The Wells Asset Management Playbook

The Three Keys to the Investment Kingdom
(Including a forecast of Dow 50,000 by yearend 2025)

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but really 1955 to date

The Three Keys to the Investment Kingdom
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Before discussing our forecast of a Dow 50,000 before the end of 2025, we need to ask three simple yet important questions regarding Human Nature:
-- Do we Humans **want** to increase the economic lot of our families?
-- Do we Humans **fear** being left behind?
-- Do we Humans **want** something for nothing?

The vast majority of us answer "Yes" to all three of these "fear" and "want" questions. This Human Nature is a deep-seated feeling/belief, which, in turns controls our actions. In fact, we argue:

Human Nature controls Us Humans. We Humans control the stock market. Thus, if we understand Human Nature, we also understand the stock market. This Understanding leads to Prudence and Performance -- the combination of these three factors constitutes the Holy Grail of Money Management.

The three key Human Nature traits that provide Understanding, Prudence and Performance are:
-- We Humans want to improve the economic lot of our family. This Human Nature trait leads to Productivity that, in turn, makes the stock market a long-term Winners Game.
-- We Humans have a Basic Fear of "being left behind." This Fear creates contagion. This contagion or group think drives the stock market to cyclical extremes until the investment crowd screams, "This Time Will Be Different." The exact same fear and resulting actions work on both the way up and the way down. Similarly, we hear the exact same words, "This Time will be Different," at both the major tops and bottoms.
-- We Humans are always looking for "something for nothing." In the case of the stock market, "the something for nothing" is active managers who can outperform the market and all we need to do is "click a mouse." Like most Get Rich Easy schemes, this approach proves to be self-defeating. Index Funds produce both Prudence and Performance.

The elegance of an investment algorithm based on Human Nature is that Human Nature does not change. In addition to the general algorithm, our specific work forecasts a Dow 50,000 (including the reinvestment of dividends) by the end of 2025. The first six years of this Secular Bull Market did the heavy lifting (a 22.6% compound return). To reach our 50,000 target, we need this Secular Bull Market to compound at 9+% until the end of 2025.

The charts, schematics and brief verbiage on the next 17 pages try to explain/show/prove: 1) the Three Keys to the Investment Kingdom, 2) the Pathway to a Dow 50,000 by the end of 2025, and 3) the summary of The Holy Grail of Money Management.

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Focus on the Knowable and the Important

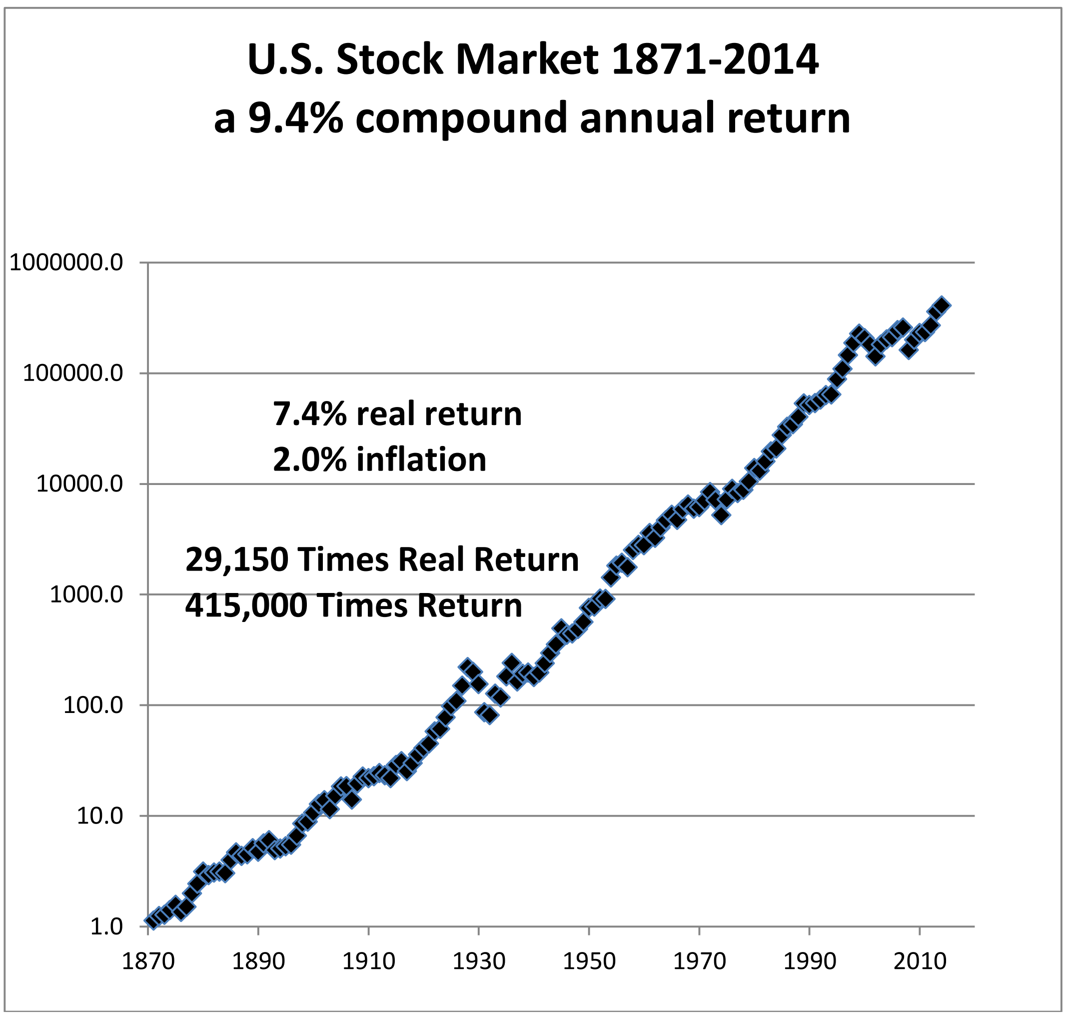
A 2x2 matrix with the Knowable and Unknowable on one axis and the Not Important and Important on the other axis depicts the Investment Process. Obviously, the focus needs to be on the Knowable and Important.

