WESTLAKE INVESTMENT ADVISORS

THE TRENDWISE PORTFOLIO

Guiding Principles

In real estate, it's: *"Location, location, location!"*
In stock investing, it's: *"The market, the market, the market!"*

We know that even the best of portfolios will likely perform poorly when the market performs poorly. We all remember the devastation on portfolios from the crashes of 2000-02 or 2007-09.

The key, then, is to be WISE about the market's TREND and proactively move to the sidelines when the market's trend turns negative.

THE TRENDWISE PORTFOLIO uses a complex mathematical model to assess the longer-term stock market trend and invests portfolio assets accordingly. The use of such a model, as well as the investments used in the portfolio to carry out the dictates of the model, makes THE TRENDWISE PORTFOLIO **very** different than most portfolios.

At Westlake Investment Advisors, we manage the wealth of several dozen successful families. While each family has achieved their success in different ways and are at varying stages in life, they tend to have similar wishes:

- They like the lifestyle that their wealth affords them. They're millionaires – they have no desire to become "thousand-aires."
- They want to take care of their family, enjoy their retirement and leave a meaningful legacy.
- They're willing to take some risk, but they want to avoid crippling losses.
- They want to work with an advisor who understands them, cares about them, puts their interests first, communicates well with them, and is always available for them. In short, they want a relationship with an advisor that they trust.

In this white paper, we'll explore why our clients choose THE TRENDWISE PORTFOLIO.

FOUR GUIDING PRINCIPLES

THE TRENDWISE PORTFOLIO has four guiding principles that provide the framework for the management of your funds:

1. Avoid big losses.
2. Eliminate emotions from decision-making.
3. Make reduced-risk choices.
4. Design it client-first and client-friendly.

We will review each principle in detail, providing both the logic that compels us to use it and how THE TRENDWISE PORTFOLIO lives up to it.

