What We Do

June 2013

Dear Clients and Friends:

The often short-sighted, one-dimensional, questionable conclusion drawing, over-sensationalized press reporting of financial, economic, business and financial markets information (and misinformation) has created a persistent noise that seems to be confusing our clients and investors in general. Our communications to you and some of the complexities in our (your) portfolios are complicating this situation.

So, let's get some things straight: Gordon Thompson and I formed TDCapital in 1996 because we want to provide focused, appropriate portfolios for our clients and friends—ALL comfortably within the confines of long-term investing, ALL recognizing integration with our clients' needs and expectations, and ALL exhibiting the characteristics below.

When it comes to investing and portfolio management—I (we) are focused, as always, on five important factors:

1. Diversification
2. Provision of appropriate cash-flow
3. Tax-efficiency
4. Portfolio cost control and efficiency
5. Service

I am going to necessarily violate Peggy Campbell's mandate that I keep these notes to one page. The following discussion defines and describes these five "controllable" factors of appropriate portfolio management and explains some of the allocations and techniques we deem necessary to remain focused on these factors.

Diversification

Diversification is the pretty simple concept of not putting all your eggs in one basket – if the basket falls, the eggs *not* in the basket aren't affected. By diversifying portfolio holdings over a number of asset classes, sub-classes, positions, etc. it will often reduce the volatility (swings) in the portfolio. The idea is to reduce volatility over the short-term without affecting long-term returns. It works if the diversification is real; and it works if long-term is pretty long.

The first step is to divide the portfolio between exposures to equities (stock market) and fixed-income (cash, bonds, cd's). The next diversification opportunities exist within these two broad categories – diversification within the equity side of a portfolio can include multiple positions, exposures to large and small companies, holding investments in U.S and non-U.S. companies, extending the idea of "non-U.S." to include multiple geographical areas (Europe, Far East, emerging markets), etc. Step two on the bond side includes multiple terms until maturity, various issuers – U.S., corporate, non-U.S., exposures to differing credit qualities and bond "personalities," etc.
The techniques described just above are commonly called asset-allocation strategies – designed to give exposure to differing investment opportunities within the concept of diversification. These are effective if the external forces that influence their investment returns vary in the effects on the investment holdings. Our internal methodologies suggest not only

utilizing this asset-allocation approach to diversification, but also adding a controlled and limited element of tactics designed to enhance diversification further. So, on the equity side of our portfolios we often have a little "lean" in the direction of some additional exposures. For instance, our U.S. large-cap, U.S. small/mid-cap, and developed non-U.S. allocations in our model portfolios emphasize value, "quality" and dividend growth.

The other manifestation of our internal methodologies involves increasing or decreasing equity exposures overall. We have named this segment of our model portfolios, "dynamic allocation." At the beginning of each month we measure four factors that we deem important to assessing the fairly near-term likelihood of equity (stock) market rises or falls. These measurements are traditional in nature and, importantly, available to many analysts. Because use of these measurements is prevalent amongst portfolio managers and investors, they become a fairly accurate measure of investor sentiment.

Provision of appropriate cash-flow

One of the biggest stresses on a portfolio is the very simple fact that lots of folks need their portfolio to help with their monthly bills and other cash needs. The portfolio can only help with these cash needs via withdrawals of cash (utility companies don't accept shares of stock or mutual funds in payment of our light bills).

So, we help estimate and predict our clients' cash needs for the next several years. Note – "next several years" is a constantly forward-moving target and needs to be considered regularly. We fund the estimated cash needs within the portfolio via bonds, cd's, target-maturity mutual funds or etf's, or by matching duration (kinda like maturity). As these investment vehicles mature, they become cash and are available to go to our clients' bank accounts and pay their bills. In fact, we often refer to this intentional allocation within our portfolios as the "pay the bills" allocation. That's the "cash-flow" part.

The determination of "appropriate" is another matter. We have always maintained that an expectation of withdrawing up to 5% of a portfolio annually is reasonable. It can't be determined or guaranteed that this is the perfect amount, but history suggests it is within the range. We didn't (and don't) simply pull this number out of the sky. Rather, we see this as a reasonable balance between enjoying the portfolio through cash provision while protecting wealth for the long-term. Note – we're not predicting returns of 5% each and every year – in fact returns over time need to exceed that number to maintain spending power. We are helping our clients establish reasonable guidelines. It's certainly ok with us and the growth opportunities for our clients' portfolios if they determine to withdraw less than this 5% guideline each year. On the other hand, withdrawals above this number suggest risk that may not be appropriate.

