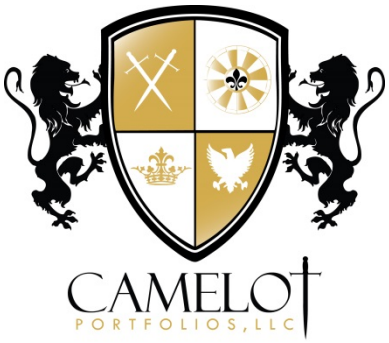
Volatility – A source of concern or a reason for optimism?

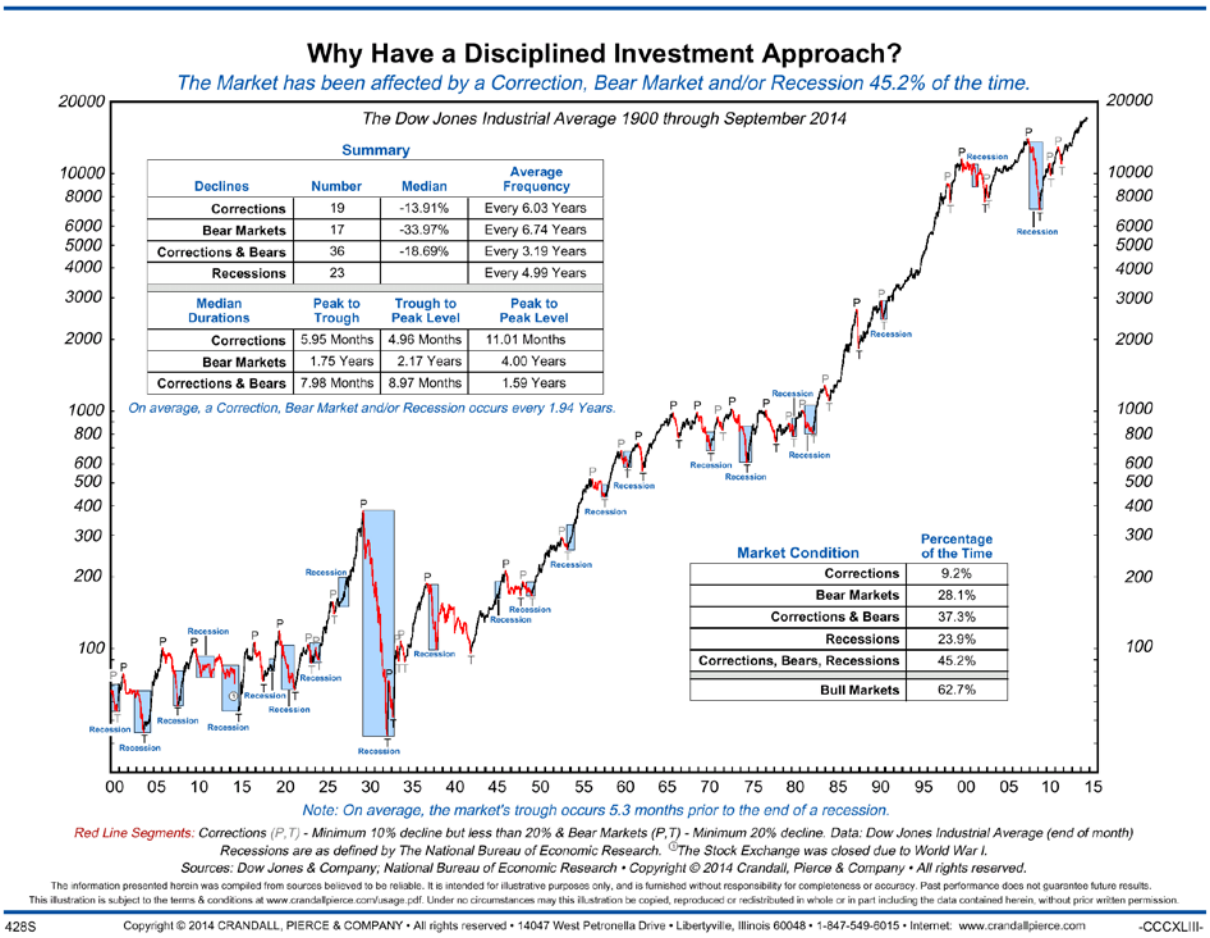
Matthew Moses, CAP®



Investors sometimes have to fake a smile when they hear us tell them that we *embrace volatility* or that *volatility creates opportunity.* We empathize with the varying emotions that often accompany a volatile market, unfortunately our investment philosophy is much more sinister than we are…it has no place for emotions (good or bad). It has been said that "Individuals who cannot master their emotions are ill-suited to profit from the investment process." - Benjamin Graham, so let's consider some of the reasons we believe this to be true.

History Shows Investors are "The House"

As illustrated by the chart below, investors who can weather the highs and lows of the market are ultimately rewarded as "the house." Similar to the way that games at a casino are skewed to favor "the house," the market has historically rewarded investors who stay invested over long periods of time. *See the appendix for a full size version of this chart.*

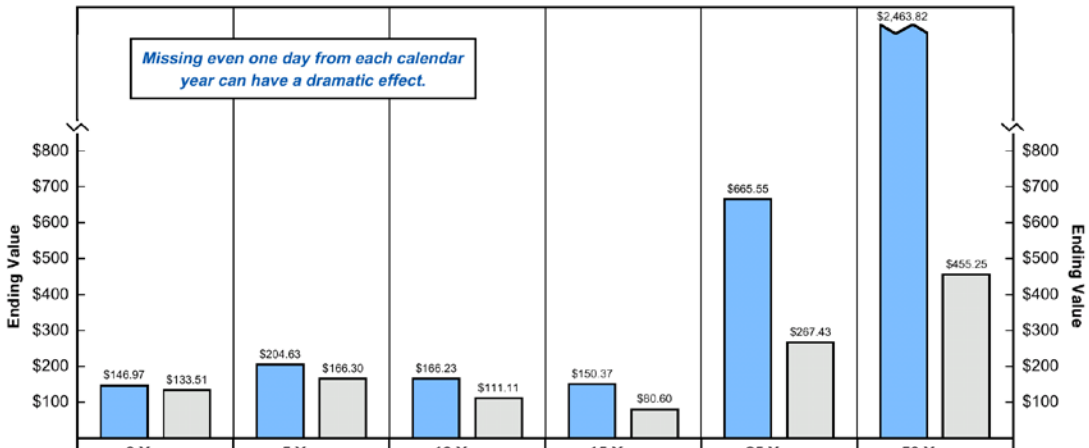


Clearly, the road to success is not a steady one when it comes to investing. In fact, 45.2% of the time that we are invested the market is actually in a “losing” scenario. This really begins to put things into perspective for investors who experience volatility in the short term. It also highlights why timing the market is such a dangerous technique. When we consider the impact that missing just one day of positive market performance per year can have, we begin to understand why attempting to time the market can be so detrimental to a portfolio. With such a small margin between the good days and the bad days, being wrong when it comes to timing the market means potentially missing out on gains that could make or break the long term success of your portfolio.

The chart below highlights the impact that missing just one day per year of gains in an account can have on your ability to succeed as an investor. An individual investor that participated in the S&P 500 for 25 years from 1989-2013 would have experienced a 565% gain. That same investor, had he/she attempted to time the market and missed just 25 of the best days over that period would have experienced growth of just 167%. Put a different way, a $100,000 investment would have grown to $665,550 versus $267,430 compounded over time. *See the appendix for a full size version of this chart.*

