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August 29, 2014

TO: All clients and interested parties
FROM: Bob Kargenian

At least in the financial press we review, there has been a lot of focus in the past six months on the optimization of Social Security benefits. In this edition, we'll share the details of another client story, the analysis we did, and how this may benefit other clients as well. It's a good example of the many aspects of financial planning that we delve into, that go beyond portfolio management.

In addition, there's quite a bit of detail on TABR's new Dividend Stock strategy, which we'll be rolling out in the next couple of months. We're pretty excited about the research we were able to complete, taking the testing back to 1973. It's another tool we are adding to help clients achieve their goals in coming years, and we may not be done in this area. There is one other stock screening approach we are trying to replicate which has even better historical results.

I'd intended to include in this edition long-term research on our high yield bond strategy, which is a big component of our bond allocations and our all-bond accounts. But, I think it will make this piece too long, so we'll save it for next quarter. As usual, we've included a recap of performance of TABR's various strategies, through the first six months of the year.

Client Corner---Social Security Analysis

As there continues to be a move away from defined benefit (DB) pensions to defined contribution (DC) plans such as 401 (k), post-retirement risk is shifting more and more from the employer to the individual. As a result, maximizing Social Security benefits is much more critical.

For many who may take the attitude of, "hey, I'm 62 now and I'm going to take my money because I might not be around," or "I can use it now," that decision can be both flawed and quite regretful, without proper research beforehand.

Recently, we were meeting with some long-time clients for a semi-annual review. Both are currently 65 and still working, so the topic of Medicare coverage came up, along with Social Security. They'd mentioned that the Medicare worker they'd consulted with had suggested they could perhaps receive certain Social Security benefits early without impacting overall benefits. Since we were not certain what was conveyed to them, we ran an analysis using the financial planning software that we use for all clients, and also used a second software program that is dedicated to optimizing benefits.

Sure, it's pure math that one would get greater benefits at age 66 vs age 62, or at age 70 vs age 66, but there are many other options available to married couples, widows, widowers and divorced spouses that most people simply don't know about.

Below is a portion of a table that our software produced for our clients, whom we'll call Bob & Michelle:

Social Security Strategy	At retirement	At age 70	Bob begins At age 70 and Michelle begins At FRA	Bob files/ suspends, Michelle restricted application	Michelle files, suspends Bob restricted application
Start age					
Bob	66	70	70	70	66
Michelle	66	70	66	67	70
First year benefit in Current dollars					
Bob	$29,616	$39,093	$39,093	$39,093	$7,074
Michelle	$14,148	$18,675	$14,148	$14,808	$18,675
Maximization Based On Cash Received					
Total Lifetime Benefit In Current Dollars	$1,183,980	$1,310,000	$1,280,850	$1,354,424	$1,338,200
Break Even Point					
Bob	N/A	82	82	79	80
Michelle	N/A	83	83	80	81

First, let's review the obvious from above. Bob's benefit will increase by 32% (nearly $10,000 annually) should he delay his benefit from 66 to age 70. There is a similar corresponding bump in Michelle's benefit if she waits as well. Not everyone, though, can afford (or wants to) deferring some $43,000 in annual benefits starting at age 66.

In this case, the optimal strategy is for Bob to file and suspend, while Michelle files what is called a restricted application. This produces the most benefit over time, with break even ages of 79 and 80, and a potential increase of $171,000 in benefits.

This is just one example for married couples, but others exist for widows, widowers and divorced spouses. The key is analyzing this data in the context of one's personal situation, BEFORE you make a decision. Much like deciding whether it is best to take a lump sum from a pension or an annuity payout, it doesn't do any good to ask these questions after the fact. Then, it's too late.

There's a very helpful guide we came across written by James Mahaney, Vice-President of Strategic Initiatives at Prudential Investments. In it, Mahaney cites four costly mistakes that retirees make about Social Security---1) underestimating the real value of Social Security; 2) rushing to collect, then regretting the reduced benefits for the rest of your life; 3) not understanding the various ways married couples can integrate their benefits and 4) getting blindsided by the tax torpedo. Feel free to let me know if you'd like a copy.

If you're nearing retirement and this decision, we'll make sure to run this analysis beforehand to aid in your decision-making. In addition, to keep on top of your estimated benefits, it is a good idea to set up your personal account at www.ssa.gov. This way you can access your earnings statement annually (they are no longer being mailed to individuals under the age of 60) and stay on top of any material changes.

