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Find Bonds Confusing? Here Are the Basics You Need to Know

For nearly 30 years, declining inflation and interest rates have perpetuated a massive bull market in bonds, producing excellent total returns. But with interest rates driven to dramatic lows by Federal Reserve policy, it's only a matter of time until the pendulum reverses course and bond investors will be forced to deal with a new landscape of rising interest rates.

That means it's more important than ever to understand the basics of bonds and the factors that influence the bond market's risks and returns. Let us introduce you to the often poorly understood world of investing in bonds.

by Austin Pryor

It was wonderful to be young and working on Wall Street in the 1980s: never before had so many unskilled twenty-four-year-olds made so much money in so little time... There has never before been such a fantastic exception to the rule of the marketplace that one takes out no more than one puts in.

So begins *Liar's Poker*, Michael Lewis' fascinating and often hilarious book on his experiences working in the bond market. He starts by telling of an incident that took place in 1986, and which he claims became a legend at the firm he worked for, Salomon Brothers. To dispel any pre-conceived notions you may have that the bond market is too boring to warrant your interest, I'm going to share part of it with you. It begins when John Gutfreund, Salomon's chairman, walked out onto the bond trading floor to have a few words with John Meriwether, one of his top bond traders.

He whispered a few words. He said, "One hand, one million dollars, no tears." Meriwether grabbed the meaning instantly. Gutfreund wanted to play a single hand of Liar's Poker, a bluffing game played with the serial numbers on dollar bills. For a million dollars! Normally

his bets didn't exceed a few hundred dollars. A million was unheard of. The final two words of his challenge, "no tears," meant that the loser was expected to suffer a great deal of pain, but wasn't entitled to whine about it. He'd just have to keep his poverty to himself. It seemed an act of sheer lunacy. Meriwether was the King of the Game, the Liar's Poker champion of the entire bond trading floor. He and the young traders who worked under him were obsessed by the game. They regarded it as their game. And they took it to a new level of seriousness.

People like John Meriwether believed that Liar's Poker had a lot in common with bond trading. It tested a trader's character. It honed a trader's instincts. The game has some of the feeling of trading, just as jousting has some of the feel of war. The bond traders of Morgan Stanley, Merrill Lynch, and other Wall Street firms all played some version of Liar's Poker. But the place where the stakes ran highest, thanks to John Meriwether, was the New York bond trading floor of Salomon Brothers.

I'd like to tell you what happened that fateful day, but that would spoil the fun. If you're interested, buy Lewis' book. You'll learn a lot about Wall Street, the bond market, and the revolutionary changes that took place in

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"FOR GOD HAS NOT GIVEN US THE SPIRIT OF FEAR BUT OF POWER, AND OF LOVE, AND OF A SOUND MIND."



EDITORIAL

Practicing What I Preach

Have you ever wondered how I invest *my* money? You're too polite to ask, but likely curious all the same: "Does this guy invest for his retirement the same way he tells me to invest for mine?" With my annual rebalancing behind me, it's fresh in my mind and I'm happy to tell you about it.

I've tailored a strategy to fit my own sense of risk, need for stability, and desire for growth. The result is a retirement portfolio that is personalized to *me*. My allocations aren't intended to be a blueprint for anyone else to follow. I'm in my late 60s; the portfolio of a younger investor will look quite different. That's why I've asked SMI's executive editor, Mark Biller, to weigh in with his comments as well. (You'll see his remarks in italics.)

As you probably know, I'm big on diversification. I reflect this in my personal investing by carving my retirement plan assets into four pieces, each reflecting a different *strategy* of investing. Taking them together, my money is spread across many classes of assets. Each strategy is mechanical,¹ so I don't have to agonize over when to make changes and what they should be. Perhaps it will encourage you to see that I continue to use the same strategies we recommend in SMI. So, here we go:

• **40% in SMI's Dynamic Asset Allocation (DAA) Portfolio.**

This strategy was designed specifically to hold up well during bear markets. It has a built-in defensive capability that periodically moves completely out of stocks into cash, bonds, and other better-performing asset classes. At my age, I need to shift my primary focus from *growing* my capital to *protecting* my capital.

MB: Over the past year, we've suggested a 50% DAA, 40% Upgrading, 10% Sector Rotation "default" portfolio to SMI readers. Austin is below that 50% DAA level here, which makes sense given the additional 30% he's allocating to bonds (see next item). A total of 70% in DAA and bonds is quite conservative but fitting for his season of life. Personally, I have about 44% of my portfolio allocated to DAA as 2015 begins, a percentage that is likely to grow as I pare back my SR holdings over the next year or two.

• **30% in Bonds.** This represents one-half of my remaining assets. Given my season of life, it's prudent to have a hefty fixed-income allocation. I divided my bond portfolio into two parts. The larger share goes to SMI's *new* bond Upgrading strategy, unveiled last month.³ I really like its flexibility. A smaller share stays in one of SMI's *former* bond recommendations—the Scout Unconstrained

Bond Fund. It didn't have a great 2014, but the managers have a superior long-term record and I'm giving them more time to shine.

MB: At age 42, I don't have any money allocated specifically to bonds (although DAA may own some from time to time). Also, Austin explains his bond allocation differently than how we normally suggest readers approach their stock/bond allocation within Upgrading. But it's really no different than allocating 40% of the portfolio for Upgrading (the 30% Bond and 10% Upgrading piece—see below), then dividing that portion 25% to stocks and 75% to bonds. That may seem too heavy a bond allocation, but this is partially to offset Austin's ownership interest in SMI's business which already significantly ties much of his income and net worth to the stock market.

• **20% in SMI's Sector Rotation (SR) Strategy.** With 70% of my portfolio invested conservatively, I'm venturing out on the risk scale in search of returns higher than those DAA or bonds are likely to provide. SR has done great the past two years, and I'm back for (hopefully) more.

MB: There's the old gunslinger! But note how Austin offsets higher risk here with lower risk elsewhere. In my portfolio, my SR allocation will gradually shrink from almost 25% at present to around 15% as this bull market ages, with that money shifting to DAA.

• **10% in SMI's Fund Upgrading Strategy.** Despite a stumble in 2014, I continue to expect Upgrading to produce market-beating returns. Ten percent may seem like a small allocation to our flagship strategy, but I look at it as one-third of the 30% I have left for stock investing (after setting aside the DAA and bond allocations). I could have split that evenly between Upgrading and SR with 15% each, but was willing to tilt toward the higher-risk, possibly higher-return strategy given how conservative the rest of my portfolio is.

MB: I have slightly more than a quarter of my portfolio invested in 100% stock Upgrading. Both Austin and I are a little light on Upgrading and heavier on SR—make sure you have a wrought-iron stomach/risk tolerance if you choose to make a similar tradeoff!

There you have it—my personalized investing plan for 2015. Feel free to borrow from it, but be sure to reshape it to fit your temperament, investment goals, and level of understanding.

Once your plan fits comfortably, hopefully you'll be able to stay with it during the occasional tough times. That's one of the keys to long-term investing success.


AUSTIN PRYOR
FOUNDER/PUBLISHER

NECESSARY CAUTIONS

It should not be assumed that all investment recommendations will necessarily be profitable. The information published in SMI is compiled from sources believed to be correct, but no warranty as to accuracy is made. SMI is not responsible for any errors or omissions. The counsel given herein is not a substitute for personal legal or financial planning advice.

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Find Bonds Confusing? Here Are the Basics You Need to Know

(continued from front page)

the 1980s. (Warning: Rated PG-13 for offensive language. A lot of the people who work on Wall Street seem to have limited vocabularies.) I won't promise that if you pay attention to what follows, you'll end up playing Liar's Poker on Wall Street. But I am sure that you'll have a better understanding of bonds: what they are, how they work, and why they should be included in your portfolio if increased stability is your goal.

Bonds are simply IOUs

America's largest banks and corporations (not to mention our local, state, and federal governments) need your help—they'd like to borrow some of your money. To make sure you get the message, their ads are everywhere. The *government* promotes safety of principal and has created certain kinds of bonds with special tax advantages. *Banks* want your deposits and want you to know your money is safe with them because it's "insured." *Bond funds* tantalize you with suggestions of still-higher yields, although in their small print they remind you that "the value of your shares will fluctuate." And of course, *insurance companies* promote the tax-deferred advantages of their annuities. You're in the driver's seat. To all these institutions, you're a Very Important Person.

Does the thought of "renting" out your money seem strange? Chances are, you do it all the time. You probably think of it as buying a certificate of deposit (or Treasury bill, bond, or fixed annuity), but actually, you're making a loan. The "rent" you're being paid is called interest. In the financial markets, investors with extra money (lenders) rent it out to others who are in need of money (borrowers). The borrowers give their IOUs to the lenders.

Bonds are basically IOUs, kind of like bank CDs. They are a promise to repay the amount borrowed at a specified time in the future. The date on which the bonds will be paid off is called the maturity date and may be set at a few years out or, believe it or not, for as long as 100 years away. On the maturity date, the holder of the bond gets back its full face value (called par value). In order to make bonds affordable to a larger investing public, these IOUs are usually issued in \$1,000 denominations.

Bonds promise to pay a fixed rate of interest (called the coupon rate) until they mature (are paid off). *This rate doesn't vary over the life of the bond.* Remember that. Once the rate is set, it's permanent. That's why bonds are referred to as "fixed-income" investments. As we'll soon see, *it's the unchanging nature of the interest rate that causes bonds to go up and down in value.*

Why buy bonds?

If you want to protect your principal and set up a steady stream of income, then bonds, rather than stocks, are the answer. Current income is traditionally the most important reason people invest in bonds, which usually generate greater current income than CDs, money-market funds, or stocks.

They also can offer greater security than most common stocks since an issuer of a bond will do everything possible to meet its bond obligations. (Even Donald Trump accepted a humbling at the hands of his banks in order to gain the money necessary to meet his bonds' interest payments.)

The interest owed on a corporate bond must be paid to bondholders before any dividends can be paid to the stockholders of the company. And it's payable before federal, state, and city taxes. Being first in line helps make the investment safer.

While time is passing, many things can happen to interest rates or to the bond issuer (whoever borrowed the money from investors in the first place) to affect the value of the bonds. The more distant the maturity date, the more time for things to potentially go wrong. That's why bonds with longer maturities carry more risk than ones with shorter maturities.

