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TO: All clients and interested parties
FROM: Bob Kargenian

In this first newsletter of the year, besides detailing the good and not so good in the various parts of the portfolios last year, we have another client story, and a discussion on the difference between active and passive management as well as tactical management. We have updated research on how our relative strength method has been working with our fund selection, but this letter is too long as it is, so that will wait for next quarter. So, here we go.

Another Client Story

As we come across them, we want to continue to share client situations that go beyond the norm of portfolio management, not in a manner to boast, but rather to remind and inform our client base of the many areas that we sometimes get involved in, all as a part of serving you.

In this particular case, our client was in the process of buying a new truck, and trading in their existing vehicle, but was not particularly knowledgeable about car pricing and whether or not she was getting a fair deal. In the past, only the most astute car buyers would shell out $16 and purchase a special report from Consumers Report on the vehicle they were considering, so that they would have much of the pricing information that the dealer had, and therefore would be in a much stronger negotiating position.

Today, much if not all of this type of information is available on the Internet and is mostly free, but not everyone knows this or knows how to use it. My favorite car site for this area is www.edmunds.com.

In this case, after our client had given me the details of the car she was considering, including all the options and accessories, I entered the data into a pricing worksheet that also factors in the zip code of the area one is doing business in. After doing this, I found that the price the dealer was asking for the truck was only a few hundred dollars apart from what the true value was, indicating to me that this was a fair deal.

We conveyed that to our client, who really wanted and liked this truck, but that was not the end of it. When I entered similar information into the worksheet on her trade-in, I found that the dealer was only offering her $1500 for her truck, while the website was suggesting her vehicle was worth closer to $3500.

You never really know how much slack a dealer has in these transactions---sometimes they are more desperate than at other times (perhaps at the end of the month when they are trying to meet a quota?), but there's no doubt you will drive a better deal for yourself if you are informed. Also, I firmly believe the transactions need to be a win-win. The dealer needs to make a fair profit, and we, the consumer, need a fair price.

So, in this case, I suggested she go back to the dealer and tell them she wanted $2500 for her trade-in, and as it turned out, they gave it to her. I don't know if the dealer would have paid her the full $3500 that the website suggested, but what we do know is she was able to extract an extra $1000 out of the transaction simply by being more informed. With car buying and selling, there is no reason not to be, and in this case, it probably took us no more than about 20 minutes once we had all the information. Many of you can do this yourself, but for others, we are just a phone call away.

What is Active Management? What is Passive Indexing? Tactical?

In last quarter's newsletter, we presented research detailing the fully-invested index approach to portfolio management which is heavily favored in the industry, and introduced TABR's PBA Account (Passive But Active). This past week, we were presenting a potential solution to a client who is inheriting a fairly substantial sum from his father who recently passed away, and he asked us, "hey, can you explain to me what the difference is between active portfolio management and passive management?"

I thought the explanation might be of benefit to many of you, not just him, so here goes. Though I am going to refer to stock funds and indexes, the concept also applies to bond funds and indexes as well as other asset classes. Active managers believe you can "beat" the market by owing certain companies which are "undervalued" or exhibit superior "growth" characteristics. Therefore, in their funds, they may own only 100 or 200 companies, and in some concentrated portfolios, there may be only 30 or 40. Some active managers are almost always fully invested, and rely strictly on their stock picking abilities or process, while other active managers will at times hold substantial amounts of cash, ranging from 10% to 50%.

Some examples of mutual fund companies who are known for their active management would be the teams at Dodge & Cox, American Funds, Yacktman Funds, Weitz and FPA Crescent, run by Steven Romick. The latter three are currently holding 20%, 29% and 43%, respectively in cash as of late January. Another well known active manager is Warren Buffett, who runs Berkshire Hathaway. More on him in a moment.

Passive investing, which can also be characterized as buy and hold, is a fully invested strategy in various asset classes that is mostly associated with index funds (which can be mutual funds or ETF's ((exchange traded funds)). In an index fund, you cannot beat the market, because the index IS the market. Now, though, there are many indexes from which to choose.