	Not Important	**Important**
Knowable	• The Current P/E, The Average P/E • Last period's winning stocks and managers • What the stock market has done in December, October, March or any other month or series of months • The political party in power in Washington	• **Human Nature, the increasing Body of Knowledge, and Property Rights drive Productivity and Productivity makes the Stock Market a long-term Winners Game.** • **The Stock Market can be even more of a Winners Game if you can harness Fear, Greed and the Extreme Market Tops and Bottoms. ("TTWNBD")** • **Fees matter greatly; chasing individual stocks for Performance is an Expensive Fool's Errand.**
Unknowable	• The Deficit • The direction of Interest Rates • The next "Ebola"	• Short-term Market moves • Which stocks will perform the best • Future Recessions • Black Swans

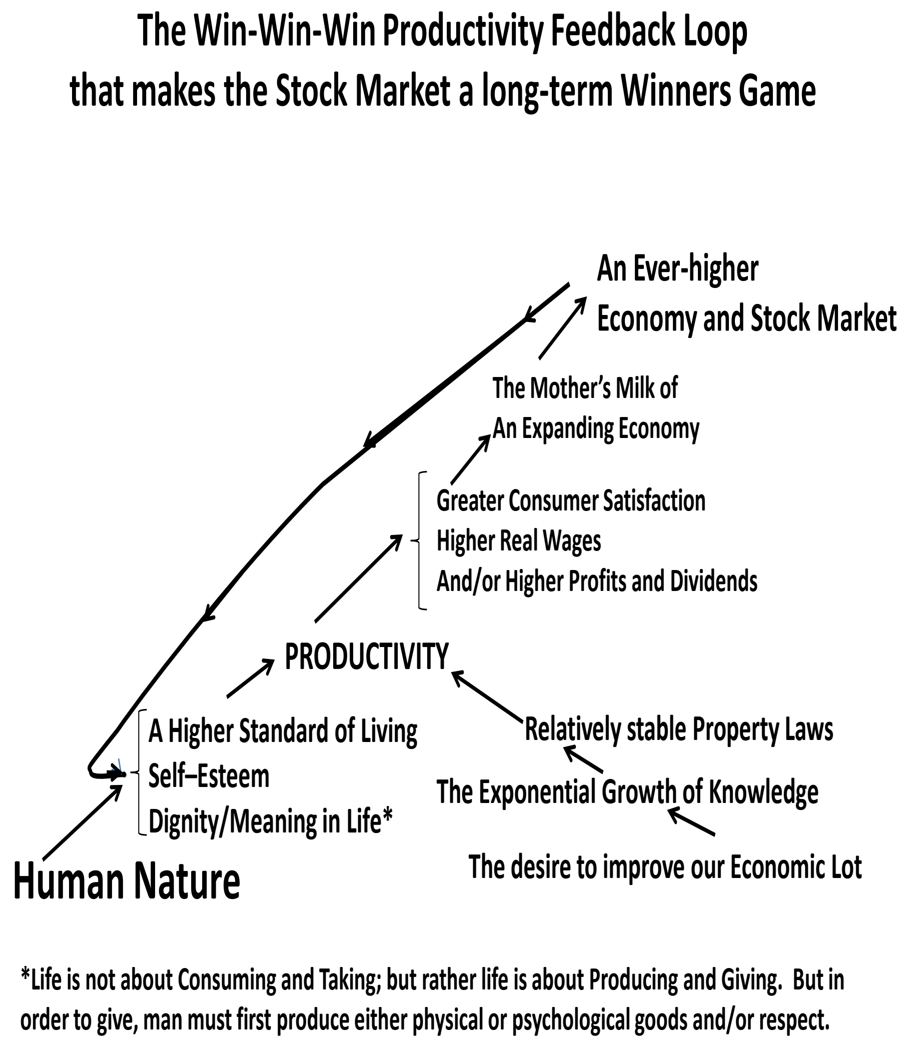
Key #1: Productivity Makes the Stock Market a Long-term Winners Game

Before we digress to the subtleties of the stock market, let us make the most Basic and Important Point: **The Stock Market has been and should continue to be a Winners Game.** Forgetting whether you have bought High or Low, with patience **the Stock Market has been a Winners Game**. Later, we will discuss methods of selling near the Extreme Highs and buying near the Extreme Lows, but let us not lose the main point: **The Stock Market is a Winners Game**. Given our forecast of a Dow 50,000 before the end of 2025, we ardently believe that **the Stock Market will continue to be a Winners Game.**

Despite WWI, WWII, the Great Depression, the Great Recession and literally 500 other crises, the stock market has grown 415,000 times in the last 144 years. One thousand dollars invested in 1871 would be worth $415 billion today.