A bond investment example

Let's learn how bond values fluctuate by working through an example. Assume XYZ Inc. wants to borrow \$200 million for advanced research and doesn't want to have to pay the loan back for 30 years. Banks generally don't like to lend their money out for such long periods of time, so the company decides to issue some bonds. Let's say that XYZ agrees to pay a coupon rate of 6% annual interest. Bond traders would call these bonds the "XYZ sixes of '45." (XYZ will pay 6% interest and repay the loan in 2045.) No matter what happens to interest rates over the next 30 years, XYZ is obligated to pay investors 6% per year on these bonds. No more. No less. If you purchase one of these new XYZ bonds, you will receive \$60 per year from XYZ on your \$1,000 investment (6% times \$1,000). Since bond interest is usually paid twice a year, you would receive two checks for \$30 spread six months apart.

The simplest transaction would work this way. Assume that when XYZ first sells its bonds (through selected brokerage firms), you buy one of these brand-new bonds at par value. In effect, you lend XYZ \$1,000. You collect \$60 interest every year for 30 years. It doesn't matter how high or how low interest rates might move during this period, you're still going to get \$60 a year because that was the deal that you and XYZ agreed to. Finally, in 2045, XYZ pays back your \$1,000. You made no gain on the value of the bond itself; your profit came solely from the steady stream of fixed income you received over the 30 years.

XYZ bond risk #1: You might not get all your money back

The pros call it "credit risk" because you're depending on the creditworthiness of the borrower. You're taking the risk that the issuer of the bond might go into default. This means the borrower is not able to keep up its interest payments or even pay off the bonds when they mature. This is the worst-case scenario that faces all bond investors.

To help evaluate this risk, ratings are available that help determine how safe the bonds are as an investment. Standard & Poor's and Moody's are the two companies best known for this.¹ There are nine possible ratings a bond can receive. Most bond investors limit their selections to bonds given one of the top four ratings—AAA, AA, A, and BBB. As you might expect, the lower the quality, the higher the rate of interest investors demand to reward them for accepting the increased risk of default.

By definition, all other domestic borrowers are less creditworthy than the U.S. government. Therefore, borrowers who are in competition with the federal government for your money *must* pay you more to give you an incentive to lend to them instead of Uncle Sam. That's why U.S. Treasury bills (most commonly 90-day IOUs)

¹While these ratings are the best readily-available measure of a bond's safety, be aware that these ratings proved to be unreliably optimistic for a small number of high-profile companies during the 2008 financial crisis.



establish the floor for interest rates. Other rates are higher than the T-bill rate depending on how creditworthy the borrower is.

Returning to our earlier example, if XYZ gets into trouble due to poor management and earnings, its ability to pay off its bond debts may come into question. Assume its quality rating is lowered from AAA to A, and that shortly thereafter you need to sell your XYZ bond to meet an unexpected expense. A buyer of your bond will now want a greater potential profit to reward him for the greater perceived risk of default. As a practical matter, it may seem to be a very minor increase in risk, but the buyer will want compensation nevertheless.

But remember, the interest that XYZ pays on these bonds is fixed at \$60 per year and can't be changed. The only way anyone buying your bond can improve his profit potential is *if you will lower the price of your bond*. Then, in addition to the interest received from XYZ, the buyer will also reap a profit when he ultimately collects \$1,000 (if all goes well) for a bond he bought from you for only, say, \$900.

Thus, as the quality rating of a bond falls, sellers must lower their asking prices to make the bond attractive to potential buyers. Always remember that a bond can become completely worthless if the issuer gets into financial difficulty and defaults.

How can you minimize the credit risk? One way to virtually eliminate it is to stick solely with U.S. Treasuries. The drawback, however, is that because U.S. government bonds are regarded as the world's safest fixed-income investments, the interest rates they pay investors are lower than those of corporate bonds. The most common way to minimize the credit risk is to add safety through diversification. Spread your holdings out among many different bond issues. That's one of the primary advantages of investing in bonds through a mutual fund.

XYZ bond risk #2: Getting locked into a below-market yield

This is referred to as the "interest-rate risk." It's the same dilemma you face when trying to decide how long you should tie up your money in a bank CD, but it has even greater significance when investing in bonds. If you invest in a two-year CD and it turns out that rates go up and a six-month CD would have given you more flexibility to take advantage, you're only missing out on better rates for 18 months. Try making that 18 *years*, and you get an idea of how painful it can be to hold long-term bonds during a period of rising interest rates when new bonds are being issued with higher coupon rates.

A fear of inflation leads to rising long-term interest rates. Just for the moment, assume that you're back in 1980 and inflation is running at 12% per year. Now ask yourself this question: Would you be willing to pay full price for a 30-year Treasury bond with an 8% coupon rate? Not likely. A \$1,000 bond would be paying you only \$80 in interest per year at a time when you need \$120 just to keep up with inflation. You'd be agreeing to a deal that would guarantee you a loss of purchasing power of \$40 each year. Eventually, you'd get your \$1,000 back, but it wouldn't buy nearly as much in the future as it does now.

But what if the seller would lower the price of the bond so you could buy that bond at a big discount? If you only had to pay \$665 for a \$1,000 bond, it might make economic sense. The \$80 interest per year—remember, the coupon rate stays fixed

throughout the life of the bond—would represent a 12% return (\$80 received in interest divided by the \$665 invested). Now, at least you're even with inflation. Plus, when the bond matures down the road, you get a full \$1,000 back for your \$665. That's 50% more than you paid for it.

So you can see that high inflation (or even the fear of high inflation) causes bond buyers to demand a higher return on their money to protect their purchasing power. And to create that higher return, bond sellers must lower their asking prices. That's why the bond market usually goes down when any news comes out that could reasonably be interpreted as leading to higher consumer prices. And it's why bonds tend to perform so well when inflation expectations are low, as has been the case in recent years.

Here's how this affects your XYZ bond. Although you originally intended to hold onto your XYZ bond for the full 30 years, real life is rarely quite that simple. Very few investors hold onto their bonds for so long a period of time. Let's say that you decide to sell your XYZ bond and use the money to take the family to the beach this summer. You want your money back *now*, not in 2045.

Where do you sell it? In the bond market where older bonds (as opposed to new ones just being issued) are traded. Your broker can handle it for you. Assuming that XYZ is still in tip-top financial condition with a AAA credit rating, you might expect to get all of your \$1,000 back. Well, maybe you will, and maybe you won't. The big question is: *what is the rate of interest being paid by companies that are now issuing new bonds?*

If the rate of interest being paid on new bonds is higher than what your bond pays, you've got a problem. Assume that interest rates have gone up since you bought your XYZ bond, and that new bonds of comparable quality are now paying 7%. Why would any investor want to buy your old XYZ bond that will pay him only \$60 per year in interest when, for the same price, he can buy a new one that will pay \$70? Obviously, he wouldn't. So, to sell your bond you will have to reduce your asking price below \$1,000 to be competitive and attract buyers.

On the other hand, if interest rates have *fallen*, to let's say 5%, then the shoe is on the other foot. Your old bond that pays \$60 per year looks pretty attractive compared to new ones that pay only \$50. This means you can sell it for a "premium," meaning more than the \$1,000 par value you paid.

Here's the lesson: anytime you sell a bond *before* its maturity date, it will either be *worth more* than you paid for it (because interest rates have gone down since you bought it) or *worth less* than you paid for it (because interest rates have gone up since you bought it). That's why it's possible to lose money even with investments like U.S. Treasury bonds. For example, the average long-term government bond temporarily lost approximately -11% in only three months during the summer of 2013 as the Fed began talking about ending its stimulative Quantitative Easing program. In that case, just the *prospect* of higher future interest rates was enough to cause the bond market to decline sharply. Treasuries are safe from default, but no bond can fully protect you against rising interest rates *unless* you hold it until it reaches maturity. That's why if you hold onto your XYZ bond until 2045, it will be worth \$1,000. At that time, XYZ will repay the par value to whomever owns its bonds.

However, the longer you must wait until maturity, the longer



you are vulnerable. The closer you get to a bond's maturity date, the more the bond's price reflects its full face value. That's why interest rates eventually lose their power to affect the market value of a bond. How can you shorten the wait and reduce the risk? Buy old bonds that were issued many years back and are now only a few years from their maturity. There are "short-term" bond funds that specialize in just such securities. The shorter the maturity, the less volatile a bond's (or bond fund's) price will be.

Buying bonds through mutual funds

There are many varieties of bonds. You can choose from among high-quality bonds or higher-risk, higher-yielding ones of lower quality. You can vary the maturities—seeking to keep your average maturities at four years or less, or going for better yields (and more risk) with maturities of 20 years or more. The interest paid on some bonds is tax-free, and for others the interest is taxable. Some bond investors limit themselves to the U.S. market, whereas others invest overseas. Now imagine that you started mixing and matching all these possibilities to see how many different combinations are possible. The answer? A lot!

Why worry about all this when you can have a professional bond manager put together a portfolio for you? Investing in a pre-assembled portfolio via a bond *fund* offers convenience and professional management, plus you get great diversification which adds to safety. But there is one drawback you should know about—*bond funds never reach maturity*. Whereas the diversification you get in a bond fund lowers risk, the lack of an ultimate maturity date increases risk. Here's why.

The job of the bond fund manager is to maintain the average maturity of the fund's portfolio at the level stated in its prospectus. For example, look at our three recommended bond funds on page 26. Note their "duration," third column from the right. Duration is expressed in years, similar to the maturity date, but one that additionally takes into account the interest being received along the way. The duration of a bond fund can tell you roughly how much its value is likely to change in response to a change in interest rates. For every percentage point (1%) change in interest rates, the fund's value will move in the opposite direction by a percentage roughly equal to the fund's duration. For example, our recommended short-term bond fund, BSV, recently had an average duration of 2.7. This duration figure means that *if interest rates were to rise* one percent this year, the value of the bonds in this fund would *fall* approximately 2.7%. As with the maturity date, the longer the duration, the greater the risk of the bond fluctuating in value.

Each of the three current recommendations is tailored to either a short-, medium-, or long-term emphasis. As time goes by and bonds get closer to their maturity dates, the portfolio manager will replace some of the shorter-term bonds with longer-term ones in order to keep the average within the stated range. That's why, although time is passing, bond funds never get close to a day when the entire portfolio matures and cashes out whole. There is no final maturity date when all the IOUs in the portfolio will be paid off, and thus no guarantee you'll get all of your investment back.

This is different from what takes place if you buy an individual bond.¹ Assume you invest in a bond that has a 15-year maturity. Each year, it moves closer to the date when it will be paid off. That means the tendency of your bond to experience

wide price swings in its current market value (due to fluctuations in interest rates) is reduced year by year. Eventually, there will come a time when you will receive all your money back. This is not an assurance that investors in most bond funds have.

