DECAMILLA
CAPITAL MANAGEMENT, INC.

Investment Process - A multistage approach

Building a Customized Portfolio

"I want to invest in something that respects the environment, that's morally responsible, socially active, aids the poor and the homeless and makes me a bundle."

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I. Initial Assessment

A. *Where are you in the investor life cycle?*
Key Issue: Compatibility of goals and objectives with age and income.

Individual Investor
- Early Career (starting out; capital expenditures for house, car, furniture)
- Mid-Career (peak earning years, growing income; discretionary investment income, savings begin)
- Pre-Retirement (late career, stable income; prepare for retirement)
- Retirement (income a function of savings, retirement, retirement plans, Social Security)

Third-Party Representative
- Pension Trustee/Personal Fiduciary (person responsible for investing capital for others)

B. *What are your goals, and have you quantified your objectives?*
Key Issues: Making money vs. managing money; concept of risk-free rate of return.
- Realistic Goals
  Reaching goals: a function of time, funding level, and rate of return
  Historical data: returns from cash & cash equivalents, bonds, & equities
- Strategic Thinking vs. Tactical Thinking
  Strategic: focuses on long-term outcomes from actions taken in the present
  Tactical: focuses on now and when rather than how and why. For long-term investor, timing least important consideration; commitments to save and invest are most important. Time in the market, over the long term, trumps timing the market.

C. *What is your willingness to take risk versus your ability to take risk? Be a skeptic: why does something work and why does something not work?*
Key Issues: Don't take more risk to meet your pre-stated goals than is necessary; types of risk; risk assessment and measurement.

Types of Risk
- Market: systemic, can't be avoided
- Inflation: purchasing power risk
- Interest rate: affects the value of fixed income and equity (e.g., stocks)
- Non-systemic: avoidable capital loss, diversifiable, can be reduced by process control
- Speculative: asset has no track record or history (e.g., unseasoned company vs. blue-chip stock firm)
- Black Swan: totally unforeseen catastrophic event

Personal Assessment and Risk Measurements
- Personal Assessment: effect of adverse outcome on your lifestyle, emotional reactions, capital resources
  Time Horizon:
    short-term – liquidity, capital preservation, mistake of investing in long-term assets for short-term profit
    long-term – capital appreciation, income growth, tax-deferred appreciation, investing income, mistake of investing for long-term gains utilizing fixed income
- Risk Measurements: stock beta measure of volatility, real estate loan-to-value ratio, appraisals, bond credit ratings, yields, risk-free rate

II. Capital Market Forecast

What are the assessments of global and domestic economic, social, political, sector, and security considerations?
Key Issues: Using the evaluation of these considerations to make a capital market forecast, to minimize undue worry, and to understand that the world will only end once.

Potential Long-term Scenarios

- Stagflation: sluggish capital markets, economy muddles along, steadily rising prices
- Deflation: a break in inflation psychology due to some prominent financial crisis (e.g., 2008-2009 U.S. mortgage crisis, Texas after the oil price collapse, the 1930s)
- Runaway Inflation: flight from money into real assets, gold at $800/ounce (e.g., post-World War I Germany)
- Better Times: global boom, worldwide peace, standards-of-living increase worldwide

III. Investment Policy

Have you committed to an investment policy and does it guard against short-term crises and whims?
Key Issue: Determine how to most efficiently distribute assets among equity/cash/fixed income in order to meet your financial objectives. Caveat: Be wary of liquid alternatives (also known as "alternative investment strategies") (i.e., partnerships, hedge funds, private equity) that, in reality, are usually illiquid.

Needs Analysis Determines Investment Policy

1. Goals: Expected rates of return for different asset classes: stocks, bonds, treasury securities versus inflation

2. Appropriate Asset Mix Strategy for Achieving Objectives
   Asset Allocation: should conform to your goals, be wary of over diversification and complexity, cannot outperform inflation without equity exposure

3. Operating Tactics & Portfolio Management
   - Buy/Sell Discipline: trading attitudes, high price-earnings ratio, valuation techniques, yield, earnings-per-share growth
   - Security Selection Guideline: portfolio's gatekeepers/quality control
   - Active vs. Passive Management: advantages vs. disadvantages
   - Individual Equity vs. Funds: fund (i.e., indexes, exchange-traded funds) managers tend to receive money when stock prices are highest
   - Portfolio Investment Turnover: buy and hold vs. active trading, tax consequences (retirement plans/personal)
   - Costs of Investing: management fees; transparency

IV. Asset Allocation

What is the right asset allocation for you? Have you reduced your risk?
Key Issue: Maintain proper asset mix to minimize risk and maximize return.

