DEIGHAN
ASSOCIATES

INVESTMENT QUARTERLY

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When constructing your portfolio, we utilize a combination of both active and passive managers.

Market Commentary

For most Americans, New Year's is a time to make resolutions, some for keeping and some for breaking. For investment professionals, however, New Year's is a time to make wild prognostications about the future while simultaneously taking credit for correctly guessing everything that happened in the previous year. I could sit here and put myself through that same foolish exercise, recounting a 2011 that bore witness to a devastating natural disaster in Japan, Europe in shambles, the U.S. government on the verge of political shutdown, and a topsy-turvy stock market. I could lay out a completely logical, though possibly unreliable, roadmap for the next twelve months and even make, as some have, concrete predictions of where the S&P 500 will finish on December 31, 2012. But I won't.

Instead, I'll use this space to provide a bit of insight into something we do here on a daily basis – grapple with other investment professionals. No, we don't literally wrestle with anyone, but we do wrestle, on your behalf, with all sorts of conflicting financial opinions and performances. On a typical day, for example, we hear from at least a dozen, if not more, different companies prodding us to buy their investment products with your money. We read countless news articles about the state of world affairs while trying to parse out objective facts from subtextual propaganda. We listen to commentaries from multiple renown specialists only to find that no one truly agrees on anything. We then push this big red button that's locked away deep under the building, and after a bit of whirring and a lot of smoke out pops a conclusion.

Okay, so that's a little over dramatized. But the fact is, investors today are faced with an intoxicating blend of marketing, news, and infotainment, only some of which is actually useful in making good investment decisions. So that you don't get poisoned, we at Deighan act a lot like royal taste testers, making sure only the best finds its way into your portfolio.

One particular issue with which we have been grappling is the issue of active mutual fund performance. An active mutual fund manager is one who does research in the hopes of building a portfolio that can beat the market. Without active management, an investor would never be able to actually outperform the market. The downside to active management is that it's expensive and not particularly easy to consistently do well. Therefore, there exist many proponents of passive management, otherwise known as index investing. Their thought is, if it's so difficult and expensive to beat the market, why not just meet the market at a very low cost?

As you know, we use funds of varying types to meet certain needs in your portfolio. We do not purport to specialize in Japanese stocks or Brazilian bonds, and so we sub-manage these areas to those who do. When constructing your portfolio, we utilize a combination of both active and passive managers so you have an opportunity to beat the market at a cost that's lower than pure active management. It also gives your portfolio protection in case an active manager makes a wrong-way bet.

This strategy has served us well, and we'd like to think we do a good job of selecting managers. But 2011 was a difficult year for active managers of all stripes. Across nearly all stock categories, passive index funds tended to outperform. The Schwab S&P 500 Index fund, for example, landed in the 17th percentile, meaning 83% of active large cap managers did worse than the index. The Columbia Small Cap Index Fund, which tracks the Russell 2000 Index, performed in the 10th percentile, beating out 90% of active small cap managers.

Why was 2011 so hard for active managers? Well, when you have a year full of ups, downs, dips, twists, curveballs, and oddballs, active managers are typically going to be at a disadvantage. That's because an active manager needs time for his investment thesis to play out. He must be somewhat agnostic to the gyrations of the market, assuming he continues to have conviction in that thesis. In fact, the last thing you want in an active manager is someone who constantly changes the portfolio in response to the latest news headlines. That's a sure fire way to get higher trading expenses and poorer performance.

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Market Commentary *continued from page 1*

Restructuring a well thought-out, long-term, active portfolio is akin to moving a barge at times; it's not to be done lightly.

If you were to look at 2011 in a vacuum, then you'd almost never hire an active fund manager. But the problem isn't necessarily the manager, it's frame mismatch. Trying to assess the validity of an active manager's long term thesis by comparing him or her to short-term market performance is truly like comparing apples to oranges. We don't measure our ages in terms of days, and neither should a long-term investment idea be measured in quarters or even years. Rather, it should be measured over the course of a full market cycle.

Everyone grapples with active manager underperformance, and we are no exception. This year, though we had several managers who performed well, we also had a handful that underperformed. And so we start to ask questions. Has the manager lost his way? Is this indicative of some continued downward slide? Is the investment thesis flawed? The grass starts looking greener elsewhere, but many situations are not cut and dry. In fact, we have seen instances where very skilled managers lag for several years before turning the corner.

found this gap to be widest among funds whose performance was the most volatile, implying investors are driven by emotion rather than sound decision making. In 2010, investors earned 2% less than the funds in which they were invested, due solely to their own movements into and out of those funds. Over the three year period ending 2010, investors earned on average 1.28% less per year than the funds in which they were invested. Morningstar cites one extreme example of the Victory Stock Index, a plain vanilla S&P 500 Index fund. That fund returned 2.23% per year for the 10 year period ending 2010. Its average investor realized negative returns of 7.87% per year. Talk about shooting yourself in the foot!

