it the appropriate benchmark? 2) Does it comport with my personal goals? and 3) Are the *risks* similar to those I am comfortable with?, etc..

Strategy vs. Tragedy

By setting appropriate benchmarks, outlining goals and properly accounting for risks, investors can find comfort in the product of those endeavors … namely a *strategy.* Well defined, a strategy is the hallmark of successful investing where everyday we are bombarded with calls to action that suggest our current portfolio is somehow misaligned. By having a strategy, we can largely ignore the day to day machinations of the media or market movements in favor of a more pragmatic approach that allows us to evaluate, research, measure and adjust according to our goals. Conversely, those unfortunate enough to abandon the aforementioned rigor in designing their investment posture and goals will likely be persuaded to take more risk at the wrong times, less risk when it is appropriate to increase it and, most likely, measure their performance against the wrong benchmarks. This all leads to a failure to meet even their most modest goals, leaving them in with a sense of despair … *a tragedy*. The importance of having a well defined strategy cannot be understated. It keeps undue risks from creeping into your portfolio at all the wrong times and forces unemotional risk taking as markets sell at discounted prices. This balance will likely temper portfolio returns at market tops and reduce volatility on market sell-offs, but produce long term consistency that the effect of compounding will highlight. In addition, and as a word of caution, a good strategy will likely give an investor a

sense of comfort in what is likely to be a messy exit of central bank intervention. If you're not sure what this means, it is the unprecedented monetary injections by the European Central Bank (ECB), the Bank of Japan (BoJ), the Peoples Bank of China (PBC) and our own Federal Reserve Bank. These have served to create a buffer in world economies since the 2008 financial crises, but are experimental in nature and expected to end at some future date leaving who knows what in their wake. The uncertainty of how the (un)anticipated exit will affect all assets will undoubtedly be more challenging for market participants that do not have a disciplined strategy in place.

In conclusion, have a well thought-out strategy that not only uses the appropriate benchmarks for comparison, but also has your goals and risk tolerance solidly as a centerpiece. The risks inherent in your portfolio should be a close match to what you can likely tolerate when things are not going so well and, remember, those same constraints reduce potential returns when euphoria abounds in the markets. Keep a guided path and you will achieve your ultimate goals!

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