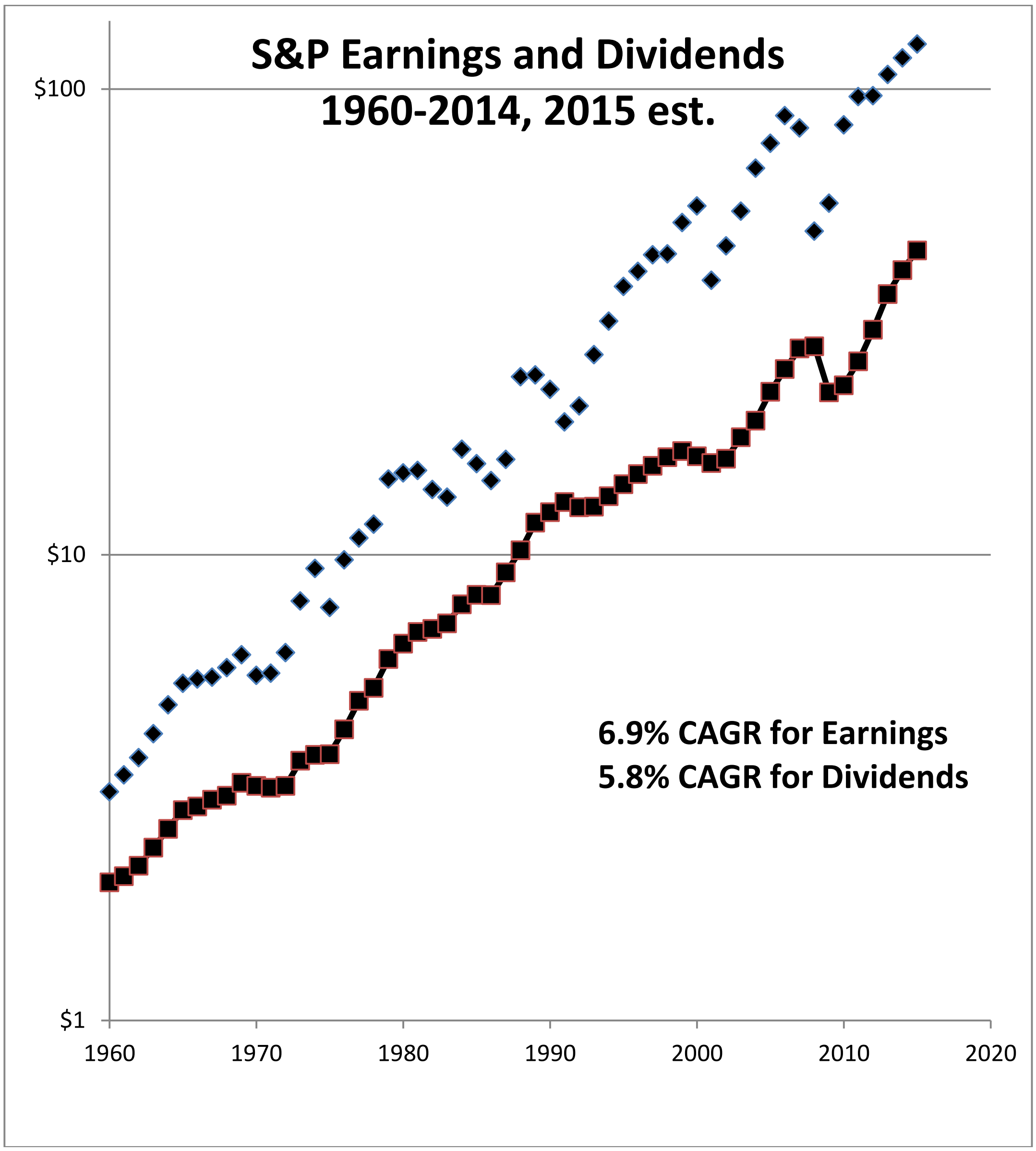


The desire to improve the economic lot of our family causes Win-Win-Win Productivity, which, in turn, makes the Stock Market a long-term Winners Game.



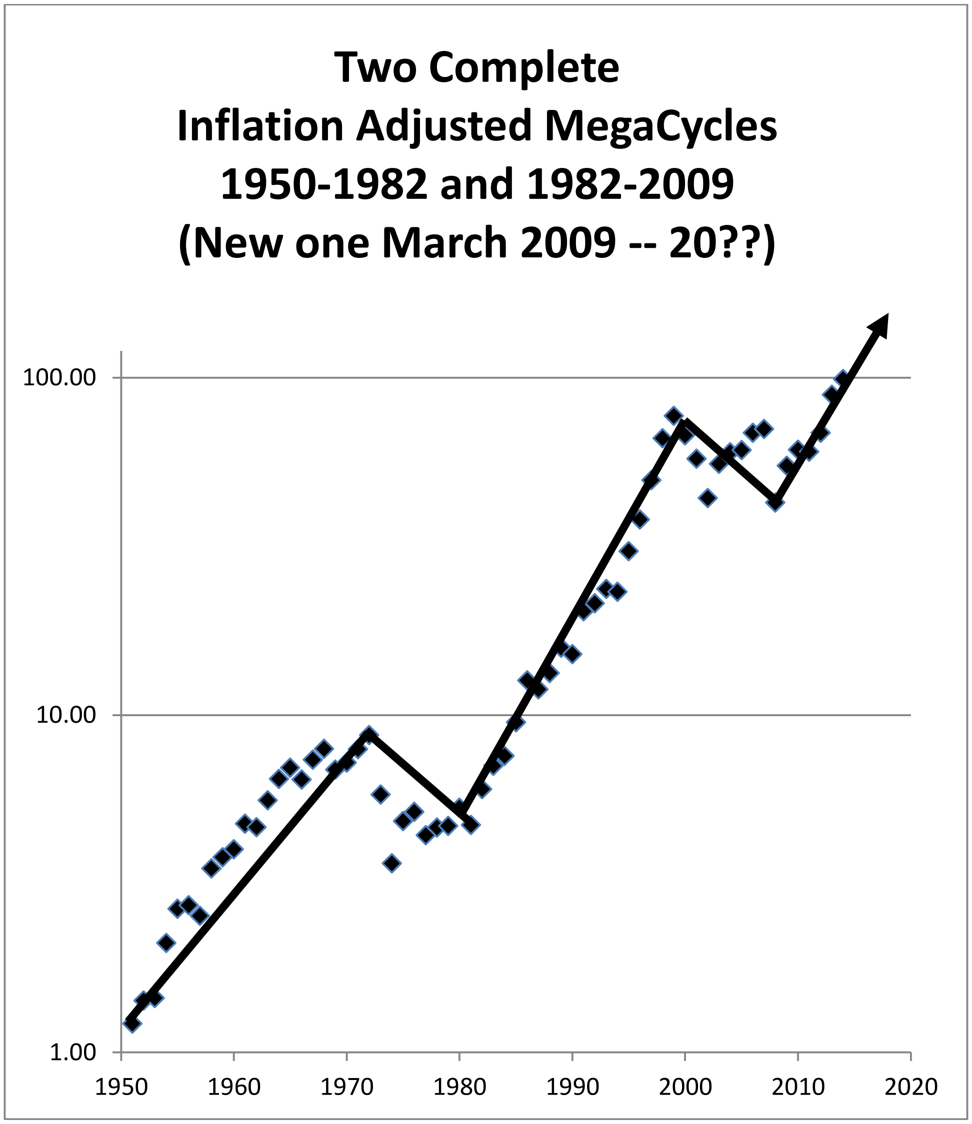
And Human Nature does not change.

