

In previous white papers in our "Economic Outlook" series, we discussed the many variables affecting both the U.S. and the global economy, including the debt supercycle, faltering economic confidence, unsustainable government spending and the 2012 U.S. presidential election. Now, we turn our attention to the question of how to respond to those various factors. In

AN INVESTMENT PHILOSOPHY FOR A CHANGING WORLD

A SIGNATUREFD WHITEPAPER

abstract

In this white paper, we outline SignatureFD's unique investment philosophy, discuss models of investing cycles and make some predictions about what the future might hold. Our goal is to provide a clear framework to help investors understand how SignatureFD is addressing the problems we currently face and our efforts to create a template for investing that is appropriate for our new economic reality.



Warren Buffett once observed that "price is what you pay; value is what you get." History is littered with investment quotes, which often go in one ear and out the other. But sometimes we need to pause and reflect. The economy and market are constantly evolving, but the pace of change seems more rapid today and the volatility and sense of unease that we have talked about throughout our "Economic Outlook" white paper series is not likely to dissipate soon. As we conclude this white paper series, we wanted to bring together our analysis, observations and forecasts to create a strategy for investing in a period of high uncertainty. We also want to use this opportunity to expand on the SignatureFD investment philosophy and provide readers with insight into how we think and make decisions.



WE BELIEVE IT IS CRITICAL TO BE AWARE OF THE HUMAN CONDITION AND THE CHALLENGES OUR BRAINS CREATE FOR US AS WE INVEST.

HOW BEHAVIORAL FINANCE EXPLAINS INVESTORS' ACTIONS

The essence of investing seems so easy—buy low, sell high, go against the crowd, repeat until wealthy. So why is investing so much more difficult in practice than theory? Over the last 30 years, a field of study called *behavioral finance* has provided theories and tools to help investors deal with many of the biases and preferences that lead to poor decision making. Yet even with expanded visibility and deeper awareness of the challenges investors face, investment results can only be classified as poor. In one recent study, the average stock fund provided an annualized return of 8.2% over the last 20 years (1992–2011), while the average investor in those funds earned 3.5%. In other words, the typical investor underperformed the same funds they invested in by 4.7%, a phenomenon the report dubbed the “Investor Behavior Penalty.” Basically, the sum of all the actions of an average investor caused him or her to capture only 43% of the potential gain. On a \$1 million portfolio in 1992 this would equate to forgone gains of \$3 million. What can account for such a huge difference in potential versus actual gains? The report highlights three specific causes: first, buying “high” (the most recent best-performing funds); second, “selling low” (the most recently poorest-performing funds); and third, abandoning long-term investment plans during a period of volatility, typically at the highest or lowest points of the market cycle.¹

We believe it is critical to be aware of the human condition and the challenges our brains create for us as we invest. Every decision in investing is about a trade-off—an economic exchange, if you will. In each transaction there is a buyer and a seller and it is important to remember which role you are filling. The majority of the investing world is framed from the perspective of the seller, but the investor is usually the buyer. The Wall Street marketing machine constantly distracts by focusing on the “price you pay.” But as investors (and as consumers generally) the critical question to ask is, “What am I getting?” Simply reframing a choice through this lens often leads to new insight and decisions.

SIGNATUREFD INVESTMENT PHILOSOPHY

In 1949, Benjamin Graham, the grandfather of modern value investing, said, “The combination of *precise* formulas with highly *imprecise* assumptions can be used to establish, or rather to justify, practically any value one wishes ... Calculus ... [gives] speculation the deceptive guise of investment.” This would



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seem to be well understood after the crisis of recent years. Many investment firms and banks failed precisely because they were too reliant on quantitative models that gave a false sense of comfort. The trick to investing is to understand the difference between what is timely and what is timeless. The metrics used to interpret the market, the data used to measure values, and the strategies used to allocate capital are all temporary and shift as markets, technology and human understanding evolve. That said, other attributes the investor relies on are unchanging over time. At SignatureFD, we believe the following five investment principles are timeless and of critical importance.