Tax-efficiency

We can't make taxes go away. We don't want to have the tax "tail" wag the economic "dog." We use the term "efficiency" here to suggest doing all we can without losing sight of the bigger picture – our clients' personal economics. So we employ a few techniques to enjoy the efficiencies available. One is something we call, *asset location* strategy – the idea is to have the less tax-efficient investment vehicles *hide* in tax-deferred accounts – i.e. IRAs, retirement plans, etc. This leaves the more tax-efficient investment vehicles available for location in taxable accounts. Note – em

ployment of this strategy requires looking at our clients' total portfolio allocation instead of attempting to make each separate account a well-diversified portfolio on its own – we think this is the appropriate approach anyway.

Another technique used in this tax-efficiency area is sometimes called "harvesting" losses. This ain't nearly as much fun as some of our other work because losses are never fun. However, there can be losses from time to time in some portfolio positions and selling these in taxable accounts and replacing them with similar positions can leave the portfolio intact while allowing utilization of the losses for current income tax purposes. This is one of the reasons we request copies of your tax returns each year, and the reason for our year-end special look at your portfolio from a primarily tax focused perspective.

One other tactic joins with the cash-flow topic above. Considering and helping our clients determine the most efficient source of their cash flow can be helpful in the tax area. We sometimes recommend deferring social security benefits for retirees until later while replacing cash flow with portfolio withdrawals. We sometimes suggest using different accounts (taxable / tax-deferred) for cash withdrawals to best utilize our progressive tax rates, and so on – these tactics are very client specific, and very important.

Portfolio cost control and efficiency

Portfolios incur expenses. Some of these expenses are readily apparent and some are not. We have been managing portfolios for our clients and friends for a very long time. Unlike most things we buy, the costs of participating in the investment world have not gone up much over the years.

Transaction costs at the brokerages (Fidelity in most of our client cases) have actually come down a little over the years – primarily due to competition and technology efficiency. Internal expenses of mutual funds have been subjected to similar competitive forces – in the active fund world expenses have not declined, but have also not grown much. In the passive, index, world the growing prominence of exchange-traded funds has pressured the regular old index funds. Some of the more broadly based exchange-traded funds and index funds have stunningly low expense ratios.

Our work considers all the various costs of investing without losing sight of the big picture. As a recent example – we are replacing the only traditional mutual fund in our model portfolios with four exchange-traded funds – this change will take effect in the next few weeks. In this case, we are actually seeking to reduce exposure to interest-rate risk. However, the net result will be lower internal expense ratios. All things being equal, we absolutely favor lower cost over sex appeal.

We get paid for our work. Our fees are based on a percentage of the assets under our management and care. We originally strived to have among the lowest fees in our industry. That was easy seventeen years ago because fee schedules for many other folks in our industry were higher than they are now. Competition is the essence of capitalism. It was also true that we were a little-bitty firm seventeen years ago and our expenses were almost non-existent. Today, expenses related to maintaining regulatory compliance, rent and similar, the smart folks who work on your portfolio, etc. have all increased. We maintained our original expense structure for all those years, but kept growing via investment returns and new clients to maintain the viability of our business. Earlier this year we made modest changes to our fee schedule.

However, these small increases do not apply to our clients who joined us prior to the implementation of this new schedule and our overall fees remain at the low end of industry levels.

Expenses of all kinds "subtract" from investment returns. It is our duty to recognize this simple truism and shop for the best "deal" in all our work. However, much like the comment about the tax *dog* mentioned above – our clients' economics must dominate our work and decision processes.

Service

My wife is a marketing professor. Dr. Rach tells me that customers (clients) seek to evaluate their purchases before, during and after buying them. Clients generally hire us due to our reputation, investment approach, a relationship or referral of some sort, etc. Their evaluation of our work on their portfolios is difficult because of the inherent integration of portfolios with their lives, the influence of the various investment markets, the general business and economic cycles, the regulatory and tax environments, and so on and so on. I was thinking about all this and our very earnest desire to provide excellent service and comfort to our clients regarding how we manage and care for their portfolios as I was being interviewed for a case study to be published in an academic journal. Here's the quote from the journal article, "You have to give the clients extremely good service on the things they understand and give them comfort on the things they don't understand." I don't expect everyone to understand all we do for our clients, but I do want our clients to get good service and be comfortable with what we do

That's kinda the mission of our client service initiatives – we think our clients deserve and expect great service. We try to meet or exceed their expectations because they deserve it, it's the right thing to do, AND great service serves as something of a "signal" that all our other work is being accomplished with the same level of quality.

So that's our story and we're sticking with it. We are not going to lose sight of the benefits and opportunities associated with long-term investing. We are not going to be distracted by the *noise* flying around the press and rumor worlds. We're going to control the things we can and we're going to recognize the risks and opportunities in the various investment marketplaces. And, we're going to trust the elegance, logic and dominance of capitalism as we do our work.

Call or come see us soon. God Bless,

Doug

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