The Productivity-to-Earnings proof is the long-term Earnings and Dividend record for the S&P.



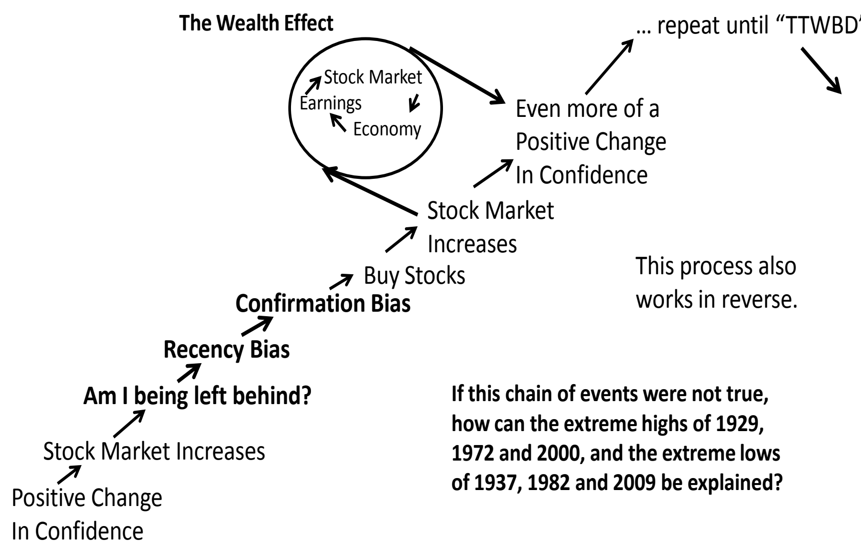
Key #2: The fear of "Being Left Behind" generates Contagious Confidence that keeps building and building ... UNTIL the Investment Crowd screams at <u>both</u> the major tops and bottoms that "This Time Will Be Different."

Critical Observation:



1950 Beginning of the modern stock market
1972 One-decision stocks such as IBM, EK, PRD, AVP
1982 Twin Dilemmas of High Unemployment and High Inflation
2000 The Internet would solve all problems efficiently
2009 The prospect of Worldwide Financial Collapse

The Three Critical Feelings/Biases are: "Am I being left behind?" and the Recency and Confirmation Biases. These factors drive the Stock Market in the same direction for many years at a time.



Make no mistake: many negative disruptions will plague this market as we move from "TTWBD" Negative to "TTWBD" Positive. The ride will be volatile and anything but smooth. The problem is that these negative disruptions will be random and thus not forecastable. One of these negative variables is a garden-variety economic recession. If one could be early and be right, this would be a worthwhile call. However, keep in mind that the stock market has called eleven of the last five recessions -- yes eleven of the last five recessions.

Unless these events are repeatable and forecastable, they just become random noise that causes stock market volatility. The bad news is the volatility; the good news is that stocks over the long term have a higher return than bonds because of the volatility. The higher return is the so-called Equity Premium, which is the dividend yield.

If in doubt, Feelings are the final stock market arbiter. The key words are : "This Time will be Different."

Forecasting the Stock Market

The Telltale 2x2 Forecasting Matrix

What is a Secular Bull Market? We believe the stock market is a linked-series of MegaCycles. MegaCycles typically last 30 or so years. A MegaCycle goes from an Extreme Valuation Low to an Extreme Valuation High and back again. The move from an Extreme Valuation Low to an Extreme Valuation High is a Secular Bull Market. Think of 1949- 1972 and 1982 - 1999. A Secular Bull Market contains many so-called Market Corrections (10-15% down moves) and some so-called conventional Bear Markets (a greater than 20% decline from a previous top). A conventional Bear Market may mark the beginning of a Secular Bear Market, but not necessarily.

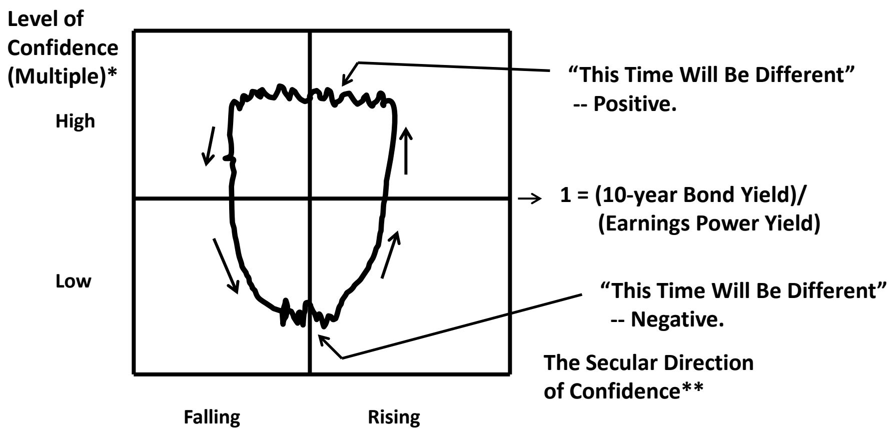
Per earlier, we break our stock market analysis into a 2x2 Matrix. On one Axis we have the **Important and Not Important**, and on the other Axis is the **Knowable and Not Knowable**. We only focus on the **Important and Knowable**.

-- Short-term random variables cause Market Corrections, and thus Market Corrections are Not Knowable.

