ROCKBRIDGE INVESTMENT MANAGEMENT, LLC

Financial Common Sense

April 2013

Craig A. Buckhout
CFA

Anthony R. Farella
CFP®

Rockbridge Investment Management is a group of like-minded professionals working with a select group of clients with whom we can have a significant impact. Everything we do is focused on building and preserving wealth for our clients. We help remove complexity so clients can focus on the simple but difficult process of successful investing.

Rockbridge Investment Management, LLC

101 South Salina Street
Suite 400
Syracuse, NY 13202

Phone: 315-671-0588
1-888-689-2351
Fax: 315-671-0589

www.rockbridgeinvest.com

Market Commentary by Anthony Farella

Stocks wrapped up a stellar first quarter with the S&P 500 finishing at an all-time high, besting its last high in October 2007. For the quarter, large-cap stocks (represented by the S&P 500) were up 10.6%. Small-cap stocks also did quite well, returning 12.4% in the first quarter. International markets had a positive return of 5.3% for the period January through March, while emerging market stocks lost some ground, with a negative return of -1.5%. Domestic real estate did well, gaining 7% as measured by the Dow Jones US Select REIT Index.

Positive economic news likely fueled the excellent quarter for all stocks. The final government report for fourth-quarter GDP showed an annual increase of 0.4%, slightly higher than the expected increase of 0.3%. The housing market has continued its slow comeback from the Great Recession, though the housing market in general has benefited from record low interest rates and improving employment conditions. The supply of new homes remains near record lows while median home prices rose 2.9% year over year to $246,800. The decline in consumer confidence in March and the increase in jobless claims over expectations did not seem to have a negative impact on the strong stock rally this quarter.

It is not likely that stocks will continue to rise at this torrid pace. History says double-digit stock market gains in the first quarter all but assure a gain for the full year; however, the average gain is 1.4% for the remainder of the year.

Challenges Ahead For the Bond Market

Bond returns were near zero for the quarter with the benchmark Barclays US

(Continued on page 2)

Hindsight is 20/20, But the Future is Unpredictable
by Craig Buckhout

How many times have you heard someone say, "In 2008 I knew the market was going to crash…" – or some similar statement of prescience?

That would be an example of how hindsight creates an illusion of understanding, as described by psychologist Daniel Kahneman, who won a Nobel Prize in economics for his work in behavioral finance. In his recent book *Thinking, Fast and Slow*, he explains how hindsight alters our memory. A result that seems obvious when viewed in hindsight is remembered as being evident at the time, when in fact it was not.

No one knew what was going to happen in 2008. Some people thought there would be a crisis, but they did not know it. Kahneman points out that using the word "know" fosters the illusion (an unsubstantiated belief) that we understand the past, and therefore the future should be knowable. You will not hear anyone say, "I had a premonition that the sub-prime debt crisis was overblown and knew markets would recover nicely in 2008 – but I was wrong." First off, it sounds silly, and secondly, most prognosticators have forgotten they ever held that belief! Author Nassim Taleb describes a similar effect of hindsight in his book *The Black Swan: The Impact of the Highly Improbable* where he introduces the notion of a *narrative fallacy*, to describe how flawed stories of the past shape our views of the

(Continued on page 4)

Market Commentary (cont.)

Government/Credit Bond Index down -0.16%. The Federal Reserve is acting aggressively to keep short-term interest rates down while also buying treasury bonds, which depresses long-term bond yields. The Fed does not look to change course anytime soon. When the Fed does decide to raise interest rates, it plans to do so slowly.

The bond market had a great 10-year run that mathematically is virtually impossible to duplicate due to the very low yield environment. However, it is critical to remember the importance of bonds in a globally diversified portfolio. The ability of high quality and less risky bonds to smooth out the volatility of an overall portfolio that contains domestic and international stocks is critical to long-term investor success.

Investing Is Uncertain

Building investment portfolios is what we do. We build them for real people who want to maintain their standard of living in retirement. We integrate the best scientific evidence with the art of portfolio construction in an effort to give our clients the best possible chance of being successful investors. However, markets are uncertain and risky by nature so we also spend time making sure our clients do not make emotional decisions based on short-term events or news. Doom and gloom sells newspapers and books so we often get questions about the impact of recent events on our clients' portfolios.

I will contrast two very different opinions that I've read recently. First, David Stockman wrote an opinion piece in the *New York Times* promoting his book "The Great Deformation: The Corruption of Capitalism in America". The *New York Times* article was so popular it went viral on the web. The crux of the article and the book is this: the country's economic condition is worse than everyone thinks and on the brink of collapse in the near-term future. Stockman is a former congressman and director of the Office of Management and Budget under President Ronald Reagan. He is clearly a smart and experienced man who has proffered his thoughtful analysis. Stockman's prescription for investors is to flee the stock market and keep all your money in cash.