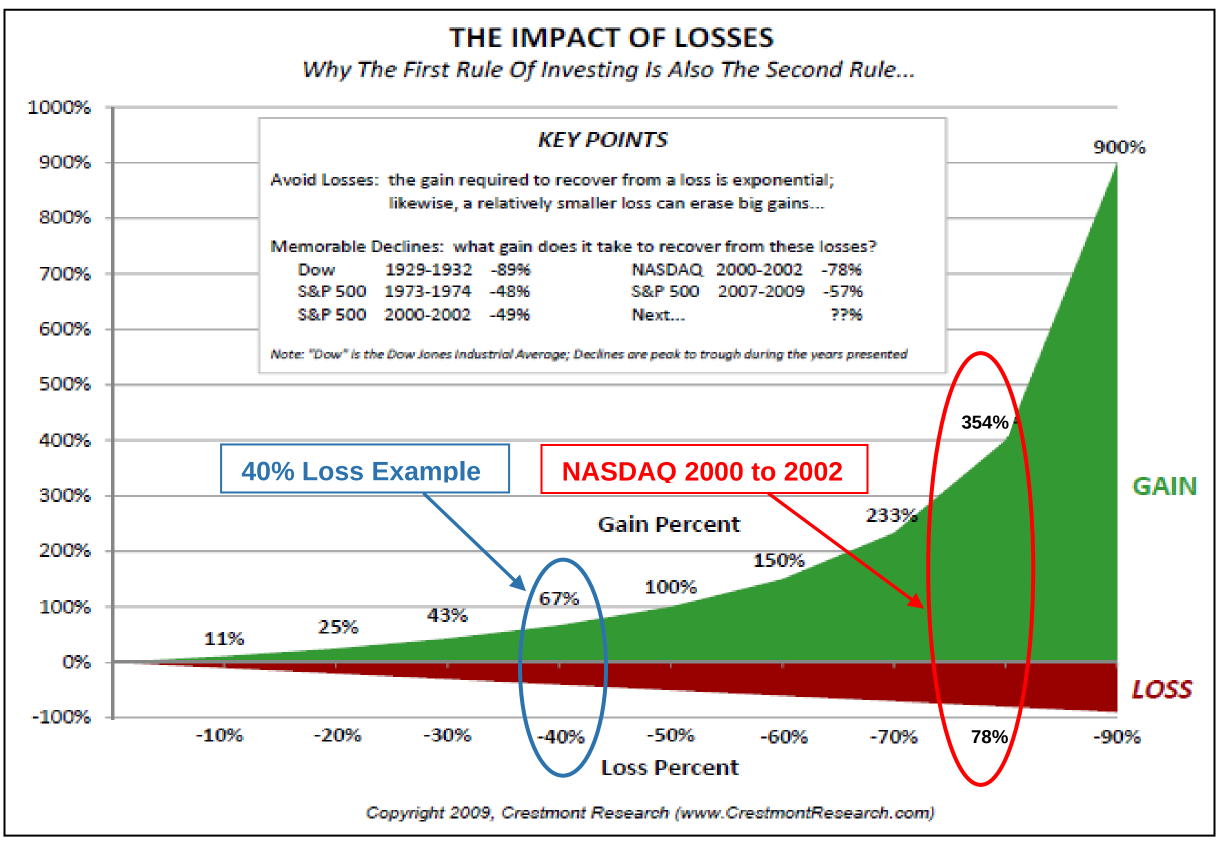
#1 Avoid Big Losses

First, let's review the "Arithmetic of Losing," which can be summed up by these three mathematical truths:

- A large percentage loss is more damaging to a portfolio than an equal percentage gain is helpful.
- It's OK to give up big gains when seeking to avoid big losses.
- It's OK to take small losses when seeking to avoid big losses.

The first statement is a mouthful, so let's clarify by way of an example. A 40% loss to a portfolio is not offset by a subsequent 40% gain. Not even close. If you started with $100 and lost 40% in year 1, you'd have $60 left. Then if you gained back 40% in year 2, you'd gain 40% of the *now-much-lower $60*, which is only $24. Your original $100 – after a 40% down year and a 40% up year – is only worth $84. In fact, if you lose 40% in year 1, it takes 67% in year 2 just to get back to breakeven.

The chart below shows how the bigger the loss, the greater the subsequent gain needs to be just to break even. The 40% example we just reviewed is circled in blue – you'll see that it's paired with the 67% gain it takes to break even. What would it take to break even from the 78% loss that NASDAQ suffered in 2000 to 2002? That one is circled, too, in red: 354%!!



Let's review a real world example:

S&P 500 Returns for 2008-11

Year	S&P 500 Performance
2008	- 37%
2009	+ 27%
2010	+ 15%
2011	+ 2%

*Would you have been at a **profit** or **loss** after these 4 years?*

Source: Morningstar 4-22-13

These charts are not representative of any specific investment. Your results may vary. These illustrations are intended to demonstrate the mathematical concept behind the impact of a portfolio decline and the corresponding gain necessary to recoup the loss. Investments are subject to fluctuating returns and there is no assurance losses will be recovered.

If you had invested your life's savings into the S&P 500 at the beginning of 2008, would you have been at a profit or a loss by the end of 2011?

Quick math would say the 37% loss in 2008 was more than offset by the 27%, 15% and 2% gains in 2009, 2010 and 2011 – after all, if we add the 27% and 15% and 2% gains that comes to 44%, and that's bigger than the 37% losses. But as you know from the previous example, the *quick* math would be wrong.

The ***right*** math says that if you started with $100, you'd have $63 at the end of 2008. A 27% gain in 2009 means you tacked on $17; you're now at $80 at the end of 2009. 2010's 15% gain amounts to $12, and 2011's 2% gain adds just under $2. So you finish the 4-year period at just under $94. **You've lost 6% from your original $100.**

The table below illustrates that it's OK to give up big gains to avoid the big losses:

Giving Up Big Gains to Avoid Big Losses

Year	Big Gains AND Big Losses	Give Up Big Gains to Avoid Big Losses
1	+ 40%	+ 2%
2	+ 30%	+ 2%
3	+ 10%	+ 2%
4	- 30%	+ 2%
5	- 40%	+ 2%
Wrong Math	~~+ 10%~~	~~+ 10%~~
Right Math	**- 15.9%**	**+ 10.4%**

*The **right** math:*

it's OK to give up big gains to avoid the big losses

The "wrong math", above, was simply adding the percentages.

The "right math" involves multiplying, and gives us a completely different picture. The same logic applies below, where we show that it's OK to take small losses to avoid big ones:

Giving Up Small Losses to Avoid Big Losses

Year	Big Gains AND Big Losses	Take Small Losses to Avoid Big Losses
1	+ 34%	+ 16%
2	- 24%	- 3%
3	- 22%	- 4%
4	+ 31%	+ 14%
5	+ 2%	- 2%
Wrong Math	~~+ 21%~~	~~+ 21%~~
Right Math	**+ 6.1%**	**+ 20.7%**

The ***right*** *math:*

it's OK to give up small losses to avoid the big losses

This is a hypothetical example and is not representative of any specific investment. Your results may vary.

