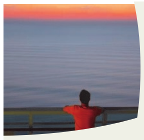

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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Looking Beyond Return: Why Risk Management Matters

When it comes to investing success, there's no better measuring stick over the long term than return. But there are always risks along the way, and it's these risks that can jeopardize that return over the long term. Imagine as you're reading this that it's January 1, 2012. We recently went through a very sloppy debt ceiling debate that led to a U.S. credit downgrade, there are still significant uncertainties surrounding the European debt crisis, our economy is just barely growing and at risk of stalling, and a much anticipated presidential election is only months away. Given this set of circumstances, would you feel comfortable investing all of your money in the market and seeing where the year ends up? Or would you rather take steps to reduce the risk within your portfolio to better weather any potential storm that may blow through – even if that means not doing quite as well as the market if these negative events don't happen to materialize?

Congratulations on answering "reduce risk", well done. To choose otherwise would put your financial goals in great jeopardy. So now that we've decided to manage risk along the way, it's important that we understand how to measure it and ultimately evaluate whether the return we achieved in the end is a good one.

We'll use a scenario that incorporates three separate investment strategies that are managed at Cadence to demonstrate how we measure risk and determine the effectiveness of an overall portfolio strategy. We'll refer to the primary strategy as the Core Diversified Account and the others as Alternative Account 1 and Alternative Account 2. The Core Diversified Account comprises 60% of the portfolio and Alternative Accounts 1 and 2, 20% each. The objective of this particular strategy is to not only achieve diversification across asset classes – as is carried out within the Core Diversified Account – but also across investment approaches and separate account strategies.

The important thing to keep in mind when it comes to diversification is that there will always be one particular investment or strategy that is the top performer over a given time period, and there will always be a laggard.

This is a good thing – we never want all investments to be moving in the same direction over all time periods. By definition, this would imply very poor diversification and risk management which could result in large losses when markets don't behave well. Below are the portfolio statistics net of all fees for all three portfolio components. Don't worry, we'll define each statistic for you.

Account Strategy	Return	Standard Deviation	Sharpe Ratio
Core Diversified Account	10.18%	6.00	1.47
Alternative Account 1	8.32%	10.12	.69
Alternative Account 2	17.36%	5.61	2.86

Return – This is the return net of fees that the strategy earned in 2012.

Standard Deviation – This represents the fluctuation or swings in returns the portfolio experienced in 2012. Smaller is better so long as it doesn't compromise the strategy's ability to grow.

Sharpe Ratio – This is a measure of the return the portfolio achieved relative to the risk it took on to achieve it. Generally, higher is better and it's best to look at it relative to an index or benchmark for comparison.

So with respect to the table above, we can see that on their own Alternative Account 2 performed the best, while Alternative Account 1 did the poorest. When looking at the risk measures, we come to the same conclusion. But what else should we consider when evaluating whether the strategies are helping or hurting us? The answer goes back to diversification. The three accounts strategies could look very similar on the surface, but if they achieved their returns differently throughout the year, they're giving us meaningful diversification. We typically measure this using r-squared – a measure of a strategy's correlation to a given benchmark. Let's take a look.

Strategy	R-Squared
Core Diversified Account	.84
Alternative Account 1	0.00
Alternative Account 2	.49

R-Squared – This is a measure of correlation of an investment to a given benchmark (in this case the S&P 500). 1 means perfect correlation, where 0 indicates no correlation. High correlation leads to an investment behaving similarly to the benchmark it's being compared to.

We can see from looking at the above figures that the Alternative Account strategies appear to have generated their returns in a way that isn't perfectly correlated to the S&P 500 (the benchmark we're comparing to). Let's see how all of the strategies combined performed relative to the S&P 500.

