ARK ROYAL
WEALTH MANAGEMENT

THE ARK SUMMER 2015

It's Time for an Investing "Life Boat Drill"

I'm not a "cruise guy" (at least not yet) but I understand there's a protocol on cruise ships that happens early in the voyage. Passengers rehearse the route to their nearest life boat should an emergency arise. The practice of reviewing emergency procedures is a good one, and no doubt saves lives in the rare instances when disaster strikes.

Investors would be wise to adopt a similar exercise. As I write this (June 24), since the spring of 2009 the stock market is up 250% on a cumulative basis without so much as a hiccup (the Flash Crash of May 2010 not withstanding). Over that time numerous experts and pundits predicted a market pullback. And nothing happened.

It's easy in this environment for investors to become complacent, to forget that risk and return are related. My intern played golf a month or so ago with a retired gentleman who boasted of investing his entire IRA in Under Armour stock. I have no idea what the prospects are for Under Armour, but there's an enormous difference between investing and speculation - a difference that's far better to learn from another rather than experiencing firsthand. I remind clients the beauty of a diversified portfolio is forgoing the potential of making a killing in exchange for never getting killed (metaphorically speaking, of course).

"Mr. Under Armour" is one of several recent indicators that make me worry that Greed has overtaken Fear in the stock market. This isn't a market call on my part, just an admonition to clients and investors to remember a market correction is nature's response to speculation. There will be a downturn in the market, I simply have no way of predicting its date, duration or degree. When it occurs, some market participants (I hesitate to call them investors) will flee, and much like Sisyphus, they'll never quite get their nest egg to its potential (or perhaps needed) level.

True investors realize market corrections are part of the natural order of markets. Corrections serve as a "killing frost" -- weeding out investors who lack the discipline or temperament to endure temporary declines. Thus, the importance of the investing equivalent of the life boat drill.

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Remember, we cannot control the markets nor predict exactly when, where and how things may go astray. Now is the time to make sure you have the disposition to weather a market decline.

Reflect on the following as an investing life boat drill:

- If you were lost at sea for 90 days and returned to find your portfolio worth 1/4 less how would you react?
- Would you be willing to invest **more** in equities if two months from today the stock market was down 15%?
- Does it make sense that stocks are one of the few things in life that when on sale at a 25-30% discount, rarely find buyers?

We're of the opinion that successful investing is far more dependent on temperament than intellect. On behalf of the crew of the Ark Royal, remember to resist the urge to do something when the market turns turbulent. It will be far better to simply stand firm.

Would You "Settle"for Being a Scratch Golfer?

With the suspenseful 2015 US Open in the books, it made me think about the parallels between golf and investing. The investing approach we endorse is one that advocates accepting capital market returns and eschewing efforts to beat the market. Some have a hard time embracing this concept, equating it with settling for average. However, a closer look at the numbers reveals quite a different story.

According to the USGA, only the top 5% of golfers who maintain a handicap are a 4 handicap or better. **Par isn't average, it's far from it.** Unfortunately for golfers (including me!), there's no magic wand, elixir or club that will produce consistent par performance.

Investors can achieve the golf equivalent of par simply by accepting the market return. Depending on the asset class and time period, data from SPIVA indicates that the benchmark routinely outperforms 70-80% of active mutual fund managers. *With odds like that why would anyone invest any other way?*

Tiger Woods offers yet another example of why investors would be wise to utilize a markets-based investing strategy. **What if Tiger Woods were a mutual fund?** A common selection criteria for mutual funds is their five year track record. By 2001, Woods had a five year track record of professional success. He'd won six major championships, the golf equivalent of being a five star rated mutual fund. If you'd invested with "The Tiger Fund" at that point, you'd have enjoyed six years of unparalleled success. Between 2001-2007 he reeled off another eight major championships and five PGA player of the year awards. It seemed a forgone conclusion Woods would easily eclipse Jack Nicklaus' record of 19 major wins. If Tiger had been a mutual fund, he'd have undoubtedly attracted lots of new investors and had a period of phenomenal success. And then things changed.

The talent went cold, slowly at first, then with increasing speed. Woods' 2015 US Open performance was a career worst 16 over par, missing the cut by 11 strokes. To use the mutual fund analogy, he'd be a one or two star fund now, and investors would have likely given back all the great performance of those early years and then some.

For those adamant in trying to select top funds, consider this: *What is the criteria for selling a fund?* As I suggested to a good friend who served on an endowment board and asked my thoughts on their consultant - "Ask the consultant his criteria for firing managers and then ask him if he shows prospective performance of both the manager he fired and the replacement." I've yet to meet the consultant or advisor that does this, but this gets to the very essence of the value they contend they provide.

The beauty of a market based approach is that devilish dilemma is removed. We can attain the golfing equivalent of shooting par for the rest of our investing lives. That doesn't mean we only experience positive returns, but it does mean we are likely to outperform that vast majority of investors.

Quote of the Quarter – "Capital goes where it's welcome and stays where it's well treated." – Walter Wriston

Should You Invest in China?