For instance, the S&P 500, very widely recognized, really only represents 500 large companies. If one wants to have exposure in small companies, mid-sized companies or foreign companies, you must own different indexes. This concept applies to the bond market as well, along with other asset classes such as real estate or commodities.

Again, the concept behind indexing is the belief that you cannot beat the market, so you should just own it, keep expenses and turnover low, rebalance periodically (we recommend annually), and generally forget about the market. Set it, and forget it.

Before I convey another way to explain passive investing, I should point out that even with a so-called passive, fully-invested portfolio, one has to make several "active" decisions in regards to what index funds to buy, how much to allocate and whether they will stick with these allocations when markets inevitably change.

Another way to explain passive investing is the description given recently by Stephen McKee, the editor of the No-Load Mutual Fund Selections & Timing Newsletter, which happens to be one of the top performing newsletters for the past 15 years, according to MarketWatch and Wall Street Journal columnist Mark Hulbert.

In his February 2014 letter, McKee said "Personally, I don't get it; the advice that says do nothing in the face of a bear market. Ignore market valuations. Ignore trends. Ignore news. Ignore the possibility that you might lose upwards of 90% of your equity portfolio like it happened in the Great Depression or another 50% like it happened twice in the past 14 years."

McKee states his case with pretty strong conviction, and it's a good way to describe the process of what can be called a passive investment strategy. Because, once the money is allocated, the strategy is to do NOTHING (again, except rebalance).

By the way, McKee is a proponent of what is known as tactical investing, which is a form of active management. Tactical asset allocation (which could be called market timing) is a dynamic investment strategy that actively adjusts a portfolio's asset allocation in response to changes in fundamental, technical and/or quantitative factors. The goal of tactical investing is to improve the risk-adjusted returns of a passive investment strategy while minimizing losses.

This is the primary philosophy we utilize at TABR when it comes to money management, and is what makes us different from many other firms, but we also recognize that some of our clients would like to be more aggressive with a portion of their portfolio. This is why early last year we delved into the research using the fully invested approach, and during the fourth quarter initiated TABR's PBA Account (Passive But Active) with several clients.

There is nothing wrong with diversifying strategies---we diversify models in a number of asset classes. The key is fully understanding each strategy, the pros and cons, and being able to stick with it through thick and thin. Over the long term, which according to Hulbert (see above) needs to be at least 10 years, I believe that returns from passive and tactical investing will be about the same. There is no doubt, though, that tactical investing involves taking less risk.

I've been using the airplane analogy to describe the difference to clients in recent conversations. The "Passive" plane is about to fly into a thunderstorm, and the captain tells the passengers, buckle up, we have no choice but to fly through the storm. They go through some nauseating ups and downs, several people go to the bathroom and throw up, but 3 hours later, the plane lands safely.

The "Tactical" plane is also about to fly into a thunderstorm when the captain announces to the passengers, hey, buckle up, there is a storm ahead, but we are going to fly around it, it might be bumpy here and there, but don't worry, we'll be fine, and 3 hours later, the plane lands safely.

Which one do you prefer? There isn't a right or wrong answer, but what is most appropriate for each client, given their respective goals. Though TABR will always be known for its approach to risk management, clients do not need to go elsewhere to diversify strategies. It can all be done under our direction, which is why we created TABR's PBA Account---we think we can do this better than others. We've also initiated TABR's Stock Account, which is a fully invested strategy for the stock market which blends one of the best fundamental stock picking metrics of all time with technical analysis. It's a long term experiment we've wanted to try, and will have more on it in the next quarterly letter.

Speaking of long term, and the debate between active management and passive management, I'm willing to bet you didn't know the following about one of the greatest investors of all time.

Warren Buffett---Should He Be Fired?

A couple of weeks ago in all the reading I do to keep up on our industry, an interesting tidbit stood out that has not received very much attention. But first, I verified the data, and it was almost spot on. During the last six years (12-31-07 to 12-31-13), which includes the bear market of 2008 and the subsequent recovery, Buffett's investment arm, Berkshire Hathaway, has a cumulative return of 25.6%, which is 3.9% compounded, while the Vanguard Total Stock Market Index (VTSMX) has earned 48.5%, or 6.8% compounded. In other words, the "passive index" approach on a cumulative basis has nearly doubled Buffett's return (active management) during the past 6 years. Both strategies, it should be noted, lost over 50% of their value (maximum drawdown) during the 2008/2009 decline.

