



IAM Investment Philosophy

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Introduction

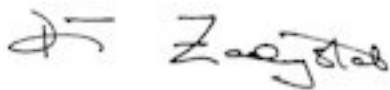
The purpose of this document is to explain to IAM clients and prospective clients our philosophy on investment management. Our approach is based on my own studies, research, and experience in the field as well as the wisdom of many other investment professionals whose perspectives and methods we have incorporated over the years.

Early in my career I spent three years studying the Chartered Financial Analyst program and attaining the CFA certification, which is considered the global gold standard in portfolio management. I found this course excellent in terms of giving me a deep understanding of how various investments work and how to analyze securities. However, as the Portfolio Management section of the CFA program correctly implies, much of the theory that investment advisors are taught relies on assumptions that are not always applicable in the real world. Yet I have found that many people who call themselves financial advisors apply these theories blindly without understanding the assumptions upon which they are based.

They spend a great deal of time trying to convince their clients that portfolio management is an exact science where formulas can be applied that will give consistent results over time and investment characteristics are well-determined and constant.

My own experience leads me to believe that in fact this is not the case. Investment characteristics such as volatility, returns, and correlations, change dramatically with time and investment models, such as those based on Modern Portfolio Theory, do not reliably describe the real world. For this reason I haven't said much about theory here and have instead focused on practical methods that I have found useful over the years.

This document ended up being a lot longer than I expected, and no doubt will get longer still as it is periodically updated. For those who would rather skip the details there is a "in a nutshell" version provided in the summary.



Tom Zachystal, CFA, CFP™
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Summary

As promised, here is the “in a nutshell” version of this document.

What we do at IAM

- Understand economic, business, and investor behavioral cycles and which investments outperform during each part of these cycles.
- Recommend a Strategic asset allocation based on a client’s risk tolerance and return expectations and a Tactical asset allocation based on current and expected economic and market conditions.
- Understand investment risks and client-specific risks and employ strategies to selectively protect against these risks.
- Employ asset classes and investments that we expect will yield positive investment returns while maximizing diversification benefits.
- Research and understand the characteristics of investment products to see which are the best fit for our clients’ portfolios.
- Conduct our own research on each investment we recommend but also use research from other independent respected sources to broaden our scope of investment ideas.
- Focus on value investments and not get caught up in investor bandwagon behavior.
- Use trend analysis to find sustainable long-term investments.
- Customize portfolios based on each client’s specific financial planning considerations.
- Have a sell strategy based on an investment’s value and the client’s specific situation rather than on hard price targets.
- Rebalance when it makes sense to do so rather than at pre-defined periodic intervals; and on an investment basis rather than indiscriminately rebalancing each investment in an asset class.

What we don't do

- Employ market timing strategies.
- Use overly complex or illiquid investment strategies.
- Employ technical trading strategies that are not based on investment fundamentals (except perhaps to choose entry or exit points for investments otherwise selected based on fundamentals).
- Use algorithmic or high frequency trading or other computer driven models.
- Slavishly employ financial theories and models that do not reflect real world investment behavior.
- Try to mitigate all investment risks at all times, as this would lead to an investment portfolio with the same characteristics as holding a risk-free asset such as cash. In which case the investor might as well hold cash and not pay investment advisory fees.

Economic and Behavioral Cycles

Business, the economy, and investor sentiment, follow a cyclical pattern:

- **Growth:** Corporations expanding and adding people. Unemployment decreasing. Moderate inflation. Steady interest rates. Investors shifting into riskier assets – fear turns to hope.
- **Top:** Corporate profits stagnating. Higher inflation. High interest rates. Overvalued stock prices. Asset bubbles. Investors are giddy – buying overpriced securities, flocking to real estate and investment seminars.
- **Slowdown:** Overpriced assets start to crack. Unemployment increasing. Interest rates decrease to try and spur the economy. Investors still hopeful, hanging in there but not adding to risky assets.
- **Recession:** Corporate profits declining. Unemployment increasing. Interest rates declining. Investors fearful, shedding risky assets, flight to security. Bond prices increasing, equity prices decreasing.
- **Bottom:** Corporations are lean. Consumers not spending. Debt defaults are high. Dividends decreased or halted. Business failures are high. Interest rates are low. Stocks are cheap. Investors have thrown in the towel and are sitting in conservative bonds or cash.
- **Recovery:** Business picks up and profits increase faster than sales due to lean corporations. Interest rates steady. Inflation low. Equity markets rally strongly in relief but investors still fearful.

