July 25, 2013

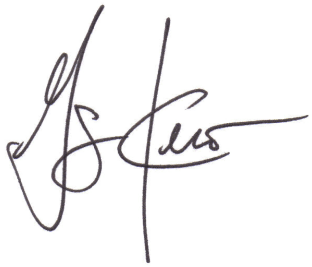
Dear clients,

We understand effective communication is essential for our clients to have a successful experience working with us. Our objective is to be fully transparent about the way we manage your (and our) assets and the thought process that goes into constructing our portfolios. These quarterly investor letters are our way to inform clients about our investment philosophy, portfolio construction process, risk management, portfolio returns and market outlook. These letters are in addition to the quarterly newsletters where we provide you with other pertinent, but primarily non-investment related, information.

This quarter we thought it would be helpful to share some of our email exchanges with clients about recent volatility in interest rates and the affect on performance. Clients often contact us with questions and concerns that many of you likely share. We use these conversations as ideas for what to include in our quarterly letter, so we encourage our clients to contact us with any questions or concerns they might have.

Because I so much enjoyed the recent conversation with one of our clients, this letter and possibly a new blog-like section on our website are being named after her—thank you Margo!

All the best,



Greg Kero
Founder
Ragnar Wealth

Conversations with Margo

Margo:

These are crazy times in the financial world. Do you have any words of wisdom you could share?

Greg:

These continue to be interesting times....but to be honest, I can recall very few stretches of time since I started in this industry nearly 20 years ago where the market seemed "normal," without looming risks. This is simply the newest set of challenges. We continue to believe the best way to protect assets while trying to also grow them is to be broadly diversified to asset classes that can drive our performance in various economic environments. For instance, **Equities** tend to do well when economic growth is accelerating. **Fixed Income** (bonds) tends to do well when economic growth is flat to decelerating; and **Real Assets** (real estate, commodities, and energy/infrastructure) tend to do well when inflation picks up.

In May and June there was a 'policy expectations' tug-of-war, where things were looking better economically in the US but getting worse in China and Europe. Unfortunately, that is a scenario that, in the short-term, was bad for all three major asset classes. It was bad for Real Assets because China has been the marginal buyer of all commodities, so China's decelerating growth is deflationary for commodities and natural resources. It was bad for Equities because it means global demand is weak and much of the Dow/S&P500 companies have significant non-US business exposure; and, it was bad for Fixed Income because when the U.S. economy improves it changes expectations for how soon the Fed will raise rates.

With regards to that last point, the market misunderstood the Fed's comments in late May on the subject, so the Fed scramble in the following weeks to correct the misunderstanding through the media. The Fed has made it clear that any move toward tightening is data dependent, so if the impact of the Chinese/European economy on the U.S. economy is too negative, the Fed will continue its accommodative monetary program and not make any changes to interest rates until that is no longer the case.

For some perspective, these recent changes only caused the equity markets to dip in June to their late April lows, which was not much of a set-back in terms of *time*. While it has been a lousy environment this year for Real Assets, Fixed Income, and for about half of our Equity exposure (International Developed markets are only up about 4% year-to-date ("YTD") and Emerging Markets are down about 10% YTD), our broadly diversified portfolio is up approximately 3% YTD. In comparison, our diversified portfolio was up approximately 13% in 2012. (Our long-term expected return for the model portfolio is about 8%.)

Clearly being up 3% YTD does not feel like much when the Dow is up about 15% YTD, but that is how diversification works. Diversification is primarily a risk management tool and an admission that we cannot forecast markets or changes in economic cycles, especially in the short run. However, the positives of having a diversified portfolio is that in economic downturns like 2000-2010, where Equities returned nearly zero percent, our broadly diversified portfolio returned 7-8% annually (driven by gains in Real Assets and Fixed Income).

There will always be short-term noise in returns. We attempt to smooth the noise out as much as we can through thoughtful diversification. We are always exposed to the risk of losing money, especially over short time periods. However, there are very few examples in history when broadly diversified portfolios, in a risk-balanced framework, lost money over periods of three to five years; and, importantly, when there have been losses, they have not been large enough to have a significant impact on living standards (which is what we are working hard to protect!).

At Ragner Wealth, we invest to achieve goals, not to beat markets. If you can achieve your financial goals with less than an 8% return, that allows us to reduce the risk in your portfolio and let you relax a little more. If you have any further questions about this please discuss them with Leanne. My last words of wisdom are that I agree with Leanne's recent commentary on the media, where she asserted that investors would be better off if the media could only publish once per month, which would eliminate a lot of the noise.

I hope this helps you better understand our process and beliefs.

Cheers,

Greg

Margo:

Thanks Greg, I appreciate you taking the time to help educate me. It is a bit over my head but I think I get the gist of most of what you are saying.

Just so you know I do not watch the news - do not even have a TV. About the only financial media I look at is the DOW, S&P and the occasional article that looks interesting when I am checking the indexes.

I do not mind if my asset values do not go up with the 'waves' - it is just a bit unsettling that my values go down and do not seem to recover. Is this partly due to the fact that I am now invested in mutual funds and they do not respond to the market as quickly as my individual stocks used to?

I am also aware that, percentage wise, my asset values have only gone down a little bit.

I just hope to see them grow as time goes on. My mother's financial manager has managed to make her asset values grow and bring in substantial dividend income in spite of the market instability and the fact that she is taking unbelievable amounts of cash out of her account every year.