Contrast that opinion with Warren Buffet, arguably the most successful investor in history, who shared his thoughts in his much anticipated annual letter to shareholders of Berkshire Hathaway. Quote from the shareholder letter:

> *American business will do fine over time. And stocks will do well just as certainly, since their fate is tied to business performance. Periodic setbacks will occur, yes, but investors and managers are in a game that is heavily stacked in their favor. (The Dow Jones Industrials advanced from 66 to 11,497 in the 20th Century, a staggering 17,320% increase that materialized despite four costly wars, a Great Depression and many recessions. And don't forget that shareholders received substantial dividends throughout the century as well.)*
>
> *Since the basic game is so favorable, Charlie and I believe it's a terrible mistake to try to dance in and out of it based upon the turn of tarot cards, the predictions of "experts," or the ebb and flow of business activity. The risks of being out of the game are huge compared to the risks of being in it.*

End quote. The contrast can be boiled down to "pessimism" vs. "optimism". While Stockman may be correct in articulating the very big problems facing America, I do not believe that we are facing the downfall of capitalism in general. I prefer the optimistic view of the future described by Warren Buffet, and I expect the markets to survive and reward those willing to endure the risks of investing.◆

Form ADV Notification

Form ADV, Uniform Application for Investment Adviser Registration, for Rockbridge has been filed as appropriate with the Securities and Exchange Commission, and may be reviewed at the offices of Rockbridge Investment, 101 S. Salina St., Suite 400, Syracuse, NY 13202, or may be obtained by mail by requesting same at this address or by phone at 315-671-0588.

Market Madness by Patrick Rohe

Patrick E. Rohe
CFP®

During this time of the year office brackets and friendly wagers are seen everywhere, luring in even the faintest of sports fans. This epidemic, also known as March Madness, has gotten ahold of everybody and is the craze of the nation for almost a full month! So besides edge of your seat excitement-filled games, what other takeaways can this basketball tournament bring us?

Let's take a look at some common mistakes made when filling out your brackets and why you want to make sure they don't translate to the way you run your personal finances!

Hometown Bias: People have a tendency to be partial towards what they know. In NCAA Tournament brackets, this is seen by people advancing teams they know or have heard of. They build a bias in their heads that since they know the team, they must win. This is apparent by the plethora of Central New Yorkers advancing Syracuse to the NCAA championship, the staggering amount of all Big East teams in the Final Four, and other similar bias you see every day in local office bracket pools.

The key is to not let this bias run into your personal investing life. Just because you work for a company, recognize a stock's name, or feel you know a particular industry does not mean that it is worth owning. Take a step back and make sure you are making a sound investment decision, and not an off-the-cuff "hometown bias" guess!

Expert Analysts: Being an expert does not always give you an edge, but rather can make you more dangerous. This was very evident in our Rockbridge office pool where Tony's 10-year-old daughter, Lauren, has won two of the last three years! I'm a bit embarrassed to admit it, but there are very few college basketball games I don't watch; however, it certainly didn't give me any strategic advantage over Lauren who filled out her bracket over a bowl of Cheerios the morning they were due!

Overconfidence can lead investors to believe they can outperform the market. It will lead you to make non-prudent investment decisions that will ultimately have a negative effect on your retirement portfolio. One basketball expert couldn't see any way for the small school, Wichita State, to make it to the Final Four.

> *No. 8 Pittsburgh over No. 9 Wichita State: Pittsburgh goes 10 deep with no stars. The Panthers are a very good offensive rebounding team, ranking fourth in the nation in getting more than 40 percent of their own misses … Because Pitt is better on the offensive end, The Bilastrator favors Pittsburgh, and the Panthers will move on to face Gonzaga.*
>
> – Jay Bilas, ESPN Analyst 2013

Don't leave your retirement accounts to chance. Make sure you have a financial plan in place and be disciplined enough to adhere to it. Even bright people make bad predictions. Don't let your finances fall victim to one of them!

The Cinderella Story: We Americans love our underdog stories. When I glance at ESPN in the morning it is filled with the best of yesterday's sports, which always includes a few "Cinderella-like" comebacks! Have you ever seen a movie where the worst team in the league didn't end up winning the championship in a stunning comeback? A team that starts out bad and stays bad just isn't worthy of the spotlight! I certainly remember the 2010 NCAA Tournament when my alma mater, Cornell University, made it to the Sweet 16! I seem to forget to mention their quick exit from the tournament in 2008 and 2009. Ooops!