These cycles happen over and over again. Understanding where we are in this cycle is key to portfolio positioning but this is easier said than done and it is very difficult to accurately call tops and bottoms.

Having said that, we can turn to certain statistics such as leading indicators, and analyze corporate profit trends to help guide us. We can avoid or take advantage of extreme markets such as avoiding fixed income investments at a time when interest rates are historically low and likely to rise or bubbles that lead to overpriced assets such as company stocks trading at historically high price/earnings or price/book ratios. We can also look for behavioral signs amongst investors and in the media – when everyone is sour on the market that is the time to look for value and when investors are flocking to investment seminars, that is the time to look for asset bubbles.

At IAM we incorporate this type of analysis at the top level of our investment strategy. This guides us in selecting relatively attractive asset classes, choosing whether or not to incorporate a hedging strategy, and also in specific investment selection.

Asset Allocation

Asset allocation, how an investment portfolio is apportioned amongst the various asset classes, is considered to be the most important investment decision to make; accounting for between 70% and 95% of the return characteristics of an investment portfolio depending on whose research you believe.

The three main asset classes are stocks, bonds, and cash, and most portfolio managers identify two or three additional asset classes: real estate, commodities, and some consider gold to be a separate asset class.

Investopedia, the online dictionary of investment terms, defines “asset class” as:

A group of securities that exhibit similar characteristics, behave similarly in the marketplace, and are subject to the same laws and regulations.

The reason the asset allocation decision is so important is because securities within an asset class tend to exhibit similar return characteristics. That is, within an asset class securities tend to be well-correlated, tending to move up and down together rather than independently; however, separate asset classes are less correlated. So stocks as a group do not necessarily go up and down in value at the same time as bonds – which means that a portfolio composed of both stocks and bonds will be better diversified and give smoother returns than one composed of only stocks or only bonds. A portfolio composed only of stocks or only of bonds, even if there are hundreds of stocks or bonds in the portfolio, will not be well-diversified because to a large extent all the stocks or all the bonds will go up and down in value at the same time in response to whatever economic or market environment is driving things.

So another definition of “asset class” might be:

A group of securities that, when combined in an investment portfolio with other asset classes, yields meaningful portfolio diversification.

At IAM, we view asset allocation in two portfolio contexts: The Strategic asset allocation and the Tactical asset allocation:

The Strategic asset allocation is the manner in which a portfolio is to be apportioned amongst asset classes on average over the long term. This is decided together with the client based on each client’s risk tolerance and return expectations. We look at historical returns for asset classes and historical correlations between asset classes in deciding the Strategic asset allocation. So, for example, a more conservative investor would have a greater Strategic allocation to cash and bonds since these are historically the most conservative asset classes.

The Tactical asset allocation is dependent upon our view of current investment market conditions. We allocate more or less to each asset class than in the Strategic asset allocation depending upon how we expect each asset class to perform given our view of current and expected market conditions. As an example, in an era of historically low interest rates we might apportion less of the portfolio to bonds since bond prices fall when interest rates rise.

Market Timing

It is widely accepted amongst both portfolio managers and academic researchers that trying to time investment markets by buying and selling investments using a short-term trading strategy is most often a losing game. Even if the portfolio manager has a strategy that generates more winning trades than losing trades (and most trading systems do not manage this over the long run), the trading costs in the form of commissions and spreads, and tax costs if in a taxable account, will likely wipe out any excess profits as compared to a strategy where investments are held longer term based on fundamentals and where tax efficiency is optimized.

Furthermore, if the trading strategy is manual in the sense that the manager has to initiate and close trades himself then this is very labor-intensive, which will undoubtedly be reflected in the fees charged to clients. If the strategy is automated, such as with most quant-based strategies, then there is a very real risk that a similar strategy is employed by many other traders, which can lead to an excessively volatile investment strategy and considerable downside risk as all these traders respond to the same market indicators at the same time. We saw exactly this happen in the hedge fund industry in 2008 and 2009 as many quant-based investment strategies triggered selloffs because they were programmed to respond to very similar market indicators in a very similar manner.