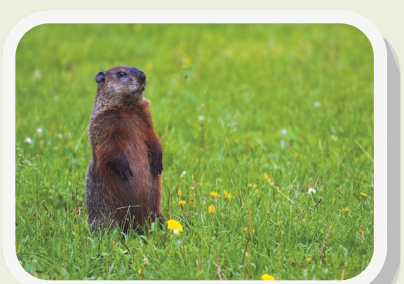
Strategy	Return	Standard Deviation	Sharpe Ratio	Alpha
Total Portfolio	11.00%	4.56	2.12	5.13
S&P 500	13.41	10.11	1.19	0

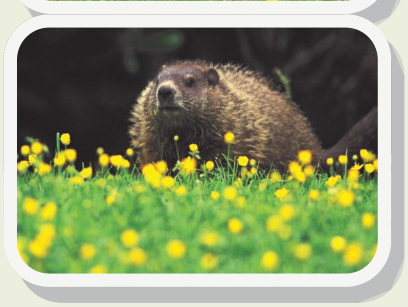
Alpha – Another way to try and quantify the amount of return that was achieved over and above the level of risk that was taken. This approach uses a definition of risk that is based on the investment or strategies correlation to the benchmark, which in this case is the S&P 500. This can result in Alpha being a nice measure of "success" for a complete portfolio or an investment that tends to behave more like the benchmark, but not such a good one for those that don't. As a result, we'll use Alpha as a measure of success for the total investment strategy rather than for its individual parts.

Now the full picture comes to light. The total portfolio return of 11.00% looks nice, but it isn't until we look at the level of risk that was taken to achieve that return that we can properly evaluate the portfolio strategy. What the "risk" side of the coin tells us is that the total portfolio achieved a much higher return than is typical relative to the risk that was taken last year. The higher Sharpe ratio indicates a higher risk adjusted return than the S&P 500, while the Alpha of 5.13 also suggests excess return over and above the risk taken. This is a very nice indication of investment success.

A common mistake investors can make is to compare their returns to those of the stock market over a short period of time. The temptation can be irresistible especially when markets are rising, but the reality is, unless we're willing to accept negative returns comparable to the stock market in bear markets, we have to accept that when stocks rally sharply, we will likely underperform. Anybody who's run the Boston Marathon knows that the race is never won in the first mile. Even if the group is pulling away from you slowly, you have to stay within yourself and run your own race or else you run the risk of tiring and finishing much later than you planned, if at all. This is precisely the role the markets play when they sprint ahead of us, trying to tempt us into running a faster pace than we're comfortable with. If we succumb, we'll likely be very disappointed with our results. If we remain disciplined, not only are the odds of finishing the race improved, but there's also a chance that we pass a few tired and exhausted runners a little bit further down the road.

As we learned very recently in 2008, it only takes one year to do a devastating amount of damage to our long term goals. We must always have a keen focus on risk management. Over the longer term this discipline will provide us a much better opportunity to realize the portfolio returns we need to reach our financial goals.





GROUNDHOG DAY FUN FACTS

- If Punxsutawney Phil sees his shadow, there will be 6 more weeks of Winter. If he does not see his shadow, there will be an early Spring
- The celebration of Groundhog Day began with Pennsylvania's earliest settlers. They brought with them the legend of Candlemas Day, which states, "For as the sun shines on Candlemas Day, so far will the snow swirl in May..."
- Punxsutawney held its first Groundhog Day in the 1800s. The first official trek to Gobbler's Knob was made on February 2, 1887.
- So the story goes, Punxsutawney Phil was named after King Phillip. Prior to being called Phil, he was called Br'er Groundhog.

Source www.groundhog.org

2013 Retirement Plan Contribution Limits

	2013	2012	2011
IRAs			
IRA Contribution Limit	5,500	$5,000	$5,000
IRA Catch-Up Contributions	1,000	1,000	1,000
IRA AGI Deduction Phase-out Starting at			
Joint Return	95,000	92,000	90,000
Single or Head of Household	59,000	58,000	56,000
SEP			
SEP Minimum Compensation	550	550	550
SEP Maximum Compensation	255,000	250,000	245,000
SIMPLE Plans			
SIMPLE Maximum Contributions	12,000	11,500	11,500
Catch-up Contributions	2,500	2,500	2,500
401(k), 403(b), Profit-Sharing Plans, etc.			
Annual Compensation	255,000	250,000	245,000
Elective Deferrals	17,500	17,000	16,500
Catch-up Contributions	5,500	5,500	5,500
Defined Contribution Limits	51,000	50,000	49,000
ESOP Limits	1,035,000 205,000	1,015,000 200,000	985,000 195,000

Source IRS.gov