SMI's approach to bond investing

All of this naturally leads to the question, what maturities should you buy, particularly in light of today's incredibly low (by historical standards) interest rates? SMI's latest answer to this question was provided last month in the article detailing our new bond Upgrading approach.² After relying on Vanguard bond index funds for a number of years, SMI introduced a couple of actively managed funds to our Upgrading lineup in 2014. This shift was begun in anticipation of what many expect to be a rising interest-rate environment over the next several years.

However, those rising interest rates have yet to materialize. With much of the global economy struggling under the weight of massive debt loads and unfavorable demographic trends, it's an open question whether the next few years will involve higher interest rates—as most experts have expected, and continue to expect—or whether these deflationary forces will keep interest rates low for a while longer.

It's a crucial question, given the significantly higher returns *and risk* involved with longer-term bonds. Both of these facts are illustrated in the table. Long-term bonds have provided significantly better returns, but there's little question that they will suffer much more when interest rates finally start rising. Because of this uncertainty, our desire was to move away from the fixed bond allocations SMI has utilized in the past. We found what

PERFORMANCE OF AVERAGE BOND FUND BY RISK CATEGORY

Risk Category	15-Year Average	Relative Risk
Cat 3: Long-Term	7.8%	3.08
Cat 2: Intermediate	5.2%	1.16
Cat 1: Short-Term	3.6%	0.65

we believe will be an effective way to do so by implementing an Upgrading approach to the bond market that will rotate part of our bond holdings among bond funds of different types and maturities. This Upgrading recommendation is paired with *constant* allocations to Vanguard's short-term and intermediate-term index funds, which provide a core of stability to our bond portfolios.

At present, SMI's bond Upgrading recommendation is Vanguard's long-term bond index fund. But if rates rise, the momentum scores of the various bond options will shift, and the built-in Upgrading mechanism will tell us to sell that fund and move into a different, presumably lower-volatility, alternative.

In our Just-the-Basics strategy, we use a middle-of-the-road approach by investing in a bond fund that currently has a duration of just under six years. On the risk ladder, it falls into our intermediate-term bond group (bond Category 2). For the 15 years ending December 31, 2014, it generated an average annual return of 5.5%, right in line with the average for that group. Furthermore, it did so with less volatility.

And of course, our Dynamic Asset Allocation strategy also is invested in bonds at times. This strategy utilizes bonds somewhat differently, however, in that it will always utilize long-term bonds (when it calls for bonds at all). When DAA calls for exposure to a category, it wants that exposure to be pronounced! Of course, the protection within that approach is the ability to exclude bonds altogether when they aren't performing well. ♦

Strengthening Your Foundation

Wise money management begins with a strong financial foundation. In this column, we cover topics such as how to manage cash flow, apply strategies for getting debt-free, make wise purchasing decisions, build savings, choose appropriate insurance protection, navigate marital financial issues, and many more.

“By wisdom a house is built, and through understanding it is established.” Proverbs 24:3

INSURANCE INSIGHTS: CHOOSING BETWEEN TERM AND WHOLE LIFE

by Mike Cave¹

Having sold hundreds of whole-life (or *cash value*) policies in my career, I’m familiar with the arguments in their favor. This is the story of how I moved from whole-life enthusiast to skeptic.

When I began my career in 1977, I received most of my training from my company, one of the top insurers in the industry. As the years passed, I started having doubts about whether selling families whole-life policies was really the best way to help them.

The process was triggered when a client—a computer programmer—showed me a formula that calculated the internal rate of return of a policy’s cash value. That analysis—information I never received in my training—gave me a deeper understanding of the charges and rates of return with a cash-value policy.

Adding to my discomfort was my growing awareness of the biblical emphasis on debt repayment. The much higher premium required for whole-life insurance (as compared to term insurance) often absorbed money families could put toward paying down debt.

The final leg of my journey began in 1990 when I subscribed to *Sound Mind Investing* and started to appreciate the superior long-term return of stocks vs. bonds. This was significant because a whole-life policy is really a long-term investment (tucked inside an insurance wrapper) comprised mostly of bonds and other fixed-income securities.

The more I reflected on these facts, the harder it was to promote my whole-life products. I didn’t exit the insurance business entirely, but I stopped selling whole-life policies in 1993. Since then, developments such as the introduction of the Roth IRA, which dramatically eclipses the tax advantages of cash-

value insurance policies, have further confirmed my decision.

How does insurance really work?

The main difference between whole-life insurance and all other insurance is that while other insurance *may* pay a claim (i.e., if certain events occur), whole life *will* pay a claim (because we all die). Thus, whole life must do something no other insurance does: accumulate a fund to be able to pay the inevitable claim at death. The fund within each policy designed to do this is called “cash value.”

Term-life insurance, by contrast, is pure insurance. The premium charged is based strictly on the insured person’s life expectancy plus a relatively small commission for the agent and profit for the insurance company. Statistics tell us that out of 1,000 healthy 40-year-old males, two will die before reaching age 41. How much would it cost for each of these men to have a \$100,000 term policy? Since \$200,000 will be needed to pay the two expected claims, the insurance portion of the premium would be \$200 (\$200,000 divided by 1,000 policies).

Now, let’s consider whole life. It combines the insurance aspect of term with an accumulating fund. As the cash-value fund grows, the death risk becomes gradually *self-insured*. Within a whole-life policy for a healthy 40-year-old male, this combination of insurance and savings requires a higher annual premium—say \$1,200. This pays for the insurance (\$200), a commission for the agent, profit for company, and the cash-value fund—although this fund usually doesn’t start accumulating until the second year.

It’s important to understand that insurers profit much more from *saving* for you (they earn more on your savings than is credited to your account) than from *insuring* you! This explains why the industry promotes whole life

so aggressively and agents are paid more for selling whole-life policies.

The fundamental difference between whole life and term—the cash value—makes whole life an investment product and it should be evaluated as such. Following are the three most important characteristics of the investment within a whole-life policy.

- **Transaction costs.** The expense load is by far the highest of any common financial product. Therefore, buying term and using the premium savings to pay down debt or invest will grow your net worth more quickly.

- **Rate of return.** If you pay a high transaction cost to enter, you might hope the rate of return would make up for it. However, insurers invest 80%+ of cash values in bonds, mortgages, policy loans, and cash. Since 1926, Vanguard says stocks have generated an average annual return of just over 10% compared to 5.5% for bonds. The buyer of whole life makes the longest possible commitment (until death), but for bond-like returns. (“Variable-life” policies address this weakness, but not optimally.)

- **Taxation.** This used to be a major plus for whole-life insurance since cash values accrue on a tax-deferred basis, and if held until death, become tax-free as life-insurance proceeds. But Roth IRAs dwarf cash-value insurance as a tax shelter.

During the contribution stage, whole life and Roths are similarly funded with after-tax dollars. Whole life is tax-free if kept until death, as is a Roth. But if the insured cashes in the whole-life policy before death, as many people do, any gains are taxed as ordinary income. Contrast this with the Roth, which allows you to withdraw all money tax-free if you are over age 59½ and the account has been open at least five years.

(continued on page 28)

Developing Your Investing Plan

Investing decisions are best made as part of a comprehensive personalized plan. In this column, we focus on topics that will help you implement an investment strategy that takes into account your personal goals, attitude toward risk-taking, and current season of life. We explain investing essentials, discuss SMI's core investing strategies, and help you decide which is best for your situation.

"The plans of the diligent lead to profit as surely as haste leads to poverty." Proverbs 21:5

HOW TO CALCULATE YOUR PORTFOLIO'S RATE OF RETURN

How did your investments perform last year? It's an important question, and at first glance, it seems like it should be easy to answer. However, when you consider any contributions or withdrawals you made and whether you received any interest or dividend checks, the math can start to look much more complex. And, while some brokers do a good job with this analysis, what if you have money at more than one broker?

Not to worry. If you know just four facts about your investments—the starting balance, how much you contributed, how much you withdrew (including interest and dividends you received), and the ending balance—this article will show you a relatively simple way to calculate your returns.

Some brokers make it easier than others to find the facts required for the calculation, but even if it takes a phone call, you should be able to find the numbers you need.

The returns we'll help you calculate won't be perfectly precise, as we'll give up a little accuracy in return for simplicity, but they'll be close enough

for most investors' needs.¹

In Example #1 below, steps 1 through 6 make adjustments to the ending and beginning balances in a college savings account so as to take into account a \$3,200 withdrawal and contributions of \$400 per month. In step 7, the adjusted beginning balance is subtracted from the adjusted ending balance in order to measure how much the account has gained or lost in dollar terms. Steps 8 through 10 compute an approximate average monthly balance, and step 11 gives you the gain or loss in percentage terms—in this case, a gain of 16.6%.

Example #2 shows a couple's retirement account, which is being tapped for monthly income. The ending balance is lower than the beginning balance, but this doesn't necessarily mean the account lost money on its investments. After neutralizing the effects of \$600 monthly withdrawals, the account actually generated a positive return of 7.4% for the year.

Similarly, just because an account grows in value over the year doesn't mean its investments were profitable. Example #3 shows an IRA that grew from \$26,188 to \$29,456. However,

after factoring in a \$5,000 deposit, the account actually lost 6.2% on its investments.

When comparing your investment returns with those of a benchmark such as the Wilshire 5000, remember that benchmarks assume the amount invested is unchanged throughout the year. If you're dollar-cost-averaging (investing the same amount every month), it's unlikely your results will be the same. Because you weren't fully invested for the entire period, you'll tend to do better than the averages in a down year and worse in an up year.

You can perform this calculation for each individual account you own (401(k), IRA, taxable account) or you can run it as a total across all accounts.

If you want a more accurate measure of your investment returns, you could learn how to use the IRR and XIRR functions in Microsoft Excel or another spreadsheet program, or you can buy a financial software package such as Quicken Premier. Either way, the process can be time consuming, and the additional accuracy may not be worth the additional cost or effort. Using the method shown in this article should meet the needs of most investors. ♦

EXAMPLE #1

What was the return in a college-savings account which began the year at \$17,692, ended at \$22,919, and where \$400 is added every month and \$3,200 was withdrawn on August 20?