Market Timing - Caution

The Standard & Poor's 500 Stock Index



	3 Years 2011 - 2013		5 Years 2009 - 2013		10 Years 2004 - 2013		15 Years 1999 - 2013		25 Years 1989 - 2013		50 Years 1964 - 2013	
	Entire Period	Less Best 3 Days	Entire Period	Less Best 5 Days	Entire Period	Less Best 10 Days	Entire Period	Less Best 15 Days	Entire Period	Less Best 25 Days	Entire Period	Less Best 50 Days
Ending Value	$146.97	$133.51	$204.63	$166.30	$166.23	$111.11	$150.37	$80.60	$665.55	$267.43	$2,463.82	$455.25
Percent Change	47.0%	33.5%	104.6%	66.3%	66.2%	11.1%	50.4%	-19.4%	565.6%	167.4%	2,363.8%	355.3%
Compound Annual Rate	13.7%	10.1%	15.4%	10.7%	5.2%	1.1%	2.8%	-1.4%	7.9%	4.0%	6.6%	3.1%
Percentage of Days	100%	99.6%	100%	99.6%	100%	99.6%	100%	99.6%	100%	99.6%	100%	99.6%

Example: For the 3 years 2011 - 2013, $100 invested grew to $146.97. If the best day is removed from each of the 3 calendar years, the ending value would be $133.51.

Data: Capital Appreciation; $100 invested at period inception.

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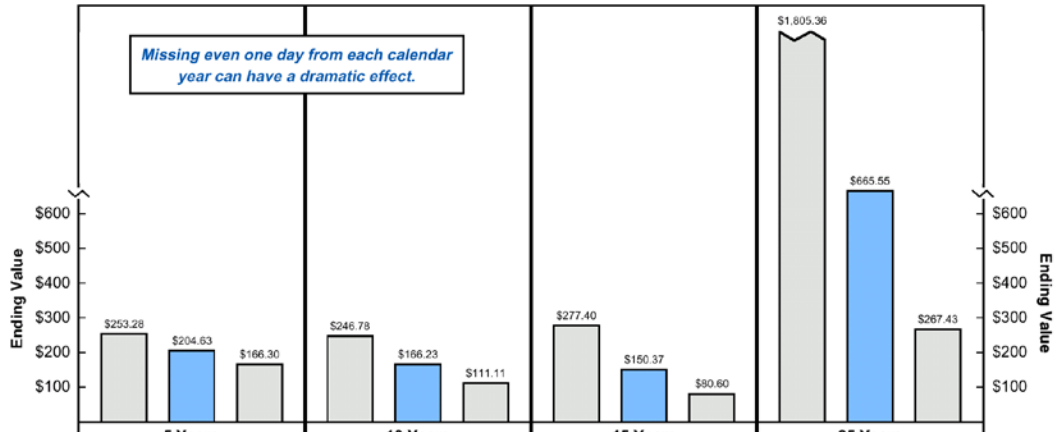
Those that promote market timing strategies will often point out the potential positive effects that timing the market could have on a portfolio. The chart below highlights the best and worst one day inclusion and exclusion scenarios, as well as full market participation. Essentially, if investors eliminated just the 5 worst days in a 5 year period they outperformed those that were fully invested from 2009-2013 by 48.70%. It is possible that accurately timing the market could yield better results for investor's over the long-term, as highlighted below. *See the appendix for a full size version of this chart.*

Market Timing - Summary

The Standard & Poor's 500 Stock Index



	5 Years 2009 - 2013			10 Years 2004 - 2013			15 Years 1999 - 2013			25 Years 1989 - 2013		
	Less Worst 5 Days	Entire Period	Less Best 5 Days	Less Worst 10 Days	Entire Period	Less Best 10 Days	Less Worst 15 Days	Entire Period	Less Best 15 Days	Less Worst 25 Days	Entire Period	Less Best 25 Days
Ending Value	$253.28	$204.63	$166.30	$246.78	$166.23	$111.11	$277.40	$150.37	$80.60	$1,805.36	$665.55	$267.43
Percent Change	153.3%	104.6%	66.3%	146.8%	66.2%	11.1%	177.4%	50.4%	-19.4%	1,705.4%	565.6%	167.4%
Compound Annual Rate	20.4%	15.4%	10.7%	9.5%	5.2%	1.1%	7.0%	2.8%	-1.4%	12.3%	7.9%	4.0%
Percentage of Days	99.6%	100.0%	99.6%	99.6%	100%	99.6%	99.6%	100.0%	99.6%	99.6%	100%	99.6%

Note: The "Entire Period" includes every day, while "Less Worst" removes the worst day and "Less Best" removes the best day from each calendar year.

