PROCTOR FINANCIAL

RETIRE BETTER®

October 20, 2014

Dear Client:

Stock markets around the world had average to good performance during the first three quarters of 2014. However, the fourth quarter has started off very poorly. In fact, the downturn started during the last week of September (after the Dow and S & P 500 had reached all time highs), and has continued in the first two weeks of October, with the Dow losing 900 points (5.3%) in the first half of this month. We know that when the stock markets behave as they have in the last four weeks, it can cause some anxiety. It is helpful at times like these to remember advice given to passengers on cruise ships:

> *When feeling seasick due to rough waters, keep your eyes on the horizon.*

In this letter we want to address the steps we've already taken to protect your portfolios against a large market decline, remind you that trying to predict the short term behavior of the stock market is a fool's errand, and reiterate some of the guiding principles we use when managing money to help our clients achieve their goals. For those of you just looking for a summary of this information, please read the Executive Summary. For more details, continue reading until the end.

EXECUTIVE SUMMARY

We have 2 types of investments in our portfolios that help mitigate the effects of a major market decline:

1) **Hedges**
   As part of our normal asset allocation process, we place hedges in your portfolio to protect you against large market declines. We keep the ration of equities to hedges at 4 or 5 to 1. Though there is a lag before the hedges kick in, once they do (which happened this week), we expect them to gain enough to during a major decline to offset the losses in the equity portion of your portfolio (though this is not guaranteed).
2) **Partially Protected Enhanced Investment Notes**
   We have two Enhanced Investment Notes in our portfolios with some principal protection, one tied to US equities and one tied to International equities. Though their current values are still harmed by a market decline, if held to maturity there is a very good probability that at a minimum they will return their original investment. On average we have between 15 to 25% of client portfolios invested in these two notes.

We don't know whether the bull market of the last 5 ½ years is taking a temporary breather, or whether we are seeing the beginnings of a real correction, but if a bear market is on its way, we have your portfolios well prepared for the possibility.

Trying to predict what is going to happen in the short term with the equity markets, as shown in this comprehensive report by Vanguard (see p. 6 for the most relevant data), is a job for the media, but not a worthwhile pursuit for investors. So although we have the protections built into our portfolios as described above, we haven't abandoned any of our equity holdings to achieve this protection level. So if the bull market continues, we will still continue to capture some of those gains.

Finally, we will maintain our guiding investment principles for you going forward. These include:

1) Calculating the amount of cash flow you need from your portfolios in the next five years, and keeping that money out of the equity markets. This should allow us to avoid having to sell into a down market.
2) Creating globally diversified portfolios.
3) Using hedges to protect portfolios from major market declines.
   Portfolios are much more successful when they don't have to recover from catastrophic losses.

In the remainder of this letter, we will go into more detail about the items summarized above. Please read on if you would like more explanation.

<u>Protections Already in Place</u>

We currently have 5 different investments in place that are either designed to deliver outsized positive returns when the stock markets decline substantially or are built with some amount of principal protection built into them.

Portfolio Insurance-like Investments

We have two investments in our portfolios designed with the specific intention to act like portfolio insurance in the case of a major market decline similar in scope to what happened in 2008. We also have a third that can act in a similar fashion, but not quite as directly. As we've discussed with you previously, though, the investments that are designed more like portfolio insurance aren't designed to immediately kick in when the market starts declining, and are also meant to only protect against large declines. At this point, the first of these investments (the new JPMorgan Strategic Volatility note) has just started to switch to protection mode, and should start delivering good results if the market decline continues. The second investment we have specifically to protect against catastrophic loss (the Deutsche Bank ProVol index) looks like it will begin protecting portfolios in the next few days if things continue as they have. For most of our clients, these two investments represent a weighting of about 20 to 25% of their equity-based assets. Therefore, if these investments can deliver 4 to 5 times as much positive performance compared to the stock market's negative performance, then your portfolio as a whole should be fairly well insulated from large market declines. Based on historical results (which of course are not guaranteed), this performance expectation is not unreasonable for these investments.

Another investment we own in your portfolio that has the potential to deliver upside performance when the market is down substantially is the Deutsche Bank Emerald Index. It is already up over 13% for the year (through Friday), so while it might still act as a hedge against the market declining further, it has already delivered a fairly impressive return as it is. It profits more from up and down volatility, and may not do as well if the market simply goes straight down. However, if the stock markets

continue to have big up days while declining overall, it can still deliver some good return to offset the other parts of your portfolio.

