MALLARD ADVISORS

Comprehensive Financial Planning
& Wealth Management Solutions

THE QUARTERLY MALLARD CALL

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Notices

Bill will be out of the office April 1st-3rd enjoying some family time while school is out for Spring break.

Congratulations to Cheryl Starr for earning the Financial Paraplanner designation from the American College.

When sending confidential and/or financial information to us, please remember to use the **secure *ShareFile* link** contained at the bottom of each of our email signatures rather than using the attachment function of your email software.

Are you receiving our e-mail newsletters (which are different from this quarterly newsletter)? If not, let us know by sending an e-mail requesting to be added to our e-mail newsletter list.

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Splitting the Market to Gain Clarity

William D. Starnes

I would like you to take a moment to close your eyes and visualize an image of U.S. stock market movements over the last year. What do they look like? Is it a straight line; moving up; moving down; or a jagged line? When most people visualize market movements over time, they generally see something like the following chart:

The line in the chart above represents actual historical changes in the value of the S&P 500 over the last twelve months. As we know, over the long-term, changes in the stock market are driven by the profits and value of U.S. businesses. However, in the short-term, prices can change rapidly and dramatically based upon new relevant business/economic news, and/or the emotions of investors. This simply means **the prices of stocks tend to be much more volatile than the values of the underlying companies**. **This is a critical distinction that cannot be garnered from the chart above or by most investors**. Because most investors can't make this distinction, it has a major impact on why most investors don't succeed in obtaining the returns they deserve. They are distracted and emotionally shaken by the short-term volatility.

However, what if you could separate the above line into three parts? Of these three parts, one could represent downward volatility, the second could represent upward volatility, and the third could represent all other market changes over time. I would like to show you how looking at stock market movements this way could be beneficial towards your investment success.

Eddy Elfenbein, editor of *Crossing Wall Street*, has created the chart (at the top of the next page) which

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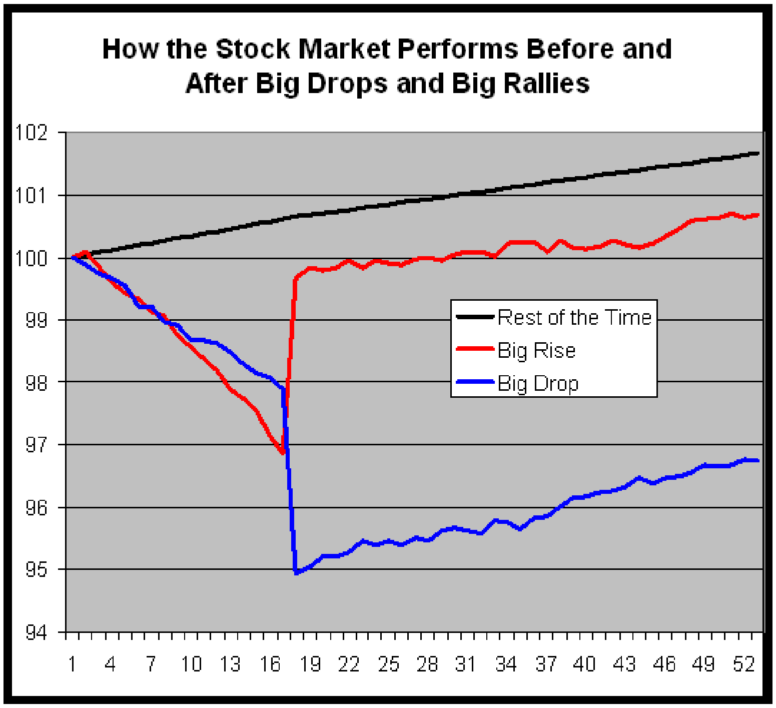
Announcements

Gear Up for Tax Time

For our Wealth Management clients, we will begin preparing your 2014 income tax returns quite soon. We will send your tax organizer within the next two weeks. We provide this valuable service in order to ensure that our tax planning advice gets reflected as planned on your actual tax return.

breaks stock market moves into these three groups represented by the following three colors of lines: **Blue**, **Red**, and **Black**. These groups, in aggregate, represent all stock market *daily* changes since 1950. However, they have been split into the volatile days (blue and red) and all other days (black). The blue and red days were then averaged to show how the market moves in the days prior to, during, and after these volatile days.



If you follow the **blue** line along the X axis (days) you will see the average stock market move in the 16 days prior to a 2% (or worse) drop. Then you will see the 2% drop as represented by the steep one day drop in the blue line. Finally, you will see the average of the 35 days following the big 2%+ drop. So, prior to the big move, the market slides. Then, after the big move, the market moves higher over the subsequent 35 days. This type of move occurs about once every two months.