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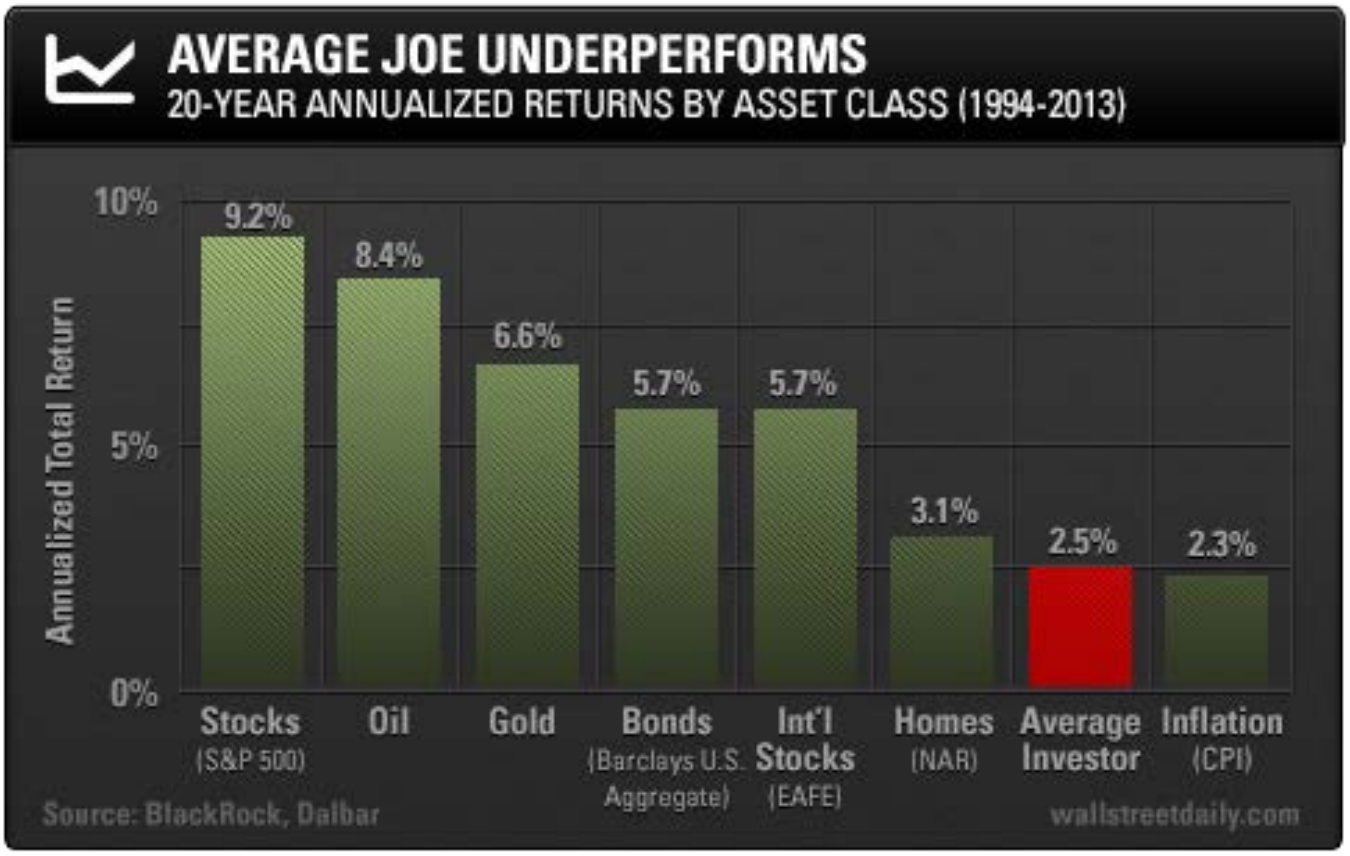
So, if timing the market could potentially be more favorable for investors than not timing the market, why not time the market?