Determine Asset Allocation

1. **Asset Allocation:** a function of an investor's time horizon and life cycle; your asset mix (i.e., equities, cash, fixed income) directly relates to your life status (i.e., early career, peak earning years)

2. **Asset Configuration: A means to adjust and balance risk exposure:**

High Risk	Low Risk
Highest Return	Lowest Return

3. **Factors Affecting Your Asset Allocation:**
   - Time until retirement
   - Definite need for funds at a fixed date
   - Risk profile: ***willingness*** to accept risk vs. *ability* to accept risk
   - Levels of pre-existing liquidity: don't put yourself in situation where you are forced to sell
   - Discipline: asset appreciation/depreciation may force portfolio rebalancing to meet asset allocation
   - Capital market changes may require periodic review of asset allocation
   - Abrupt, unexpected specific client factors and events may influence asset mix

4. **Asset Classes – Investment vehicles available to reach your goals:**

Class: Cash (advantage: always stays at a $1.00 / disadvantage: always stays at a $1.00)
Purpose - Provide liquidity, investment flexibility, decreases overall return over time
Risk -Purchasing power eroded by inflation

Class: Debt (e.g., bonds, certificates of deposit, Treasury securities, debentures, mortgages)
Purpose- Provide predictability of cash flow and income
Risk- Goes up and down in value, can lose out to inflation

Class: Equity (e.g., stocks, real estate, etc.)
Purpose- Capital appreciation, income growth, best long-term performance
Risk- Volatility (e.g., September 11, 2001) – difference between risk & volatility: diversifiable vs. non-diversifiable risks

V. Selection Criteria

Are the assets you selected meeting your investment objectives?
Key Issue: Difference between managing money and making money; healthy dose of skepticism is important.

1. Equities

a. Individual Stocks

- Income-generating Power & Dividend Growth: dividend yield, market capitalization 500 million
- Level of Debt: affects managerial flexibility
- Valuation: price/earnings, price to book – price-earnings ratio
- Earnings Momentum: continuous earnings-per-share growth over several years
- Market Position: dominant player, safe niche, low-tech vs. high-tech
- Relative Value: price earnings compared to market
- Other Opinions: Standard & Poor's rating, Value Line, major brokers-dealers
- Insiders: not reliable, decisions to buy generally carry more weight

b. Mutual Funds/Indexes/Exchange-Traded Funds

- Size of Fund
- Years in Business: stability of management
- Objective: fund goal, cash policy
- Style: value, total return, growth, contrarian sector rotation, yield
- Portfolio Asset Turnover
- Management Fees: loads, no load
- Market Cycle Performance
- Standard & Poor's, Bloomberg, Barron's, Forbes Survey, Lipper Analytical
- Fund manager's dilemma
- Liquid Alternatives: costly, not transparent; in reality, "illiquid"; generally not appropriate

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V. Selection Criteria (continued)

2. Fixed Income (portfolio objective; predictable cash flow and safety of principle)

a. Individual Bonds (corporate)

- Interest Coverage: the more the better
- Credit Risk
- Call Protection
- "Event" Risk: the company can experience a Black Swan event (e.g., WAMU, BP, Lehman)
- Yield Curve: risk-free rate of return
- Standard & Poor's Rating: investment-grade only, BBB or better

b. Treasury Securities

- Treasury Bills: 3 months to 1 year
- Treasury Notes: 2 years to 10 years
- Treasury Bonds: 10 years to 30 years
- Non-callable
- Highest Credit, Lowest Yield
- Managing Maturity vs. Reaching for Yield

c. Bond & Fixed Income (Mutual Funds)