UNDERSTAND YOUR GOALS

In many ways, understanding your goals is the most important principle of all. The point is that the success of investing is all about an investor's personal goals and objectives and not about the market. An investor should still objectively aim for maximum investment results in light of targeted risk, and comparing to benchmarks can be a useful exercise for tracking progress. But ultimately, it is of little concern to an investor how a random basket of investments performs, or how your colleagues or friends at a cocktail party invest. (We promise that their results aren't as good as they say.) What truly matters is that an investor enjoys their desired standard of living, protects their family and loved ones from financial risks, and optimizes the desired legacy for their heirs or charitable beneficiaries.

The investment community is geared toward measuring point-to-point performance results. For investors with time horizons in the decades or longer, this information is of little value. The presenter of performance data is often presenting that data in a way to make themselves look good. It is critical to understand that shifting the performance backward or forward by a period or two can change the results significantly. Understanding the totality of the investments you make—both quantitative and qualitative—becomes the key to making good decisions.

INVEST FOR GROWTH

Most investors worry about their portfolio's day-to-day volatility. Certainly, watching one's net worth rise and fall can be stressful. However, it is often the slow and progressive actions in life that cause the most harm, not the risks that are right in front of us. This is true in investing as well as life. A portfolio that is not designed to exceed the rate of inflation by a material amount will provide the investor with limited benefit in the long-run. In our opinion, investing in what we call growth-based (or ownership-based) assets is necessary as these are the only assets designed to provide this type of return.

Cash and fixed income investments are key for producing liquidity and are important to investors who are making recurring withdrawals from their portfolio. But it is important to remember that the primary purpose of these investments is to allow the rest of that portfolio to remain invested in growth assets without being forced to sell them at an inopportune time. Investment success, therefore, is the cumulative impact of all decisions over an infinite time horizon.

Good long-term results are achievable in one of two ways, or a combination of both. The first involves making more correct decisions than incorrect decisions. We operate in a world of uncertainty and thus a significant share of decisions will be wrong. The goal, however, is through constant reflection and preparation to make slightly more good decisions than bad. The second way to add value can have a greater affect—making sure that the impact of good decisions is more positive to portfolios than mistakes are negative. Because we live in a world of uncertainty and know that many decisions will be wrong it is even more critical to limit the damage from those decisions that end up being incorrect.

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The mathematics of positive to negative impact is the reason successful long-term investors are constantly thinking about what can go wrong, because “the upside will take care of itself.” It is also critical to realize that the more decisions one makes, the more opportunities there are to be wrong. We find that when many investors are faced with uncertainty they tend to believe that something must be done. In reality, without a high level of conviction in the change, the best course of action is often to do nothing. As the Roman playwright Plautus said, “Patience is the best remedy for every trouble.”

DIVERSIFY YOUR PORTFOLIO

Conventional wisdom says that diversification is the only free lunch in economics. In theory, investments that perform differently in different economic periods can reduce portfolio volatility by smoothing out the ups and downs of a cycle. In practice, diversifying is a challenge because the way different investments perform in relation to others is not constant. For example, for much of the last 20 years, investing in emerging market equities provided investors with a source of return that did not track closely with investments in the U.S. or Europe. However, in recent years, much of the emerging world has become very economically coordinated with developed markets and this diversification benefit has been minimized. As such, we are constantly searching for investments that perform differently in various market environments, and which reduce volatility risk without impairing long-term returns.

FOCUS ON VALUE

As we alluded to earlier, if we had to choose one investment principle to apply in all situations, it would be to focus on value. Often, this means doing things in



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a contrarian way. Sometimes, we find ourselves selling the types of assets that are getting the most publicity and are the most entertaining to discuss. Alternatively, we may be interested in buying the things that no one is interested in. When meeting with investment company sales representatives, one of our favorite questions to ask is what products none of their clients are asking about.

However, being contrarian is not helpful in and of itself. Ned Davis, founder of Ned Davis Research, says that he “would rather make money than be right.” In our experience, people are sometimes so eager to take the other side of an argument that they are willing to lose money to be right. Investment research shows that the crowd is often correct. In fact, it appears that about two-thirds of the time going with the crowd ends up being the best choice, while it only pays to be contrarian about one-third of the time. As a result, we often find that we invest in ideas too early and sell them out before they eventually crest. There is no harm in this, but we continue to study our past choices to improve the odds that we achieve the most positive benefit of good decisions and minimize losses from incorrect decisions.