Attempting to time the market removes our one advantage. We are no longer "the house." We become the sweaty-palmed gambler spilling his money at the casino. Sure we have the opportunity to "win" by timing the market, but there is also a great risk that our actions will leave us much worse off than if we simply remained invested. Those at a casino may have short spurts of success, but statistically it is impossible to win at any casino over a long enough time horizon. We refer to this as "timing risk," and timing risk cannot exist when you do not time the market. It is also worth noting that no market timer has ever been right 100% of the time. The longer (more chances) a market timer has to make the choice between being invested or not being invested, the higher the likelihood of failure (just like the games at the casino).

Let's now consider more specifically why we *embrace volatility*, and *why volatility creates opportunity.* Investors are emotional, markets are irrational, and both of these facts give birth to opportunity. Investors often attempt to time the market and allow emotions of fear (and greed) to drive their decision making process. The result is investors who make irrational decisions and end up selling low and buying high. Consider the fact that the average investor from 1994-2013 averaged just 2.5% growth per year vs stocks which averaged 9.2% annually...ouch.



Camelot Portfolios believes that all investing is done for the purpose increasing a future stream of cash flow. In other words, we believe that all assets will eventually be used to serve a purpose at some point in time. Therefore, our primary objective for any portfolio is to keep the buying power of the money we manage consistent and rising over time regardless of the market conditions. It is important that we differentiate buying power from increasing principle value of an account. The two are very different as we will explore in our next example.

A Reason Not to Panic – A different "House" Perspective

We regularly help clients conceptualize our investment approach by using the following real estate analogy. Assume that you own a house that you rent to a tenant. Let us also assume that next to your house, is another house owned by someone else that rents to a tenant. Both your house and the house next to yours were purchased for $100,000 in 2006. Both homes have also had tenants renting for $1000 per month since you each purchased the properties. Imagine that it is now 2008, and the housing market has pushed the value of your home down to $70,000. Did you reduce the amount you were charging your tenant as a result of the price of the home changing? Most likely no, in fact you may have even raised the rent over that period to keep up with inflation.

We view investing in a very similar manner. Companies that reward investors in the form of a dividend or distribution payout are similar to the tenant in this case. Just because the price of an investment falls does not mean that it will cut its dividend or distribution to an investor. So then, how should you measure the true value of your investments? Was your rental property offering any less value in 2008 when it was worth 70k when compared to its 2006 valuation of 100k? The answer is no; unless you chose to sell the house. Selling the house would have meant that you locked in a $30k loss on an investment that is still rewarding you the same $1,000 per month.

Passive vs. Active Investing

You may have the feeling that we are promoting a passive, buy and hold style of investing based on the real estate analogy thus far. Actually, Camelot Portfolios promotes an active management approach. The differentiator from our seemingly passive buy and hold real estate example comes down to the reasons we choose to buy/sell investments at any given point. This is where we start to look at how volatile markets create opportunity in our efforts to increase future cash flow and reduce risk.

Assume that the property next to your rental property, which is also being rented out for $1,000 per month, fell to $65,000 in 2008. Because your neighbor panicked and decided that he couldn't "take any more losses" he put the house up for sale. This creates opportunity for you because this property which has historically been valued equal to yours, and has a tenant paying the same amount of rent, is now available at a price lower than yours. This means that the dividend ($1,000 rent) produced from your neighbor's property is actually generating a better yield. Owning his property instead of yours would mean both less risk and more growth potential because you own a property with an equal long term valuation at a lower cost. This would also create an opportunity for you to increase your cash flow if you took the spare $5,000 and bought another investment that would reward you in the form of a dividend or distribution.

Investors are emotional and markets are irrational. A person selling out of fear creates opportunity for the level-headed investor that chooses logic over emotion. If you focus on what your investments are providing (cash flow/rent) as opposed to the short term value (price/volatility), you may be able to profit from the poor decisions of others.