Partial Principal Protection

International Equities

We made a very effective modification to our international holdings this summer and fall when we sold a note tied to international equities that had delivered over 22.8% return since we purchased it, and then replaced it recently with a similar note (from Societe General). Even though the underlying investments are very similar between the two notes, we were able to take the profit off the table and reset the principal protection level at a much higher level.

The current market decline will have no effect on the value of the note as long as we hold it until maturity. The markets would have to continue to decline much more significantly, and importantly, remain depressed for another 2 ½ years before any loss would be suffered at maturity. With the note we replaced, the current market decline would have been felt at maturity, as would further losses. The entire 23% gain could have been lost before any protection kicked in. Because the new note is still almost 2 ½ years away from maturity, its current value in your portfolio will still show a loss, but that loss will not be realized as long as we hold the note until maturity and neither international index it's tied to is down more than 30% since purchase.

Domestic Equities

Last fall, we did the same "sell and replace" modification as above for our US equity note. It was up over 24% and had outperformed the US equity market by almost 8%. Because of this change, we similarly protected that investment note (from BNP) against a market pullback, and reset the principal protection at a level that was on average over 18.5% higher. And as long as two criteria are met at maturity in 2 ¼ years, the original purchase price is guaranteed. Those two criteria are:

1) The S & P 500 is not more than 34.4% lower from current levels on the day of maturity; and
2) The Russell 2000 is not more than 28.6% lower from current levels on the day of maturity.

Even though the *current* value of this note is also being hurt by the recent market decline, as long as it's held to maturity, the

principal protection feature built into it should prevent any realized loss.

No one can predict short-term market movements

Since the advent of financial news networks, a cottage industry has sprung up of pundits forecasting the direction of markets in the next three, six and twelve months. However, as we've stated before, predicting the short-term movement of the market requires markets to be rational in the short term, and they most certainly are not.

Anyone who claims they can predict short term market movements is either kidding themselves, kidding you, or being paid to talk in the media. The evidence on this is clear-cut – and comprehensively illustrated in a study by Vanguard of stock market prediction techniques. This study examined 15 popular measures used to forecast returns – and found that ***none*** of them had meaningful predictive power for the next 12 months (see especially page 6). Indeed, the most accurate of these only explained barely 40% of returns *over the following 10 years*.

Because it is not possible to predict the future of the stock market, we don't know what will happen this week. However, over the long term, which is how we view your investment horizon, we still believe that you need to have equity exposure to meet your goals and have a successful retirement. Just as the study from Vanguard teaches us that there are no ways to be successful in predicting the short-term future of the stock market, our study of history tells us that equity exposure dictates our ability to outperform inflation and taxes. So we've chosen to build your portfolios with the appropriate amount of equity exposure, which will benefit you if the bull market continues. But we've been somewhat skeptical of the ability of the market to continue moving up only because it's gone up now for over 5 ½ years. We were careful not to fool ourselves into thinking that we could predict when the bull market is going to end, so rather than trying to predict, we purposefully and meticulously prepared for the possibility. Whether we are at the beginning of a new bear market, though, is still impossible to know. If we are, though, you can rest easier knowing that we have designed your portfolio to survive well through it.

Guiding Investment Principles

Principle #1 - Cash Flow Needs Are Protected

In good times or bad, our investment plans for our clients still start with a complex set of calculations designed to answer a simple question – how much money does your portfolio need to generate each year in the future? By answering this question, we can determine how much of your portfolio is needed in the next 5 years, and keep that portion away from the ups and downs of the stock market. Therefore, even if we are entering a bear market, we won't be forced to sell equities during it (at low levels) unless it persists for more than 5 years (see chart below for list of all bear markets since 1871 – data from Robert Shiller). You'll note that there has only been one bear market since the Great Depression that lasted more than 5 years, and it lasted only 63 months. Therefore, because of this guiding investment principle, even in a bear market, we can tap 5 years' worth of your needed withdrawals without having to sell equities at a deep loss. This should increase your peace of mind when or if encountering a bear market.