-- We have two problems with conventional Bear Markets. First, even if we knew the exact start and exact finish, it would take 10% on both the downside and the upside before we believed we had seen the turn. Trying to trade these 20-25% moves may be helpful to the IRS and the brokers, but it is unlikely to help your portfolio. Second, most Bear Markets are triggered by the fear of an upcoming Recession and the concomitant, down Earnings. The only problem is that there are many false positives in calling Recessions. Thus, while conventional Bear Markets are Important, we do not think they are Knowable.

The Market Multiple Forecasting Matrix:

(Unlike Productivity which continuously rises, Confidence over an entire Stock Market Cycle must be Neutral at 1.)



*** Since the Level of Confidence is in essence the P/E ratio, the Level of Confidence is also the Level of the Stock Market.**
**** The Secular Direction of Confidence is Contagious … Until "TTWBD."**

Where is the stock market today?

Comparing this Secular Bull Market with the last two Secular Bull Markets:

	1949-1972	1982-2000	2009-????
Total Return Yrs. 1-6	3.2x	3.0x	3.4x
Compound Return Yrs. 1-6	21.3%	20.0%	22.6%
Total Return Yrs. 7-17	3.7x	6.5x	**
Compound Return Yrs. 7-17	12.6%	18.6%	**
Total Return for Entire Run	17.5x	18.5x	
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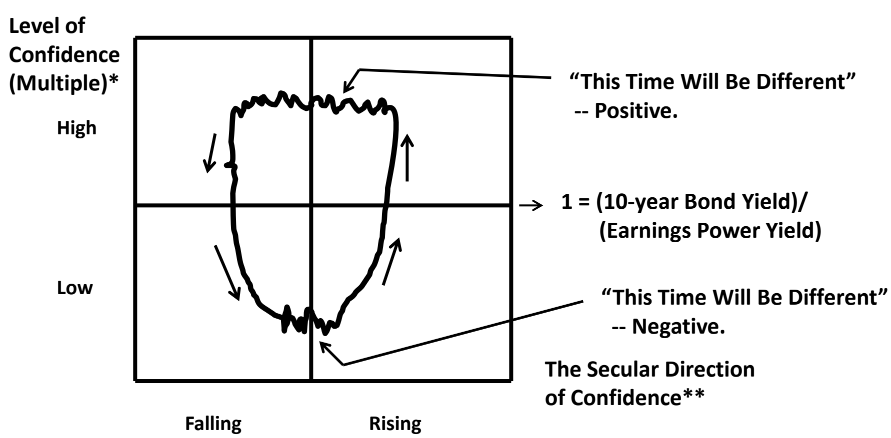

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The three Telltale Signs when a Secular Bull Market is over:
-- There are no societal problems. The horizon is crystal clear. Technology has won. Indeed, "Trees can grow to the sky."
-- The Investment Crowd is screaming, **"This Time Will Be Different."**
-- The 10-year Government Bond Yield is at least twice as high as the Earnings Power Yield.

The Telltale Signs reverse at the bottom of a Secular Bear Market:
-- Problems exist everywhere. We are trapped and doomed. "The Sun will not rise tomorrow."
-- The Investment Crowd is screaming, **"This Time Will Be Different."**
-- The Earnings Power Yield is at least twice as high as the 10-year Government Bond Yield.

Constructing and Managing Your Portfolio

-- Finding Your Comfort Zone and then Adjusting for Secular Bull and Secular Bear Markets
-- The Relationship between Bonds and Stocks
-- Key #3: Index Funds Provide both Prudence and Performance
-- Comforting Thoughts for the Inevitable Dow Periods

The Relationship between Bonds and Stocks

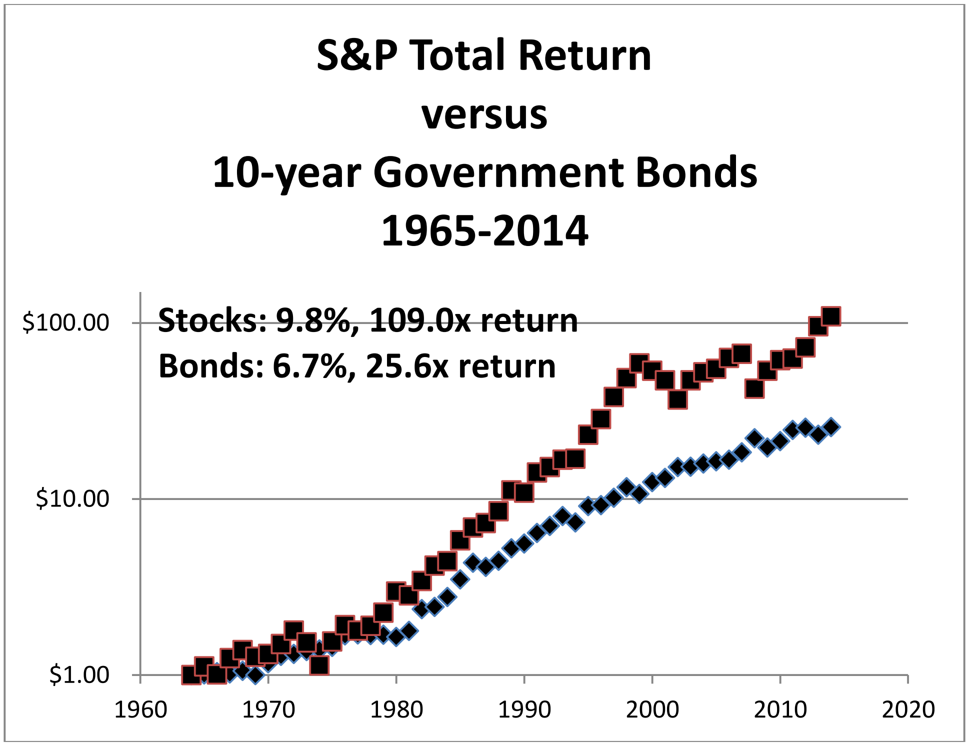
Bonds and stocks comprise the vast majority of most investment portfolios. When we talk about stocks, we mean the S&P 500; when we talk about bonds, we mean the 10-year U.S. Government Bond. There are many shades of gray for both stocks and bonds, but these are the two pillars. Understanding the relationship between the two is important for both Prudence and Performance.