Why Have a Disciplined Investment Approach?

The Market has been affected by a Correction, Bear Market and/or Recession 45.2% of the time.

The Dow Jones Industrial Average 1900 through September 2014

Summary

Declines	Number	Median	Average Frequency
Corrections	19	-13.91%	Every 6.03 Years
Bear Markets	17	-33.97%	Every 6.74 Years
Corrections & Bears	36	-18.69%	Every 3.19 Years
Recessions	23		Every 4.99 Years

Median Durations	Peak to Trough	Trough to Peak Level	Peak to Peak Level
Corrections	5.95 Months	4.96 Months	11.01 Months
Bear Markets	1.75 Years	2.17 Years	4.00 Years
Corrections & Bears	7.98 Months	8.97 Months	1.59 Years

On average, a Correction, Bear Market and/or Recession occurs every 1.94 Years.

Market Condition	Percentage of the Time
Corrections	9.2%
Bear Markets	28.1%
Corrections & Bears	37.3%
Recessions	23.9%
Corrections, Bears, Recessions	45.2%
Bull Markets	62.7%

Note: On average, the market's trough occurs 5.3 months prior to the end of a recession.

Red Line Segments: Corrections (P,T) - Minimum 10% decline but less than 20% & Bear Markets (P,T) - Minimum 20% decline. Data: Dow Jones Industrial Average (end of month)
Recessions are as defined by The National Bureau of Economic Research. ①The Stock Exchange was closed due to World War I.
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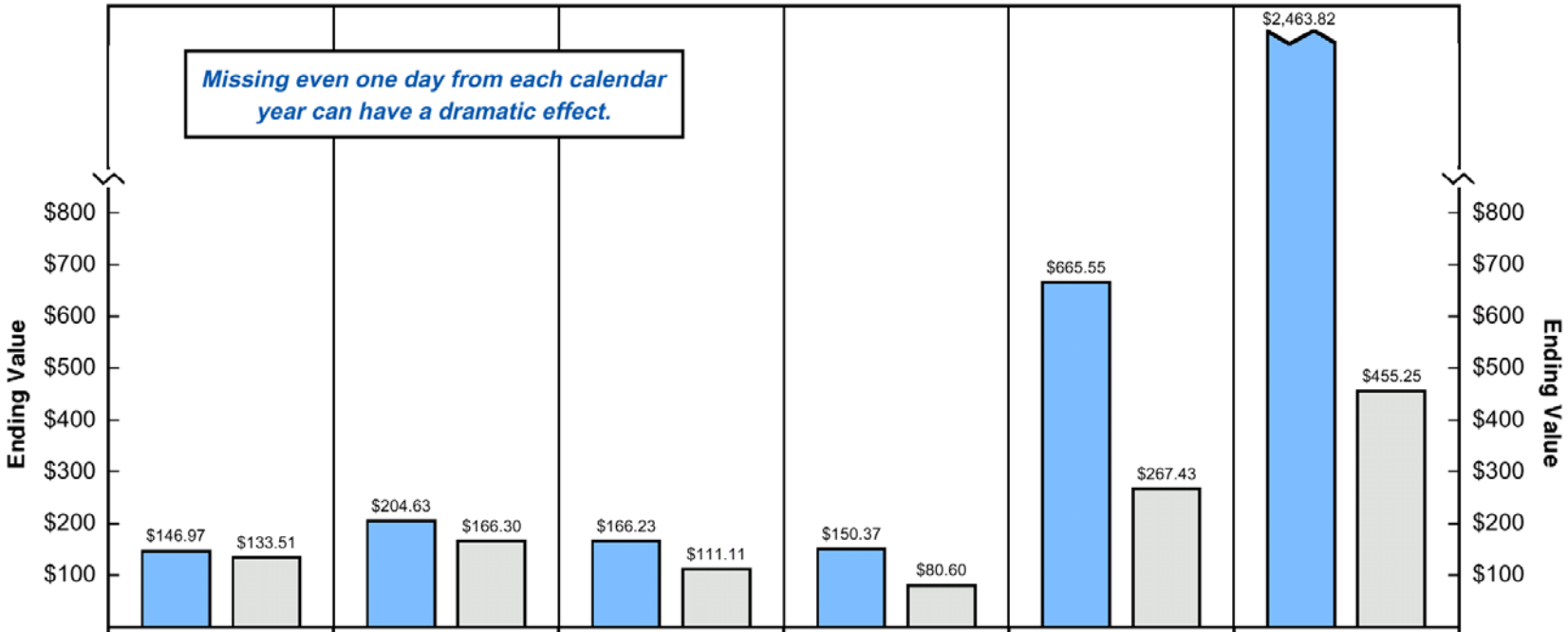