At IAM we do not undertake to time the market. Our investment strategy is fundamentally- based and we do not employ quant-based strategies or technical indicators (except perhaps to determine initial entry or exit points for investments that we have already vetted through our fundamental process).

There is a big difference between what we call Tactical Asset Allocation (see above) and market timing. Our tactical portfolio shifts are based on fundamental and longer-term views on investment markets and the economy not on short-term technical indicators or market events.

There is also a more subtle difference between market timing and some of the hedging strategies we employ (see “Hedging” section), which may be short-term in nature. If we employ a short-term hedging strategy it is because we are concerned about a specific event that could negatively affect our clients’ investments. For example, in July of 2011 we became concerned that the US congress would not reach agreement on raising the debt ceiling by its deadline and our opinion was that if this came to pass it would have severe short-term implications for stock markets. We chose to hedge our clients’ stock investments for what turned out to be a relatively short period of time (about two weeks) while this issue was resolved. This was a one-off hedge based on fundamentals, not an on-going market timing strategy.

Understanding Risk

There are broadly two types of investment risk – systemic and unsystemic. Systemic risk refers to a risk that affects the whole market or an entire market segment. Unsystemic risk affects only a specific group of securities or an individual investment.

Examples of systemic risks would be a recession since this would presumably cause the broad stock market to fall, or an increase in interest rates since this would negatively affect all fixed income investments. Systemic risk cannot be addressed by diversifying within the at-risk group, it needs to be addressed through hedging or by avoiding the at-risk investments altogether.

An extreme example of systemic risk occurred during the 2008-2009 financial crisis as stocks, real estate, commodities, and most bonds all fell in value. It would have been very difficult to address this situation through diversification alone since even a well-diversified portfolio would have fallen in value.

Examples of unsystemic risks would be business risk associated with a specific company or credit risk associated with a specific bond. Unsystemic risk can be mitigated through diversification; holding a number of different stocks or bonds in a portfolio helps mitigate this type of risk.

Another issue is how to define risk. Most financial advisors and financial models, such as those based on Modern Portfolio Theory, equate risk to volatility and measure risk in terms of the standard deviation of an investment's returns. However, we have found that most clients, and investors in general, often think of risk in very different terms – perhaps as the risk of not achieving financial goals such as being able to maintain one's lifestyle in retirement. Investors also often have a greater sensitivity to downside risk than to opportunity cost – caring more about losing money than about missing out on the possibility of making money.

Even though for every risk there is a strategy that will control or eliminate that risk, it is not useful to try and remove all risks from an investment portfolio. Doing this would result in a risk-free portfolio that would have the return of other risk-free assets, such as cash held in a savings account. So if an investor wants to remove all risk then the best solution is simply to hold the risk-free asset and save themselves the financial advisory fees.

Our role at IAM is to have a deep understand of the risks related to each investment we recommend and how these can be addressed. We also try our best to foresee which risks are most important to address at any given time. While it is never possible to foresee the future, often it is clear that certain risks are more likely to occur than others. As an example, when interest rates are very low and economic indicators are turning positive, perhaps the risk of recession is not as great as interest rate risk.

Most importantly, before we undertake to manage a client's investments we always have a discussion with our client to ensure that we understand what is important to them in terms of risk management. This is very different from the approach seen elsewhere where often the focus is only on whether or not market benchmarks are met.

As an example, suppose a client is interested primarily in ensuring that they can maintain their lifestyle during retirement. Perhaps they are not too concerned if their portfolio only increases by 10% in a year

when the stock market goes up by 20% but they would be considerably affected by a 20% loss in a bad year. Clearly it is much more important in this instance to avoid a substantial downside loss, and therefore, if it seems there might be a recession coming or some other systemic risk on the horizon, we might recommend a hedging strategy, and the portfolio could be diversified in such a manner that it would in general be less risky than the stock market.

A different situation might exist for a relatively young person who is well-employed and has considerable financial flexibility for years to come. In such a case perhaps it might be more important to not miss out on investment gains and relatively less important to hedge potential downside risk.