What, if anything does this mean, or prove? As you are about to see, all it means is that during the last 6 years, indexing was better than Buffett. When you change the time horizon that is being evaluated, you get different results. Below are the year-end prices of each investment (using dividend-adjusted data for VTSMX---Berkshire does not pay dividends), which allows for the computation of three different time periods.

	VTSMX	Berkshire
12-31-99	26.18	56,100
12-31-03	21.63	84,250
12-31-07	31.43	141,600
12-31-13	46.67	177,900

Last 6 years	6.8%	3.9% (compounded)
Last 10 years	8.0	7.8
Last 13 years	4.2	8.6

Now, one can see that during the last 10 years, both strategies were almost identical in return, but when you go back 13 years, Berkshire has more than doubled the return of the Vanguard fund. So, again, I ask, which is better? It depends on your time horizon, doesn't it?

What the research shows, not just with this example, but with many other studies, including those of Mark Hulbert, is that even the BEST strategies over time will experience LONG periods of underperformance. Hulbert has recently cited periods of 10 to 15 years, and that jives with the above comparison.

The problem is that most investors do not have the patience nor the discipline to stick with a strategy long enough to experience the results that the last 13 years have shown. Instead, after a few years of underperformance, many investors will jump ship, to try "something different" in hopes of doing better. Wall Street has coined this "chasing performance." Practical experience shows that most of these moves take place very near the time the under-performing strategy is about to start doing better, while the "new" strategy chosen, which of course has been doing well recently, is about to start under-performing.

Now you can see why an investor's behavior is often the biggest impediment to success. The solution is to understand the advantages and disadvantages of the strategies one is using, to expect periods of underperformance (of many years sometimes), yet to have the discipline to stay the course during poor periods. This is how successful investors become successful.

For some investors, one strategy/philosophy is enough as long as they stick with it. For others, multiple strategies may be appropriate. There is no reason that active and passive strategies cannot co-exist to help investors meet their goals. In fact, a combination of the two may very well smooth out the ups and downs of each approach.

As an aside, trying to "time" each approach is likely futile. Currently, passive investing has enjoyed an edge the past five years because in hindsight, there has been very little downside. Playing any kind of defense or holding excessive cash during this period has harmed performance. But, when you take the time horizon out to six years, it is a whole different picture. In our view, because of several stock market valuation metrics with strong reliability and a bull market that is "old" by historical standards, this is a time to be embracing tactical investment management, not shunning it.

However, that is not what many investors are doing. Instead, many are chasing what has worked recently, without any regard to risk. For those investors who have no exposure to passive management, we are recommending only up to a 25% allocation at this time. There will be a much more attractive entry point after stocks have declined 20% to 30% from current levels. As one veteran observer remarked many years ago, “if investors don’t heed the lessons of financial history, Wall Street is an expensive place to find them out.”

2013 Performance---All of It

In the first edition of this letter each year, we’ve made it a practice to review the prior year, how our various accounts did, along with the components of those accounts. It is an on-going, fully transparent report card. Some of you have an interest in the details, since it helps you understand what we are doing and our thinking, and some of you could care less. This section is for the former. For the rest of you, skip to our conclusion.

It will be broken down into categories---gold, real estate, bonds, stocks and alternatives, with the overall numbers at the end of each type of account and several benchmarks.

Gold / Gold Funds

Van Eck International Investors	-48.91%

The only thing positive about this sector is that we were rarely more than 50% invested in our typical allocation to this area. As a result, we estimate our trading lost -22.5% to the point when we liquidated all positions in late June. As mentioned in the September newsletter, we’ve eliminated allocations to this area going forward. Should we ever come up with a robust model that can handle the risk/reward better than one we’ve had, perhaps we’d take another look, but portfolios WITHOUT gold/gold stocks have done just fine for over 40 years.