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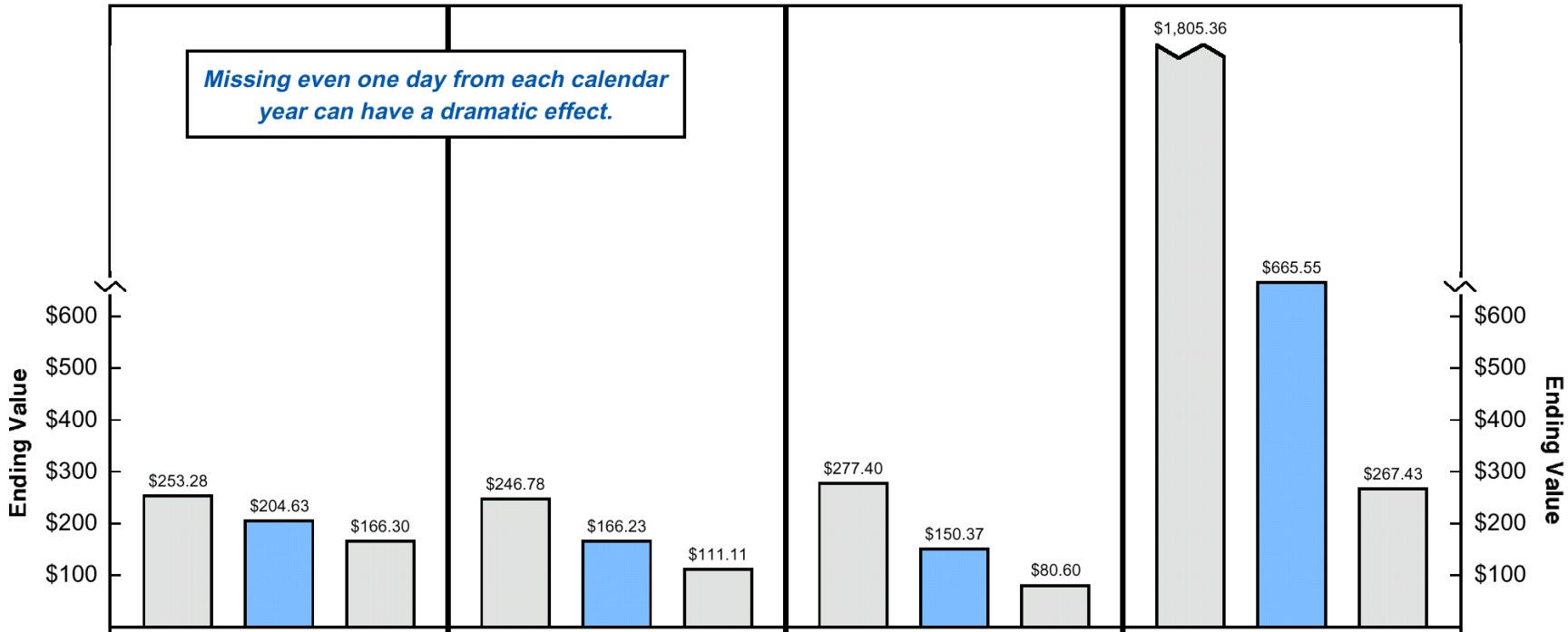

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