In summary:
-- Stocks are more volatile than Bonds. Thus, over the long-term, stocks must return more than bonds to compensate for the unwanted volatility. This so-called Equity Premium is the Dividend Yield.
-- Over the long term, the return of bonds is <u>equal</u> to stocks before dividends. After the reinvestment of dividends, the long-term return for stocks has been half again greater than bonds (9% vs. 6%).

The return for Stocks vs. Bonds
for 1965-2014

	CAGR	Total Return
10-year Gov. Bonds	**6.7%**	**25.3x**
S&P Index (no dividends)	**6.7%**	**25.3x**
S&P Index (with dividends)	**9.8%**	**109.0x**

The following paragraph is important but complicated. The S&P Index return before dividends is a function of the Earnings Growth (Productivity + Inflation) since over a long-period the change in multiple makes little difference. Productivity + Inflation is 1) the value of money and 2) the price (yield) that bondholders are willing to lend money to the government over a 10-year period. Thus, since the S&P Index before dividends and the 10-year yield are both a function of Productivity + Inflation, it is no surprise that they produce equal returns over a long time-period. The additional return for stocks comes from the dividend yield of successful companies, which, in turn, comes from the inherent leverage in balance sheets.



Finding Your Comfort Zone and then Adjusting for Secular Bull and Secular Bear Markets

(1) Determine the long-term asset mix between stocks and bonds that makes you comfortable. Over the long-long term, each 10% mix shift from bonds towards stocks should increase the total return of the portfolio by three-tenths of a point.

(2) Make the judgment call whether the stock market is in a Secular Bull Market or a Secular Bear Market.

(3) Move the portfolio allocation twenty points from the long-term comfort level depending on whether the stock market is in a Secular Bull or Bear Market.

(4) At all times, use only Index Funds with the highest quality securities and lowest fees.

(5) Be vigilant for signs that the Secular Market is at a Major Turning Point. **"This Time Will Be Different."**

(6) Now, go focus on the important facets of your life.

Key #3: Index Funds Provide both Prudence and Performance.

Studies after study after study have shown that the asset allocation is the number one predictor of performance. We have written extensively that we believe the long-term stock market is a linked series of MegaCycles. Moreover, each MegaCycle has a 20-year or so Secular Bull Market which is followed by a 10-year or so Secular Bear Market. More important, we believe these Secular Markets are measurable and predictable. In our opinion, this is by far the most important aspect of Constructing and Managing a portfolio.

There are two other popular methodologies for attempting to gain performance: 1) selecting individual stocks and 2) making short-term stock market calls.

Let's handle these in reverse order. Given that there are so many leveraged derivatives, if anyone could successfully make these market calls, they would be the world's first Trillionaire. Since this person does not yet exist, we strongly suspect this strategy is akin to chasing "Fool's Gold."

The other popular strategy is to pick "undervalued" individual stocks. In essence, this is the entire Mutual Fund Industry. This is a relative easy strategy to sell because we investors want to believe that the stock market is akin to Chess or Duplicate Bridge where the odds strongly favor the "smart players." Moreover, we can pick up this added performance with just the "click of a mouse." Importantly, we are willing to pay a higher management fee to pick up this additional net performance.

But there is the rub. It is counter intuitive, but paying higher fees for money management increases the chances that Roulette is the proper analogy. With higher fees, investment companies increase the size of their army of analysts who analyze individual companies. Analysts are very good at insuring that stocks relative to each other are properly priced for growth and risk.

Financial editors like to publish stories about spectacular crashes and spectacular successes. Where are the stories today about fund managers who for the last five, ten and fifteen years have outperformed the market? Most potential readers would surely be drawn to such an article. Unfortunately, the material for the article does not exist.

The list of active Portfolio Managers from the Financial Press and Barron's that have outperformed the S&P by picking individual stocks over the last five, ten, and fifteen years.

1.	
2.	
3.	

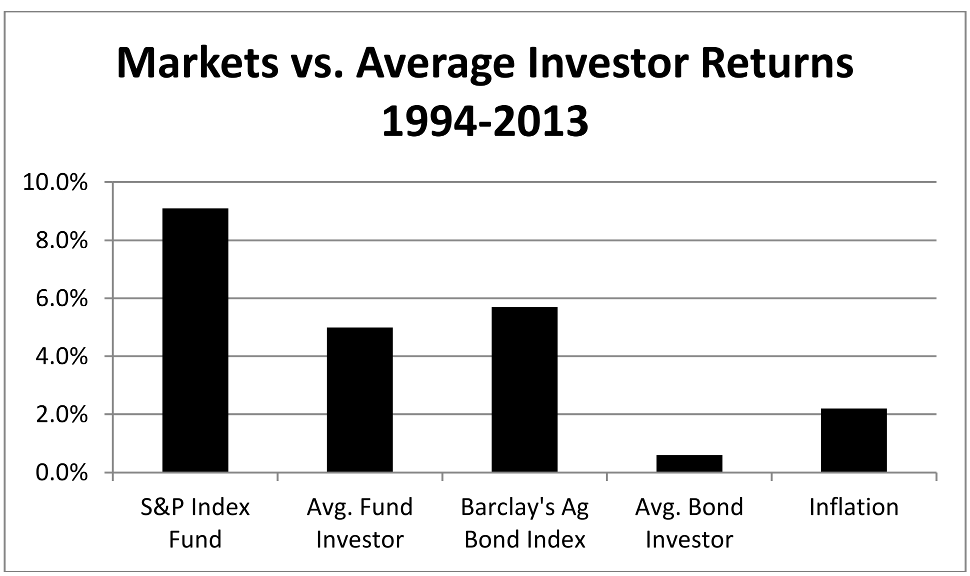
This list was <u>not</u> intentionally left blank -- nor were high-fee managers excluded.

