



October 25, 2013

Dear Valued Client:

Enclosed is your portfolio report for the period ended September 30, 2013.

### **Big Business in America**

The American capitalist system appeared pretty dismal in 2009 following the subprime mortgage crisis. *The Economist* magazine (9-21-2013) reports that at that time only three of the top 10 companies in the world were American. Among the top 10 were four state controlled giants. The four were Petro China, China Mobil, ICBC (a China controlled bank) and Petrobras, a Brazilian government oil and gas company. The appearance was that the U.S. was headed downhill and a government company model used by emerging countries was going to overwhelm the rest of the world.

Fast forward to today and nine out of the top 10 companies are in the U.S. One of the reasons given by *The Economist* is rising productivity due to successful shale oil exploration and development. When the top fifty companies in the world are considered, the U.S. represents over half and the percentage is rising.

In the interest of full disclosure, six of the nine companies in the top ten sell more overseas than in the U.S.A. It certainly demonstrates the necessity to think globally in the world of investing.

### **Eugene Fama**

Recently, three economists were awarded the Nobel prize for economics. One of the three was Eugene Fama of the University of Chicago. The prize was awarded for Fama's work on asset pricing and markets first presented 30 years ago. More relevant to KIS portfolio allocation decisions, Fama and Kenneth French (Dartmouth College) later developed the three factor model that empirically proves that value stocks and small stocks will outperform the market as a whole over long periods of time. We utilize Dimensional Funds (DFA) extensively in many of our portfolios and Dimensional (founded by University of Chicago alums) credits the inspiration for founding of DFA to Fama. The DFA philosophy is utilized by many advisors and large pension funds. As of Sept. 30, 2013, DFA had \$315.4 billion under management.

DFA was founded in 1981 and has grown continually by implementing strategies based on the Fama / French three factor model. Basically, the model states that in the long-term:

1. It is better to be in the equities market than in the absolute safety of Treasury bills
2. Small stocks will outperform large stocks
3. Value stocks (stocks with a high book to market ratio) will outperform growth stocks

Eugene Fama and a number of other economists, sit on the Board of Directors of DFA.

## Investment Philosophy – Risk Tolerance

The old saw, higher risk / higher reward is true. However, when it comes to investing, the truth is a long-term proposition. The place holder for risk in the investment world is volatility. In other words, your invested assets are going to rise and fall in value and all of the choices in factors 1-3 above are more volatile than the alternatives (i.e. equities are more volatile than Treasury bills, small stocks are more volatile than large and value stocks are more volatile than growth stocks).

KIS has looked at and utilized numerous risk tolerance questionnaires to assess clients' tolerance for risk. The interesting (and understandable) truth is that investors are more tolerant for risk when things are going well than when their portfolio value is going down. In addition, how the questions are framed can make a huge difference.

A number of years ago we reached the conclusion that a risk tolerance quiz, while informative, did not do a better job than simply getting to know our clients really well. To support this position we offer a story of questions asked by David Kahneman (Nobel prize winner) as related in *Capital Ideas Evolving* by Peter L. Bernstein:

### Situation Presented to Two Groups

A dreaded disease has occurred and experts are predicting that the disease will kill 600 people if nothing is done. There are two alternative courses of action:

- Program A – 200 people will be saved
- Program B – there is a 1/3 chance that all 600 people will be saved and a 2/3s chance they will all die.

The majority of respondents were in favor of program A.

The restated choices - A dreaded disease has occurred and experts are predicting that the disease will kill 600 people if nothing is done. There are two alternative courses of action:

- Program C – 400 people will die
- Program D – There is a 1/3 chance that nobody will die and a 2/3s probability that all 600 will die.

The majority of respondents were in favor of program D.

You will be quick to note only the language has changed but the outcome is different because of how the question was presented.

We are pleased (proud) that our clients have maintained their positions in down markets and, just as importantly, have not gone overboard in an investing frenzy when equity markets are rising rapidly.

## Country Report

Since we commented on how business is going in the U.S., we thought it would be interesting to look at a chart of how other countries are doing. The attached chart comes from Dimensional Funds.

We welcome your comments and questions in regard to your quarterly reports.

Sincerely

Judy Kehoe

Bob Kehoe