Introducing TABR's Dividend Stock Strategy

Last newsletter I shared some preliminary research using dividend-paying stocks that were consistently growing their dividends, and that we were working on a variation of this strategy, based on some work from Ned Davis Research.

There is a plethora of data on this subject now, and I'd neglected to mention there are several ETF's (exchange traded funds) that offer one-stop exposure to either high dividend yield or high dividend growth strategies. One is called the S&P 500 Dividend Aristocrats, which owns all the companies in the S&P 500 that have raised their dividend for at least 25 years in a row.

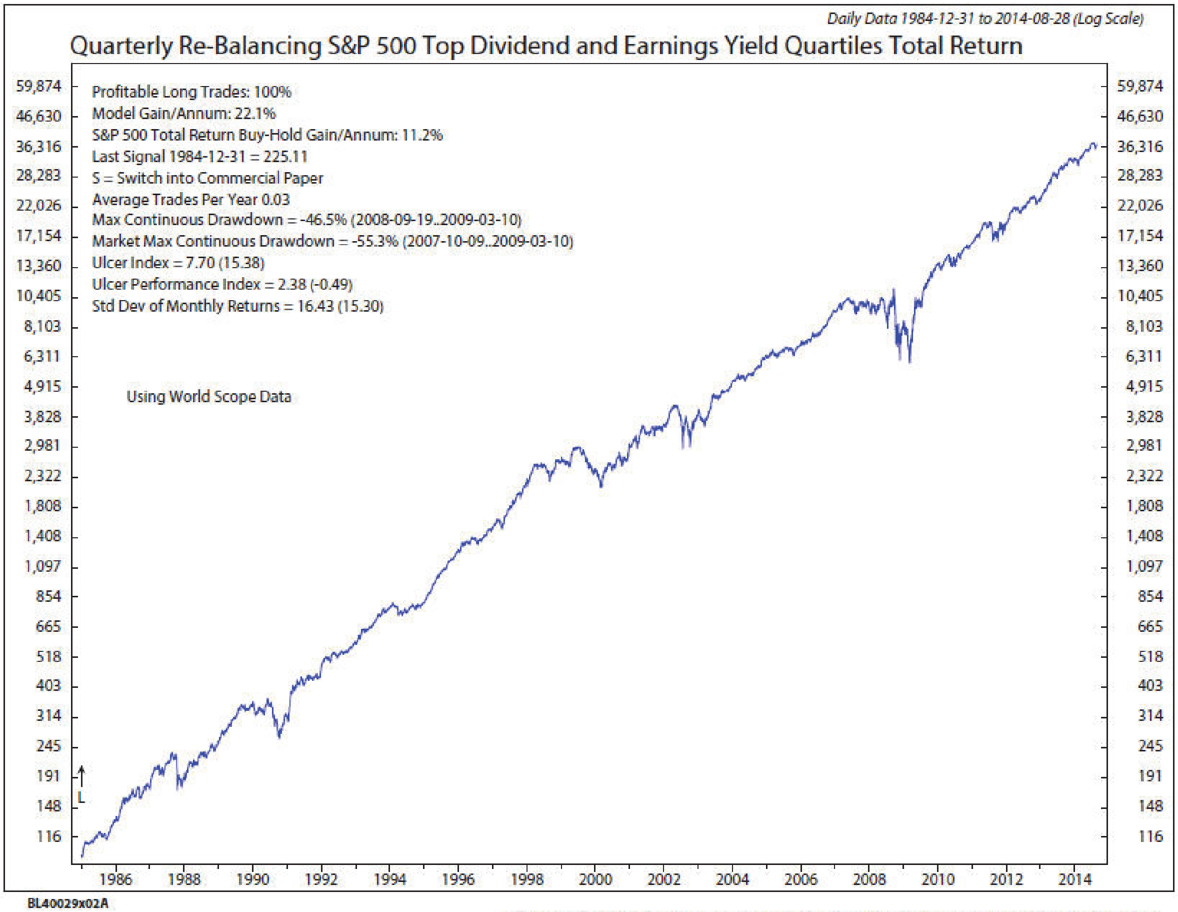
This is certainly a compelling concept, and fairly easily understood, but unfortunately, I've not seen any data that goes back for more than a few years. For us, that doesn't cut it. As I wrote in the last letter, "It is our contention that many investors, and their advisors, have embraced this philosophy (**dividend paying stocks**) during the last few years, with very little knowledge of what they're getting into. As a result, they are primed to fail. The worst thing an investor can do is to embrace a strategy without a sense of history or realistic expectations."