Hedging

Hedging is the process of mitigating investment risk by taking a position in a security that offsets adverse price movements in an investment or investment portfolio.

As an example, if an investor holding a portfolio of US stocks was concerned that the broad US stock market might fall as a result of temporary factors he might want to maintain his investment portfolio but take out the risk of a broad market decline by shorting a corresponding amount of an S&P500 index fund. “Shorting” means selling first and covering (buying back) an investment later – in this case the investor would be hedging by selling the S&P500 index fund first and hoping to buy back the position later at a lower price if the S&P500 index fell. So if the whole US stock market fell in value, dragging down the investor’s portfolio with it, he would have a more-or-less corresponding gain on his S&P500 index fund short position to help offset this loss.

At IAM, we may employ such a market hedging strategy if we believe that the whole market may be negatively impacted by an upcoming event or by transitory economic conditions. We may also employ strategies such as paired-trades or put options to protect against risk of loss on a specific investment or category of investment.

Meaningful Diversification

An important part of what we do at IAM is to search for investments that will help us control portfolio risk through diversification while still allowing us to meet investment growth expectations.

Most people understand the concept of not putting all their eggs in one basket when it comes to investments. A well-diversified portfolio means that some investments will go up when others are underperforming, which will help mitigate volatility in the portfolio as a whole. Having said that, *meaningful* portfolio diversification is in fact very difficult to achieve and takes a considerable amount of research and understanding of how various investments work. By *meaningful* diversification we mean two things:

First of all, the investments in the portfolio have to offset each other in a meaningful way in order to control volatility. For example, a portfolio consisting of 100 stocks will likely not be as well diversified as a portfolio consisting of 10 stocks and 10 bonds, which in turn will likely be less diversified than a portfolio consisting of 10 stocks, 10 bonds, and some commodities, real estate, and cash. Often it isn't the number of investments that is important in terms of diversification but rather the way the investments work together.

Secondly, there is no point putting money into an asset class or investment just for the sake of diversification – that is, there should also be a reasonable expectation that the investment will contribute positively to portfolio return. While investment markets are difficult to predict, with diligent research we can often determine which investments are more likely to under or out-perform in the years to come. As an example, at a time of rock-bottom interest rates and an improving economy a reasonable expectation might be that bonds could decrease in value as a result of increasing interest rates in the near future – and so it might be prudent to avoid bonds even though they offer good diversification benefits to a portfolio.

In portfolio management we use a measurement called “correlation” to quantify the diversification between various investments. This is a number between -1 and +1 (or between -100% and +100%). A correlation of +1 means that two investments fall and rise perfectly together whereas a correlation of -1 means that when one investment increases in value the other decreases in value at exactly the same time (but not necessarily by the same amount). A correlation of zero means that the movement between the two investments is random.

Often we see prospective clients come in with portfolios they believe are diversified because they hold different types of stocks (such as small cap, large cap, value, growth, foreign, US, emerging market, and so on) and we have to point out that in fact all these types of stocks are very well correlated – perhaps in the range of 80% or 90% correlation. So in fact this is not at all a diversified portfolio – they may as well just have all their money in one stock fund.

At IAM we spend a great deal of time and effort in analyzing asset classes, strategies, and underlying investments so that we can create a portfolio that has meaningful diversification consisting of investments we believe will offer good returns in the future but that also have relatively low correlations so as to control portfolio volatility as much as possible.

Investment Product Research

Once upon a time there was cash – most people earned money by working for a living and put that money in a savings account where it earned interest and hopefully the combination of a lifetime of work and the interest on their savings provided for their needs. Cash has low risk but the returns on cash struggle to keep up with inflation, especially on an after-tax basis.

Then along came real estate and people invested not only in their own homes but sometimes they bought investment properties that they rented out. This created an attractive cash flow but there were issues with finding tenants, having to pay the management company, and maintaining the properties.

Then along came mutual fund companies and brokerage firms and made it possible for the average person to easily put their savings into investment vehicles like stocks and bonds. There was more risk in this but the potential for greater returns than just interest on cash made these attractive investments for some.