Clearly, **avoiding big losses is priority #1**. How can you pursue this?

That's easy: don't ride up and down with the market. In falling markets, you want to exit the stock market. In rising markets, you want to participate in it.

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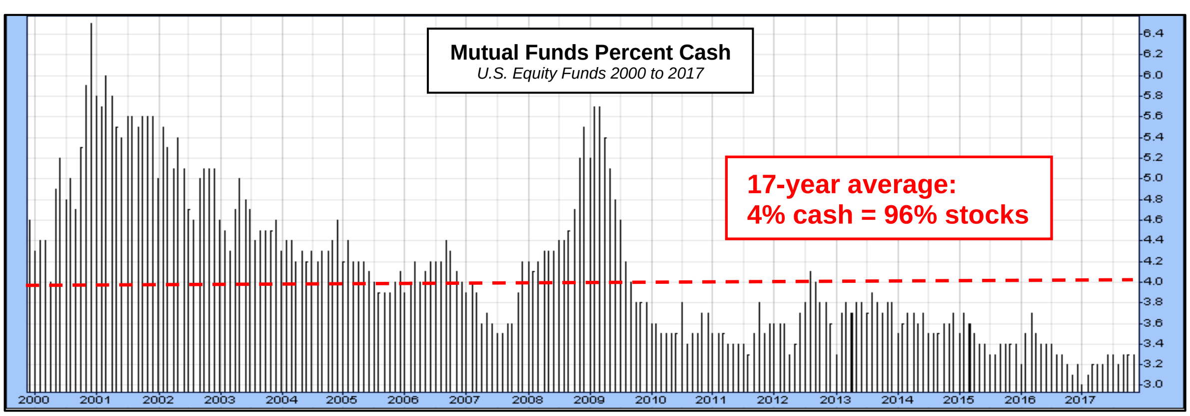
Unfortunately, you can't do that by simply buying and holding a mutual fund. As the chart below shows, the average equity mutual fund stays pretty much fully invested all the time. You can see that for the 17 years shown, their portfolios have averaged around 4% cash. The rest – 96% – stayed in stocks. The latest data (through 2018) shows equity funds held only 2.9% cash.

Equity Stock Fund Holds Very Little Cash



Investing in mutual funds involves risk, including possible loss of principal. Source: ICI November 2017

The typical fund does not pare down its stock exposure when the trend is falling. And they can't increase it when the trend is rising – there's not much room above 96%. In other words, they maintain their near-100% stock exposure all the time.

If the mutual funds won't dial up or down their stock exposure, we must. We simply determine our stock exposure based on market conditions.

To make these changes, you must have a reasonable assessment of the market's trend. Of course, there is no crystal ball – there is no way of knowing for certain what the trend of the market will be.

THE TRENDWISE MODEL is purely math-based and compares short term market movements with longer term market patterns to determine the market's trend.

When THE TRENDWISE MODEL indicates that the market trend is rising, we take positions **IN** the market.
When THE TRENDWISE MODEL indicates that the market trend is falling, we move our positions **OUT** of the market.

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Such analysis does <u>not</u> react to the constant barrage of news, such as global events or Washington-speak. Instead, it indicates whether we should be protective or participative.

Summary

- Big losses should be avoided – the hole they put you in is very hard to climb out of:
    - It's OK to give up big gains when seeking to avoid big losses.
    - It's OK to take small losses when seeking to avoid big losses.
- The key is: move into or out of the stock market as the market's trend dictates.
- THE TRENDWISE MODEL uses math-based inputs to determine the market's trend.

#2 Eliminate Emotions From Decision-Making

Emotions negatively impact investment decisions. Of the many psychological factors that can wreak havoc on your portfolio, *greed* and *fear* are among the most influential.

> *Greed* makes you buy at higher prices – you believe that what you're buying can go nowhere but up. And greed keeps you invested longer than you should.
>
> *Fear* is just the opposite. It forces you to "panic out" of the investment at low prices and keeps you from getting back in.
>
> *Greed* and *fear* combine to make investors buy high and sell low – just the opposite of what is needed.

Can the impact of emotions be measured? Yes.