1. Ending balance from statement	\$22,919
2. Add withdrawals for the year	3,200
3. = Adjusted ending balance	26,119
4. Beginning balance from statement	17,692
5. Add deposits for the year	4,800
6. = Adjusted beginning balance	22,492
7. Line 3 minus Line 6 = Gain for year	3,627
8. Line 3 minus Line 4	8,427
9. Line 8 times 50%	4,214
10. Line 4 + Line 9 = Avg Month Balance	21,906
11. Line 7 divided by Line 10 = Return	16.6%

EXAMPLE #2

What was the return in a retirement-savings account which began the year at \$63,440, ended at \$61,111, and where \$600 was withdrawn at the beginning of every month for living expenses?

1. Ending balance from statement	\$61,111
2. Add withdrawals for the year	7,200
3. = Adjusted ending balance	68,311
4. Beginning balance from statement	63,440
5. Add deposits for the year	0
6. = Adjusted beginning balance	63,440
7. Line 3 minus Line 6 = Gain for year	4,871
8. Line 3 minus Line 4	4,871
9. Line 8 times 50%	2,435
10. Line 4 + Line 9 = Avg Month Balance	65,875
11. Line 7 divided by Line 10 = Return	7.4%

EXAMPLE #3

What was the return in an IRA which began the year at \$26,188, ended at \$29,456, and where a \$5,000 deposit was made on April 15?

1. Ending balance from statement	\$29,456
2. Add withdrawals for the year	0
3. = Adjusted ending balance	29,456
4. Beginning balance from statement	26,188
5. Add deposits for the year	5,000
6. = Adjusted beginning balance	31,188
7. Line 3 minus Line 6 = Gain for year	-1,732
8. Line 3 minus Line 4	3,268
9. Line 8 times 50%	1,634
10. Line 4 + Line 9 = Avg Month Balance	27,822
11. Line 7 divided by Line 10 = Return	-6.2%

¹These examples treat all deposits and withdrawals as though they took place at mid-year. This method will usually get you within one percent of the account's actual return.

Broadening Your Portfolio

This column goes beyond the investing essentials taught in Level 2, introducing you to a wider range of investment securities and markets. By further diversifying your holdings, you can create a more efficient, less volatile portfolio. We also comment quarterly on the performance of the various markets, and on how SMI's fund recommendations and strategies have fared.

"Divide your portion to seven, or even to eight, for you do not know what misfortune may occur on the earth." Ecclesiastes 11:2

2014 YEAR IN REVIEW: SOLID GAINS CONTINUE, BUT VOLATILITY RETURNS

U.S. stocks rose for a sixth straight year, the bond market was surprisingly strong as interest rates unexpectedly declined, and all of SMI's strategies (except the Optional Inflation Hedges) made money in 2014. Cause for celebration all around, right?

While it was definitely a good year for investors overall, not everything was blue skies and sunshine. For starters, the healthy gains posted by the S&P 500 and other large-company dominated indexes fail to show how difficult 2014 was for small-company and foreign stocks. As the small table at right shows, the average foreign stock fund *lost* about 5% for the year. Small-company stocks performed better than that, but they suffered through a pair of 10%-plus corrections en route to total gains less than half those of their large-cap counterparts (the small-company Russell 2000 index gained +4.9%; the S&P 500 +13.7%).

In short, it was the kind of year when investors were making money, yet feeling like they should be making more. Compounding this effect was the

fact that less than 20% of U.S. equity-fund managers beat their respective benchmark, and even fewer could keep up with the S&P 500, which outperformed virtually everything else.

Still, it's difficult to complain six years into a bull market. To put these grievances in perspective, despite lagging "the market" in 2014, both Just-the-Basics (JtB) and Upgrading have gained *more than 60% in the past three years*. That's rarified air, and obviously lagging a benchmark during a period of abnormally strong returns is preferable to the type of problem presented by bear markets!

Performance table changes

Before diving into the specifics of each SMI strategy, we want to draw

2014 PERFORMANCE OF SMI'S RECOMMENDED FUNDS BY RISK CATEGORY

Risk Category	SMI ¹ Funds	All ² Funds
Cat 5: Foreign Stock Funds	-5.3%	-4.9%
Cat 4: Small Company/Growth	5.1%	4.4%
Cat 3: Small Company/Value	4.4%	4.5%
Cat 2: Large Company/Growth	10.1%	10.0%
Cat 1: Large Company/Value	9.8%	9.7%

FOOTNOTES: [1] Average of the four recommended funds for each risk category (page 26), assuming any suggested changes were made on the last trading day of each month. [2] An average of all the mutual funds in the SMI risk category shown, including both load and no-load funds.

your attention to the new performance table at the bottom of the page. In the old days, SMI's stable of options consisted of only JtB and Upgrading. But over the last decade or so, other strategies have become "mainstream" for SMI readers. We've started reflecting that shift by listing them here.

Of course, some of these strategies are relatively new and don't have long real-time track records. As most SMI readers realize, our strategies are all mechanical. We intentionally design them that way so that action is dictated by performance, rather than our expectations or emotions. This gives us confidence that our back-tested numbers are reasonably close to what would have actually happened if each strategy's rules had been in place at the time. But there's still no substitute for live performance. So in those cases where we don't have 10 full years of live performance to report, you'll see a footnoted "H" (for "hypothetical") next to any backtested results included in the table. Again, we think those numbers are valid "what would have happened" numbers, but they aren't actual, live results.

SMI's Bond Upgrading strategy presented a unique challenge. *(continued on page 29)*

A HISTORICAL LOOK AT THE PERFORMANCE OF SMI MODEL PORTFOLIOS

	U.S. Market	SMI Basic Strategies			SMI Premium Strategies			Footnotes
	Wilshire 5000	Just-the-Basics ¹	Stock Fund Upgrading ²	Bond Fund Upgrading ³	DAA	Sector Rotation	50-40-10 Portfolio ⁴	
2014	12.7%	7.5%	5.1%	8.4% ^H	13.0%	49.9%	13.6%	Results for all SMI strategies assume all transactions were made on the last trading day of the month. Transaction costs are not included because they vary from broker to broker. [1] Results assume the account was rebalanced at the beginning of each year with 40% of the stock allocation invested in the S&P 500 (VOO), 40% in Extended Market (VXF), and 20% in Total International Stock (VXUS). [2] For a 100% stock portfolio. [3] For a 100% bond portfolio. [4] For a portfolio allocated 50% to DAA, 40% to Stock Fund Upgrading, and 10% to Sector Rotation. See the May 2014 cover article for details. [5] The dollar results show the amount of profits in an account with a \$100,000 balance at the beginning of 2005. [H] Results are hypothetical from backtesting a strategy following a mechanical rules-based system.
2013	33.1%	31.2%	34.5%	1.1% ^H	16.2%	65.7%	28.4%	
2012	16.1%	17.6%	14.1%	4.6% ^H	13.9% ^H	23.3%	14.9% ^H	
2011	1.0%	-3.4%	-5.4%	6.5% ^H	1.4% ^H	-3.2%	-1.8% ^H	
2010	17.2%	20.0%	17.8%	17.9% ^H	20.3% ^H	9.1%	18.2% ^H	
2009	28.3%	33.9%	33.6%	13.5% ^H	17.6% ^H	30.5%	25.3% ^H	
2008	-37.2%	-39.3%	-38.8%	6.6% ^H	1.3% ^H	-31.5%	-18.0% ^H	
2007	5.6%	7.1%	14.3%	8.3% ^H	10.1% ^H	28.1%	13.5% ^H	
2006	15.8%	17.2%	17.4%	7.6% ^H	25.7% ^H	-1.9%	19.6% ^H	
2005	6.4%	9.0%	12.0%	2.0% ^H	8.6% ^H	46.1%	13.7% ^H	
Past 10 Years (Total Gain)	115.7%	113.7%	120.8%	106.9%	226.7%	430.3%	208.7%	
Dollar Profits on \$100,000 ⁵	\$115,700	\$113,692	\$120,830	\$106,948	\$226,712	\$430,259	\$208,708	
Annualized Rate of Return	8.0%	7.9%	8.2%	7.5%	12.6%	18.1%	11.9%	

Looking Toward Retirement

As you move through your 50s, 60s, and beyond, you face a new set of financial decisions related to reducing your investment risk and generating income from your portfolio. In this column, we address such topics, as well as those pertaining to Social Security, long-term health care, advanced giving strategies, estate planning, and other matters of importance to those nearing and in retirement.

“There is precious treasure and oil in the dwelling of the wise.” Proverbs 21:20a

THE POSITIVES—AND PERILS—OF “BACK-DOOR” ROTH IRA CONTRIBUTIONS

This article is more technical than our usual fare, but if the opening paragraph describes your situation, it’s worth taking the time to understand this particular retirement-planning option.

If you are a high-income earner and would like to contribute to a Roth IRA, a quick review of the IRS rules indicates you’re out of luck. Roth IRA eligibility starts phasing out for singles with adjusted gross income above \$116,000 and for married couples filing jointly making more than \$183,000.

However, you still have options. Your easiest Roth on-ramp may be through a workplace plan that offers Roth savings options. There are no income restrictions governing who can contribute to a Roth 401(k), 403(b), or 457 plan.

Of course, not everyone has access to such a plan. Even if you do, you still may prefer contributing to a Roth IRA. Maybe you’re planning to max out how much you can contribute at work and want to invest more via an IRA (the maximum IRA contribution for 2015 is \$5,500, or \$6,500 for those age 50 or older). Or maybe you don’t like the investment options available through your workplace plan, in which case you may want to invest only enough to take advantage of any employer match, and then do the rest of your investing elsewhere via an IRA.¹

While your high income may seem to shut you out of a Roth IRA, there’s another option to explore: making a “back-door” Roth IRA contribution. Before delving into that, here’s a quick review of what makes Roths great.

Roth IRA essentials

Two Roth IRA benefits stand out. First, while there’s no tax deduction for contributions, that money *and earnings* will be available to you completely tax-free starting at age 59½. This is the op-

posite of how a traditional IRA works: there, contributions *are* tax deductible, but money taken out in retirement is taxed at ordinary income-tax rates.

Roth advocates love to encourage young people to use a Roth because of all the years they’ll be able to generate tax-free earnings. But with longer life spans, many older people have plenty of time to enjoy those benefits as well.

A second Roth benefit is there’s no requirement to start taking withdrawals at age 70½ as there is with a traditional IRA. This provides extra time to generate tax-free earnings and enables you to pass on a tax-free income stream to heirs.

With those benefits in mind, let’s look at the ins and outs of making back-door Roth IRA contributions.

