



Dimensional

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To our clients and friends:

As we enter October, we're now three quarters through a surprising 2012.

In this letter, I hope to offer some insight into this year's performance thus far, and what we might expect going forward. In that vein, I've decided to take some lines from a legendary investment guru who passed away earlier this year after 40 years in the industry—Barton Biggs. Before we get into his views, here's a summary of 2012 to date.

Third Quarter Review: A Strong Comeback

This year has been a tale of three quarters, with year-to-date returns through September 30 now strongly positive.

The first quarter saw the fastest start for the U.S. stock market since 1998, driven by a reduction of fears about Europe, as well as stronger economic data in the U.S. The second quarter gave many of the gains back, due to escalating concerns about the European currency union and slowing global growth, accompanied by discouraging data on employment. We also saw a slowdown in China and India, putting downward pressure on the price of oil and other commodities, and on stocks in general.

The third quarter, however, saw markets bounce back, as the U.S. Federal Reserve Board and the European Central Bank (ECB) put measures in place to stabilize economies and to boost growth prospects. In particular, European confidence was boosted by the ECB's announcement that it would backstop Greece, Spain and other countries whose economies are struggling. Here's a summary of global market performance in 2012, on a quarter-by-quarter basis, and then on a year-to-date.

2012	U.S.	Canada	Europe	Emerging Markets	Global Returns
Q1	+13%	+5%	+8%	+11%	+12%
Q2	(3%)	(6%)	(4%)	(5%)	(4%)
Q3	+6%	+7%	+7%	+6%	+6%
2012 to Date	+16%	+5%	+11%	+11%	+13%

Source: MSCI returns including dividends, all returns in local currency

Insights and Guidance from a Wall Street Legend

Looking back is the easy part of investing – looking forward is more challenging. To illustrate this point, I'd like to share the views of a legendary Wall Street veteran, the late Barton Biggs.

Biggs entered the industry in 1961. In 1973 he joined Morgan Stanley, where he served as Chief Global Strategist from 1985 until his retirement in 2003. He was named 10 times to the All-America research team and was voted Wall Street's top global strategist each year from 1996 to 2000.

Among his more notable accomplishments were: a) Predicting the 1982-2000 bull market; b) warning investors that Japanese stocks were about to collapse in 1989; c) identifying a bubble in the U.S. stock market in 1999 in which he advised investors to sell tech stocks; d) Correctly calling the bottom in U.S. stocks in March 2009.

Biggs wrote extensively on how investors can prosper in volatile markets. Three of his themes are especially relevant today: 1) Why owning stocks is essential for most investors; 2) The challenges of investing rationally in an irrational world; and 3) The psychological makeup of successful investors.

Theme #1 from Barton Biggs: Why owning stocks is essential

This single insight from Biggs articulates why *most*—if not *all*—investors must own equities at some point in their investing lives:

“The history of the world is one of progress. As a congenital optimist, I believe in equities. Fundamentally, in the long run you want to be an owner, not a lender.”

Biggs has also warned against the trap of making short-term safety your sole investment consideration, thereby sacrificing decent overall returns in exchange for the inability to tolerate even a tiny bit of volatility.

Theme #2 from Barton Biggs: Rational investing in an irrational world

Biggs also wrote widely on the challenges of being caught up in the emotions of the market. We have a tendency to root our investment outlook in what happened in the immediate past rather than in what's happening today and what will happen tomorrow.

The following comment from Biggs helps explain peculiarities such as massive inflows into government bonds during a period of all-time low rates, leading to the virtual certainty of capital losses when interest rates rise:

“As investors....we forget that Mr. Market is an ingenious sadist and that he delights in torturing us in different ways Mr. Market is a manic-depressive with huge mood swings and you should bet against him, not with him, particularly when he is raving.”