Then we have the **red** line which shows what happens around the time of 2% positive moves (or better). If you then follow the red line along the X axis, you also see a downward slide prior to the 2% market pop. You will also see a rising market after the market pop.

The **black** line represents all other days (the less exciting/volatile market days).

If you really look at this chart and think about it, there are some fascinating realizations to come from this. They include:

- The black line shows the return of what you are actually invested in (businesses) and realizing when you invest (and maintain your investment).
- The red and blue lines represent the fears of investors, or big changes due to “new” news.
- The black line represents the ongoing advance in the values and dividends of businesses, while the red and blue lines illustrate the rare punctuations of temporary declines.
- The data that generated the black line occurred **96% of the time** from 1950 to present. In other words, while the daily volatility is real and intermittent, what we really experience on a daily basis is relatively smooth market moves.
- In the 16th day — which is prior to the 2% volatile moves — everyone fears the market will drop further. Sometimes it does (and it will seem obvious), and sometimes it does not (in which case we will feel relieved). The truth is that no one knows which it will be. Nor does it matter in the long-run.

Can you suffer through the daily temporary jolts in equity prices in order to capture the long-term returns from the stock market (i.e. black line)? Investment success comes from being able to capture the long-term returns represented by the black line. It is not a result of capturing the upward zigs and avoiding the downward zags.

My hope is that you will visualize the chart above, rather than the one on the front-page, in order to achieve even more investment success.

Bill Starnes is the founder and senior advisor at Mallard Advisors, LLC

Looking back on the chart on the first page of this newsletter, people are going to say it was a great year to be an investor. They won't remember how uncertain the journey felt right up to the last day of a year that saw the S&P 500 close at a record new high on 53 different days. Think back over this past year in the market. Was there ever a time (honestly) when you felt confident that the market would deliver double-digit returns?

The Vanguard S&P 500 Index fund finished the year up 13.5%, on the basis of a strong 4.9% return in the final three months of the year. The index completed its sixth consecutive year in positive territory, and believe it or not, this was the second-***weakest*** yearly gain since the 2008 market meltdown.

Small company stocks, as measured by the Vanguard Small-Cap Index fund, gave investors a 7.4% return, with most of it coming from a strong 6.8% gain in the final three months of the year.

Total Return as of 12/31/2014

.	December	4th Qtr	YTD	Last 12 Months
PORTFOLIOS**				
60% Equity	-0.6%	2.3%	7.1%	7.1%
40% Equity	-0.3%	2.2%	7.0%	7.0%
STOCKS				
Larger-Cap	-0.3%	4.9%	13.5%	13.5%
Smaller-Cap	1.3%	6.8%	7.4%	7.4%
International - Developed Mkts	-3.7%	-4.2%	-4.2%	-4.2%
International - Emerging Mkts	-5.0%	-3.8%	0.4%	0.4%
Real Estate	1.9%	14.3%	30.1%	30.1%
Inflation Hedges*	-2.4%	-13.3%	-12.5%	-12.5%
BONDS				
Investment Grade Bonds	0.1%	1.7%	5.8%	5.8%
Emerging Local Market Bonds*	-6.7%	-6.9%	-6.3%	-6.3%
TOTAL CASH				

** Each asset class is represented by a relevant Vanguard Index fund except for Inflation Hedges where the Morningstar Category average for* ***"Natural Resources"*** *is used, and for Emerging Local Market Bonds where* ***PIMCO Emerging Local Bond*** *is used.*

*** Each portfolio is represented by a Vanguard Lifestrategy Index fund.*

While the U.S. economy and markets were delivering double-digit returns, the international markets were more subdued. While the Vanguard Total International Stock index of companies in developed economies lost -4.2% in 2014, this actually is a result of the rising value of the dollar. In local currencies, this index actually earned 6.4%! Emerging markets stocks of less developed countries, as represented by the Vanguard Emerging Stock Market index, fared better, with a small gain of 0.4% (in dollars) for the year. **I have had clients call to "get out of international stocks" because of their economy.** However, the recent losses result from the rising dollar and not due to economic factors.

Looking over the other investment categories, real estate investments, as measured by the Vanguard REIT index fund, was up a robust 30.1% for the year, with 14.3% gains in the final quarter alone. Inflation Hedges, as measured by the Morningstar Natural Resources category was the worst performing asset class in 2014, losing –12.5% of their value, largely because of steep recent drops in gold and oil prices. Clients generally have little to no direct exposure to this asset class. The other losing asset class was Emerging Market Bonds which lost -6.3% for the year due to concerns that low oil prices will impact their economies badly. This could get worse.