Real Estate

Dow Jones Real Estate Index	1.16%
PIMCO Real Estate Real Return	-13.27%

Our model for this area had been bullish since January 2012, and generated a SELL in mid-August of 2013. The trade for the entire time period of about 20 months generated decent profits using both the IYR and the PIMCO Real Estate Real Return Fund (used in smaller accounts). However, for 2013, we estimate that accounts using the IYR (including dividends and cash) lost -2.29% and accounts using PIMCO lost -14.86%. At year-end, both of the models we use in this area were in cash, but our trend model based solely on price generated a BUY on February 24 and at that time we purchased the IYR in all accounts, since now at Fidelity, this exchange-traded fund can be purchased with no commission/transaction fee. Our relative strength model for this area remains in cash.

Bond Funds

Blackrock High Yield	9.52%
Prudential High Yield	7.23%
Principal High Yield	6.97%
JP Morgan High Yield	6.94%
American High Income Trust	6.66%
MFS High Income	6.61%

Loomis Sayles Bond	5.88%
PIMCO High Yield	5.75%
Blackrock Low Duration	1.32%
PIMCO Short Term	0.84%
Fidelity Short Term Bond	0.57%
MFS Limited Maturity	0.57%
Short Term Bond Fd of America	-0.17%
Loomis Sayles Limited Term	-0.60%
Sierra Core Retirement Fund	-1.20%
PIMCO Total Return Bond	-1.92%
Blackrock U.S. Govt. Fund	-2.19%
PIMCO GNMA	-2.37%
U.S. Govt Securities Fd (American)	-2.93%
Hussman Strategic Total Return	-8.37%

As a refresher, our bond strategies are broken down into a conservative bucket, consisting of PIMCO GNMA and the Hussman Strategic Total Return Fund, along with a more aggressive bucket consisting of Loomis Sayles Bond and typically a pairing of a high yield corporate bond fund with a short to intermediate fund (i.e. PIMCO High Yield with PIMCO Total Return and PIMCO Short Term). Other high yield corporate bond funds we use are Blackrock, Principal, American Funds, Prudential, MFS and JP Morgan. Entering 2013, we had approximately 70% of the overall bond allocation devoted to Loomis Sayles and high yield, with the other 30% devoted to GNMA and Hussman.

In May and June, though, we eliminated the position in Hussman and replaced this allocation with the Sierra Core Retirement Fund. As noted in our September newsletter, though we earned a respectable profit during the five-year plus period we have owned the Hussman Total Return Fund, we were no longer comfortable having part of our bond allocation use the tools Hussman is using for a part of the portfolio (utilities, currencies and gold stocks). So, this sleeve of our bond allocations lost -7.55% to the point of sale, and the position in Sierra lost -1.72% from its purchase dates in May and June through the end of the year. We are very comfortable with the risk management that Sierra uses, and will likely be shifting existing positions into their Strategic Income Fund soon, since it will reduce expenses, but effectively, owning Hussman in 2013 negated much of the value of our bond strategies in the other areas.

Our model for the PIMCO GNMA fund turned negative on June 10 and these funds were moved to the PIMCO Short Term Fund at that time. This combination lost -1.19% for the year, while the GNMA fund was down -2.37%.

There were a couple of sales and subsequent purchases during the year in Loomis Sayles and the various high yield funds we use. I estimate that our trading in Loomis Sayles resulted in gains approximating 3.39%, while the fund earned 5.88% and the Loomis Sayles Limited Term Fund lost -0.60%. As only one example in the high yield area, using the Blackrock funds, it is estimated we earned 5.63% for the year, while High Yield was up 9.52%, Low Duration was up 1.32% and the U.S. Government Fund lost -2.74%.

At any given time in regards to corporate high yield, we are usually 90% invested in high yield on BUY signals, with 10% remaining in the shorter duration funds, and this is reversed on SELL signals. With Loomis Sayles, we are using three different risk models, two of which are price-based and the third which has a relative strength component.