From time to time I get questions from clients or friends asking about investing in China, most convinced it represents a great investment opportunity. MSCI (the same folks who create international and emerging market equity indices) recently announced they expect to include China shares in their global benchmarks in the not too distant future. "We look forward to a fruitful collaboration that will contribute to the further opening of the China A-shares markets to international investors and the inclusion in the MSCI Emerging Markets Index," read a June press release from MSCI.

So what are the issues astute investors should consider about frontier and emerging markets?

Wouldn't it be advantageous to be early into markets seemingly rich with opportunity like China?

Let's look at several important considerations about the Chinese markets specifically. The Chinese equity market is segmented into two broad classes of shares: 1) shares available for unlimited foreign investment and 2) China A-shares with restricted access to foreign investors.

The first category primarily consists of shares of firms incorporated controlled by entities in mainland China but which trade outside of China, generally on the Hong Kong exchange in HK dollars (H-shares). These stocks trade like any other stock on the Hong Kong exchange (a developed market exchange). These are the class of shares currently included in DFA's emerging markets strategies, which most clients of Ark Royal have some exposure to.

Chinese A-shares trade exclusively in mainland China on the Shanghai and Shenzhen exchanges in Chinese Yuan (CNY). Historically, the access of foreign investors to these shares has been restricted. Foreign institutional investors can apply to receive an allocation to invest in the A-share market. If an allocation is granted, **there are significant restrictions around access.** In particular, there are significant restrictions around repatriation of capital. These restrictions have made holding A-Shares less appropriate for institutional investors. In addition, there are daily quotas for foreign investment that can run out before the end of the day, making it hard for index funds to buy at the close.

There are also differences in the composition (companies, sectors, size distribution) of H-Shares versus A-Shares. As of March 31 2015, there were approximately 100 firms with both H- and A- share listing. These firms represented just 30% of the total investable capitalization of firms with A-share listings. Thus, 70% of the market capitalization of A-Shares is not accessible through H-Shares. This can lead to some very significant distortions in the two indices. Telecommunications was 11% of the MSCI China index (primarily H-Shares) versus less than 1% of the MSCI China A-share index. Industrials were 19% of the MSCI A-share index versus 7% of the MSCI China Index.

These differences in composition lead to meaningful performance disparities. In 2005, A-Shares were transferred in greater than previous amounts from state to private shareholders through mechanisms such as rights offerings. Actions like these tend to impact the returns the classes of stocks differently.

In 2003, the MSCI China Standard Index (H-Shares) returned 87.6% versus 5.1% for the MSCI China A-Standard Index. In 2014, the MSCI China Standard Index returned 8.3% versus 46.9% for the MSCI China A Standard Index. In 6 of the 14 years since 2001, there have been greater than a 20% return difference between

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H-Share and A-Shares (as measured by the MSCI Indices).

We believe secure property rights, transparent and efficient market exchanges and the ability to move one's capital with ease are fundamental requirements before considering investing in any country. As noted in this issue's quote – capital goes where it's welcome and stays where it's well treated.

For now, mainland China falls short in these areas, and accordingly, we do not recommend investing there. Our best guess is the Dimensional approach of not slavishly following an index, but rather focusing on asset class attributes and allowing trading flexibility, will serve investors well if and when Chinese capital markets meet the requirements for investment.

The Power of Authenticity

As I've embarked on the journey of forming my own advisory firm I've spent considerable time trying to capture the unique qualities I bring to working with clients. Most people draw very little distinction between stockbrokers, investment advisors, and financial planners.

I asked a number of my long-time clients to share what it was about my work with them that led them to work with me. Many cited the usual qualities one might expect; experience, trustworthiness, intelligence. But a handful of clients pointed to something that surprised me – authenticity.

The folks who pointed to authenticity shared a common theme – my willingness to reveal personal vulnerability. In some cases they recited times when I'd been willing to readily admit the limitations of my expertise. In others they welcomed my sharing personal experience about mistakes or family challenges. These clients expressed that my openness had given insight into my character, what values were important to me, and ones they shared.

Conversely, a couple of years ago I experienced a less inspiring example of authenticity. A former colleague of mine had remarried after his first marriage ended in divorce. He'd not had children in his first marriage and was eager to start a family. One day he sent an email to everyone in the firm titled "Exciting News!" His email read in part, that he wasn't writing to inform everyone that his wife was pregnant, but that they had "equally exciting news" – they'd bought a new home.

Not everyone can or chooses to have children, but most people, irrespective of their circumstance, wouldn't equate buying a new home with the birth of a child. In a seemingly innocuous email he'd revealed a great deal about his authentic self.

I recently read Adam Grant's book *Give and Take* and I was surprised to learn about research surrounding trust and relationships. Grant points to fascinating research about how sincere givers innately share vulnerability, and as a result are more trusted and build rapport faster.

I've never "cultivated" authenticity, my candor is a by-product of my belief in dealing with clients the way I'd want to be treated. I need to know my clients on a deeper level, and they need to know me. It's reaffirming to learn that such an approach is appreciated by those I serve.

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