Navigating the path to the back door

While a high income may disqualify you from making *deductible* contributions to a traditional IRA, it doesn’t prevent you from making *non-deductible* contributions (as long as you’re younger than 70½). So, the first step toward making a back-door Roth IRA contribution is to make a non-deductible traditional IRA contribution. Then you can convert it to a Roth. While this back-door maneuver was once limited to those earning less than \$100,000, it is now open to all.

Sounds easy enough, right? Ah, but there’s a problem, and a potentially significant one at that.

A roadblock on the path

The process just described—making a non-deductible contribution to a traditional IRA and then converting it to a Roth—will work fine if you don’t have *other* money in non-Roth IRAs, including traditional, SEP, or SIMPLE IRAs. If you *do*, you’ll find the IRS standing guard at the back door ready to apply its “pro-rata rule” and collect taxes on a

portion of your conversion—possibly a *large* portion.

That may seem nonsensical since the back-door contribution money has been taxed already. The problem is the IRS won’t let you specify only the new, non-deductible IRA money is being converted to the Roth. In the eyes of the IRS, that non-deductible contribution is just a small portion of your total IRA assets. And in a conversion to a Roth, all of your traditional IRA assets—deductible and non-deductible contributions alike—are drawn from the same pot.

Say, for example, you have \$95,000 in prior, non-Roth IRA accounts and you make a new, non-deductible contribution of \$5,000. Your intent is to convert only the new \$5,000 to a Roth. Unfortunately, when you convert, the IRS will say 95% of the conversion amount came from the original IRA assets and only 5% of the conversion amount came from the new, non-deductible contributions. Even worse, you’ll have to go through a similar pro-rata calculation for any future conversions or distributions (including required minimum distributions starting at age 70½).

The good news is there are three possible workarounds. First, if your spouse has no other non-Roth IRA assets, this back-door approach can be undertaken in his or her name.

Second, if you have a workplace plan that accepts “roll-ins,” you could transfer all of your non-Roth IRA funds into that plan, freeing you to pursue this approach without extra tax complications. (Self-employed investors could set up a solo 401(k) for this purpose.) Just be sure to review the investment choices offered by your workplace plan. If your 401(k) offers a wide variety of options that enable you to invest as you have been, this route may be fine. If not, you may be giving *(continued on page 30)*



Basic Strategies

The fund recommendations shown for Upgrading accountholders are based primarily on their most recent “momentum” scores at mid-month (not the earlier end-of-month scores shown on this page), but consistency of performance and the portfolio manager’s philosophy and number of years at the helm are also important. Four recommendations are made in each risk category so that you can select the one(s) most in accord with your preferences and broker availability.

“Plans fail for lack of counsel, but with many advisers they succeed.” Proverbs 15:22

RECOMMENDED FUNDS FOR SMI’S JUST-THE-BASICS STRATEGY

Data through 12/31/2014	Portfolio Invested In	Performance						3Yr Avg	Rel Risk	Expense Ratio	Stock/Bond Mix				Ticker Symbol
		MOM	YTD	1Mo	3Mo	6Mo	12Mo				100/0	80/20	60/40	40/60	
Total International Stock ETF	Foreign stocks	-18.9	-4.7%	-3.9%	-4.4%	-9.8%	-4.7%	9.0%	1.46	0.14%	20%	16%	12%	8%	VXUS
Extended Market Index ETF	Small company stocks	15.3	7.6%	0.9%	6.4%	1.4%	7.6%	20.8%	1.33	0.10%	40%	32%	24%	16%	VXF
S&P 500 Index ETF	Large company stocks	24.5	13.6%	-0.3%	4.9%	6.1%	13.6%	20.4%	1.01	0.05%	40%	32%	24%	16%	VOO
Total Bond Mkt Index ETF	Medium-term bonds	9.4	5.8%	0.1%	1.6%	1.9%	5.8%	2.5%	1.01	0.08%	None	20%	40%	60%	BND

VANGUARD JUST-THE-BASICS FOOTNOTES: Just-the-Basics is an indexing strategy that requires just minutes a year to assure that your returns are in line with those of the overall market. You won’t “beat the market” using this simple strategy, but neither will you fall badly behind. Your JtB portfolio should be allocated among as many as four Vanguard funds (as shown above) depending on your stock/bond mix. For more on Just-the-Basics, see the [New Reader Guide](#) and June2012:p89.

RECOMMENDED FUNDS FOR SMI’S FUND UPGRADING STRATEGY

Risk	Data through 12/31/2014 ¹	Date Added	Scottrade Avail ²	Fidelity Avail ²	Schwab Avail ²	Performance						3Yr Avg	Relative Risk ⁴	Exp Ratio	Number Holdings	Redemp Fee ⁵	Ticker Symbol
						MOM ³	YTD	1Mo	3Mo	6Mo	12Mo						
Category 5 Foreign	1. Fidelity Intl Capital Apprec	11/14	Yes	NTF	Yes	4.1	3.0%	-1.7%	2.3%	-1.2%	3.0%	16.4%	1.39	1.14	230	1% 30days	FIVFX
	2. Marsico International Opp	12/14	NTF	NTF	NTF	-3.3	-4.1%	-1.9%	3.0%	-2.2%	-4.1%	10.5%	1.44	1.60	36	None	MIOFX
	3. Selected International	08/14	NTF	Yes	Yes	-10.8	-0.3%	-5.8%	-2.9%	-7.6%	-0.3%	13.3%	1.49	0.83	39	2% 30days	SLSDX ⁶
	4. Dodge & Cox International	05/14	Yes	Yes	Yes	-11.8	0.1%	-4.7%	-4.7%	-7.3%	0.1%	15.2%	1.53	0.64	96	None	DODFX
Category 4 Small/Growth	1. PRIMECAP Odyssey Aggr Gro	11/12	Closed	Closed	Closed	31.9	16.6%	-0.3%	8.3%	7.0%	16.6%	29.8%	1.57	0.65	139	None	POAGX
	2. Nicholas Fund	08/14	NTF	Yes	NTF	33.1	15.3%	0.8%	8.9%	8.9%	15.3%	23.9%	1.06	0.73	43	None	NICSX
	3. Fidelity Growth Strategies	10/14	Yes	NTF	Yes	28.9	13.7%	-0.1%	7.8%	7.4%	13.7%	20.6%	1.23	0.71	125	1.5% 90days	FDEGX
	4. Janus Venture T	01/15	NTF	NTF	NTF	30.6	10.2%	2.9%	12.5%	7.9%	10.2%	22.3%	1.27	0.94	118	None	JAVTX
Category 3 Small/Value	1. Vanguard Strategic Equity	06/14	Yes	Yes	Yes	24.2	13.7%	0.7%	6.5%	4.0%	13.7%	24.1%	1.25	0.29	468	None	VSEQX
	2. Ariel Fund	11/14	NTF	NTF	NTF	24.8	11.0%	1.2%	8.5%	5.3%	11.0%	24.5%	1.53	1.03	38	None	ARGFX
	3. Vanguard Mid Cap Index	12/14	ETF	ETF	ETF	25.9	13.8%	0.3%	6.7%	5.4%	13.8%	21.3%	1.15	0.09	376	None	VO ⁹
	4. Fidelity Value	06/14	Yes	NTF	Yes	19.5	11.7%	0.5%	5.6%	2.2%	11.7%	23.1%	1.18	0.76	298	None	FDVLX
Category 2 Large/Growth	1. ☎ Touchstone Large Cap Gr Y	02/15	Yes	Yes	No	20.6	10.9%	-0.1%	4.8%	4.9%	10.9%	15.4%	1.10	0.99	37	None	TIQIX
	2. Fidelity OTC Portfolio	12/14	Yes	NTF	Yes	31.4	16.5%	-0.6%	5.8%	9.1%	16.5%	23.8%	1.59	0.77	191	None	FOCPX
	3. Powershares QQQ ETF	09/14	ETF	ETF	ETF	34.7	19.2%	-2.3%	4.9%	10.6%	19.2%	24.4%	1.30	0.20	108	None	QQQ
	4. BMO Large-Cap Growth Y	12/14	NTF	NTF	NTF	27.3	14.2%	-1.1%	4.9%	8.2%	14.2%	21.6%	1.08	1.24	65	None	MASTX
Category 1 Large/Value	1. ☎ Lazard US Equity Concen	02/15	NTF	NTF	NTF	35.5	18.3%	1.2%	8.5%	8.8%	18.3%	21.2%	1.09	1.25	21	1% 30days	LEVOX
	2. Fidelity Mid Cap Value	04/13	Yes	NTF	Yes	32.1	16.7%	1.2%	8.1%	7.4%	16.7%	24.5%	1.16	0.80	130	.75% 30days	FSMVX
	3. iShares Transportation Avg	10/14	ETF	ETF	ETF	46.2	25.4%	-0.6%	8.9%	12.0%	25.4%	23.6%	1.19	0.45	21	None	IYT
	4. T. Rowe Price Div Growth	01/15	Yes	Yes	Yes	25.3	12.3%	0.2%	6.4%	6.5%	12.3%	18.9%	0.93	0.66	116	None	PRDGX
Bond Risk Categories	Vanguard L-T Bond Index ⁶	01/15	ETF	ETF	ETF	33.5	20.3%	2.1%	5.9%	7.3%	20.3%	5.7%	3.20	0.10	14.4 ⁷	None	BLV ¹²
	Vanguard I-T Bond Index	01/15	ETF	ETF	ETF	13.1	7.8%	0.5%	2.5%	2.7%	7.8%	3.6%	1.54	0.10	6.5 ⁷	None	BIV ¹⁰
	Vanguard S-T Bond Index	07/12	ETF	ETF	ETF	2.1	1.4%	-0.3%	0.4%	0.4%	1.4%	1.2%	0.39	0.10	2.7 ⁷	None	BSV ¹¹

UPGRADING FOOTNOTES: For tips on how to launch your Upgrading strategy, go to the Start Here tab on our website’s homepage. [1] **Fund Recommendations:** The funds in each risk category are selected (and ranked 1 through 4) primarily based on their momentum scores in mid-January, not the performance data shown on this report. When an owned fund is removed from this page (not when it merely shifts out of the #1 ranking), you should immediately sell that fund and invest the proceeds in the highest-ranked fund in the same risk category that is (1) available at your broker and (2) you don’t already own. The fund ranked fourth is the one which currently appears most likely to be replaced next. A telephone symbol (☎) next to a fund’s name indicates that fund is a new recommendation. See

the fund writeups in “MoneyTalk” for more information. [2] **Fund Availability:** NTF means the fund can be bought and sold free of transaction fees as long as you stay within the trading limitations imposed by Scottrade (800-619-7283), Fidelity (800-343-3548), and Schwab (800-435-4000). Policies change frequently, so be sure to verify their accuracy. ETFs trade like stocks and are typically available at all brokers for a modest commission. [3] **Momentum** is a measure of a fund’s performance over the past year and is our primary performance evaluation tool. For more, see July2014:p103. [4] **Relative Risk:** A 1.0 reading indicates the fund has had the same volatility as the market in general over the past three years. For example, a fund with a relative risk score of 1.4 would mean the fund was



Premium Strategies

The strategies on this page are available to those with an SMI Premium web membership. They can be used in combination with – or in place of – our Just-the Basics and Upgrading portfolios. These strategies have special characteristics that could make them desirable depending upon your individual goals, risk tolerance, and tax bracket. You can learn more about each strategy in the Premium section of the SMI website.