While we did not keep pace with being fully invested in high yield or Loomis all year, we made reasonably good gains, and significantly outperformed broad-based bond indexes. One should not forget that the high yield bond area lost over -25% in 2008, and our approach is designed to avoid this. Overall, TABR's Bond Account lost -0.46% for the year, while the Vanguard Total Bond Index was down -2.27%.

Stock Funds---Core Tactical Holdings

Brown Small Company	48.98%
Hodges Small Cap	45.56%
Hotchkis & Wiley Mid Cap Value	42.20% (purchased on 10-1-13)
Southern Sun Small Company	41.98%
Touchstone Sands Capital Growth	40.60% (purchased on 1-9-13)
Pro Funds Small Cap Growth	40.13%
Hennessey Focus Fund	35.33%
Alger Spectra Fund	35.06% (sold on 1-9-13)
Pro Funds Mid Cap Growth	30.16%
Yacktman Focused Fund	27.01% (sold on 10-1-13)

Our core tactical equity funds have been performing quite well in comparison to the benchmark we use, which is 75% Vanguard Total Stock and 25% Vanguard Total International Stock. The benchmark earned 28.77% last year, while the average of our five funds was up 38.22%. We'll have a complete update on this in the next letter, but clearly, over time, our fund selection methods are working. Last year, though, for the second year in a row, our various stock market risk models had us invested on average at the 49% level, causing a big lag with our stock allocations. It's tempting for many to just give up on risk management and go fully invested---hey, last year the allocation would have earned 38%. But, that is forgetting that a similar approach would have lost over 40% in 2008.

Alternative Funds

Leuthold Core Investment	19.18% (Leuthold Asset Alloc merged into this on Nov. 8)
Marketfield Fund	16.93%
PIMCO All Asset All Authority	- 5.90%
Hussman Strategic Growth	- 6.62%

At the risk of re-hashing what we've already explained in the September letter, this area of the portfolios is what caused the most heartburn in 2013. Simply put, too much allocated to

Hussman and PIMCO when they had horrible years. The overall allocation to this area has been reduced to about 10% of portfolios, with no more than about 3.5% in any one of them, and about 2% on the lower end. So, there is very little over-weighting.

It would not surprise me if this area is one of the strongest in 2014, just as many investors want to throw some of them in the trash---remember the data on Buffett above.

Below is the performance, net of management fees, of four real-time portfolios we are tracking. 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 one-year period ending December 31, 2013, as well as the peak-to-peak cycle from September 2007 to December 2013.

Type of Account/Strategy	**YTD**	**Benchmark**	**09/07 to 12/13^**	**MaxDD**
TABR Moderate Risk	+1.83%	+ 14.57%*	+ 0.72%	-25.06%
TABR Conservative Risk	+0.70%	+ 10.14**	n/a	
TABR Bond Account	-0.46%	- 2.27	+6.37%	-19.73
Vanguard Total Stock	+33.35		+5.90	-55.38
Vanguard Total IntlStock	+15.05		-0.40	-60.60
Vanguard Total Bond	-2.27		+4.70	-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 12/31/2013
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

In Closing

We're certainly disappointed in our "numbers" the past two years relative to fully invested benchmarks. I'm sure Warren Buffett is disappointed in his own numbers as well in the short run. As noted, all strategies go through periods like this, and it does not mean they are a failure and should be abandoned. This is when discipline and patience are most necessary, especially in light of a historically aging bull market and an incomplete market cycle.

We've made significant changes in our overall allocations since last June to address the question of upside capture, without compromising the risk management approach that TABR is known for. The results will not be evident until more time passes, but the results have been encouraging on both the up and downside since all changes were implemented last October.

We’ve also introduced other strategies that may appeal to some of our clients who may want to be more aggressive with a portion of their capital. In many ways, given the position of markets and this point in the cycle, we are feeling like an undervalued stock. Our expectation is to prove our value in the coming months and years, when investors will need it most, if history is any guide. Our humble aim is to help you meet your goals with much less risk following a structured, disciplined approach. We’re so grateful for the trust and confidence you express in us daily.

Pressing On,

Bob Kargenian

Bob Kargenian, CMT
President

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