ADOPT A DEFENSIVE ATTITUDE

Saying one is trying to be defensive can be a confusing statement. By “defensive,” we do not imply that growth is not important. Rather, we try to emphasize that it is more important to avoid big losses than try to earn big gains. According to Charles Ellis, investing can be compared to tennis. It is what he calls the difference between a winner's game and a loser's game. In professional tennis, points are won about 80% of the time while in amateur tennis, points are lost about 80% of the time.² The corollary to investing is that the goal is to make as few unforced errors as possible. One way that we try and adhere to this is by managing all of the inherent risks that can create mistakes.

We already mentioned that the key focus of investors is often volatility risk. We are constantly aware of this, because we know clients are watching it. However, volatility tends to even out over any relevant period of time. As planners and investors, one of the most significant risks remains inflation, which results in a



continual erosion of the purchasing power of one's assets and the need to increase spending in the distant future to achieve the same standard of living. In contrast to volatility risk, inflation risk becomes more significant over time. Volatility and inflation are not the only risks. Other risks include interest rate, default, tax, regulatory, currency, manager, counterparty, and political. One final risk is important to recognize—permanent loss of capital. We are keenly aware of this hazard and just as we focus on inflation risk, we also spend a disproportionate amount of time trying to defend against this risk.

INVESTING CYCLES

In the past, we have compared the process of investing to that of meteorology, a comparison that seems even more appropriate in light of recent Superstorm Sandy. To us, the similarity between these two disciplines has to do with the multiple and overlapping cycles and understanding where one stands within these cycles. For example, in meteorology, an observer deals with three broad cycles that have varying lengths and impact on the current state. The first and broadest cycle is the climate. Trending over multi-decade or century periods, these forces are driven by latitude, geography, prevalent wind patterns, and long-term climate changes based on glacial, sunspot and ocean current activity. A second cycle is much more familiar to us—the seasonal cycle. We know that spring is often a wet and cool period while summer is hot and dry. These cycles repeat themselves with regularity, though each season has its unique events. Finally, the shortest cycle is the day-to-day pattern that includes what we call weather. These forces are driven by air-pressure, wind speed and direction, and moisture, among other variables.

Though meteorology is a “harder” science than investing, there are many similarities between the two. The amount of data and the combination of historical patterns is nearly infinite, making quantitative analysis tricky. As a result, some amount of human judgment is usually required. The investment landscape, in our opinion, has three overlapping cycles that are similar to those in meteorology. The first cycle is the “secular phase.” Both equity markets and fixed-income markets tend to move in cycles that last from 15 to 30 years. On the equity side, this is generally characterized by alternating cycles of expanding and contracting earnings multiples. For fixed income, this cycle is generally characterized by periods of rising and falling interest rates, often tied to expectations about future inflation. In each of these cases, the direction of the cycle acts as either a tailwind or headwind for the investor.

The second cycle, called the “cyclical phase,” is somewhat shorter and generally runs on a period of three to seven years. This phase is linked most closely to the business cycle. For the equity markets, this cycle is mostly based on earnings—a general pattern of growth during the expansion phase and then a period of contraction during the recessionary phase.

The final cycle, “the technical phase,” is generally the near-term momentum of the market (either up or down). This cycle is typically from days to months in length. Though many managers try to anticipate and allocate capital around this cycle, we believe it is hard to consistently capture these moves and therefore this cycle is more noise than anything useful to a long-term investor.

WHERE WE ARE TODAY

With an understanding of investment cycles as background, where do we find ourselves today? First, we are in a long-term period of earnings multiple contraction. At this point, it is clear that a long-term bullish cycle in the equity markets ended in 1999/2000 and the markets subsequently moved into a bearish cycle of earnings multiple contraction. Specifically, in a period of earnings multiple contraction investors are not willing to pay as much for the earnings that a company produces. Another way to interpret this is that investors are not willing to pay as much for the potential of future growth. We have discussed the concept of confidence in previous white papers and within this context the tendency of investors to take a “what have you done for me lately?” attitude makes sense. In 1999, when it appeared the world was a low-risk place and growth would be constant into the future, it seemed plausible to pay 30- to 50-times the earnings of solid companies.