“If any of you lacks wisdom, he should ask God who gives generously to all . . . and it will be given to him.” James 1:5

DYNAMIC ASSET ALLOCATION

• **Overview:** This is a stand-alone strategy that can be used alongside (or in place of) SMI’s basic strategies. It involves rotating among six assets classes—U.S. stocks, foreign stocks, gold, real estate, bonds, and cash. Only three are held at any one time. **Who should consider this strategy:** Anyone, especially investors focused on loss avoidance

and preservation of capital. • **Pros:** Excellent downside protection, reflected in very low relative-risk score and worst-case result. Great long-term track record. • **Cons:** Can lag in up years. Emotionally challenging in making trades promptly and concentrating entire portfolio in only three asset classes.

Strategy	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Avg 12Mos ¹	Worst 12Mos ¹	Rel Risk ¹
Dynamic Asset Allocation	7.1%	4.0%	10.4%	22.4%	19.3%	8.6%	25.7%	10.1%	1.3%	17.6%	20.3%	1.4%	13.9%	16.2%	13.0%	12.5%	-13.7%	0.60
Wilshire 5000	-10.9%	-11.0%	-20.9%	31.6%	12.5%	6.4%	15.8%	5.6%	-37.2%	28.3%	17.2%	1.0%	16.1%	33.1%	12.7%	4.7%	-43.3%	1.00

SECTOR ROTATION

• **Overview:** The sector-fund recommendations in this strategy are designed to be used in combination with Upgrading up to a maximum of 20% of the stock allocation. These are special-purpose stock funds that invest in a very narrow slice of the economy. Only one fund, selected using the momentum and upgrading concepts, is held

at a time. **Who should consider this strategy:** Experienced investors willing to concentrate an investment in a single sector of the economy. • **Pros:** Very attractive long-term returns. • **Cons:** Much greater month-to-month volatility and relative risk with dramatic short-term loss potential.

Strategy	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Avg 12Mos ¹	Worst 12Mos ¹	Rel Risk ¹
Sector Rotation	39.2%	3.7%	-13.1%	54.4%	12.6%	46.1%	-1.9%	28.1%	-31.5%	30.5%	9.1%	-3.2%	23.3%	65.7%	49.9%	17.7%	-38.6%	1.77
Wilshire 5000	-10.9%	-11.0%	-20.9%	31.6%	12.5%	6.4%	15.8%	5.6%	-37.2%	28.3%	17.2%	1.0%	16.1%	33.1%	12.7%	4.7%	-43.3%	1.00

INFLATION HEDGES

• **Overview:** These mutual fund recommendations are designed to be used in combination with Upgrading up to a maximum of 20% of the stock allocation. **Who should consider this strategy:** Those who are concerned that federal budget deficits projected for the coming decade are likely to be inflationary. We expect Upgrading to do a

reasonably good job in an inflationary environment, but these investments offer *additional* protection against a declining U.S. dollar by diversifying further among gold, real estate, energy, and emerging markets. • **Pros:** Very attractive long-term returns. • **Cons:** Much greater month-to-month volatility and relative risk.

Strategy	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Avg 12Mos ¹	Worst 12Mos ¹	Rel Risk ¹
Inflation Hedges	7.5%	1.8%	18.7%	47.3%	23.3%	32.0%	30.3%	22.4%	-41.4%	48.1%	28.4%	-7.0%	11.1%	-7.2%	-0.3%	11.8%	-51.0%	1.31
Wilshire 5000	-10.9%	-11.0%	-20.9%	31.6%	12.5%	6.4%	15.8%	5.6%	-37.2%	28.3%	17.2%	1.0%	16.1%	33.1%	12.7%	4.7%	-43.3%	1.00

ENHANCED JUST-THE-BASICS

• **Overview:** This is a stand-alone strategy to be used in place of our regular Just-the-Basics portfolios. • **Who should consider this strategy:** Those currently using Just-the-Basics who are willing to do more frequent maintenance (quarterly rather than annually) and are willing to take slightly higher risks while seeking higher

returns. • **Pros:** Higher long-term returns than Just-the-Basics. • **Cons:** Greater month-to-month volatility and relative risk. Requires a quarterly review of your portfolio (made relatively easy by using SMI’s online Personal Portfolio Tracker) to see which, if any, of your holdings should be replaced.

Strategy	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Avg 12Mos ¹	Worst 12Mos ¹	Rel Risk ¹
Enhanced Just-the-Basics	-13.2%	-4.0%	-18.6%	37.6%	18.3%	20.1%	22.3%	23.6%	-44.7%	30.7%	16.1%	-5.2%	16.1%	30.2%	6.7%	6.5%	-49.9%	1.14
Just-the-Basics	-11.6%	-12.3%	-19.6%	35.7%	15.6%	9.0%	17.2%	7.1%	-39.3%	33.9%	20.0%	-3.4%	17.6%	31.2%	7.5%	5.0%	-45.4%	1.09

1.4 times (40%) more volatile than the market. See September2014:p135. **[5] Redemption Fees:** Depending on how long you hold this fund, a redemption fee may be charged by the fund when selling (for example, a fee of 1% if you sell within six months of purchase). This is not the same as the short-term trading fees charged by brokers on fund sales that take place before the broker’s minimum holding period. Fees change often and vary from broker to broker, so be sure to check with your broker for the most current information. See our broker review (Feb2012:Cover) for more details. **[6] Rotating Fund:** This bond recommendation changes periodically based on SMI’s Upgrading methodology. The Short-Term and Intermediate-Term Index recommendations below this fund selection are fixed and don’t

change from month to month. See January2015:p7 for more information. **[7] Duration:** For bond funds, this column shows the average duration of the bonds in the portfolio in years. Typically, the longer the duration, the greater the risk/reward. See Jun2012:p88. **[8] Buy SLSX** if possible, otherwise SLSSX. See Aug2014:p122 for details. **[9]** Those preferring a traditional mutual fund option can buy VIMAX where available, otherwise VIMSX. See Dec2014:p190 for details. **[10]** Those preferring a traditional mutual fund option can buy VBILX where available, otherwise VBIIX. **[11]** Those preferring a traditional mutual fund option can buy VBIRX where available, otherwise VBISX. **[12]** Those preferring a traditional mutual fund option can buy VLTCX where available, otherwise VBLTX.

¹The three data points on the far right in each of the four tables are for the Jan2000-Dec2014 period. “Avg12Mos” represents the average investor experience over 168 rolling 12-month periods from 2000-2014. “Worst12Mos” represents the worst experience during the same period.



MONEY TALK

NEW FUND RECOMMENDATIONS FOR UPGRADING STRATEGY

[When more than one fund *in the same risk category* is replaced, you should evaluate which of the newly recommended funds is the best fit for your portfolio. Those seeking the simplest method for picking new funds can simply refer to our 1-4 rankings on the “Recommended Funds” page, selecting the highest ranked fund(s) available through your brokerage. • Funds are selected with the hope they will be held for at least 12 months in order to qualify for long-term capital gains tax treatment. Nevertheless, changes are suggested when a recommended fund’s performance violates certain mechanical guidelines. Our guidelines provide objective criteria for making the decision as to when to “upgrade” to a better performing fund. When these guidelines are violated, the fund is recommended for sale even if the twelve-month holding period has not yet been met. However, a “\$” symbol following the name of the fund being sold lets you know that we still think well of the fund and its management and you might elect to continue holding the fund for a few months to achieve a tax benefit or save on transaction or redemption fees. Be aware, however, that from 2006-2010, the performance “cost” of retaining such funds has been roughly 0.5% per month. For more details, see Oct2011:p153.]

◆ **In the Large/Growth group, Marsico Focus (MFOCX, 10/2014) is being replaced.** After beating the large/growth category average in 2013 and the first nine months of 2014, this fund looked primed to deliver strong gains for us. Unfortunately, despite a December rally that earned it a brief reprieve, its overall performance during the last quarter of 2014 was below average for its category. The fund has fallen out of the top quartile, which means it’s time to upgrade.

• **Touchstone Large Cap Growth (TIQIX) is being added.**¹ SMI members who have been around a while may remember us recommending this fund twice back in 2011-2012. The fund is run by well-known growth manager Louis Navellier, a newsletter author himself who made his name back in the late 1980s with several consecutive years of eye-popping returns.

His track record since then has been more hit and miss, but that’s not particularly unusual and can still be useful for Upgrading’s purposes. This fund has occasionally lagged when the market gets hot, but it seems like a good fit for the type of ebb-and-flow market we seem to be in at present. Of course, none of that would matter if it weren’t near the top of our momentum rankings. But it is, so we’re adding it this month.

Note that TIQIX was below the quartile at the end of December, which is where it will show up in the Tracker and FPR. Its strong performance during January brought it up to the 3rd percentile by late in the month, when it was the highest ranked available fund in our large/growth group.

◆ **In the Large/Value group, iShares S&P 100 (OEF, 11/2014) is being replaced.** Over the roughly three months this fund has been recommended (through Jan 25), OEF has posted a gain of +4.7%. That’s pretty strong in absolute terms, but not strong enough to keep the fund from slipping below the quartile of the large/value group. It’s time to sell and move on.