Start Date	End Date	Duration (Months)	Magnitude
1872.06	1877.06	62	-47.3%
1881.07	1896.08	183	-42.1%
1902.10	1903.10	14	-29.27%
1906.10	1907.11	15	-37.69%
1910.01	1921.08	141	-37.38%
1929.10	1932.06	34	-84.76%
1934.03	1935.03	14	-25.71%
1937.03	1942.04	63	-56.71%
1946.06	1949.06	38	-25.29%
1962.01	1962.06	7	-22.46%
1969.01	1970.06	19	-29.02%
1973.02	1974.12	24	-43.35%
1987.09	1987.12	5	-26.84%
2000.09	2003.02	31	-43.65%
2007.11	2009.03	18	-50.82%
Average		45	-40.16%
Median		24	-37.69%
5th Percentile		6	-24.44%
95th Percentile		154	-65.12%

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Principle #2 - Maintain Globally Diversified Portfolios

Similar to how people cannot predict short-term movements in the stock markets, we don't believe we can make short-term predictions about which types of investments will deliver the biggest return with the least amount of risk. Therefore, we invest

in globally diversified portfolios in an attempt to lower volatility in your portfolios, while still aiming to capture the economic growth that is occurring across the globe. When one area of the world is doing especially well, as the US equity market has been doing until recently, this approach will underperform the best market. But our portfolios will continue to capture some of the gains from the best performing areas because they are diversified. Over longer market cycles, maintaining a diversified portfolio and rebalancing regularly will typically deliver superior returns on a risk-adjusted basis. And avoiding large losses is one the biggest keys to successfully managing investments, more so than capturing large gains (see the hypothetical example of portfolio results below – results are not meant to illustrate any specific or actual investment, and are not guaranteed). Because the portfolios we build for clients are designed this way, we are confident in the results we deliver when looked at over full market cycles (bull through bear market), even when our portfolios might underperform the best asset classes during a bull market.

Table Showing Effects of Capturing Less Upside and Downside

		Option 1	Option 2
Hypothetical Starting Value	$	100,000	
Upside Capture*		100%	65%
Downside Capture*		100%	25%

Full Market Cycle			Yearly Values Option 1		Yearly Values Option 2
Year 1 Return**	20%	$	120,000	$	113,000
Year 2 Return**	20%	$	144,000	$	127,690
Year 3 Return**	10%	$	158,400	$	135,990
Year 4 Return**	5%	$	166,320	$	140,410
Year 5 Return**	-25%	$	124,740	$	131,634
Final Values		**$**	**124,740**	**$**	**131,634**

* The percentage of the market return received when the market goes up, and the percentage of the market return received when it goes down.
** All Returns are hypothetical and for illustrative purposes only.

Principle #3 - Hedge Equity Portfolios to Protect Against Large, Protracted Declines

We invest in hedges in our client portfolios in order to protect them from large declines in the market, as we discussed above.

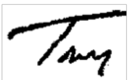
In our opinion, this is superior to more traditional methods of protecting portfolios, which consist of simply owning more bonds to offset equity risk. In traditional portfolios, when stocks declined, the bond portion of the portfolio would stay even and thus “hedge” the risk. However, our hedges are designed to actually generate a substantial positive return when stocks face a steep decline. Because of this, they actually have the chance to replace the value that was lost when equities decline. This is clearly a more favorable result. Of course, even though the hedges have worked this way in the past, there is no guarantee that they will work that way in the future, just as there is no guarantee that bonds won’t lose value as stocks decline.

Summary

Even before the current downturn began, we took steps to prepare for it and protect your portfolio from a large correction. These steps included creating investments that can act like insurance and investments that have partial principal protection. The insurance-like investments are just beginning to start paying off if the current downtrend continues. Because neither we nor anyone can accurately predict short-term market movements, we are not trying to judge whether we are at the beginning of a new bear market, or just experiencing a temporary pullback of the bull market that started 5 ½ years ago. Because of this, we will continue to rely on our guiding principles of managing your portfolio, which we hope will protect you from any realized harm. Ultimately, we want you to have peace of mind by knowing what we are doing for you during this current decline to help meet your long-term goals. And we want to remind you to keep your eyes focused on your long-term horizon, despite the choppy seas of today’s current market volatility.

We thank you for reading this, and for continuing to place your trust in our ability to help you achieve your financial objectives.

Our best regards,



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