Finally there came the investment bankers and other financial intermediaries and they created more exotic investment products that, as a group, they called “alternatives”. They allowed the average investor to put money into various commodities, structured products that had a plethora of risk/return profiles, private equity, hedge funds, and the list goes on and on.

Then came the financial crisis of 2008-2009 and many of these exotic investments turned out to offer little protection and, to make things worse, little liquidity, so investors had a difficult time pulling their money out when they most wanted to.

All this to say that an important part of what we do at IAM involves investment product research. We analyze various types of investment products to determine whether they are a good fit for our clients. We generally use only liquid investments that can be bought and sold on publicly traded exchanges. Occasionally we might find a more exotic investment that we feel would be an attractive addition to a client’s portfolio but before we make such an investment we will always discuss the pros and cons with our client.

A good example of this investment product research is our investments in Business Development Corporations (BDCs). BDCs are publicly traded private equity. So our clients can invest in private equity through a vehicle that has the liquidity of the stock market, low leverage, lower fees than the typical private equity fund, and the diversification of a pooled investment – which is very important when dealing in private equity investments. BDCs typically pay a high dividend yield and may also offer good potential for capital appreciation. We use BDCs on the income side of our investment portfolios but we always understand that these are more volatile investments than bonds and so we may need to compensate for this additional volatility in other areas of the portfolio for more conservative clients.

One last point about investment products: Many of the more exotic products, especially private offerings, are sold through financial advisors who receive a substantial fee in return for selling these to their clients. As an example, in the case of privately offered real estate funds the advisor may receive 7% of the invested value as a commission payment. This means that 7% of the investor’s money comes off the top to pay the advisor rather than being invested. Where possible IAM policy is to not accept such payments. If it is not

possible to avoid a payment (some products only have one type of offering that includes a payment to the advisor) then we disclose this to our clients before they undertake the investment.

Investment Research

In addition to researching investment products, we also undertake the research of individual investments such as stocks and bonds. Many advisors choose to depend simply on stock screens, or technical analysis, or outsource their research to managers of pooled investments such as mutual funds – we carefully research each investment we recommend.

In the case of stocks, quarterly corporate earnings calls are analyzed and meetings with management attended when possible to keep up with how the company is doing on an on- going basis. Reports from independent analysts are also considered so as to gain additional perspective on our investment recommendations.

We also look at what successful mutual funds and other investment companies such as Berkshire Hathaway and certain of the large college endowments are buying and selling to see whether some of these investments might be appropriate for our clients.

Since many companies' prospects depend on the overall economic cycle – doing well in expansionary times and poorly in recessionary times, an important part of our research involves finding counter-cyclical businesses so that we have investments to turn to even in bad economic times. For example, pawn shops and deep discount retailers tend to do better than others during an economic downturn. Also, to the extent interest rates are cut (which often happens during an economic slowdown) bonds may be a good investment and we may overweight this asset class and underweight equity investment during such times.

There is another benefit to doing our own investment research. In researching specific companies we gain a better understanding of the business, economic, and political environment in various global regions. Listening to earnings calls and reading financial reports from multinational companies gives us insight into many industries and global regions because these companies operate internationally and across industries.

Furthermore, listening to earnings calls from one company often leads us to other, even more interesting, investments. Perhaps we learn that a certain company may be switching from one supplier to another – which would represent a significant amount of new business for the new supplier. Or maybe we notice that some of the joint ventures in which a certain firm is involved are doing very well and this leads us to look at its joint venture partners.

This type of insight is simply not available to financial advisors who merely choose mutual funds or other pooled investments for their clients. Neither is this insight available to most mutual fund managers since they typically focus on only their investment mandate, which may be quite narrow.

Value and Growth Investing

We favor companies trading at a historical discount to value as indicated by price/earnings or price/book ratios. This mitigates the risk of an investment since the downside is presumably limited. It is, however, important to avoid “value traps”; companies that seem cheap but whose business is in a downward spiral. For this we look at corporate profit and general business trends as well as the sustainability of dividends. Ideally we would like to see increasing dividends, well-covered by free cash flow.

Another important consideration on the growth side of the portfolio is where a company is in its business cycle. Often a company will have a few years of very good business performance as it benefits from the introduction of new products or services, geographical expansion, or in response to general economic expansion in their sales region. As the new products age, the expansion slows or the economy turns and we see a plateauing of the business and perhaps an eventual downturn until the next cycle.