Since 1994, DALBAR's Qualitative Analysis of Investor Behavior has been measuring the effects of investor decisions to buy, sell and switch into and out of mutual funds over both short- and long-term time frames. The results consistently show that the average investor, by virtue of their emotional shifts in and out of mutual funds, earns much less than the mutual fund performance reports would suggest. They found that for the 30 years ending 2018:

Emotions reduced stock and bond returns by around 6% per year

- The average equity investor earned 4.1% per year while the S&P 500 returned 10.2% per year. That's an under-performance of just over 6% per year.
- The average bond investor earned 0.3% per year while the Barclay's Aggregate Bond Index returned 6% per year. That's an underperformance of just under 6% per year.
- In short, it appears that **emotions reduced stock and bond returns by around 6% per year**.

According to DALBAR, "The psychological factors that batter away at average investor returns remain dominant and the 'code' to crack these behaviors remains elusive." DALBAR president Louis S. Harvey adds "Investors diligently seek investments that they hope will produce the best returns but lose much of that benefit when they yield to psychological factors". [1]

Emotions can not only negatively impact basic investor buy and sell decisions, but they can similarly affect one's outlook for the market as a whole. In other words, if (as discussed in the prior section) the key to dialing stock market exposure up or down is having a reliable set of market indicators, we must also eliminate emotions from this analysis.

THE TRENDWISE MODEL is – by design – highly objective with very little room for subjective, emotional bias. It yields a non-equivocal stance on the market.

Summary

DALBAR found that for the 30 years from January 1989 through December 2018:

- Emotions have a significant negative impact on investment decision-making.
- The opinion of the stock market can similarly be impacted by emotion and bias.

THE TRENDWISE MODEL seeks to avoid these impacts by using highly objective inputs.

The indices mentioned above are unmanaged and cannot be invested into directly.

#3 Make Reduced-Risk Choices

THE TRENDWISE MODEL determines our stock market exposure: protective or participative. How we implement these decisions – in other words, what investments we make in an effort to achieve the desired exposure – can also impact the results. How can we manage risk with these implementation choices?

Managed Mutual Fund or Index Fund?

By "managed" we're referring to equity mutual funds where the manager is paid to outperform the market. This outperformance is called "alpha" – it's the holy grail of investment management. Alpha measures the difference between a portfolio's *actual* returns and its expected performance, given its level of risk. A positive (negative) alpha indicates the portfolio has performed better (worse) than expected. But roughly two-thirds of all equity managers do not generate <u>any</u> alpha! According to Morningstar as of April 2020, only 34% of managers had positive 3-year alphas! [2]

> Only 34% of managers had positive 3-year alphas!

Why pay for a manager's alpha if the odds of achieving any alpha are so small? We don't. Instead, we buy index funds. These funds are not managed, per se – they're designed to replicate the return of a specific underlying index (less internal expenses). So, for example, the performance of an index fund based on the S&P 500 will generally mirror the S&P 500's performance, less about a 1/5 of 1% in internal expenses. Index funds do not generate any alpha – they will never outperform their underlying index. They simply deliver the underlying index.

> Why pay for a manager's alpha if the odds of achieving any alpha are so small?

An investment in an index fund involves the risk of losing money and should be considered as part of an overall program, not a complete investment program. An investment in index funds involves additional risks such as not diversified, price volatility, competitive industry pressure, international political and economic developments and index tracking errors.

Diversification

Owning any one stock carries with it "individual stock" risk. Sure, if the one stock you own soars (think Google or Tesla?), you'll reap the benefits. But if that one stock tanks (Enron or Kodak?), you'll pay dearly.

Diversification can reduce this individual stock risk. THE TRENDWISE PORTFOLIO does not buy any individual stocks – just index funds that in turn own or emulate well-diversified portfolios.

> Diversification can reduce this individual stock risk.

THE TRENDWISE PORTFOLIO also diversifies by the size of the company (a.k.a. "market cap", such as large caps or small caps).

Of course, there's no guarantee that a diversified portfolio will enhance your overall returns or outperform a non-diversified portfolio.

And remember, while diversification can reduce *individual* stock risk, it does not protect against *market* risk. This, as we explained in section #1, is why we must utilize a model like THE TRENDWISE MODEL.

Bonds

We've spent a fair amount of time talking about the stock funds, but how do we invest the portion that's not in stocks? Of the many non-stock choices, bonds provide an historically low risk complement to stocks. This is especially true if we keep the duration (which measures a bond's sensitivity to interest rate changes) low and maturity short. We may also utilize other non-equity income-generating vehicles.