It is always hard to prove any negative case, but we would ask these questions:

-- What does it take to be right on a stock?
-- What is the Magellan Dilemma?
-- Where are the performance ads in Barrons?

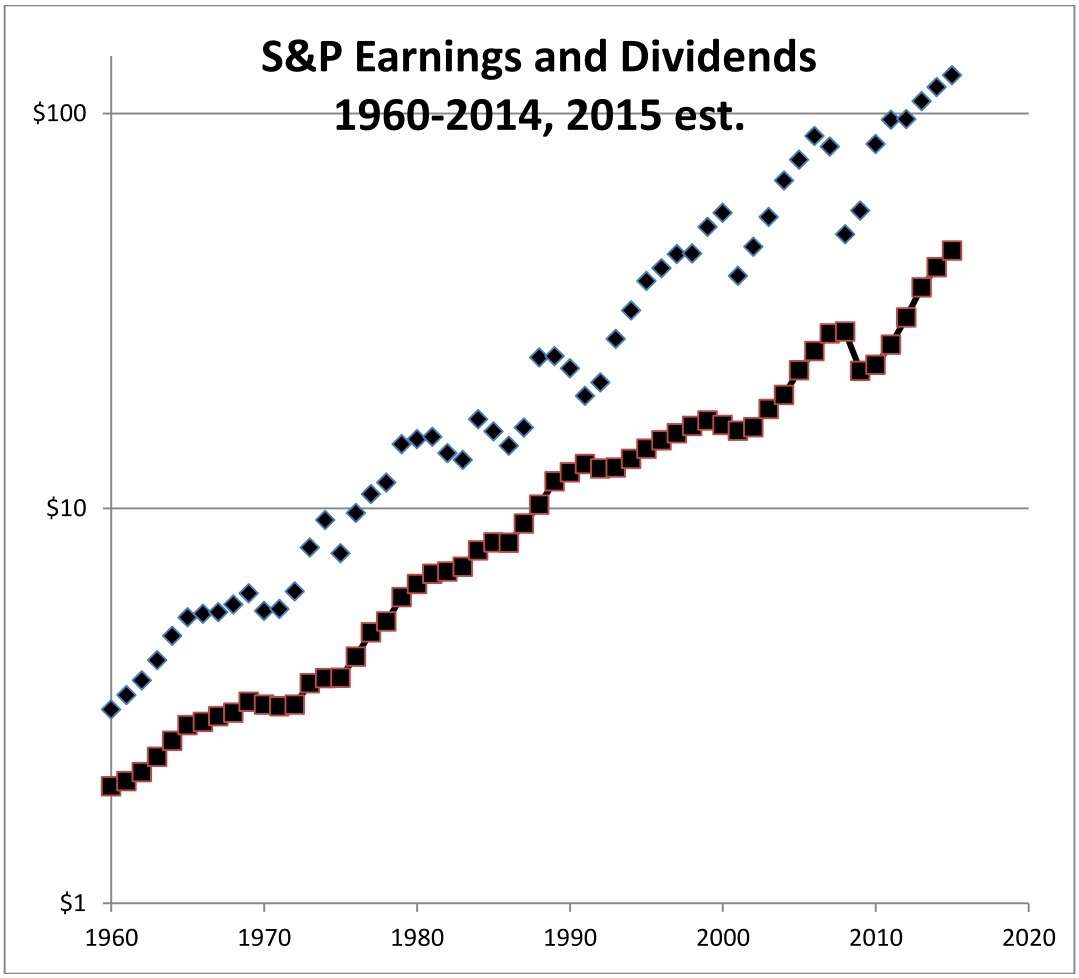
As it turns out, Index Funds with their much lower fees provide both performance and Prudence. This is counterintuitive but factual. **By far and away, the best way to build a long-term portfolio to achieve both Prudence and Performance is by investing in the highest quality stocks and bonds through Index Funds with the lowest fees.**

This chart demonstrates the sad investing facts for the last twenty years. High fees and investors moving in and out of the market at the wrong times equally cause this huge performance gap.



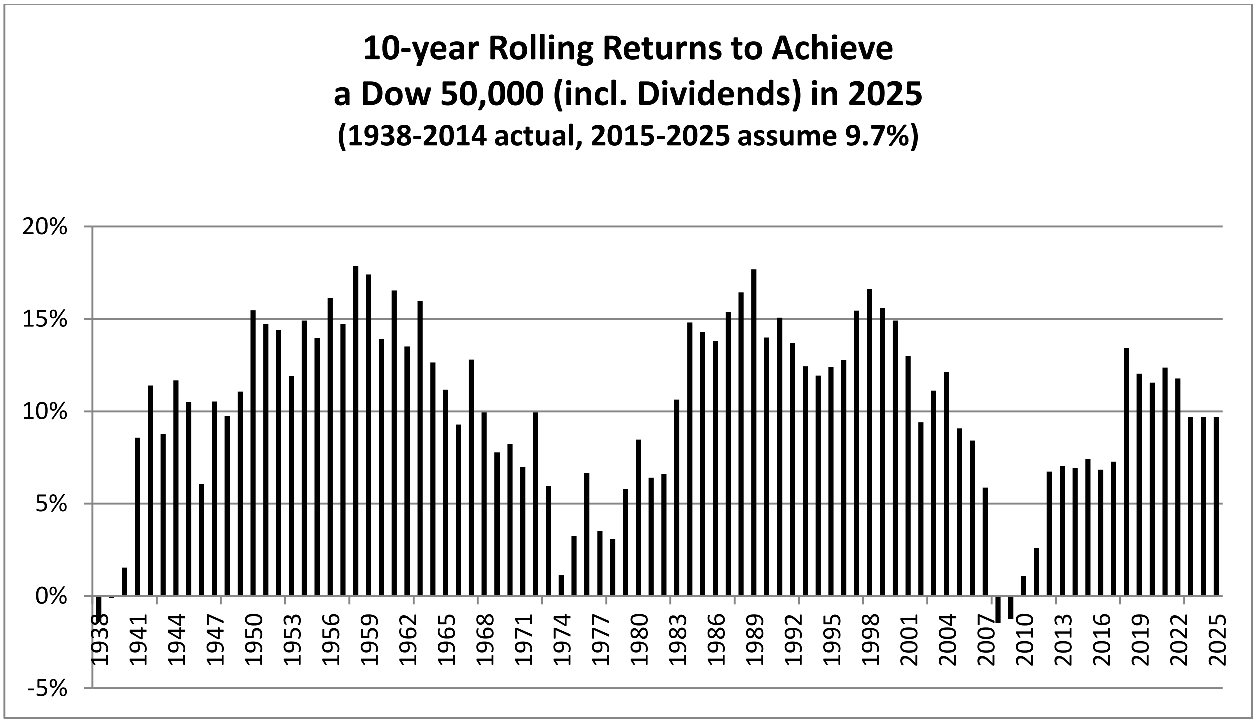
Source: Dalbar.