In our case, we've settled on an approach which first produces the top quartile of highest yielding stocks in the S&P 500, combined with a fundamental screen called the earnings yield. Since there are now 428 companies in the S&P 500 paying a dividend, the first screen passes through about 107 companies, and the second screen whittles that down to the top quartile of that list, with the final list at 27 names.

As I'd hoped, we were able to take the research back on this approach to 1973, yielding results over a 40-year time period, which has included stock market declines of greater than 40% three different times (1973-74, 2000-2002 and 2008), plus the Crash of 1987, when stocks fell over 35% in about 3 months.

The methodology works as follows. Each quarter, the screen is run producing about 27 names, and the portfolio is rebalanced with an equal weight in dollars in each company. As tested here and shown below, the results are based on being fully invested in stocks at all times. You'll see later that we will be modifying this in an attempt to control downside risk.

Below is a chart produced for us by Ned Davis Research, showing the model line of the strategy from December 1984 to July 2014.



You can see the strategy produced a substantial edge over the S&P 500, earning 22.2% annually compared to 11.3% for buying and holding the index (which includes reinvested dividends). However, it should be noted that the edge is not quite this strong when the study is extended to 1973. As illustrated in the table below, the S&P 500 compounded at 10.3% annually from 1973 to 2013.

The gross return for the dividend strategy was 16.1% annually, which is nearly a 600 basis point edge, but to make it realistic, one needs to deduct management fees and trading costs. In our work, we've assumed a management fee of 1.10% and trading costs of 0.40%, for a total of 1.5%. When this is factored in, the net return is reduced to 14.5% annually vs 10.3%. This is still a substantial edge, but the one sticking point for many investors (and also was mentioned by several clients to whom we've shown this) was the maximum drawdown of -47%).

