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PORTFOLIO WATCH

Veripax FINANCIAL MANAGEMENT, LLC

Email: Jerry.Verseput@veripax.net
Phone: 916-358-5635
Website: www.Veripax.net

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Importance of Past Performance

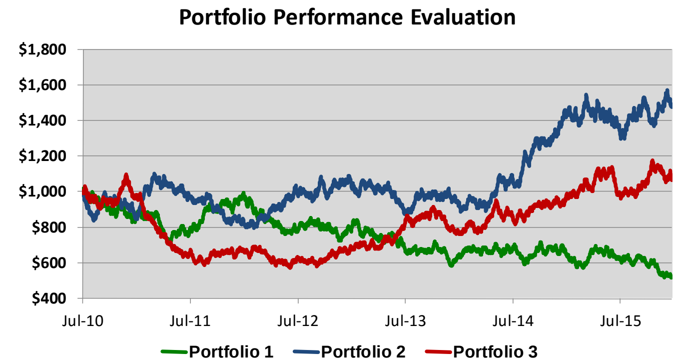
It's February, and that means the most dangerous and justifiably feared day of the year is approaching…Valentine's Day. There's a reason that the symbolism of Valentine's Day includes a creepy, flying creature ready to shoot you with an arrow. If you make the mistake of forgetting, or almost as bad, accidently repeating the same thing you did last year to be "romantic," you run the risk of getting shot. It's a lot like investing (OK, that's a stretch). Just because something worked great last quarter, or year, or decade, doesn't mean it will work again.

Evaluating the Right Strategy

When evaluating an investment or strategy, it seems obvious to ask "how has it done?" It's also the easiest question to ask and evaluate, which is why 5-year, 3-year, and even year-to-date performance is so widely used to judge investments. The three portfolios in the chart make a good example. Portfolio 1 can be ruled out pretty quickly since it clearly has a losing strategy. Portfolio 2 has the best overall gain, so it would appear to be the best choice. Here are the performance numbers:

	3-Year Avg	5-Year Avg	
Portfolio 1	-13.20%	-9.36%	(Ugh)
Portfolio 2	11.08%	11.15%	(Consistent)
Portfolio 3	**17.17%**	1.79%	(17%!!)

The 3-year average for Portfolio 3 looks pretty good. However, with only 3 or 5 observations, it's all about the starting point. You might as well flip a coin to choose between #2 and #3. In fact, that's exactly how all 3 of these "portfolios" were generated. I used a Coin Flip Simulator to generate random numbers. If the number was even (heads) the portfolio received a 1% gain; if it was odd (tails) it received a 1% loss. Rinse and repeat every day for



5+ years. The 3 portfolios in the chart are just 3 runs out of 5, and all three are *completely* random coin tosses.

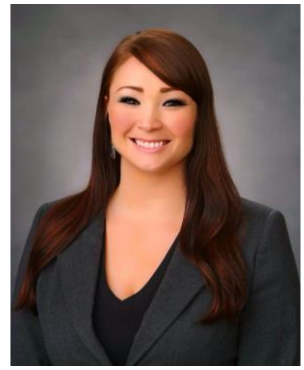
Is the Market a Coin Toss?

My point is not that performance is meaningless. It's that short-term performance on its own is useless. Whether it's 3 years or 5 years, that's not enough observations to rule out randomness. A tweet from a presidential candidate kicked off a drop in the Biotech sector that erased almost 2-years of gains, and Biotech as a whole is now down about 18% over the last year. That significantly affects the 3-year and 5-year numbers, but those numbers on their own don't convey *any* useful information. In fact, they cover up the one thing that is useful. What we can conclude from the recent Biotech drop is that the sector can be volatile…and that's it. But that information comes from the fact that the sector has experienced a 34% drawdown (high point to low point) in the last 6 months, not that it's 3-year average is +23%.

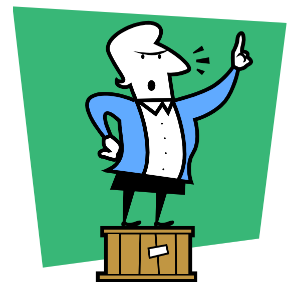
Using Past Performance

If 3 or 5 years is not enough, then what is? Maybe 10 or 20? 100? This brings up another problem. Today's market and investment tools are very different than they were in, say, the 80's, which makes very long-term performance equally as meaningless when evaluating a portfolio today. Drawdown, however, is always important because it tells you how volatile your strategy is. After that, strategies need to be evaluated based on whether they make logical sense. Basing an evaluation on a 5-year number is like giving your wife the same teddy bear with a heart for Valentine's Day and hoping it works as well as it did last year.

New Office Manager at Veripax



I would like to introduce Brenna Hammes, who came onboard in January as the full-time Office Manager. My wife, Kathy, has been helping me part-time for several years, and I can't thank her enough. The business has grown to the point where it was past time for a full-time manager who could focus on account administration, compliance, and other client issues, so if you are a client you will be talking to Brenna eventually. Brenna has previous experience as an administrative assistant in a financial planning office, so she has hit the ground running and already driven technology and process improvements. I look forward to being able to provide improved customer service with Brenna on the team.



Market Comments

Since January's newsletter got out a little late, I already talked about the horrible start to the month. Since about mid-month the market has really had no direction. It has been characterized by some pretty wild swings, though. I was just thinking today that it's been a while since the market *didn't* have a 100+ point move in one direction or the other, which is the exact opposite of a few years ago when it went for months without a 100-point move. That was the effect of the Federal Reserve. Even though the Fed is no longer printing gobs of money (i.e. Quantitative Easing), the market is still being affected by the likelihood of the next rise in interest rates. On the last day of January some particularly weak economic numbers were published and the market jumped, thinking that another 0.25% increase in interest rates is unlikely this year. This week the unemployment number dropped and the market tanked, thinking that maybe an interest rate increase is a little more likely. The market is clearly still ignoring sanity.

I could talk more about the market, but instead I want to mention that this month's article is probably one of the most important I've ever written. The last 6 years of Quantitative Easing, or $4.7 trillion worth of money printing, has created a situation where blindly investing in the US market with little concern for risk has created some very attractive 5-year performance numbers. Managers who ignore risk management (most of them) will be pushing those performance numbers hard as the market remains volatile, and especially if it pulls back more. No strategy works the best all the time, and risk managers, of which I am one, have lagged as the Federal Reserve continued to surprise the market with more stimulus. We are now simply seeing another part of the market cycle (it's about time), and risk management strategies are intended to operate over an entire market cycle. Because of the unprecedented level of Federal Reserve involvement, there have been few times in history when the last 5 years is less relevant to the next 5 years. As I attempted to point out in the article, 5-year (and 3-year, and year-to-date) performance numbers have always been next to useless on their own, but now they are downright dangerous. The market cycle is shifting, which means the effectiveness of different strategies will shift. Make sure you know what strategy you are following, and that it makes sense for a market that has potentially grown fat and drunk off of 6 years of stimulus.