It all comes down to discipline, and that's what you pay us to have. We don't want you to end up like the investors in Morningstar's study. No matter how many investment companies come knocking on our door with the latest and greatest newfangled way to hedge pork rind futures, they will each be held to the same objective taste test. We look for managers with reasonable expenses and a proven process. We want that process to play a specific role in your portfolio, and we want it to

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And so we wrestle. What does the manager have to say for himself? What are his competitors doing? Fortunately, because we have an objective process in place to evaluate our managers, it is easier for us to end up on top. We don't always get it right, but we combine due diligence with patience to reasonably determine whether or not an active manager is likely to succeed. The problem for a lot of investors is that they don't have a process, and therefore they are ruled by emotion. Too often, investors jump on board with the hottest manager, only to leave when the ride gets bumpy. This is the equivalent of buying high and selling low.

Morningstar, the mostly widely recognized authority on mutual fund research, has found "…there's often a wide gap between a fund's total returns and its investor returns, which factor in inflows and outflows. This gap suggests that investors are leaving a big chunk of funds' gains on the table." Morningstar

complement the roles of our other managers. Lastly, we look for managers who have the gumption to see their investment theses through to their conclusions and who defend their ideas when under assault. In return, when we choose a manager, we will give him or her time, as appropriate, to do their job.

We hope markets straighten out in 2012, as a more predictable world makes for a more predictable portfolio. Nonetheless, we have positioned portfolios to withstand a variety of scenarios just in case. 2012 promises to be an eventful year, between the presidential elections, the ongoing turmoil in Europe, and the rumored Mayan apocalypse. But we will refrain from predicting exactly what will happen and leave that to the prognosticators. Until next time, each of us here at Deighan would like to wish you and yours a happy and prosperous New Year!

Matthew T. Skaves, CFA
Senior Vice President

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NextGen Direct Series Still a Great 529 Plan

Recently, Maine's 529 college savings plan, the NextGen College Investing Plan, was downgraded by Morningstar from Above Average to Below Average. The announcement read, "New to the Below Average list is the NextGen College Investing Plan, a Maine-based plan that features a pricey lineup of investment options. Also, NextGen's program manager, Merrill Lynch Pierce Fenner & Smith, was fined by regulators for not establishing proper supervisory procedures to determine which college savers were suitable for enrollment."

At first we were concerned, but upon closer inspection we realized the downgrade was far too broad. The NextGen Plan offers two investment "tracks" to choose from. The NextGen Client Select Series (the part of the plan responsible for the regulatory fine) is a rather pricey, broker-sold platform available through Merrill Lynch. It is available to families that want to work with a Merrill Lynch advisor. The NextGen Client Direct Series, by contrast, has the potential to be a low cost option when selecting one of the age-based Exchange Traded Fund (ETF) portfolios managed by iShares. By downgrading the entire NextGen Plan and not just the errant Select Series, Morningstar inadvertently threw out the baby (the Direct Series) with the bathwater.

The NextGen Client Direct Series is a good plan that offers sound investment choices. Although participants will not have access to a plan investment advisor, they can still benefit from the professionally managed iShares portfolios. These portfolios take much of the guesswork out of the investing process, reducing the need for an advisor. Of the iShares choices, the age-based portfolios are particularly compelling, because they automatically shift an account's asset mix toward less aggressive investments as the beneficiary grows up. While they may not be custom-tailored Hong Kong suits, the age-based portfolios are sensibly designed off-the-rack solutions. They are perfect for participants who want to have one simple box to check, so they can responsibly "set it and forget it".

From a cost standpoint, the Client Direct Series is competitive. The expense ratio applied to the iShares Age 0-6 Portfolio, for example, is 0.60% (in other words, $60 annually on a $10,000 account). As the portfolio shifts toward more defensive investments over time, the expense ratio drops to 0.52% ($52 on a $10,000 account). This fee structure is less than half the cost of the Client Select Series, and it compares favorably with most programs offered by other states.

Most importantly, the NextGen Client Direct Series is hard to beat for Maine residents, because the incentives are wonderful for Maine beneficiaries. The Harold Alfond Challenge provides a $500 grant for every Maine child for whom a NextGen Plan (either Direct or Select) is opened during his or her first year of life. This applies even if the account is never funded! For those Maine accounts that do not qualify for the Alfond grant, there is still a generous initial funding grant of $200. To learn more about the Harold Alfond Challenge, visit 500forbaby.org.