TABR Dividend Strategy Yearly Returns

	Model Return	Mgt Fee*	Net Return	Rolling 5 year CompoundReturn	Compound Return	S&P 500 Total Return	S&P 500 Compound
12/31/1973	-24.89	-1.5	-26.39	736.1		-14.66	853.4
12/31/1974	(16.98)	-1.5	-18.48	600.07		-26.47	627.51
12/31/1975	58.61	-1.5	57.11	942.76		37.2	860.94
12/31/1976	43.25	-1.5	41.75	1336.36		23.84	1066.18
12/30/1977	(0.57)	-1.5	-2.07	1308.7	5.5	-7.18	989.63
12/29/1978	13.93	-1.5	12.43	1471.37	14.8	6.56	1054.54
12/31/1979	34.16	-1.5	32.66	1951.91	26.6	18.44	1248.99
12/31/1980	31.60	-1.5	30.10	2539.43	21.9	32.42	1653.91
12/31/1981	5.44	-1.5	3.94	2639.48	14.6	-4.91	1572.71
12/31/1982	15.96	-1.5	14.46	3021.14	18.2	21.41	1909.42
12/30/1983	35.07	-1.5	33.57	4035.33	22.3	22.51	2339.23
12/31/1984	23.75	-1.5	22.25	4933.19	20.4	6.27	2485.89
12/31/1985	36.89	-1.5	35.39	6679.04	21.3	32.16	3285.35
12/31/1986	29.16	-1.5	27.66	8526.46	26.4	18.47	3892.15
12/31/1987	6.34	-1.5	4.84	8939.14	24.2	5.23	4095.7
12/30/1988	32.97	-1.5	31.47	11752.28	23.8	16.81	4784.18
12/29/1989	20.74	-1.5	19.24	14013.42	23.2	31.49	6290.72
12/31/1990	(10.32)	-1.5	-11.82	12357.04	13.1	-3.17	6091.31
12/31/1991	62.75	-1.5	61.25	19925.72	18.5	30.55	7952.2
12/31/1992	25.45	-1.5	23.95	24697.93	22.5	7.67	8562.13
12/31/1993	28.61	-1.5	27.11	31393.53	28.5	9.99	9417.48
12/30/1994	2.67	-1.5	1.17	31760.83	22	1.31	9540.84
12/29/1995	44.16	-1.5	42.66	45310	29.7	37.43	13111.97
12/31/1996	22.15	-1.5	20.65	54666.51	22.4	23.07	16163.9
12/31/1997	38.06	-1.5	36.56	74652.58	24.7	33.36	21520.17
12/31/1998	9.97	-1.5	8.47	80975.65	20.9	28.58	27670.63
12/31/1999	(5.73)	-1.5	-7.23	75121.12	18.8	21.04	33492.53
12/29/2000	25.34	-1.5	23.84	93029.99	15.5	-9.11	30441.37
12/31/2001	26.07	-1.5	24.57	115887.45	16.2	-11.88	26824.94
12/31/2002	(7.36)	-1.5	-8.86	105619.83	7.2	-22.1	20896.63
12/31/2003	29.41	-1.5	27.91	135098.32	10.8	28.7	26893.96
12/31/2004	13.69	-1.5	12.19	151566.8	15.1	10.87	29817.33
12/30/2005	1.19	-1.5	-0.31	151096.95	10.2	4.91	31281.36
12/29/2006	22.02	-1.5	20.52	182102.04	9.5	15.8	36223.81
12/31/2007	(12.80)	-1.5	-14.30	156061.45	8.1	5.49	38212.49
12/31/2008	(29.08)	-1.5	-30.58	108337.86	-4.3	-37	24073.87
12/31/2009	25.19	-1.5	23.69	134003.09	-2.4	26.46	30443.81
12/31/2010	8.62	-1.5	7.12	143544.11	-1	15.05	35025.6
12/30/2011	17.69	-1.5	16.19	166783.9	-1.7	2.11	35764.64
12/31/2012	20.66	-1.5	19.16	198739.69	5	16	41486.98
12/31/2013	33.67	-1.5	32.17	262674.24	19.4	32.39	54924.61
1973 to 2013				14.5			10.3

Profitable in 32 of 41 one year periods, or 78% of the time
Profitable in 33 of 37 five year periods, or 89% of the time

*includes a hypothetical TABR management fee of 1.10% annual plus 0.40% to Fidelity to cover the cost of trading commissions.

For some context, one must first understand that the maximum drawdown during the same period for buying and holding the index itself was -57%, during the 2007-2009 period.

Nevertheless, because risk management is at the core of our primary philosophy, we tend to attract clients who are more conservative, and in general, conservative (and even moderate risk) investors are typically not interested in temporarily losing -50% of their capital. Yet, in order to achieve superior results, this is sometimes necessary. And, if one bails out on the strategy at its worst point, one will never achieve the results that were intended in the first place.

As we have examined numerous strategies over the years, I've often found that the highest return strategies also tend to come with the highest volatility (or drawdown). If one knows what to expect, you can deal with it. For instance, with the above history in mind, one can see that in the past 41 calendar years, you would have lost money 22% of the time, or about once every four years. The largest single year loss was just over -30%.

When the periods are extended to five years, you see that losses occurred in just 4 of 37 periods, or 11% of the time, with the worst being a -4.3% annualized loss. Can the future be different? Of course, but at least now one knows what has happened over a 40 year period in a variety of market conditions.

<u>The Premise---Why Should This Strategy Work?</u>

This strategy combines high dividends with low valuations (high earnings yield). In a 2003 study published by Rob Arnott and Cliff Asness titled "Surprise! Higher Dividends = Higher Earnings Growth," they found that firms with higher dividend payout ratios produced higher earnings growth than those with lower payout ratios. This is because management is forced to be more thoughtful about how it allocates capital, since there is less capital left over after a dividend is paid.

<u>Why Are We Introducing This Strategy?</u>

Because of historically low interest rates and poor stock valuations from a number of different methods, passive returns from stocks and bonds may be in the low single-digits for the next 10 to 15 years. Though our primary approach is active and tactical, it is not an easy task to beat market indexes. And, that is not our primary focus anyway—achieving client goals is. Fortunately, as Steve Medland and I update over 100 planning documents for clients on an annual basis, the majority of clients appear able to meet their goals in retirement by achieving investment returns in the 3.5% to 4% range, looking out 10 to 15 years and longer.