Now, after many years of uneven growth, financial and business crisis, natural catastrophes, and terrorism, investors are not willing to look as far into the future. But this cycle will eventually end and a period of optimism and expanding multiples will return.

History shows that long-term bear market endings usually unfold over lengthy periods of time. Often there is a panic low that can represent the absolute low, followed by a subsequent low at higher market values, but potentially even cheaper valuations due to earnings growth in the intervening years. The deleveraging that we have talked about in our “Economic Outlook” white paper series is also a key aspect of this cycle as overall economic growth is slowed during this phase. Debt can be productive and enhance growth if used to increase productivity capacity (i.e., create a virtuous cycle). At its core, however, debt is borrowing growth from the future into today, and only continues to help growth if it is sustained. We are now at a point when deleveraging is widely believed to be necessary. To this end, it is not possible to have deleveraging and above-trend growth at the same time.

It is not clear when we'll reach the bottom and it is futile to speculate about the timing of the shift from bear to bull market. That said, we continue to

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position ourselves based on the belief that more time is needed before the current negative cycle is complete. It is our opinion that we are in this second phase now—the period between a panic low and a subsequent final low. With history as a guide, one would expect that a final ending of the bear market would happen over the next three to five years. In many ways, we are indifferent to this cycle. As long-term students of the market, we are fully aware how difficult it is to get these trend changes correct. We are not traders but long-term asset allocators and we believe a core portion of assets must remain invested at all times. However, during the negative secular phases in the market, investors who err on the conservative side and potentially use more defensive and cautious investing approaches are rewarded. On the flipside, when markets are in a structurally bullish period, buying on dips and using more aggressive investment strategies will be rewarded.

With regard to the cyclical phase of the market, it is equally clear that we are in a positive up cycle that began in 2009. The market bottomed in March 2009 and the economy bottomed four months later. Since then, equity investors have been rewarded with a near doubling of their money. Earnings have recovered and moved beyond the previous peak in 2007 and overall national production is now at new highs. Of course, many structural challenges remain, but these statistics form the basis of a strong positive cycle.

At this stage, however, the cycle could be starting to turn. We are watching corporate and economic data closely. In recent quarters, most companies have had at best a modest ability to grow earnings. Many companies have tried to reduce forward expectations for earnings and the growth in revenues has been modest. With the economy growing at a real rate of around 2% (4% total growth, real plus inflation) corporate revenue growth is limited, making it very difficult to expand earnings. Given the risks of political stalemate and a drop in economic growth from federal tax increases and spending cuts, the balance of the risks appear to be on the downside. A recession in the next 12 months certainly seems possible.

Whether it happens in the next 12 months or the next three years, a recession is inevitable. Similar to our comments above, it is impossible to avoid market losses when corporate earnings next decline, but protecting capital in a downturn is a constant investor goal. We manage this by generally reducing risk exposure in the late stages of an up market and by tactically weighting more capital to our most conservative managers during these same periods.

The short-term, technical cycle is one that we do not try to capture through our overall portfolio management. However, we do believe some value can be generated by using these moves to direct the timing of portfolio shifts. We like to say that the core fundamental values drive the “what” and “why” of our decisions, but the technical analysis of market trends can help us answer “when” and “how.” Currently, the market appears to be moving up. We say “appears” because we have had six weeks with limited direction, though declines have been modest (less than 5%). The market had a negative period



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in May and early June and then moved into bullish territory, rising by 16% from June 4 through highs last month. Given the coming end to election uncertainty and the typical strong fourth quarter, we believe the odds are that the market moves higher into year's end.

BUILDING A PORTFOLIO IN THE CURRENT ENVIRONMENT

Now that we've reviewed the timeless philosophies and analyzed the timely cycles, how does one go about building a portfolio? At SignatureFD it all comes down to risk and reward. We constantly survey the information on political, economic and corporate trends. We combine this work with continual discussions with money managers and micro-market analysts who can give us a sense of valuation. Out of this perpetual feedback loop we believe we can develop not only a sound asset allocation strategy but a stable of money managers who can execute our ideas. Because our business structure aligns with clients, we also have an incentive to keep costs low. When we are unable to find active managers who we feel can provide value above and beyond the fees they charge, we are fully willing to use index-oriented solutions. For some firms the type of investment strategy is a timeless philosophy, but at SignatureFD, we believe that these are timely decisions based on markets and cycles.