Other incentives that combine to make the NextGen Plan one of the best in the nation include:

- The annual maintenance fee may be waived for Maine residents.
- Maine residents receive a tax deduction for contributions made up to $250.
- If a NextGen account is funded by payroll deduction or an automatic debit plan, an automatic funding grant of $50 is awarded.
- If the automatic funding stays in place, NextGen will match the payments by a third during the first two years of automatic funding. For example, if one were to start an automatic payment plan of $50 per month, then over the course of two years $1,200 will have accumulated. The NextGen Plan would match that amount by $400!

529 Plans are important college savings tools, because they compound tax free like IRA's. However, they need not be limited to traditional four year schools. Account assets may be used to cover educational expenses at any accredited institution, including vocational training schools. As a result, 529 Plans should be a part of every family's college savings plan. Our colleague, Abby Turner Pons, CFP® of Capella Financial Services, agrees:

"For almost every couple or individual I have worked with, funding a 529 is the best option for college savings. The higher fund-

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Soundbytes

In early November, Jean Deighan and Matt Skaves traveled to San Francisco to attend IMPACT 2011, an annual investment conference hosted by Charles Schwab. The three day event featured such renowned speakers as Bill Gross, Joshua Cooper Ramo, and former Prime Minister Tony Blair. While there, Jean and Matt had the opportunity to attend a number of educational sessions ranging from financial planning to investment strategy.

In October, Jean Deighan attended the annual International Women's Forum World Leadership Conference in Washington, D.C. Speakers included a range of opinion-leaders and decision-makers from around the globe, offering a behind the scenes look at the creative processes that shape our world.

On December 7th, Jenifer Wilson and Matt Skaves attended a Maine CFA Society event hosted at the University of Maine. The event featured a discussion of the risk parity approach to asset allocation and offered students and professionals an opportunity to meet.

NextGen Direct *continued from page 3*

ing limits, account control, and tax benefits make it the obvious choice in almost all situations. In Maine, matching grants and cost-efficient iShares age-based portfolios make the NextGen Client Direct Series worthwhile. For the vast majority of us, being able to set up automatic funding to cost-efficient investments inside a 529 plan is the way to go. This is especially true for people with young kids. Life is busy, and things get in the way of reviewing college funding goals. Post high school education tends to sneak up on us, so anything we can do to simplify and automate saving toward the goal is a good thing."

It might seem hard to believe, but the 2011 "take rate" for the NextGen College Investing Plan was only about 37%, as measured by participants opening plans for children born in 2010. The goal for 2012 is to increase that rate to 43%. While far better than the national average of 5%, we encourage you to spread the word to parents and grandparents that Maine has a solid, cost effective 529 Plan with excellent incentives. The Client Direct Series is a truly solid choice for Maine families, and it is still deserving of an Above Average rating. For more information, visit famemaine.com or call 1-800-228-3734.

Jean M. Deighan, CFP®
President

Portfolio Changes

Schlumberger Ltd. (SLB) – Added – Schlumberger Ltd. is a global provider of oilfield services. It is present in nearly all major oilfield sectors and typically generates a higher return on investment than its peers. Two key factors drive a positive market outlook for SLB: pricing power and the pace of international activity.

McDonald's Corp. (MCD) – Added – McDonald's is the world's leading global foodservice retailer with more than 32,000 locations serving approximately 64 million customers in 117 countries daily. We think the company will continue to see significant international growth, especially in Asian Pacific, Middle Eastern, and African markets. Share price, dividend yield, and risk profile are all attractive.

Queens Road Small Cap Value Fund (QRSVX) – Added – Queens Road Funds developed out of a registered investment advisor shop in North Carolina, Bragg Financial Advisors. We like the company's track record and commitment to smaller investors. It can be difficult to find small cap funds with both a good investment process and a small asset base. Because this fund is relatively young, we expect it to remain open to investors for some time, which is often a challenge.

Walgreen Company (WAG) – Removed - Walgreen was removed from client portfolios partly due to disappointing share price performance over several years, and partly because the company was unsuccessful in renegotiating its pharmacy benefit management contract with Express Scripts. Although WAG posted its 37th consecutive year of record sales and earnings in 2011, the market simply hasn't rewarded that success with share price increases.

Artio International Fund (BJBIX/JETAX) – Removed – We were long-time purchasers of this fund, holding it in some accounts for nearly ten years. Until recently, it had consistently performed toward the top of its category. But management has had difficulty recovering from bad timing decisions, and we think the fund has strayed from its core process. After giving management ample time to improve, it is now time to exit. We have replaced our position with index funds.

Disclaimer:
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