When a company has done well for several years it starts getting more analyst coverage and upgrades, and its business is more often featured in the media. As a result there is a bandwagon effect as investors buy in, often just as the company’s business is reaching a plateau. By following a company’s business through financial reports and earnings calls we try to invest before the crowd rushes in, and when the business cycle turns or the investment becomes overpriced we consider whether it is best to hold onto the investment through future business cycles or to sell if there is little chance of a further upside in the near future or if we can identify better opportunities elsewhere.

Trend Analysis

Experience has shown us that one of the most important aspects of investment research is the analysis of what we call “game-changing” trends.

For example, in the 1990s and 2000s a game-changing trend manifested itself under the name of “globalization”. This trend involved outsourcing of manufacturing and certain services from developed to less developed nations. Along with that came the eventual increase in wealth in these emerging markets and the coinage of terms such as “The BRICs” to indicate countries that especially benefitted. An analysis of this trend led us to be early investors in certain emerging markets in 2002 and 2003 and also led us to certain specific investments such as in companies based in developed markets that were benefitting from this outsourcing, companies in certain emerging markets that were providing these outsourcing services, and companies providing international transport such as shipping.

As I write this in 2013 we can see another potential game-changing trend developing. The term “Insourcing” has been coined to describe this trend where companies are now moving some manufacturing back to developed markets, specifically the USA. This is as a result of labor costs that have increased much faster in emerging markets than developed markets in the last couple of decades and also as a result of potentially much lower energy costs in the USA due to the discovery and exploitation of vast natural gas reserves – what is known as “shale gas”. As a result of this trend we will consider investments in companies that can take advantage of lower US energy costs and in US companies that make money by exporting or transporting natural gas.

At any given time there are a handful of such long-term, game-changing, trends happening and identifying companies, industries, or regions that will benefit (and also those that will be left behind) can make a significant difference in the performance of an investment portfolio. At IAM we spend a considerable amount of time on this type of analysis and consider this to be an important criterion in investment selection.

Global Mandate

The United States still has by far the largest, most liquid, and most diverse investment markets in the world. However, the US markets now represent less than 50% of global investment opportunities. Furthermore, while it is true that many non-US companies choose to list or cross-list on US exchanges, increasingly many non-US companies are choosing to list only on fast-growing exchanges in places like London or Hong Kong, or only on their regional exchanges in places like Canada or Australia.

To ignore non-US investment opportunities is to ignore half the world. Often non-US companies also pay higher dividends and trade at lower earnings multiples than their US peers. Furthermore, investing in assets that are not denominated in US Dollars, and that generate non-USD cash flows from dividends, enhances portfolio diversification.

At IAM, we have direct access to over 100 market centers in over 22 countries. We can initiate trades in non-US markets electronically and at discount brokerage prices; which saves considerable cost for our clients (most US advisors have to initiate non-US trades by phone through a broker). In addition, for our international clients, we can convert currencies within accounts at very close to interbank rates, saving considerable currency conversion costs, and we can wire money into or out of taxable accounts in 17 currencies (as of July 2013).

Behavioral Analysis & Technology

If investment markets responded only to fundamentals such as how a certain company's business is doing or whether the economy in general is doing well, then it would be a much simpler world and all we would need to do is perform a rigorous analysis of these fundamentals to find attractive investment opportunities. The reality is more complex; investor behavior and technology play important roles in how markets and specific investments perform.

Many studies have shown that investors tend to put more money into the market near market tops and get out near market bottoms. This bandwagon approach is very strong – it is natural human behavior. There is in fact a clear investor behavioral cycle similar to the business or economic cycles. It goes something like this:

- When investments are doing well, investors get greedy and put in more money.
- Eventually the market peaks and greed turns to hope that there will be further gains in the market.
- As the market weakens this hope eventually turns to fear and investors start to get out.
- As more investors get out the market accelerates downward and fear turns to panic.
- Panic leads to capitulation as investors get out en masse and this usually marks the bottom of the cycle.
- As markets stabilize, panic again turns to hope and investment markets turn upwards as there are more buyers than sellers.
- As the buying accelerates hope eventually turns to greed and we have come full- cycle.