As a result, if one can be adding even an extra 1% or 2% per year over time with a portion of one's capital, it can be beneficial in helping to meet one's goals. In addition, some of our clients are interested in being more aggressive with a portion of their capital in order to seek higher returns, and this is an avenue to do that. Finally, it allows us to diversify strategies from our primary active/tactical approach which uses mutual funds and ETF's.

There were a few other relevant questions that came about in a discussion with a long-time client, and I'm covering those below.

What is the cost?
TABR's management fee for these accounts will 1.10% annually, and accounts will be segregated from existing accounts, because they will be under what is called asset-based transaction pricing at Fidelity Investments. See the schedule below:

For greater than 75 trades annually:	
0 to $250,000	0.41%
$250,000 to $500,0000	.30%

However, there is a $125 per quarter minimum account fee. I anticipate at least 27 trades per quarter, meaning at least 108 annually, which will fall under the above schedule. So, for a $100,000 account, the trading costs will not be 0.41% as shown above, but rather $500 (4 quarters X $125), which is 0.50% of $100,000. So, a $100,000 account will pay a total of 1.60% annually in total costs, which is typically going to be slightly lower than total costs of our active/tactical portfolios which primarily use mutual funds.

For those of you who use electronic delivery, you already know that the transaction costs for purchasing or selling individual equities at Fidelity is normally $7.95 per trade, so you can see if we did this in a normal account, the total costs would be over $858 annually on 108 trades, so reducing this to $500 is a benefit to the client.

Can we send additional funds to invest, or would we invest a portion of our current portfolio?
Either is fine, but as noted above, a separate Fidelity account must be established, and there is no charge for that.

What is the minimum amount to invest?
Our recommendation is $100,000, simply based on pricing, but we don't want households with smaller total portfolios to be excluded if they have a strong interest. They will have to make that decision based on the following---if you invest $50,000, the management fee is still 1.10%, but the trading costs are now 1%, because the minimum charge is $500 from Fidelity, so that makes the overall net cost 2.1% instead of 1.6%. Obviously, if the results in the future are similar to the past, it will be worth it, but we'll only know that several years from now.

What is the current dividend yield of the portfolio, and some of the names?
When we ran the screen in mid-July, the average dividend yield of the portfolio was 3.71%, which is nearly double that of the S&P 500, at 1.94%. Some of the companies passing the screen that you'll recognize include Chevron, Dow Chemical, Ford Motor, JP Morgan Chase, Kellogg, Kraft Foods, Staples AT & T and Verizon Communications.

Have you started investing in this portfolio for clients?
Not yet, but we are in the process of establishing accounts in the next several weeks, including a live account from TABR, which is a portion of the trust assets owned by my wife and I. As I hope all of you know and remember, we put our own money into every strategy we use with clients (excluding things like purchasing CDs or individual bonds). It is a way to align our interests together towards a common goal, and to have skin in the game. After all, if we don't have skin in the game, why should you?

I expect to fund our account with $100,000 sometime in September or October, with the likelihood no later than mid-to-late October, depending on market activity. Normally, favorable seasonality kicks in for the stock market during the last few months of the year, and it would be nice to put money to work into some weakness, but we can't be certain of when that will happen. An additional part of our game plan is to add an additional $100,000 when the S&P 500 has declined 20% or more from its peak. I may add another $100,000 when it drops 30%. This is likely going to happen in the next several years, but when is anybody's guess.

Even though this will be a portion of my portfolio, I'm not necessarily comfortable sitting through temporarily losing 50% or more of my capital. What, if anything, are you going to do about the maximum drawdown of the strategy?

Great question. Our plan is to take 1 or 2 of what we feel are the best performing longer term stock market risk models that we use in tactical portfolios, and apply them as follows. When Model A goes negative, we'll sell 25% of existing positions. If Model B also goes negative, we'll then sell down to a 50% invested position, still owning all of the stocks, but with fewer shares.

When Model A and B then go back on Buy signals, exposure will be increased again to 75% and then to 100%. We don't want to mess with the integrity of the stock selection process, so we will not be less than 50% invested at any time. We expect that this process will reduce the maximum drawdown of the strategy, and it may enhance returns as well, but we can't know that. It is possible that this will detract from returns. This will depend on how accurate our tactical models are in the future. For those clients who do not want us to hedge their portfolios at all, we can do that as well.