Theme #3 from Barton Biggs: The psychological makeup of successful investors

As a result of the strong emotions at play, many investors find it hard to stick to their intended strategy. Here's what Biggs had to say about the importance of immunizing yourself from the psychological effects of the swings of the market:

"The investment process itself is only half the battle. The other weighty component is struggling with the psychological effects of the swings of the market, the pressure of beating benchmarks, and the loneliness of the long distance runner."

And Biggs offered one final piece of advice about knowing yourself. This will resonate for those of you who remember the tech boom in the late 1990s. While Biggs' advice here is oriented to investment professionals, it applies to individual investors as well:

"At extreme moments of fear and greed, the power of the daily price momentum and the mood and passions of "the herd" are tremendously important psychological influences on you. It takes a strong, self-confident, emotionally mature person to stand firm against disdain, mockery and repudiation when the market itself seems to be absolutely confirming that you are both mad and wrong."

Integrating Barton Biggs' thoughts into your portfolio

In my last newsletter, I outlined five guiding principles in our approach to building client portfolios. I've related these five principles to Barton Biggs' comments above.

#1. Taking the appropriate level of risk

My starting point with clients is to identify their retirement goals and to then construct a portfolio based on that objective. The goal should be to take the proper level of risk for the individual client—enough risk to be fairly confident that over the long haul our objectives will be met, but without taking more risk than is necessary.

In my view, one cannot focus strictly on how much risk investors *want* to take. After all, many investors in 2012 want to take as little risk as possible. We must also focus on the important—and fundamental—question of how much risk investors *need* to take in order to achieve their long-term goals. It is true that taking excessive risk increases the psychological stresses that Biggs describes. But taking insufficient risk—while seemingly comfortable in the short term—is a likely route to long-term failure in achieving one's objectives.

#2. A liquidity buffer for retired clients

As I've often discussed, for clients who are retired I believe in maintaining secure, liquid funds to cover at least one to two years of living expenses. Having that safety net means that we reduce the chance of having to sell holdings at depressed levels. This strategy also lessens the stress and anxiety that Biggs alluded to.

#3. Adhering to your plan

Regardless of what happens to markets in the short term—and barring a significant change in your circumstances—investors should stick to the investment parameters previously agreed upon. Barton Biggs pointed out that this is easier said than done. We will all recall the climate in March 2009 as we faced what appeared to be an end-of-the-world scenario and some stocks hit lows they hadn't seen in 20 years

To illustrate the fickleness of some investors, the strong stock performance in the first quarter of 2012 prompted some to consider increasing equity weightings above those stated in their portfolio guidelines. Then in May—after significant declines and having been gripped by fear—some questioned whether they should instead be *selling* stocks.

#4. Diversification across asset classes

We have tried taking a long-term view throughout 2012, despite a great deal of uncertainty. We continue to maintain our belief that at present there is a strong case for stocks over bonds. We also continue to believe that clients will prosper from taking Barton Biggs' advice to be an owner (equity stakeholder) rather than a lender (bond holder) of financial assets.

Of course, market reversals from current levels are always possible. Those reversals can be sudden and violent. Therefore, when building portfolios, we advocate strong diversification amongst different asset classes. We prefer to focus on lower volatility holdings and shy away from those with higher standard deviations. This focus on reduced volatility and lowered risk has helped savvy investors weather much of the severe ups and downs of the past several years.

#5. Focus on cash flow

The fifth and final principle pertains to the importance of generating cash flow from investments. In this uncertain economic and market environment, we've continued to place a premium on the dividend yield generated from our investments. We believe that having a steady cash flow reduces the psychological tensions described by Biggs.

As stated previously this year, it is our view that the returns on investment grade corporate bonds, higher-rated high yield bonds (such as Vanguard's offering) and dividend-paying equity mutual funds continue to make those investments more attractive than some of the alternatives. Thank you for your ongoing support and interest.

Sincerely,

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Dimensional Wealth Management LLC
Registered Investment Advisor

Past performance is no guarantee of future results

Nothing contained in this quarterly newsletter should be construed as investment advice