We see this over and over again.

Technology such as online trading and quantitative investment models that generate trades based on computer programs have augmented this herd effect in recent years and made investment markets more volatile. Understanding this means that we can keep our heads when markets move suddenly and look for opportunities when panic overwhelms sense.

Analyzing investor behavior and understanding where we are in this cycle is a key part of our research at IAM. When panic overwhelms fundamentals this is a golden opportunity to look for value-priced investments. Conversely, when greed has led to frothy markets we need to exercise caution. It is almost impossible to determine market tops and bottoms accurately – greed can continue to drive a market upward for a long time after investment fundamentals no longer make sense – but by analyzing investor behavior we can spot opportunities and enhance a portfolio's risk/return profile.

Customized Portfolios & Financial Planning

One of the important things we do at IAM is to customize investment portfolios for each client's specific situation. We have several model portfolios from which we initially choose based on a client's risk tolerance and return expectations but within these models we have the flexibility for considerable customization.

All portfolios are customized based on market conditions. For example, we may be holding investments within our portfolios that we intend to hold for the long term but that have recently increased significantly in value and are therefore temporarily overpriced. For new clients we might not include these investments since the upside would be more limited – so instead we would choose different investments that offer greater potential for long-term upside or we might wait for a pullback in price on the current investments.

We can also customize on the basis of account type – perhaps holding more income- producing investments in a tax-deferred account and more capital gains generating investments in a taxable account for investors who are subject to higher rates of taxation on interest than capital gains.

Portfolios can also be customized based on individual financial planning type issues. For example, we may customize a portfolio based on external factors such as a client's profession. Perhaps we might underweight technology investments if the client already has exposure to technology through his or her employment. Another example might be if the client already has considerable exposure to certain asset classes through other investments such as real estate or gold – we might underweight these assets in our portfolio so as to increase diversification and mitigate risk.

We can incorporate currency hedging into a portfolio for clients who invest in one currency but will spend their money in a different currency.

For clients who need to generate a consistent and reliable income from their investments we can put in place a bond ladder where a certain amount of bonds mature each year to satisfy the income requirement.

We suggest that every client have a financial plan completed but even if a formal plan is not in place an element of financial planning is incorporated into our investment management to determine how the portfolio should be structured

Sell Strategy

Much effort in the investment community is devoted to determining which investments to buy and when to do so but it is equally important to have a strategy on when to sell investments.

A buy and hold strategy may be appropriate in certain instances such as where there are limited investment options, as in certain pension accounts or education savings accounts, or in smaller accounts where trading costs would create an excessive drag on performance. However, in most accounts, because investment markets, the economy, and corporate profits tend to be cyclical, there is considerable advantage to making portfolio adjustments over time and this necessitates a sell strategy.

At IAM we follow a qualitative rather than a quantitative approach in our sell strategy. Experience has shown us that setting inflexible price targets or sell stops (a price at which, once breached on the downside, a security is automatically sold) does not consistently add value. We have found that incorporating sell stops is only useful in the case where a security is clearly overvalued but is still benefitting from upward momentum in its price. Sell stops often cannot protect against sudden and dramatic stock price movements since these movements will often occur based on news that comes out when markets are closed – when the markets re-open the opening price will already have dropped and the investor often ends up selling at the low point. Our research and experience has shown that if sell stops are incorporated on a routine basis then it is just as likely that an investor gets stopped out just as the security's price resumes its upward trajectory as it is that the investor benefits by selling a security that continues to fall in value.

Similarly we do not set hard price targets for securities since price is relevant only in the greater context of how it relates to value. In July 2013 Google stock was selling at \$900/share and General Electric at \$24/share – does this mean Google was overpriced and GE represented value? Perhaps, but the price alone tells us nothing; we need to make a judgment based on value metrics such as price/earnings or price/book ratios, or perhaps business growth trajectory. These metrics change with time along with changes in price so even if a security has greatly increased in price it may not be overvalued. In addition, a security, or the market as a whole, can remain overvalued for considerable lengths of time - this often happens as investor greed sets in near the top of a market cycle.