Let's review why we would buy bonds (and other non-stocks) in the portfolio. It's not for the interest it may generate, though there will be some. And it's not for the potential gains. It's simply to not have stocks in the portfolio all the time. It's simple diversification. Bonds provide ballast for the overall portfolio.

Bonds provide ballast for the overall portfolio.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

Summary

In implementing THE TRENDWISE PORTFOLIO, we want to reduce risk where possible. Accordingly, we choose:

- Non-alpha producing index funds.
- Diversification by market cap.
- Low duration, short maturity bonds and other non-stock positions.

#4 Design It Client-First and Client-Friendly

THE TRENDWISE PORTFOLIO must be designed with you in mind – putting your needs first and making the process easy for you. Here are some of THE TRENDWISE PORTFOLIO'S client-first and client-friendly design elements.

Fees

THE TRENDWISE PORTFOLIO may make several trades during the year as it determines whether to be in or out of the market. Charging a commission for each trade is simply out of the question. First, the obvious: you'd get eaten alive by commission costs. But just as important, a commission gives the manager an incentive to trade.

Charging a commission for each trade is simply out of the question.

Instead, we charge an annual fee based on assets. We never want you to think that a trade took place because it lined our pockets. The fee rate (as a percent of assets managed) decreases as the assets increase, and household assets may be combined for lower fees.

All account fees will be outlined in your account agreement, which you should read carefully.

Liquidity

You want access to your money. You don't want a contract that lasts for several years or a penalty for taking out your money. Investments held in THE TRENDWISE PORTFOLIO are liquid. That means that you can cash out any or all of the account at any time – your funds will be available in two business days. We can mail you a check or wire funds to your bank. And any unused portion of the quarterly fee is rebated to you.

Investments held in THE TRENDWISE PORTFOLIO are liquid.

Discretion

You don't want to be bothered each time we make a change. You just want it done. Can you imagine us trying to track you down while you're traveling halfway around the world or as you're inking a big contract? And then think if we had to get your permission for each trade, would you like to be the 100th call?

You don't want to be bothered… you just want it done.

Using discretion, we can execute an investment decision for all clients in literally minutes. A desired by-product of this discretion is that all clients – large and not-so-large alike – get exactly the same prices at the same time.

Administration

You want things to go smoothly. Your checks go out on schedule; your tax info is coordinated with your CPA; we take good care of your Aunt Martha who lost her stock certificate that she thought was in her safe-deposit box.

Fortunately, we have a 43-year veteran, Lin, who handles all client service matters. And she's really *really* good at it. Lin has worked with me for 25 years and knows all our clients.

We have a 43-year veteran, Lin, who handles all matters administrative.

She anchors the early shift – she arrives by 6:30 and is fully licensed to handle all situations.

Accessibility & Responsiveness

You shouldn't have to work hard to reach us. And we should respond to you quickly.

We hear horror stories of clients who could not get a hold of their broker. Or of brokers who didn't return calls or disregarded emails. This we do not understand – it makes for a truly lousy experience.

We want to hear from you and truly enjoy helping you. We use state-of-the-art phones that integrate with our cell phones in an effort to maximize our responsiveness. If we are away from our desks, your voicemail message is sent immediately to our cell phones.

We want to hear from you and truly enjoy helping you.

Summary

- We've designed THE TRENDWISE PORTFOLIO to be client-first and client-friendly, with our fee structure, liquidity and use of discretion.
- The administrative side of things is handled in a first-class way. Thank you, Lin.
- Access and responsiveness are top priorities. I challenge you to find a financial advisor with a better approach or mind-set.

Conclusion

We have reviewed, in detail, THE TRENDWISE PORTFOLIO four guiding principles:

1. Avoid big losses.
2. Eliminate emotions from the decision-making process.
3. Make reduced-risk choices.
4. Design it client-first and client-friendly.

If these principles resonate with you, let's have a conversation about making THE TRENDWISE PORTFOLIO part of your investment game plan.

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All performance referenced is historical and is no guarantee of future results.
All indices are unmanaged and may not be invested into directly. The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Robert A. "Rocky" Mills is a registered representative with and securities offered through LPL Financial, Member FINRA/SIPC

[1] *http://www.dalbar.com/Portals/dalbar/cache/News/PressReleases/pressrelease040111.pdf*
[2] *Morningstar search criteria: A or no-load shares, incepted on/before 12-31-11, 75% or more in US stocks, positive best fit alpha (1022 funds out of 2987)*