So don't forget the parallel that can be made to your own finances. We all know the guy who tells you about the great stock he bought and how it has tripled in value since, but what do you think he is choosing to not tell you? Stick with what you can control when it comes to your finances and leave the guesswork to your office NCAA Tourney pools!◆

Hindsight is 20/20, But . . . (cont.)

world and our expectations for the future.... Taleb suggests that we humans constantly fool ourselves by constructing flimsy accounts of the past and believing they are true.

In the same section of his book that elaborates on many manifestations of overconfidence, Kahneman goes on to describe a specific incident where he was invited to speak to a group of investment advisors. In preparation he asked for some data and was given the investment outcomes of twenty-five anonymous stock pickers, for each of eight consecutive years. A careful statistical analysis of their stock-picking ability found no evidence of persistence of skill – none. "The results resembled what you would expect from a dice-rolling contest, not a game of skill."

The fact that he could find no evidence of skill is not remarkable. What is remarkable is that no one changed his or her beliefs when presented with the evidence. The advisors and their superiors went on believing that they were all competent professionals doing a serious job, when the evidence clearly suggested that luck was being interpreted as skill. Kahneman's conclusion:

The illusion of skill is not only an individual aberration; it is deeply ingrained in the culture of the industry. Facts that challenge such basic assumptions – and thereby threaten people's livelihood and self-esteem – are simply not absorbed.

Three Lessons for Investors

1. Overconfidence may have helped cavemen survive when facing overwhelming odds of failure, but it rarely helps investors.

2. Beware of the narrative fallacy – A reckless leader can be labeled as prescient and bold, when a crazy gamble pays off. So consider the role of chance and luck when an investment decision turns out well. Luck does not equal skill, and remember that even good decisions can lead to bad outcomes, when the future is uncertain.

3. When a mistake appears obvious in hindsight, try to remember how uncertain the situation was in advance. No one "knew" how things would actually turn out.◆

Returns from Various Markets

The following table shows the returns from various markets over periods ending March 31, 2013:

Market/Asset Class	Quarter	1 Year	3 Years	5 Years	10 Years	20 Years
Money Market	0.0%	0.1%	0.1%	0.3%	1.8%	3.2%
Bond Market	-0.2%	4.6%	6.1%	5.5%	5.1%	6.2%
Large-Cap Stock Market	10.6%	14.0%	12.7%	5.8%	8.5%	8.5%
Small-Cap Stock Market	12.4%	16.3%	13.5%	8.2%	11.5%	8.8%
International Equity Market	5.2%	11.8%	5.5%	-0.4%	10.2%	6.1%
Emerging Markets	-1.6%	2.3%	3.6%	1.4%	17.4%	8.4%
Real Estate	7.0%	13.2%	16.9%	6.1%	12.1%	10.2%
Inflation	0.8%	2.0%	2.3%	1.9%	2.4%	2.5%

Market Benchmark Portfolios

The following table shows returns from our market benchmarks over periods ending March 31, 2013:

Benchmark	Quarter	1 Year	3 Years	5 Years	10 Years	20 Years
Capital Preservation	0.8%	3.5%	4.1%	3.3%	4.1%	4.9%
Conservative	2.5%	6.3%	6.4%	4.5%	5.7%	6.3%
Moderate	4.3%	9.0%	8.5%	5.4%	7.3%	7.4%
Aggressive	6.1%	10.8%	9.2%	5.0%	8.1%	7.6%
All Equity	8.6%	13.1%	9.6%	4.0%	9.3%	7.7%

Note: These results were developed by simulating past returns in the various markets included in each benchmark, assuming the reinvestment of dividends and other earnings and deductions of costs totaling 0.20%. The money market is represented by 90-Day Treasury Bills; the bond market by the Barclays Capital Government/Credit Bond Index; the domestic large cap market by the S&P 500; the domestic small cap market by the Russell 2000 Index; the emerging markets by MSCI Emerging Markets Index; the real estate market by Dow Jones US Select REIT Index; and the international equity market by the EAFE Index. This data is presented to show the long-term relationship between returns at various levels of investment risk. It is not intended to present performance results experienced by clients of Rockbridge Investment Management, but is intended to provide a benchmark against which actual performance might be judged. Also, readers should recognize that future investments would be made under different economic conditions. It should not be assumed that future investors would experience returns, if any, comparable to those shown above. The information given is historic and should not be taken as any indication of future investment results.