I am new with Ragnar Wealth and am willing to give it some time so I can see what happens over time. I will need your help to understand how to evaluate the performance of your portfolio, though. I can learn but this stuff does not come naturally to me so I always have to make quite an effort to understand.

Many thanks,

Margo

Greg:

Margo,

I am happy to help you understand our process and how we manage your investments.

With regard to your comparison to your mother's situation, many of our other long-term clients have had a similar experience. The clients that began with us in September of 2010 and have been withdrawing about 6% per year for income have substantially more assets now than they started with. Like your mother's portfolio, these returns have been driven substantially by dividend and interest income (as well as stock market gains). These clients have been invested in the same manner that you are now with us and have the same recent experience you have. And I believe if you look at recent performance (May and June) of the dividend payers the other advisor you mentioned is investing in, they have not done well over this stretch either.

Put simply, for the past few years, the market has viewed all income producing securities as beneficiaries of the Fed's Quantitative Easing and low rate policies, but those policies are now expected to reverse sooner than expected (and there has not been any inflation), so the market is changing its opinion with regards to these securities.

We believe we are not invested in the same commonly held income-payers that most firms are in. We have done our research and have been very selective in choosing securities (businesses) that will be most able to continue their distributions in a rising rate environment (and importantly in a rising inflation environment). But this will only be

proven out over time as some businesses succeed in doing so and others fail. In the short-run the market is treating them all the same.

It is important to remember the time frame we have in mind. Our model is built for investors with at least a 3-year time horizon. Many of our favorite income producing and inflation hedging investments are down 5-10% for May-June, but in aggregate are positive YTD (and are up about 15-20% annually for the last three years). Thus, some of this is a timing issue. However, even with bad timing, the recent pull-back represents less than two years' worth of future expected income, so the overall return is still expected to be positive regardless of timing.

Also, we believe there is a high probability that the last five years of money printing by the Fed and other central banks will lead to an inflationary environment; and,as all advisors know, inflation can be the biggest threat to financial planning (historically doubling cost of living every 15-20 years). To mitigate the potential impact, we have about 20% of our portfolio dedicated to investments that are expected to perform well in inflationary environments. That has been a drag on recent performance as everyone for the moment is OK with the notion that for the first time in history a dramatically increased money supply will not result in rising prices. We shall see.

And regarding the mutual fund question, no that's not an issue.....mutual funds perform in real-time with individual securities (not throughout the trading day, but the mutual fund values catch up at end of each day so there's no real delay). It just gets back to the fact that only about 15-20% of our portfolio is invested in US stocks.....so their recent positive performance is 'diluted' by the other diversifying investments (bonds, inflation-linked securities, energy MLP's, commodities, Business Development Companies, emerging market stocks, etc.).

I hope this is helpful. Please do not hesitate to contact us with any questions or thoughts. These questions are a great opportunity for us to write down some of our thoughts and share them with other clients that may have the same questions.

Thank you very much for hanging in there with us.

Best,

Greg

Doug:

Hi Leanne,

I have started looking at my portfolios to better understand how they are being managed and I have a few questions.

1. The overall portfolio is down, however the DOW is up significantly this year. I am not sure I understand this? Shouldn't the portfolio do at least as well as the DOW itself?
2. We have discussed income and you mentioned that we should be able to draw around 4% per year without decreasing the principal value (at least I think that is what you mentioned). The income being generated by both of the portfolios is much less than that.

My goal is to be able to monitor (to some reasonable extent) how things are going. I also realize that this is a long term strategy, so if the DOW were not up so much this year I probably would not be asking these questions.

Let me know your thoughts.

Thanks for the help.

Doug

Greg:

Doug,

I look forward to meeting you, but before we meet I want to make a couple quick comments about your questions.

The Dow (i.e., the stock market) is not a very good benchmark for our model portfolio. We are big believers that investing in a financial planning environment is much more about creating **long-term low volatility** returns than it is about "return maximization," and because of this, our investment philosophy focuses on diversifying risk more broadly than traditional portfolios which tend to be equity dominated. As a result, right now we have 35% of our model portfolio allocated to equities. Roughly half of that is US equities, and the rest is international equities. The 17-18% of your portfolio that is exposed to U.S. equities has performed similarly YTD to the Dow, in fact slightly better. In general, international and emerging markets have underperformed the U.S. market YTD, so your overall equity exposure has not kept up with the Dow.

The rest of our model is allocated in this manner: fixed income 31.5%, real assets (which include real estate, commodities/natural resources, and infrastructure) 18.5%, and alternatives 15%.

We construct the portfolio in this way so that it can deliver productive returns (we believe 8-10% over the long-term) in most economic and market environments, not just in good equity markets. A diversified portfolio by definition will always be underperforming some asset class, so we will always be defending ourselves against something that is beating us. A good example of the benefit of this type of portfolio is the decade from 2000-2010 which saw nearly a zero return for equities. Portfolios constructed with more of a 'risk parity' framework delivered 7-8% annualized returns. Please see the attached "All Weather" document for a good primer on this style of investing. It is more consistent with how we view the world than is the traditional “mean-variance optimization” process.

Lastly, because the return series is less volatile we are comfortable distributing income beyond what is naturally generated from the underlying investments. By producing an expected return of around 8% we can afford to distribute 4-5% and still have portfolio growth. Now, certainly that 8% is not linear, and there will be times when the principal goes down, but it should exhibit less volatility than traditionally allocated portfolios.

I hope this helps in advance of our meeting. Please send any other questions you might have.

Cheers,

Greg