At IAM, what we look for is value in any investment we choose. We consider intrinsic value, perhaps based on price/earnings or price/book and also value relative to similar investments. For the market as a whole we look at how current valuation compares to history but also consider whether there are good alternatives to investing in the market. For example, if the S&P500 has a price/earnings greater than 20, this would be historically high; but if bond yields are historically low then perhaps investors would still rather put their money into the stock market despite the relatively high valuation because the alternatives are even less attractive.

So to summarize: At IAM our sell strategy is based on a continual appraisal of an investment's value rather than on hard price targets. In addition, our sell strategy is customized for client-specific issues such as taking long-term rather than short-term capital gains, or maintaining a certain level of dividend yield.

Rebalancing

Rebalancing a portfolio means selling investments that have increased in value and buying investments that have done relatively poorly. Usually this is done on an asset class basis – so if stocks have increased in value relative to bonds, some stocks are sold and some bonds are purchased. In this manner a portfolio is brought back in line with its intended risk tolerance and there is also an element of “selling high and buying low”.

Rebalancing is an important part of any investment strategy but how it is done is perhaps more important than the act of rebalancing itself. In many investment strategies rebalancing is done on a consistent periodic basis such as annually, quarterly, or even monthly. Quite often we see the situation where a portfolio is rebalanced at the end of each year. Frankly this makes no sense – there is no magic to rebalancing at the end of the year.

There is, however, some magic to rebalancing at the end of April. Historically the stock market has done much better from November to May than from May to November. Historically there is also a so-called “January” effect where the stock market has done relatively well at or near the beginning of the year. While we would not advocate a trading strategy based on these seasonal effects because it is still better to be continuously invested than to try and time the market in such a manner, if a portfolio is to be rebalanced wouldn’t it make sense to consider these seasonal effects and rebalance in April rather than at the beginning of the year?

At IAM, we consider these seasonal anomalies in our rebalancing strategy. We also consider account-specific issues such as taking long-term capital gains and short-term capital losses in taxable accounts. Furthermore, we rebalance on an investment basis rather than just on an asset class basis.

This last point is very important and can add considerable value. We continually evaluate the investments in a portfolio so we can choose the specific investments to be used in rebalancing. For example, if several of our stock picks have increased in value to the point where we believe they are overpriced, we might sell them and then we have the flexibility to either purchase other stocks or, if we need to rebalance, we can put this money into the underrepresented asset class instead. Clearly this is a much better way of rebalancing than selling a portion of each investment in an asset class, no matter its value, and then buying a portion of each investment in the underrepresented asset class no matter its value – which is the way rebalancing is often done elsewhere.

Mutual Funds

A considerable amount of research has been devoted to analyzing whether investors are better off putting their money into actively managed portfolios or lower-cost passively managed portfolios. Most of the research compares mutual funds (the actively managed portfolios) to exchange-traded funds, which have lower fees since there is no “management”, only an assortment of investments corresponding to an index.

Overwhelmingly the research shows that on average mutual funds do not outperform their benchmarks consistently and therefore investors should save themselves the mutual fund fees and put their money into lower-cost passive investments. This is not to say that good mutual funds do not exist – but they are difficult to find.

Mutual Funds also suffer from a number of important limitations:

- They are not as transparent as holding individual investments in a brokerage account where each position and trade is reported daily or even in real time.
- It is difficult or impossible to actually speak with the person making the investment decisions for a mutual fund.
- The manager may change unexpectedly and without giving notice to investors.
- They are typically not tax-efficient and may do a lot of trading thus attracting higher trading costs.
- They are not customized to an investor’s personal situation.
- They may have hidden fees, some of which may go to the broker or brokerage firm marketing the fund (so called 12B-1 fees).

For all these reasons at IAM we prefer not to use mutual funds – we recommend individual holdings of stocks and bonds or passive indexed investments such as exchange-traded funds (ETFs). On rare occasions we may recommend a mutual fund that has a specific mandate that we find attractive and that is not accessible through passive investments, or a fund that has shown consistent outperformance over time.

Disclaimer

This document and any recommendation with respect to a particular country, security, portfolio of securities, or investment strategy is intended only for informational purposes and should not be construed as investment advice. IAM manages its clients' accounts using a variety of investment techniques and gives investment advice only after a thorough review of each client's specific situation.