We have recently used the concept of scenario weighting to allow investors to visualize how a portfolio is built. Because of the unique characteristics of this business cycle, and especially because of the significant role of policy makers and central bankers, the potential outcomes are much more varied and extreme than in other periods. As a result, we believe that even higher levels of diversification are warranted and decisions about asset types and weights can be quantified through this scenario exercise.

We have identified four possible scenarios over the one- to three-year horizon. The first is a muddle-through environment (55% likelihood), the second is an inflationary crisis (20% likelihood), the third is an upside surprise (15% likelihood) and the fourth is a deflationary crisis (10% likelihood). Within each scenario, one can build a target portfolio that would perform well. The challenge today is that any of these scenarios is possible and each has a very different outcome and desired portfolio. Our solution is to weight the portfolio holdings by the odds that a certain scenario occurs. Our Summer 2012 *Market Sense* provided a much more detailed discussion of the global economic conditions, the capital market implications, and the portfolio positioning of each scenario. If you are interested in reading more on these thoughts, please contact us for a copy.

After constructing the desired portfolio with regard to the current macro landscape, one must then stress-test a portfolio for various global risks. Today's world is filled with potential risks, both near-term crisis risks and chronic risks. In focusing on the

latter for now, most things that could go wrong will have one of three causes: U.S. political dysfunction, European economic and currency dislocation, or a Chinese structural slow-down. It is beyond the scope of this white paper to provide a comprehensive review of these risks, but a review of our conclusions is important.

In our previous white paper, "Fairy Tales, Plot Twists and the Untold Story," we talked extensively about the positive structural changes within the U.S. economy, specifically energy expansion, manufacturing recovery and technological advancement. For these reasons, the U.S. is one of the better-positioned regions within the world's investment markets. That said, we have two primary concerns. One is that political dysfunction will trigger a large fiscal pull-back next year, which could prompt a recession. This would certainly cause earnings and corporate valuations to be reduced. The second core risk is that the Federal Reserve is too active while Congress and the White House are not doing enough to help the economy recover. We view the extreme low rates and Federal Reserve involvement in the markets as distorting the value of money, and income investments specifically.

THE FEDERAL RESERVE IS TOO ACTIVE WHILE CONGRESS AND THE WHITE HOUSE ARE NOT DOING ENOUGH TO HELP THE ECONOMY RECOVER.

Recent research by The Leuthold Group shows that as of August 31, 2012, the traditional balanced portfolio of 60% S&P 500 (U.S. stocks) and 40% 10-year Treasuries (U.S. fixed income) paid an investor an undersized cash flow yield (pre-tax, mind you) of only 1.98%, a record low going back at least 140 years.³ Why is this important? Low yields are putting extreme pressure on investors to eke out yield from any place they can find it. Over time, this can lead to bubble-type environments as investors miscalculate risk due to their myopic focus on income. We are already seeing signs of this in the corporate bond market. As of the end of last quarter, corporate bonds were at record-high prices and yielded 2.8% while those of the lowest-rated companies (so called "junk" or high-yield) bonds paid just over 6.5%. Even if the difference earned on these bonds is attractive compared to Treasuries, it is hard to imagine that an investor is well protected from the twin risks of future inflation and higher corporate default.

The risks in Europe are much different. We have written and talked extensively about Europe for at least two years. After a recent trip to Central Europe, we have a view that the near-term is likely more stable than expected, but the long-term is potentially more unstable than expected. Specifically, there is substantial confidence in Mario Draghi, the President of the European Central Bank (ECB), and his ability to avert a liquidity or banking crisis in the short term. This provides at least a year, potentially longer, for politicians to work out the long-term solutions. The ECB cannot solve the problems, and thus our concern about the long-term. There still seems to be little appetite among the northern countries, and in Germany in particular, to enter into a full-blown risk-sharing relationship with the southern European countries.



Politicians have staked a lot on the European concept, but the voters are going to determine if it will be successful. Whether the Euro countries form a union or the currency comes apart will come down to elections in specific countries, including Germany. There are multiple possible outcomes, but in our opinion most either result in recurring crisis before solutions are found, or a long and drawn out stagnation, which is potentially even worse. This last scenario could look similar to Japan's struggles over the last two decades and would create a long-term period of subpar economic and corporate performance and little incentive to invest in Europe. We have found recent valuations compelling, and have added some exposure within our portfolios, but we are likely to have relatively small allocations there for years to come.