Would you like to buy this stock with this long term Earnings and Dividend record? Your answer is probably "Yes." But any company is subject to unknown and unforeseen competitive upsets. The record below is infinitely more powerful because it is diversified over 500 companies; it is the S&P Index.



Low-fee Index Funds provide both Prudence and Performance. If in doubt, be patient and take the long-sure way -- not the easy-maybe way.

The pathway to achieve a Dow 50,000
(including the reinvestment of dividends) in 2025.



<u>Answer</u>: 9.87%

<u>Question</u>: By the end of 2025, including the reinvestment of dividends, what compound annual growth rate is needed for the Dow to reach 50,000?

Comparing this Secular Bull Market with the last two Secular Bull Markets:

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Total Return for Entire Run	**17.5x**	**18.5x**	
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Comforting Thoughts for the Inevitable Down Periods

This treatise is likely as Bullish a piece as you are going to read. But we can guarantee that there will be down days, weeks, months, quarters, halves, and maybe even down years between now and a Dow 50,000. Here are some comforting thoughts for those down periods:

-- Increases in Productivity produce your long-term success in the stock market. The people who are responsible for these productivity increases are so immersed in their work/passion that they do not know if the stock market is up, down or sideways.

-- Even in Mega Bull Markets such as 1950 - 1972 and 1982 - 2000, 45% of the days were down; but this means that 55% of all days are up. Gamblers in Las Vegas would be rich beyond their wildest dreams if they could play a game where the odds of winning were 55/45.

-- Most Endowment Funds pay out some percentage of the average value of the portfolio over the last three years. This prevents paying out too much during the good times and too little during the tough times. Make a similar three-year calculation for your net worth. By averaging the three points, the losses for the current period are reduced by two-thirds.

-- No stock market goes straight up. The future has a random component, albeit with a positive bias. Since the stock market reflects the future, it too has a random component. By its very definition, randomness is, as they say, random.

-- This random component does indeed create volatility. But know that the dividend yield compensates you for this volatility. This dividend yield is significant and is the long-term difference between owning stocks and bonds.

-- By owning Index Funds with the highest quality stocks and bonds, Prudence is on your side each and every day.

-- If the stock market is in the middle of a market correction (a drop of more than 10%), the fear is likely to be an economic recession and thus down earnings. It would be nice to be able to accurately predict future economic recessions before anyone else; however, that ability falls into the "Important but Unknowable" category. Take some comfort in the fact that the stock market has "correctly" predicted eleven of the last five recessions.

-- Unfortunately, the future will be full of problems/crises. However, counter intuitively, crises are your "friends." Mega Bull Markets do not end when market pundits can see possible future problems. Rather Mega Bull Markets end when there is not a problem in sight -- "This Time Will be Different." As long as you are not hearing those fateful words, your portfolio has better days ahead.

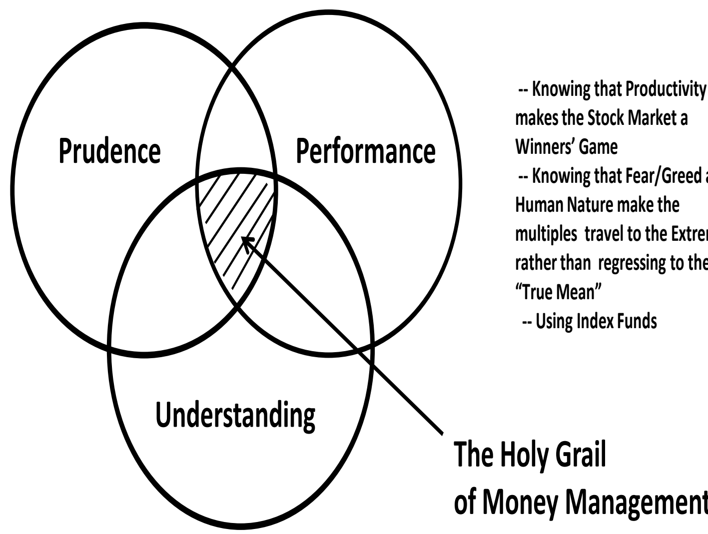
-- Don't waste your time on short-term movements that are random and unknowable; rather use this time to increase the peace and joy in your life by committing a daily random act of thoughtfulness.

The Holy Grail of Money Management

is the Special Overlapping Subset

of Prudence, Performance and Understanding

-- Minimizing the Risk while Achieving the Return of the Portfolio's Objectives
-- Minimizing the cost of Portfolio Management
-- Diversifying to a Higher Standard than the Prudent Man



-- Knowing that Productivity makes the Stock Market a Winners' Game
-- Knowing that Fear/Greed and Human Nature make the multiples travel to the Extremes rather than regressing to the "True Mean"
-- Using Index Funds

-- Knowing the relationship between the Economy, Bonds and Stocks
-- Knowing the source of the Earnings, Multiple and Dividend growth
-- Knowing the stock market drivers for the short-, medium- and long-term

March 31, 2015