KEATS CONNELLY

ENRICHING YOUR CROSS-BORDER LIFESTYLE

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REVIEW OF THE FIRST QUARTER

Portfolio Construction

As we move into mid-year 2015, we wanted to write about the thinking behind the various investments we recommend in portfolios and how they work together to make up the entire portfolio.

The best way to describe how your portfolio is constructed is to think about it in three parts. One part is fixed-income and that includes cash and bonds. One part is stocks and that includes investments in diversified mutual funds and exchange traded funds that invest in stocks around the world. A third part is a mix of asset classes that include gold, commodities and real estate.

Each of these three categories serves at least two purposes in your portfolio. The bonds and cash provide stability and income. The stocks provide growth in rising markets and also pay dividends. Dividends historically (since the 1950s at least) have not provided as much income as bonds, but recently stock dividends have rivaled bonds as income generators. The third category contains both inflation hedges and assets with growth potential that should hold up better than stocks in a market downturn.

I would like to make a few comments about each of these three categories of assets to give you a better idea as to why these specific assets were chosen for your portfolio.

The two primary functions of the fixed income (bonds and cash) are stability and income. Stability is needed in a portfolio because stocks can drop dramatically in some years. In 2008 the US stock market dropped 35% and other stock markets lost even more. Compare that to bonds where losses of 10% in any given year are extremely rare. Even if the Fed started to raise rates and bonds lost value, the overall losses in bonds are likely to be very small in comparison to what can be lost in the stock market in a bad year. We believe that portfolio risk should be taken in the growth side of the portfolio and not in the income side.

The income generating ability in high quality bonds has been very low since the economic downturn of 2008. Some of you will remember investing in the early 1980s when you could get double digit yields in fixed income investments. It has been hard to find yields above 3% in high quality bonds since 2008. There are some areas of the markets where yields are much higher, but we have made a decision not to sacrifice safety by reaching for higher income.

We have made some changes recently in fixed income portfolios. We have added a tax-free real return fund so that high tax investors now get the benefit of additional tax savings in their inflation protected bond fund. We have also begun to switch low tax investors back into taxable bond funds as the ratio between taxable and tax-free bonds has moved into more normal historical ranges. These changes should help to optimize our clients' overall bond allocations.

The stocks have one primary function and one secondary function. The primary function is to produce capital appreciation. The secondary function is to produce income through dividends. Over the last few years stock markets have been strong. Many stock markets around the world have seen growth for six consecutive years since 2009. The allocation to stocks in your portfolio will depend on your financial goals and willingness and ability to assume financial risk because stocks can also lose money quickly when market corrections occur.

Your stock market allocations contain exposure to domestic stocks, foreign developed market stocks and emerging markets. Then, inside these regions we have to determine the best way to get exposure to the markets. For most stock market exposure, we rely on funds from Dimensional Fund Advisors, also known as DFA. DFA is an institutional investment management firm that constructs mutual funds using quantitative approaches to get optimal exposure to asset classes. The firm was founded in 1981 by academics out of the University of Chicago business school to put financial theory into practice. Like many of the most successful investment managers, DFA does not advertise to the public and restricts access to their funds. Restricted access protects investors in their funds by keeping costs down and preventing short-term activity from disrupting the long-term investment strategies. Two of the long-term strategies that DFA emphasizes in their funds are higher allocations to small cap stocks and value stocks. In both cases these strategies have achieved higher incremental performance over long periods of time, although there are times when they are out of favor. DFA also keeps an eye on trading costs and has recently, over the past two years, implemented a quality bias in their funds. We believe DFA funds will continue to provide winning long-term performance over active funds where managers are picking stocks and over passively managed indexed allocations to stocks.

The third category of assets is the most diverse. We have a mix of assets in portfolios for purposes of inflation hedges and protection against market downturns. Although not all categories are in every portfolio, many portfolios will contain some or all of the following: real estate, commodities, gold, energy, materials and a merger arbitrage fund. Real estate has done exceptionally well in past three years. Energy, commodities and gold have done poorly. This is the area we are devoting most of our research efforts to in 2015. Some clients need more protection against inflation than others and everyone wants to participate in the growth that is available when markets are going up but also be protected against falling markets. The assets we hold in this category have dragged down performance during the rising bull market of the past six years.

We hope this discussion has provided you with a greater understanding of how we construct portfolios. During 2014, because of the global diversification, strength of the dollar and falling energy prices, returns in portfolio were mediocre at best. Recently, the dollar and energy prices have stabilized and both of these changes have provided economic tailwinds to many parts of the world. For example, we saw strong returns for stocks in Europe during the first quarter of 2015. But this is just one quarter and our job is to look after portfolios over a multi-year time frame. If you have not had a personalized review of your investment policy and portfolio yet in 2015 we look forward to setting up that conversation with you in the near future.

Sincerely yours,

KEATSCONNELLY

Robert F. Keats, CFP®, MSFP, CFP™ (Canada) and RFP (Canada)
President and Senior Planner

John Rice, CFA®, CFP®
Chief Investment Officer