McLEAN ASSET MANAGEMENT CORPORATION

Occam's Razor

October 2014

WHAT IS OCCAM'S RAZOR?

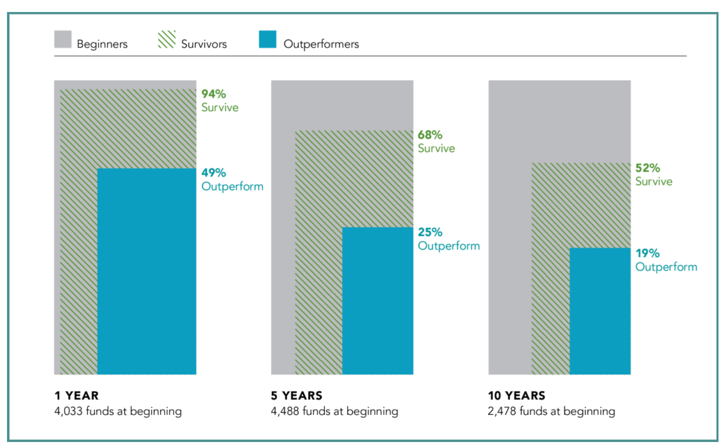
Occam's Razor is a principle attributed to William Occam, a 14th century philosopher. He stressed that explanations must not be multiplied beyond what is necessary. Thus, Occam's Razor is a term used to "shave off" or dismiss superfluous explanations for a given event. This concept is largely ignored within the investment management landscape. This newsletter will "shave off " popular investment misinformation and present what is important for achieving long-term investment success.

THE TREND IS YOUR FRIEND…UNTIL THE BEND AT THE END

One of Occam's key principles is to avoid the day-to-day noise of the financial media. Occam's knows that what purports to be news that explains or predicts market moves is more often meant solely to sell entertainment, not to provide real financial advice. However, Occam's cannot ignore a couple of recent and prominent news stories that reinforce the wisdom of a market-based and an evidence-based approach to investing versus one that is active and based on individual manager expertise. The first story is the much talked about and drama-ridden recent departure of Bill Gross from Pacific Investment Management Co. (PIMCO). The second story is the California Public Employees' Retirement System (CalPERS) decision to stop investing in hedge funds.

The point of the first story is straightforward; Bill Gross was the smartest guy in the room….until he wasn't. He helped build the PIMCO Total Return Fund into the world's largest bond fund. But because of a disastrously wrong call to sell treasuries in 2011, problems have plagued the firm's performance for the last 3 years. The firm's overall stability has suffered. While this story may seem extraordinary, it happens often in the industry and the story line is usually the same: A manager gets hot; investors chase performance; a cult of personality is born; the performance continues for a while; and then, for one reason or another, the fund craters.

A few historical examples include William Miller of Legg Mason who could do no wrong for over a decade, until he gave back all of those gains over the following three years. Peter Lynch of Fidelity was also a successful financial guru who was unable to pass his success on to his chosen and coached successor. While not in the mutual fund industry, high flying Wall Street forecasters are prescient…..until they aren't. Remember Abby Cohen and Meredith Whitney? Both made prescient and successful market calls, but have struggled to maintain consistent success. These examples and more continue to point to the fact that following the advice of the latest and greatest manager is a surefire way to put your financial future at risk. There is simply no silver bullet that would allow an active money manager to outperform the markets forever – or even over a meaningful time period. In fact, over 80% of active managers (those who seek to outperform the market) fail to keep up with their benchmarks as the following chart illustrates:



Beginning sample includes funds as of the beginning of the one-, five-, and 10-year periods ending in 2013. The number of beginners is indicated below the period label. Survivors are funds that were still in existence as of December 2013. Non-survivors include funds that were either liquidated or merged. Outperformers (winners) are funds that survived and beat their respective benchmarks over the period. **Past performance is no guarantee of future results. See Data appendix for more information.** US-domiciled mutual fund data is from the CRSP Survivor-Bias-Free US Mutual Fund Database, provided by the Center for Research in Security Prices, University of Chicago.

In this chart, the large gray boxes represent the number of US-domiciled equity funds in operation during the past one, five, and 10 years. These funds compose the beginning universe of each period. For example, an investor trying to select a mutual fund at the start of 2012 could have chosen from 4,033 equity funds.

How many of the funds that began each period still existed at the end of 2013? The striped areas show the proportions that survived. During the one-year period, 6% of equity funds ceased to operate. Over time, fund survival rates dropped sharply. In equities, the five- and 10-year survival rates were just 68% and 52%, respectively.

But investors likely have a more ambitious goal than to just pick a fund that survives. Most people are on the hunt for funds that will outperform a benchmark. What were their chances of picking an outperforming, or "winning" fund?

The blue shaded areas show the proportion of equity funds that outperformed their respective benchmarks. In 2013, only 49% of equity funds survived and outperformed their benchmarks for the one-year period. While a year of data does not provide much information, fund performance results become more meaningful over longer time horizons. Only about one in four equity funds survived to provide benchmark-beating performance over the five years through 2013. Over 10 years, the ratio dropped to about one in five among equity funds.

Now to the second story about CalPERS' decision to exit hedge funds (sometimes referred to as lottery tickets for billionaires). CalPERS stated in their press release:

"…at the end of the day, judged against their complexity, cost and the lack of ability to scale, the hedge fund investment program is no longer warranted."[1]

In English, CalPERS is saying that they don't really understand what hedge funds do, they cost a lot, and their performance hasn't been that great. This is a remarkable statement, as CalPERS is the nation's largest pension fund, managing over $298 billion in assets. They certainly have the resources to perform due diligence and to understand what hedge funds are doing. And, if they are saying it is not worthwhile, then what does that mean for the rest of us?