- Bond Objective of Predictability of Cash Flow / Safety of Principle Generally Not Met
- Total Return More Important Than Current Yield

d. Tax-Free Bonds

- Calculate Investor's Taxable Equivalent: (Tax-free Bond Yield) divided by (1 – Personal Tax Bracket)
- Managing Maturity vs. Reaching for Yield
- Investment Grade or Better (i.e., ratings by Moody's, Standard & Poor's)

3. Real Estate

a. Difficult to Incorporate into Strategic Investment Plan

- Private Limited Partnerships: high fees, lack liquidity, unsuitable for retirement plans
- Real Estate Investment Trusts: low fees, liquid, behave like stocks, interest rate sensitive
- Direct Ownership: large financial commitment if all cash, debt purchase involves risk

b. Most Investors have Enough of Net Worth Allocated to Real Estate

- Residence
- Office
- Vacation Property
- Business

VI. Portfolio Structure & Strategy

Will the structure of your investment portfolio give you the most opportunity with the least level of risk?
Key Issue: The "Efficient Frontier," what mix of stocks and bonds offers the optimal level of return, (Markowitz and Sharpe, Nobel Memorial Prize in Economic Sciences, 1990).

Portfolio Implementation Guiding Principles

1. Correlation of higher risk with higher return – are they equal?
2. Level of major sector (e.g., finance, consumer, utility, technology, energy) diversification – is it enough? (cannot diversify systemic risk)

1. Equities

Characteristics of Individual Securities:

Total Return: (e.g., banks, utilities, energy, real estate investment trusts)
- Dividend yield: 5 to 7%
- Earnings-per-share growth: 3 to 5%

Core: (e.g., diversified industrial corporations (GE, IBM, Johnson & Johnson)
- Dividend yield: 3%
- Earnings-per-share growth: 6 to 10%

Established growth: (e.g., Starbucks, Nike, VF Corporation)
- High earnings-per-share growth over several market cycles
- Dividend yield: 1% to 2%
- Earnings-per-share growth: 9 to 10%

2. Fixed Income

- (e.g. intermediate certificates of deposit, governments, higher grade corporations)
- Seven-year maximum maturity, long bonds extremely volatile
- Most money lost reaching for yield
- Fixed income mutual funds strip away advantages of fixed income securities and instead offer all the volatility of stocks
- Bond funds reduce the portfolio focus; determine if they are equity or debt

3. Privately-Owned Real Estate

- Lacks liquidity
- Financial leverage advantage
- Disadvantaged by being labor intensive and having no time leverage

VII. Measurement & Reporting

Are you doing what was established in your investment policy and is it successful? Key Issues: Organizing, measuring, and controlling investment performance results to meet your defined investment policy and avoid an unfocused portfolio.

1. Statement Formatting for Ease of Evaluation.

a. Investments Clearly Represented: stocks, mutual funds, vs. private limited partnerships
b. Statement Accuracy: are assets marked to the market; can you receive a balance sheet and income statement on demand
c. Liquidity Assessment: illiquid assets are those with no ready buyers or sellers (e.g., IBM vs. a 1968 Chevrolet Corvette, stamp collection); appraised value vs. market price (problem with appraisals is believing them)
d. Cash Flow Level: what is the portfolio's cash flow (i.e., yield on market vs. yield on cost); is the portfolio meeting income objectives (i.e., predictability of income) and dividend growth
e. Cost and Fees: are investment returns net of fees and/or management costs

2. Calculating Investment Returns

The more concise the portfolio reporting structure, the easier it is to calculate investment returns. Deviating from the traditional asset classes makes it increasingly difficult to assemble data to monitor performance; the greater a portfolio's liquidity, the greater the accuracy of portfolio management (e.g., price of General Electric vs. interest in private equity partnership).

a. Risk Adjustment: depends on market exposure built into investment portfolio; use the stock beta to measure volatility, goal is to obtain market returns with below market risk
b. Dollar Weighted Rate of Return: too insensitive to timing and amounts of cash flow
c. Internal Rate of Return: incorporates cash flow and timing of cash flow with total portfolio value; useful in evaluating if the portfolio is meeting its actual assumptions and goals
d. Compound Annual Growth Rate: represents the year-over-year growth rate of an investment for a specific timeframe