How long should I give this? A real estate analogy.

ANY strategy (fund, fund manager, advisor, etc) should be evaluated over a long period of time, typically five or more years. EVERY strategy or manager goes through under-performing periods (see above), even Warren Buffett, as I've previously written. So, part of my message is---this is not for investors who want to try it and see how it does, and then bail out because it loses money in the first 12 months. That is simply a recipe for failure.

Rather, think of it like a rental property. You buy a property for say $350,000 and rent it out, getting monthly payments (think dividend yield). As long as you have a renter, you receive predictable income, and over time, hoped for appreciation in the property (but not guaranteed). Unlike this strategy of owning dividend-paying stocks, a rental investor does not get a monthly statement showing the value of their property going up or down. Many of them think "hey, I'm getting monthly income, and if the property value does go down, eventually, it will go back up." Depending on when you buy, and where, that is mostly true. But, we've seen enough experiences with clients that the outcomes are far from consistent.

Some have had very satisfactory results over many years, but have had to withstand the ups and downs of real estate cycles. Others have had, frankly, very poor results. Here, one is getting a near 4% yield on capital, owning businesses which are growing, all without the hassle and cost of purchasing, maintaining and selling real estate.

Performance of TABR Bond, TABR Fully-Invested PBA & TABR Tactical

Below is the performance, net of management fees, of TABR's five different portfolios at present. These represent a majority of the strategies we are using in client accounts, but not all. The differences are mainly attributed to risk (example—moderate allocation versus conservative allocation or aggressive) and account size. The numbers are for the six-month period ending June 30, 2014 as well as the peak-to-peak cycle from September 2007 to June 2014.

Type of Account/Strategy	YTD	Benchmark	09/07 to 06/14^	MaxDD
TABR Tactical Moderate	+2.74%	+ 5.37%*	+ 1.07%	-25.06%
TABR Tactical Conservative	+3.27%	+ 4.96**	n/a	
TABR Tactical Bond	+4.96%	+ 3.84	+6.65%	-19.73
TABR Stock	+4.00%	+ 6.93	n/a	
TABR Fully Invested PBA	+7.03%	+ 5.52	n/a	
Vanguard Total Stock	+6.93		+6.60	-55.38
Vanguard Total IntlStock	+5.83		+0.50	-60.60
Vanguard Total Bond	+3.84		+5.00	-5.36

*consists of 40% Vanguard Total Stock Index, 15% Vanguard Total International Stock Index and 45% Vanguard Total Bond Index
**consists of 30% Vanguard Total Stock Index, 10% Vanguard Total International Stock Index and 60% Vanguard Total Bond Index
***Vanguard Total Bond Index
^ denotes annualized returns and actual period is 9/30/2007 to 06/30/2014
MaxDD stands for maximum drawdown, the worst loss from peak to trough in the period noted
Returns shown are net of management fees, and include reinvested dividends

One may notice that the Fully Invested PBA account (passive but active) is doing the best, and that the TABR Tactical Moderate account is up the least. One client had wondered if they should consider changing.

The short answer is no. Active/tactical strategies are best augmented by passive strategies. They are very different strategies, and totally replacing a tactical approach with a passive approach for one's entire portfolio would be like increasing the risk by about 50%, especially given current historical stock market valuations and low interest rates.

In the future months and market cycles ahead, we expect to integrate a portion of our equity exposure into our passive approach, all in the same account, which we expect will smooth out returns over time. For now, though, we're being careful phasing in exposure to those who want it, because we believe it is chasing the hottest strategy at exactly the wrong time. On Wall Street, the tendency of investors to chase returns is an almost sure way to the poor house.

By the way, some of you don't want all the detail we provide---you just trust us, and expect us to do our job. And, that is fine. But, we also realize that many of you do like the detail and supporting documentation, as it helps you to better understand your investments and have a better idea of expectations. To both types, please take from this what you wish. We'll always be transparent, accountable and with skin in the game, and hopefully, we'll continue to attract great clients who value those qualities.

As always, all of us at TABR are continually grateful for the trust and confidence you express in us daily.

Sincerely,

Bob Kargenian

Bob Kargenian, CMT
President