• **Lazard US Equity Concentrated (LEVOX) is being added.**¹ The Lazard name is probably unknown to most SMI readers, as most of this firm’s business is internationally and

institutionally focused. Only about 10% of the firm’s roughly \$180 billion under management is focused on U.S. stocks (which is still a big number), and relatively little of that is in retail mutual funds of the sort SMI recommends. None of that is a problem, it simply explains why readers may not have heard of the firm before. What we’re focused on is the fund’s recent performance, and on that score it looks good. In fact, last year it was one of the top funds in the large-company “blend” space—i.e., those funds that don’t fit neatly into either the “growth” or “value” management style. That’s not surprising given that this is a “best ideas” fund, with stock selections coming from multiple managers who utilize different stock selection approaches. In theory, these “best ideas” funds sound great: a concentrated fund compiled from the best picks of the firm’s other funds. While they don’t always live up to their potential, this one has performed well enough to land near the top of our rankings. ◆

LEVEL 1 / CONTINUED FROM PAGE 22:

INSURANCE INSIGHTS: CHOOSING BETWEEN TERM AND WHOLE LIFE

The chief merits of whole life

One of the better arguments in favor of a whole-life policy is that a change in your health, business, or plans always has the potential to make you unable to self-insure by the time your term policy expires. In such a case, continuing with term insurance or converting at a later date could cause you to pay much more than you would have if you had taken out a quality whole-life policy earlier.

Also, many people buy term insurance with the intention of investing the additional amount they would have otherwise spent on whole life. Instead they end up *spending* the difference. If you can’t follow through on your good intentions to invest on your own, the investment aspect of whole life may help you.

Conclusion

This discussion is not intended to encourage readers to automatically cash out old whole-life policies. Some offer attractive returns and can be viewed as an emergency fund or as part of your bond holdings. Other factors to consider include the strength of the insurer, whether transaction costs are behind you, the taxable gain at surrender, alternative uses of the proceeds, your health, and more.

Still, it’s not difficult to assemble your own *whole-life* package. First, to the degree you need life insurance, buy a level-premium term policy. After you’ve whittled down your debt, begin investing directly in a mutual fund (rather than indirectly through an insurance policy). Consider a Roth account to shelter your investment earnings from taxes.² Combining these tax advantages with dramatically lower expenses plus the earnings likely will generate a much better return over time than is available through a whole-life insurance policy. ◆



MONEY TALK

LEVEL 3 / CONTINUED FROM PAGE 24:

2014 YEAR IN REVIEW: SOLID GAINS CONTINUE, BUT VOLATILITY RETURNS

This strategy just launched in January of this year, but more importantly, it replaced a previous method that SMI investors have used to invest in bonds through the Upgrading strategy. We've decided to show the backtested Bond Upgrading history rather than the old results from our prior bond approach. Those old results are still available via the old quarterly report card articles on the SMI website. But we think showing the backtested history of the new approach is more helpful from a planning standpoint than reporting actual performance from an approach we no longer follow. That's why you see the "H" footnotes all down the Bond Upgrading column—we didn't want anyone to be confused thinking these were the actual performance numbers from the past.

Also, in the past we showed the blended stock/bond results of various Upgrading allocations (80/20, 60/40, etc.). We've decided to change that and break the Stock and Bond Upgrading components out separately. This provides greater transparency regarding which component is responsible for what portion of performance. Readers who are allocating a portion of a portfolio to both strategies can use those two base numbers to compute their specific result. For example, if Stock Upgrading gained 10% and Bond Upgrading 5%, a 60/40 reader would take $(10\% \times 0.6)$ and add that to $(5\% \times 0.4)$ to calculate their personal 60/40 Upgrading result, which in this case would be 8%. While this adds a step for some readers, it will provide greater clarity and flexibility for readers who choose to use Bond Upgrading either as a stand-alone strategy or in combination with other non-Upgrading strategies.

Just-the-Basics (JtB) & Upgrading

As previously noted, it was tough sledding for both of these strategies in 2014, primarily due to their significant allocations to foreign and small-company stocks. JtB had 60% of its portfolio allocated to those groups, while Upgrading had 54%. Ironically, Upgrading's allocations were shifted correctly in the right direction, with smaller allocations than in the past to the small-company and foreign categories, but in 2014 having *any* exposure to those categories hurt performance.

In addition to the allocation issue, the Upgrading process itself just didn't add much value last year. Usually Upgrading is able to provide significant value in at least a few of the risk categories (for example, in 2013, Upgrading's results were roughly 5% better than the average fund in four of the five groups). Last year, however, none of the Upgrading results for the five risk categories presented significant improvement over the category averages.

We don't know why Upgrading's relative performance was weaker than any other year in recent memory. But we do

take encouragement from the research that has shown Upgrading's "active" fund managers (versus "passive" managers of index funds) have historically lagged the S&P 500 by 2% during years when *interest rates have fallen* as they have in recent years. In contrast, active managers have historically outperformed the S&P 500 by about 1.5% in years *interest rates have risen*. We don't know that interest rates will rise in 2015, but it seems likely that Upgrading will soon be back on the positive side of that interest-rate trend.

From a bigger-picture standpoint, one bad year doesn't do much to dampen our enthusiasm for a strategy. But admittedly, Upgrading has now trailed the market in three of the past five years. Is it time to switch to a different approach? Not necessarily (although if you haven't already, you might consider blending one or more other strategies into your portfolio along with Upgrading—see this month's editorial for an example of that).

We explored this in some detail a few weeks ago on the SMI website and encourage you to read that article online if you haven't already.¹ But to quickly summarize, we reported on the historically streaky nature of Upgrading, showing it wasn't especially uncommon for the strategy to beat—or lag—the market for three to five years at a time. In fact, Upgrading trailed the market for eight of 11 years once, only to suddenly turn around and beat it the next 10 straight years by a huge cumulative margin! Given that historical track record, we aren't reading too much into Upgrading's weakness relative to the market over the past five years, especially given that Upgrading's *absolute* returns have been very strong over that time—+12.45% annualized.

Dynamic Asset Allocation (DAA)

If JtB and Upgrading provided unpleasant surprises in 2014, DAA was the opposite. Riding strong returns in real estate as interest rates fell and kept on falling, DAA also adeptly exited foreign stocks at the end of August and benefited from a move into long-term bonds. Of course, the fact that its stock component was invested in the S&P 500 helped as well. All together, DAA's +13.0% return beat the +12.7% gain of the broad-based Wilshire 5000 index that SMI uses as its measure of the market. For a strategy that doesn't normally expect to keep pace during rising stock markets, it was a pleasant surprise, and helped offset lower than expected gains from Upgrading for those with blended Upgrading/DAA portfolios.

Sector Rotation (SR)

We're running out of superlatives to lavish on Sector Rotation—our high-risk, high-reward strategy that rotates between narrowly focused sectors (or "slices" of the economy). For the third year in a row, SR posted an extremely strong gain, following 2013's breathtaking +65.7% rise with another

¹ tinyurl.com/n4rkot7



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+49.9% in 2014. (Just for fun, an SMI reader who had \$10,000 invested in SR last year made a profit of \$4,990. That's \$3,719 more than "the market" gained—enough to pay the extra \$5/month cost of a premium membership for the next 62 years!)

SMI readers who have followed this strategy over the past 10 years have earned a total return of +430%! (Those aren't hypothetical results. This strategy has been active since late 2003.) Such performance is incredible. But as always when discussing SR, you need to be aware of the significant degree of risk and limit your exposure appropriately. SR is great when it's soaring, but it occasionally makes equally dramatic moves to the downside. It's important to understand the risks.

50/40/10

This portfolio wasn't rolled out with the intention of it becoming an official SMI strategy, *per se*. But after seeing how its three components work together and complement each other, it has gradually grown into something of a *de facto* starting point for many SMI readers.

For those who are unfamiliar, this oddly titled portfolio refers to the specific 50% DAA, 40% Upgrading, 10% SR blend of strategies examined in detail in our May 2014 cover article. That article found this combination of strategies has worked synergistically in the past to *boost returns* while simultaneously *reducing risk*—the holy grail of investing. It accomplished this by adding the high upside of SR and the volatility dampening properties of DAA to an Upgrading base.

In our performance table, we'll be reporting the results of this portfolio as if the Upgrading portion is 100% stock (no bonds). But in real life, if your risk temperament and season of life call for you to blend stocks and bonds in the Upgrading portion of this portfolio, then by all means do so.

Also, as this month's editorial makes clear, we value each reader having a *personalized* mix of strategies that works for him or her, so feel free to customize this. But we also recognize that some people just want a good default plan (or at least a starting point), and this 50/40/10 mix provides that. So while this portfolio may or may not *exactly* reflect your own blend of SMI strategies, it should be a helpful reference point to show how readers utilizing this type of diversification are performing.

Conclusion

Given that this is the first time all of these strategies are being displayed on a year-by-year, head-to-head basis (at the bottom of page 24), it's worth pointing out a few things. We've written about the value of diversification in many ways over the years, but this table just reinforces the point.

Starting in the center of the table, notice how both Bond Upgrading and DAA have managed to avoid losses, even during the worst of the melt-down in 2008. That steadiness speaks to why we (1) gave the largest portion to DAA in designing our 50/40/10 blend, and (2) have recommended for

years that the bond portion of an Upgrading portfolio should increase as an investor approaches and enters retirement.

Moving out one column in either direction, the yearly Upgrading and Sector Rotation results show the extra upside these strategies provide in years such as 2009 and 2013. Those tempted by the cumulative returns of SR to emphasize that strategy at the expense of Upgrading should look closely at the year-by-year data: years like 2006, 2009, and 2010 make it clear SR isn't always the better option, even in rising markets.

The reality is that the performance of each strategy ebbs and flows, marching to the beat of its own drummer to at least some degree. That's what makes a well-conceived diversification plan work: some parts of the portfolio usually will be performing well if it includes enough dissimilar options. That fact is what drives our contention that rather than an either/or decision process, SMI readers are better served thinking *both/and*. Having part of your portfolio positioned to take advantage of market strength via Upgrading and SR can help keep discontentment at bay during strong years such as 2009 and 2013, while having a significant allocation to DAA should help limit any damage—financial and emotional—when the next bear market arrives. ♦

LEVEL 4 / CONTINUED FROM PAGE 25:

THE POSITIVES—AND PERILS—OF “BACK-DOOR” ROTH IRA CONTRIBUTIONS

up too much for this plan to be worthwhile.

Third, you could make a non-deductible, traditional IRA contribution but not convert it right away. By doing so, you'd at least get that money growing on a tax-deferred basis. You could always convert some or all of it down the road, perhaps at a time when you are in a lower tax bracket. (Note that this delays, but doesn't avoid, the complications that result from having both deductible and non-deductible traditional IRA assets.)