The Vanguard Total Bond Market Index Fund gave investors a windfall return of 5.8% for the year due to falling bond rates. At the low end, 3-month T-bills are still yielding a miniscule 0.04%; 6-month bills are only slightly more generous, at 0.12%.

Reviewing these asset classes and their performance, it may lead investors to feel like they should have been in the best performing asset classes and avoided the worst. However, that is not the case. The reason we diversify is because we don't know which asset classes will do well and which won't. As I mentioned in a recent e-mail update:

"Think of these asset classes as <u>*bouncing super balls*</u> in an elevator. At any one moment, there is no predicting which way each ball will bounce. If you are in the elevator moving up, all you see and feel is chaos in that elevator. However, YOU and your elevator car (which represents your entire portfolio) are <u>still moving up over time</u>. Yes, you will feel the chaos of the balls bouncing, and you will even stop at different floors on your way up. However, in the long-run, you know you will reach the top! What is amazing is that almost all investors have their eyes on the bouncing balls and never on the top floor of the building."

Is a decline in U.S. stocks likely? One can never predict these things in advance, but the usual recipe for a terrible

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Investment Commentary...continued

market year is a period right beforehand when investors finally throw caution to the winds, and those who never joined the bull market run decide it's time to crash the party. The markets have a habit of punishing overconfidence, but we don't seem to be seeing that quite yet.

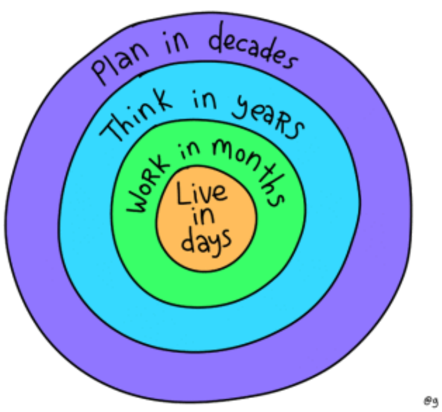
What we ARE seeing is kind of boring: a long, slow economic recovery in the U.S., a slow housing recovery, healthy, but not spectacular, job creation in the U.S., stagnation and fears of another Greek default in Europe, and stocks trading at values slightly higher than historical norms.

On the plus side, we also saw a 46% decline in crude oil prices, saving U.S. drivers approximately $14 billion this year.

The questions that nobody can answer are important ones: Will the recovery gain steam and make stocks more valuable in the year ahead? Will Europe stabilize and ultimately recover, raising the value of European stocks? Will oil prices remain low, giving a continuing boost to the economy? Or will, contrary to long history, the markets flop without any kind of a euphoric top?

Since 1875, the S&P 500 has never risen for seven calendar years in a row. Could 2015 break that streak? The odds have it, and in a way it would be a relief . It would also be a lesson to investors that down years are still possible.

A New Year's Reminder



The cartoon to the left is from Hugh MacLeod and is a nice New Year's reminder to live in the moment but with a long-term plan in mind. When planning for the long-term THINK BIG as most people underestimate the changes that can occur over a 10-year time period. Just look back over the last 10 years and think about all of the changes you have experienced. Now, think about all the positive changes that can occur over the next ten years—and write them down.

However, don't think in terms of numbers or checklist goals. Instead think about what your **Ultimate Emotional Outcome** (**UEO**) could be. For example, perhaps your UEO is to live with a feeling of financial security. Make this outcome emotionally powerful by taking time to image how it will feel to be financially secure. Image how your life is in 10 years with total financial security. Where are you living? Who are you surrounded by? What do you do each day? Focus on how this feels. Make this a fun and enjoyable process getting in touch with what is most important to you. Now, create an image (or find an actual image) that represents your UEO. Look at this picture in your mind each day adding another detail. Vivid images are more powerful and motivating. This should not be an intellectual exercise, but an emotional one. This is done by focusing on the feelings associated with your UEO.

> "We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten. Don't let yourself be lulled into inaction." – Bill Gates

Once you have your UEO, write down what it is and **WHY** it is so important to you. Why is this a must in your life?

Now with a UEO, and a WHY, you have the proper motivation and context to begin to develop annual and monthly **GOALS**. Goals are not fixed, but must be constantly set, changed, and renewed. Goals are tools to keep us moving in the right direction and to fill us with a sense of purpose and accomplishment. In our example, this may be an annual or monthly savings goal. Share these goals with an "accountability buddy" such as your spouse or a friend, mentor, or coach.

Finally, each day, take the **ACTIONS** (even if very small) that are necessary in order to take you a step closer to your UEO. Ask yourself, "what is one thing I can do today that will move me toward meeting my monthly or annual goals and ultimately towards my UEO?".