GAYNES FINANCIAL SERVICES
An independent financial services and wealth management company

Investment Beliefs

1. Capitalism earns a profit for its shareholders on average despite any political winds that blow.

2. Companies have a cost of equity capital of about 10% and that cost of capital is paid to the shareholders.

3. It is important to understand that there can be a complete divergence between the fortunes of companies and the countries in which they reside.

4. We believe that no one can accurately predict the future stock prices. Further, future prices are randomly moved by unpredictable news as it comes to light. Bad news results in lower prices and good news results in higher prices, all in an effort to keep expected returns essentially constant.

5. Uncertainty about the future usually causes investors to demand a higher expected return on investments because of the perceived additional risk, thus causing prices to drop until the uncertainty dissipates. As the uncertainty dissipates, stock prices will start to revert to normal valuations.

6. Free markets work best and current prices are the best estimate of a Fair Market Value. That doesn't mean that current prices are always right, rather just that investors should act like they are!

7. All Investing involves risk. Greater expected returns only come from greater risk. We believe there are certain risks that you are compensated for taking and other risks that you are not compensated for taking. We believe you should only take the risk that have an expected return and avoid all the others.

8. The expected return from speculation is zero and becomes negative after costs and taxes. It's important to understand the difference between investing and speculating!

9. In a study of 2,100 stock pickers over 32 years, 99.4% of managers were shown <u>not</u> to have verifiable stock picking skill. ** Laurent Barras, Olivier Scaillet and Russ Wermers, "False Discoveries in Mutual Fund Performance: Measuring Luck (February 2010)*

10. In a study of 15,000 predictions over 12 years from 237 Market Timers, there was <u>no evidence</u> of market timing skill. *John Graham and Campbell Harvey, "Market Timing Ability and Volatility Implied in Investment Newsletters' Asset Allocation Recommendations," Journal of Financial Economics, vol. 42, no. 3 (1996)

11. In a study of 660 hiring and firing decisions of investment managers, the fired managers beat the hired managers. *Amit Goyal and Sunil Wahal, "The Selection and Termination of Investment Management Firms by Plan Sponsors," *The Journal of Finance*, vol. 63, no. 4 (2008).

12. In a study of 8,755 hired investment managers, the average hired manager out performed their benchmark by about 3% per year for the 3 years before hiring, however, they under performed their benchmarks by about 0.5% per year for the 3 years after hiring. *Amit Goyal and Sunil Wahal, "The Selection and Termination of Investment Management Firms by Plan Sponsors," *The Journal of Finance*, vol. 63, no. 4 (2008).

13. The reason that every investment advertisement or piece of marketing material you see contain the phrase **"PAST PERFORMANCE IS NOT INDICITIVE OF FUTURE PERFORMANCE"** is because <u>it is true</u>! Just because something has performed well recently is not a reason to invest in it.

14. Recent Dalbar studies show that the average US stock mutual fund investor has underperformed the S&P 500 index by greater than 8% per year over the trailing 20years. **Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represents the 20-year period ending 12/31/2016.*

Investment Beliefs

15. Recent Dalbar studies show that the average fixed income mutual fund investor has underperformed the Barkley's Aggregate Bond index by greater than 4.8% per year. **Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represents the 20-year period ending 12/31/2016.*

16. The primary reason that "investor" returns dramatically under perform "investment" returns is "Investor Behavior"! Investors have a tendency to **Buy High** and **Sell Low** when left to make their own decisions! We refer to this difference as the "*Behavior Gap.*"

17. Over the 88 years ending 2016, the annualized return of a US small stock index of equities beat US large stock index by 2.40% per year. *Source: premium data provided by Centers for Research in Securities Prices (CRSP) university of Chicago April 2017 comparing CRSP U.S. Large Cap Index and CRSP U.S. Small Cap Index*

18. Over the 88 years ending 2016, the annualized return of a US Value index of equities beat US growth index by 3.71% per year. *Source: premium data provided by Centers for Research in Securities Prices (CRSP) university of Chicago April 2017 comparing CRSP U.S. Large Cap Value Index & CRSP U.S. Large Cap Growth Index*

19. Over the 52 years ending 2016, the annualized return of high profitability stocks beat low profitability stock index by 4.32% per year. *Source: premium data provided by Centers for Research in Securities Prices (CRSP) university of Chicago April 2017 comparing DFA high profitability Index and DFA low profitability Index*

20. While studies show that small companies out performs large companies and value stocks outperform growth stocks over significant periods of time, investors should not expect that this will occur every year.

21. We believe that investors are best served when they buy a risk appropriate, globally diversified, small and value tilted portfolio anytime you have money to invest. Hold. Rebalance. Loss Harvest when it's appropriate.

22. Save 20% of your annual income while you are working and spend 5% or less per year of your savings in your retirement.

23. Only sell your investments when you need the money.

24. Hire a good passive investment advisor. Everybody will benefit from their expertise, teaching, coaching, service and independent advice. A study concluded that indexers with an advisor were 27%more successful at capturing the returns of index funds than those without good advice.

Investment Beliefs

IN SUMMARY:

The preponderance of the evidence shows that no one can accurately predict what individual stock prices will do in any given period of time because what does drive the change in prices is news, and news by definition is unknowable ahead of time.

And the preponderance of the evidence shows that no one can accurately predict what market sectors will perform best in any given period of time…..

And the preponderance of the evidence shows that no one can accurately predict the performance of asset classes…whether US stocks will do better than bonds or cash or international stocks in any given period of time……

And the preponderance of the evidence shows that no one can accurately predict when to get out of stocks before they drop and/or get back in before they go up…….

If you believe, like I do, that no one can accurately predict future security prices, of market sectors, of asset classes, or accurately time the market, then why would you be willing to pay someone to try to do what you don't think can be done?
Why do those firms on Wall Street and the advisors that work for those firms continue to ask their clients to continue to pay billions of dollars every year to their firms to predict something that studies show they have yet to accurately predict on a consistent basis? I'll argue that its because it is in their shareholders best interest, not necessarily their clients. The best explanation I have seen put forth is because it is very hard to make a person see a truth when his/her job is based on this truth not being true. Sometimes this is referred to as institutional blindness

"As far as I can tell, the only groups of people who don't believe that markets are efficient and that capitalism works are the North Korean's, The Cuban's, and active money managers!"
– Rex Sinquefield