This CalPERS quote reminds Occam's of Warren Buffet's admonition to not invest in stuff you don't understand. Speaking of Warren Buffet, some would argue, "Isn't Warren Buffet an example of someone who outperformed over the years?". We have a lot of admiration for Warren Buffet. However, there have been some who have noted that his recent performance has been subpar. More important though, Warren Buffet himself, in his latest letter to shareholders, recommends a market-based or index approach to investing. Tying the Buffet paradox together, we note he struck a bet with a hedge fund manager that a general index of US stocks would outperform any chosen hedge fund over a ten year period, and as of the beginning of the year, he was ahead.

Based on these two news stories, some in the press are saying that the Era of the Guru is over. While we would like to think so, it's not likely. We are confident that you will continue to hear about the next "star" who has 'figured everything out'. It is the nature of Wall Street. As an example, right now Jeffrey Gundlach, The DoubleLine Capital founder and CEO, has been hot and has been receiving a lot of press. We wish him the best. But Occam's would ask if Jeffrey Gundlach could pass the "Mother-In-Law Test".

The mother-in-law test is simple. It importantly assumes you want to keep your mother-in-law happy, and it asks how you would invest her money. Unfortunately, while we think Mr. Gundlach is a tremendously smart individual, we would continue to invest in a market-based approach for our mother-in-law. We think that over the long term the market is smarter than any one, or group of, individuals.

Speaking of helping those who may need assistance with investments and overall planning, MAMC is offering a complimentary, no obligation "second opinion" service for our clients' friends and family. Please contact your advisor if you are interested in having one of your friends or family receive a "2nd opinion."

As always, Occam's is interested in your feedback and thoughts. Please let us know any topics you would like to see covered in the future.

Our latest Quarterly Market Review is now available

Quarterly Market Reviews highlight world capital market performance. The reports begin with a global overview, then feature returns of stock and bond asset classes in the US and International markets and conclude with a topic of the quarter.

This newsletter is published by: **McLean Asset Management Corporation**
(866) 827-0636 | www.mcleanam.com

Note to Readers

The content of this publication reflects the views of McLean Asset Management Corporation (MAMC) and sources deemed by MAMC to be reliable. MAMC is a SEC registered investment adviser. There are many different interpretations of investment statistics and many different ideas about how to best use them. Past performance is not indicative of future performance. The information provided is for educational purposes only and does not constitute an offer to sell or a solicitation of an offer to buy or sell securities. There are no warranties, expressed or implied, as to accuracy, completeness, or results obtained from any information on this presentation. All investments involve risk.

The source of data is Dimensional Fund Advisors. The information throughout this presentation is obtained from sources which we, and our suppliers, believe to be reliable, but we do not warrant or guarantee the timeliness or accuracy of this information. Neither our information providers nor we shall be liable for any errors or inaccuracies, regardless of cause, or the lack of timeliness of, or for any delay or interruption in the transmission there of to the user.

MAMC only transacts business in states where it is properly registered, or excluded or exempted from registration requirements. It does not provide tax, legal, or accounting advice. The information contained in this presentation does not take into account your particular investment objectives, financial situation, or needs, and you should, in considering this material, discuss your individual circumstances with professionals in those areas before making any decisions.

Data Appendix

US-domiciled mutual fund data is from the CRSP Survivor-Bias-Free US Mutual Fund Database, provided by the Center for Research in Security Prices, University of Chicago.

Certain types of equity and fixed income funds were excluded from the performance study. For equities, sector funds and funds with a narrow investment focus, such as real estate and gold, were excluded. Money market funds, municipal bond funds, and asset-backed security funds were excluded from fixed income.

Funds are identified using Lipper fund classification codes and are matched to their respective benchmarks at the beginning of the sample periods. Winner funds are those whose cumulative return over the period exceeded that of their respective benchmark. Loser funds are funds that did not survive the period or whose cumulative return did not exceed their respective benchmark.

Expense ratio ranges: The ranges of expense ratios for equity funds over the one-, five-, and 10-year periods are 0.02% to 4.93%, 0.01% to 4.74%, and 0.02% to 4.44%, respectively. For fixed income funds, ranges over the same periods are 0.02% to 3.27%, 0.01% to 2.53%, and 0.05% to 2.43%, respectively.

Portfolio turnover ranges: Ranges for equity fund turnover over the one-, five-, and 10-year periods are 1% to 1,315%, 1% to 3,452%, and 1% to 3,552%, respectively.

Benchmark data provided by Barclays, MSCI, and Russell. Barclays data provided by Barclays Bank PLC. MSCI data © MSCI 2014, all rights reserved. Russell data © Russell Investment Group 1995–2014, all rights reserved.

Benchmark indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio.

[1]"CalPERS Eliminated Hedge Fund Program in Effort to Reduce Complexity and Costs in Investment Portfolio," CalPERS Press Release, September 15, 2014.

Mutual fund investment values will fluctuate, and shares, when redeemed, may be worth more or less than original cost. Diversification neither assures a profit nor guarantees against a loss in a declining market.

This newsletter is published by: McLean Asset Management Corporation
(866) 827-0636 | www.mcleanam.com