Clearly, making back-door Roth IRA contributions can be more complicated than most people bargain for. If you don't have other traditional IRA assets, taking advantage of this approach is pretty simple. For high-income earners intent on taking advantage of a Roth's benefits, we're not trying to talk you out of it. You just need to understand the future tax complexity you're inviting, so you can determine if going through this process is worth it to you. ♦

SMI'S SECTOR ROTATION STRATEGY HAS BEEN GREAT OF LATE, BUT HERE'S A CAUTIONARY NOTE

After an investment (or investing strategy) has a great run of success, investors can be tempted to "overindulge." They take money away from other investments in order to double or triple their commitment to what almost seems like a sure thing. But it's *never* a sure thing, at least not in every environment. There will come a time when the investment underperforms, perhaps dramatically. And investors are left with financial indigestion, complaining "I can't believe I invested that much!"

We point out in this issue's report card that "SMI readers



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who have followed this strategy over the past 10 years have earned a total return of +430%!" However, we also emphasized: "You need to be aware of the significant degree of risk and limit your exposure appropriately. SR is great when it's soaring, but it occasionally makes equally dramatic moves to the downside."

We thought it might be helpful to expand on that warning with some historical data. The table below shows the results from Sector Rotation over every 12-, 24-, 36-, 48-, and 60-month holding period since 2000. The top two lines are the encouraging ones. What's not to like about a strategy that, on average, returned +18.4% every 12 months? Or that once turned in an annualized return of +31.7% every 12 months for 60 months?

2000-2014	12 Mos	24 Mos	36 Mos	48 Mos	60 Mos
Average Annualized	+18.4%	+16.1%	+14.8%	+14.2%	+13.4%
Best Case Annualized	+84.3%	+57.6%	+46.8%	+35.2%	+31.7%
Worst Case Annualized	-38.6%	-19.7%	-13.8%	-4.9%	-0.8%
Worst Case Non-Annualized	-38.6%	-35.5%	-36.0%	-18.1%	-4.1%

But the point of this exercise is not to focus on all that can go right with SR, but rather on what has occasionally gone wrong. The numbers in the "worst case annualized" row don't look too terrifying (other than that 12-month loss). You

may think, "Sure, I could handle a -13.8% loss over three years. Disappointing to lose, but that's not a huge setback."

That's the problem with looking at annualized data. We tend to focus on the number rather than the word "annualized." In reality what the table shows is, in that worst-case instance for a 36-month period, the strategy lost -13.8% each year for three years. That translates into a cumulative loss of 36%.

After faithfully following the strategy every month for three years, you find you've lost more than one-third of your beginning capital! That kind of consistent losing pattern is enough to push most investors to the sidelines. Which would be too bad. Because the 48- and 60-month non-annualized numbers show that SR tends to make money in years four and five after a disastrous start. The investor would have regained all but about 4% of the lost capital. But not if he or she bailed out after those first three discouraging years.

We want to leave you with these takeaways: • **Be balanced.** Don't overcommit to SR just because it's been great in recent years. • **Be realistic.** Expect some occasionally dramatic losses along the way. • **Be committed.** If you're going to start this particular journey, stay in for the long haul. ♦

MARKET NOTES, QUOTES, AND ANECDOTES

You Must Be Present to Win

- According to the Gallup organization, the percentage of Americans with money in the stock market has declined from 65% in 2007 to 54% last year.
- "The train may be back at the top of the mountain, but you're not there unless you stayed on the train." — Greg McBride, senior financial analyst for Bankrate.com, pointing out that many people missed the bull market by pulling funds out of stocks during the depths of the recession.

Trying to Gauge the Market's Direction

- "Never forget this simple truism: Forecasting is marketing, plain and simple." — Money manager/investing blogger Barry Ritholtz in an article for the *Washington Post* in which he took market forecasters to task for being so predictably wrong.
- "Whew!" — Jeff Hirsch, editor in chief of the *Stock Trader's Almanac*, after the S&P 500 eked out a modest 0.2% gain in the first five trading days of 2015. He sees the time frame as an early warning system for the year, noting, "The last 41 up First Five Days were followed by full-year gains 85% of the time with an 14.0% average gain in all 41 years."
- "A year ago, no one saw the decline in energy prices coming. This gets to the issue of forecasting. The world in general isn't much good at forecasting anything." — Scott Black, founder and president of Delphi Management, a participant in *Barron's* 2015 economic roundtable.

- "If we agree that inflation, interest rates, and growth will stay low, there is no alternative to stocks. In contrast to 2014, this will be a stockpicker's market. The averages won't do much, but within the market there will be great opportunities." — Oscar Schaefer, chairman, Rivulet Capital, also at the *Barron's* roundtable.

History Sending Conflicting Signals about 2015

- "I've always been a believer in history, and all those years of positive returns are hard to ignore." — *New York Post* writer Jonathan M. Trugman in an article noting that in the third year of a presidential term, the S&P 500 has posted positive returns the last 18 times.
- "You have never seen the S&P 500 go up seven years in a row, and you would be breaking that record if you went up this year." — Jeff Gundlach, founder Doubleline Capital.

Missing the Target?

- "Well, that must have polled badly." — *The Wall Street Journal*, commenting on news that President Obama decided to abandon his proposal to end the tax-favored treatment of 529 plans just a week after his idea was first made public.
- "There must be a statute of limitations for those who say there will be inflation." — Mario Draghi, European Central Bank President, dismissing criticism that the ECB's new trillion-dollar bond-buying economic-stimulus program might stoke inflation down the road.

PERIODICALS POSTAGE

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*Dated Investment Material
Please Do Not Delay!*



PERFORMANCE DATA

QUARTERLY BREAK DOWN OF THE INCOME MARKETS • DATA THROUGH DECEMBER 31, 2014

Risk Category For Bond Funds	3 Month	12 Months	3 Year Annual	5 Year Annual	10 Year Annual	Avg Duration	Rel Risk	Risk Category For Bond Funds	3 Month	12 Months	3 Year Annual	5 Year Annual	10 Year Annual	Avg Duration	Rel Risk
Long-Term Government	7.0%	21.7%	3.2%	9.1%	6.3%	14.5 yrs	3.59	Convertible Bonds	1.1%	6.4%	13.1%	9.7%	6.4%	1.9 yrs	2.93
Long-Term Bond	4.2%	11.3%	5.2%	8.7%	6.9%	9.3 yrs	2.23	High-Yield (Junk) Bonds	-1.6%	1.1%	7.4%	7.9%	6.3%	3.7 yrs	1.73
Intermediate-Term Govt	1.3%	4.7%	1.5%	3.3%	3.9%	4.7 yrs	0.89	Bank Loan Securities	-0.7%	0.6%	4.9%	5.1%	3.6%	0.5 yrs	0.83
Intermediate-Term Bond	1.1%	5.2%	3.4%	4.8%	4.4%	4.9 yrs	1.06	Inflation-Protected	-0.8%	1.8%	-0.2%	3.2%	3.5%	5.7 yrs	1.77
Short-Term Govt	0.2%	1.0%	0.4%	1.3%	2.6%	2.0 yrs	0.35	Money Market Funds	0.0%	0.0%	0.0%	0.0%	1.4%	n/a	n/a
Short-Term Bond	-0.1%	1.1%	1.7%	2.3%	2.9%	2.1 yrs	0.48	World Emerging Markets	-4.0%	-0.8%	2.3%	4.9%	6.7%	5.3 yrs	3.36
Ultra-Short Term	-0.2%	0.3%	1.0%	1.2%	2.0%	0.5 yrs	0.21	World Bonds	-1.2%	1.7%	2.6%	3.6%	4.0%	5.0 yrs	1.82

THE SOUND MIND INVESTING NEWSLETTER MODEL PORTFOLIOS

CURRENT RETURNS AS OF DECEMBER 31, 2014

	Year to Date	1 Month	3 Months	12 Months	3 Year Annual	5 Year Annual	10 Year Annual	15 Year Annual
U.S. Market ¹	12.71%	-0.06%	5.25%	12.71%	20.29%	15.54%	7.99%	4.75%
Just-the-Basics ²	7.50%	-0.49%	3.69%	7.50%	18.36%	13.96%	7.89%	5.04%
Fund Upgrading ³	5.13%	-0.95%	2.88%	5.13%	17.27%	12.45%	8.24%	8.35%

Notes: The newsletter model portfolios are hypothetical portfolio models based on SMI investing principles. The model portfolios are not securities and cannot be invested in directly. Further, the model portfolios do not incur expenses or trading costs. • ¹Based on the float-adjusted Wilshire 5000 Total Return index, the broadest measure of the U.S. stock market. • ²Calculated assuming account rebalancing at the beginning of each year with 40% of the stock allocation invested in the Vanguard S&P 500 Index fund, 40% in the Extended Market Index fund, and 20% in the Total International Stock fund. • ³Assumes the portfolio allocation for each risk category was divided evenly among all the recommended funds. Transaction costs and redemption fees—which vary by broker and fund—are not included.

THE SOUND MIND INVESTING MUTUAL FUND (SMIFX)

Current Returns as of 12/31/2014	Year to Date	1 Month	3 Mos	12 Mos	3 Year Annual	5 Year Annual	Annual since Inception
SMIFX	3.89%	-0.61%	3.29%	3.89%	15.88%	11.38%	6.94% ¹
Wilshire 5000	12.71%	-0.06%	5.25%	12.71%	20.29%	15.54%	7.95%
S&P 500	13.69%	-0.25%	4.93%	13.69%	20.41%	15.45%	7.77%

¹Annualized return since SMIFX inception date of December 2, 2005.
Total/Gross expense ratio: 2.18% as of 2/28/2014 (includes expenses of underlying funds)
Net expense ratio: 1.17% as of 2/28/2014 (excludes expenses of underlying funds)

Notes: The performance data quoted represents past performance, and past performance is not a guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance

may be lower or higher than the performance information quoted. • You should carefully consider the investment objectives, risks, fees, charges and expenses of the Funds before investing. The prospectus contains this and other information about the Funds. To obtain a prospectus or performance information current to the nearest month end, call 1-877-764-3863 or visit www.smifund.com. Read the prospectus carefully before investing. • Because the SMI Funds invest in other mutual funds, they will bear their share of the fees and expenses of the underlying funds in addition to the fees and expenses payable directly to the SMI Funds. As a result, you'll pay higher total expenses than you would investing in the underlying funds directly. • Returns shown include reinvestment of dividends and capital gains. The Wilshire 5000 index represents the broadest index for the U.S. equity market. The S&P 500 Index is an unmanaged index commonly used to measure the performance of U.S. stocks. You cannot invest directly in an index. • The Sound Mind Investing Funds are distributed by Unified Financial Securities (member NASD).

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