The final risk is that of a major change in Chinese growth potential. This has been a key theme in the markets over the last year, and is not likely to be settled immediately. Certainly, there is a structural slow-down occurring and the historical growth rates of 9–12% are not likely to persist. That said, the growth rates aren't likely to drop to 4–6% without some intermediate steps. We believe that on top of the structural slowing there has also been a shorter-term cyclical slowing aggravated by the situation in Europe and the current political transition in China. If these issues ease in coming quarters, it is likely that China could have better results than many are anticipating. Though risks around the social policies in China and the need to expand citizens' living standards will continue, the most likely course would seem to be one of continuing growth in the broad middle class. This has important ramifications not only for China, but also for many other emerging markets that trade with China and even the larger global companies that increase their presence in China.

Our views can be summarized into our current portfolio themes. First, within the U.S. we remain overweight to the largest, highest quality, and cash-rich companies. Second, within global markets, we have held our focus on emerging markets as opposed to Europe and Japan, though due to valuations we have slightly lessened this theme. Third, we maintain a fairly large position in our real asset category, which includes energy, natural resources, infrastructure and commodity-oriented investments. This is a result of the higher odds placed on an inflationary shock rather than a deflationary one. Finally, within fixed income, we have reduced our allocations to intermediate- and long-term bonds and invested in portions of the fixed-income market that are able to generate returns with shorter maturities. Though our themes shift and evolve, these seem relatively stable for now.



"THE MARKET CAN STAY
IRRATIONAL LONGER
THAN YOU CAN STAY
SOLVENT."
—JOHN MAYNARD KEYNES

WHAT THE FUTURE HOLDS

In putting this all together, it is important to understand the overall investment backdrop, where the economy is within the business cycle, and the current market risks. Ned Davis Research sums this up in an investing strategy that it describes as, "don't fight the Fed, don't fight the tape, and be wary of crowds at extremes." It is important to have a full panoramic view of the markets to assess when crowd behavior becomes dangerous, but the underlying trends in the marketplace can persist much longer than most people expect. John Maynard Keynes said, "The market can stay irrational longer than you can stay solvent." This reminds us that it is nearly impossible to time the market accurately over time, but being cautious about markets that are ebullient does reduce risk.

Many investors become overly focused on the current state of affairs, thinking the market is about what one sees happening in the near future. In reality, the market already factors in what the aggregate of all investors expect to happen. Thus, what really matters is the divergence between what actually happens and what we expect to happen. "The stock market represents everything everybody knows, hopes, believes, anticipates, with all that knowledge sifted down to ... the bloodless verdict of the market place."⁴ William Peter Hamilton, an editor of *The Wall Street Journal* wrote this in 1922, and it is still relevant today.

As your advisor, our primary job is to help you interpret and quantify your personal objectives and then develop a portfolio that meets those goals while accepting a reasonable amount of risk given a certain return expectation. In order to weigh the often mutually exclusive ideals of low risk and attractive return, we need to be able to understand the forces at work in the long-term, the intermediate term and the near-term and to ascertain the durability of current trends and the intricacies of inflection points. By anchoring our process to timeless beliefs, and applying our judgment to timely adjustments, we must implement a portfolio that is sound in structure and aligns our goals with yours. Finally, in all these things we strive to work with partners who espouse integrity, hard work and a commitment to client focus.

We know these are high ideals, and we can never promise specific results or perfect decisions. However, our firm works continually on behalf of our clients. Every decision we make is done with the proper motivations. For each of you who is a client, we thank you and greatly appreciate your continued confidence in our firm. For anyone—clients or friends—who is reading this, please, do not hesitate to contact anyone at SignatureFD to discuss this white paper series in more detail.

SOURCES

¹ Dalbar, Inc. *Quantitative Analysis of Investor Behavior*. March 2012.

² Ellis, Charles D. *Winning the Loser's Game*. McGraw-Hill. 1998. Pg. 3.

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⁴ William Peter Hamilton. *The Stock Market Barometer*. 1922.

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