Orthos Advisory AG

Investing: A Preventive Approach to an Old Problem

Introduction

"It's tough to make predictions, especially about the future."

Yogi Berra

Independent Investment Advice at Unconventional Cost

Orthos Advisory is an independent investment counseling firm which helps clients to manage their investment assets in a professional and cost-effective way.

As a registered investment advisor in Switzerland, we operate by managing assets directly under a power of attorney, or by giving broader advisory services to clients who prefer to take the implementation in their own hands.

Orthos further distinguishes itself for an innovative approach to pricing its services which aligns its interests with the ones of its clients.

VQF

VQF Financial Services Standards Association

SRO- and BOVV-Member VQF - an officially recognized self-regulatory organization (SRO) according to the Anti-Money-Laundering Act (AMLA) and an Industry Organization for independent Asset Managers (BOVV) with officially recognized rules of professional conduct (rules of conduct) for asset managers.

Guiding Principles

In medicine the fundamental aims are teaching how to improve your health, preventing you from getting sick and curing your illnesses. Similarly, in financial management the aims are selecting the proper investment strategy (improve health), avoiding unnecessary costs (getting sick) and reacting promptly if circumstances warrant it (cure illness).

Orthos Advisory AG helps clients integrate these observations and translate them into reality: we help investing with minimum costs and maximum consistency, following these Guiding Principles:

① We will help our clients in their investment and financial needs to the best of our abilities; we will not, however, engage in any consultancy which requires us to commit to unrealistic strategies, goals or expectations.

② We believe in aligning our interests exclusively with the interests of our clients; we will customarily be compensated only by our clients and will receive no additional emolument from banks, brokers, funds or other investment service providers.

③ We will always act and communicate in a transparent and clear way.

④ We follow the same principles in investing for our clients as we do for ourselves: if we wouldn't buy it for our own account we will not recommend it.

⑤ Investing is not about growing a business, but about doing the right thing for the right reasons; we will adhere to our investment process until something better comes along, and will not heed temporary market fads.

Some Thoughts About Investing

Investors need to be effective and efficient in implementing their investment programs.

- They need to be effective in order to come as close to obtaining their goals as possible. This requires patience, discipline and an analysis of what the markets offer in relation to the financial resources employed.
- They need to be efficient in order to achieve their goals in the least costly fashion. Today, too much of accessible returns is wasted in unnecessary costs incurred for the sake of obtaining "superior performance", something we know is both very difficult and expensive.

The value of common sense and simplicity has gotten lost for the sake of "science" and precision. To avoid mistakes or unwarranted deviations from one's investment strategy it helps to separate one's wealth in distinct categories. This will ensure that focus and discipline are maintained in carrying out an investment program. Broadly speaking, we invest for

- Current and future consumption,
- The bequeathal of capital,
- For fun (maybe).

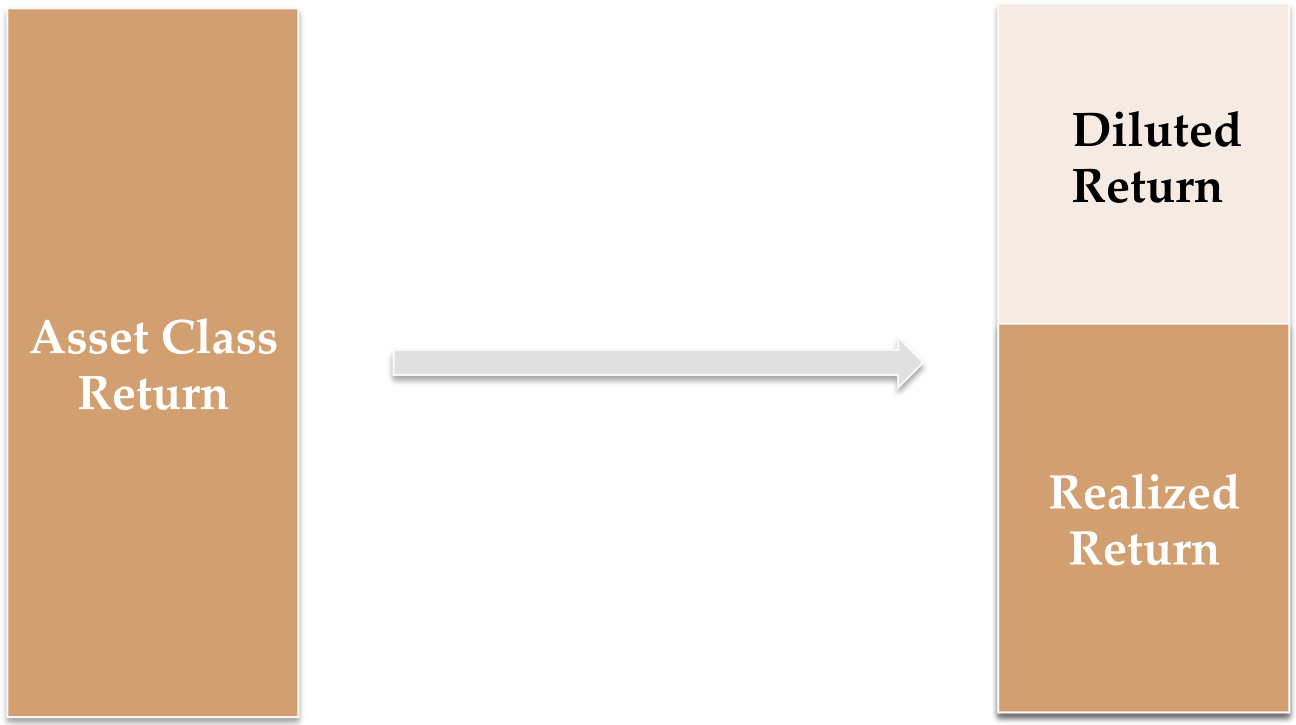
As stated in our five Guiding Principles, Orthos also operates on the premise that the alignment of interests between investor and advisor is essential. Despite this being a much talked about posture, it is seldom practiced because most of the investment advisory/management businesses are focused on asset acquisition and business profitability, not on investment returns. In other words, today the investment advisory/management activity is primarily about a business, not about investing. Orthos strives to go against this trend by, among other things, embracing a stable and disciplined investment process, and by explicitly incorporating in its business model a financial partnership with its clients.

Why Bother?

"We strive always to put the professional investment discipline ahead of the business discipline. Speaking broadly, there are four widely recognized professions: law, to keep you out of trouble or get you out of trouble; the ministry, to help you find and stay with your religion; teaching, to show you how to learn and understand; and medicine, to keep you alive and protect your health. We think there is a fifth profession: helping individual investors manage their money and their relationship to money."

Bill Hurt

A Tale of Sorrow: Dilution of Returns (How We Get Sick)



It is a known fact that investors capture only a portion of the selected asset class returns. This dilution is due to a variety of factors, some of which are unavoidable and some of which can be managed more efficiently. The total amount of diluted return varies with the asset class and individual circumstance of the investor, but it is in any case sufficiently important to warrant careful consideration.

The Composition of Sorrow (Diagnosis)

Diluted Return

Realized Return

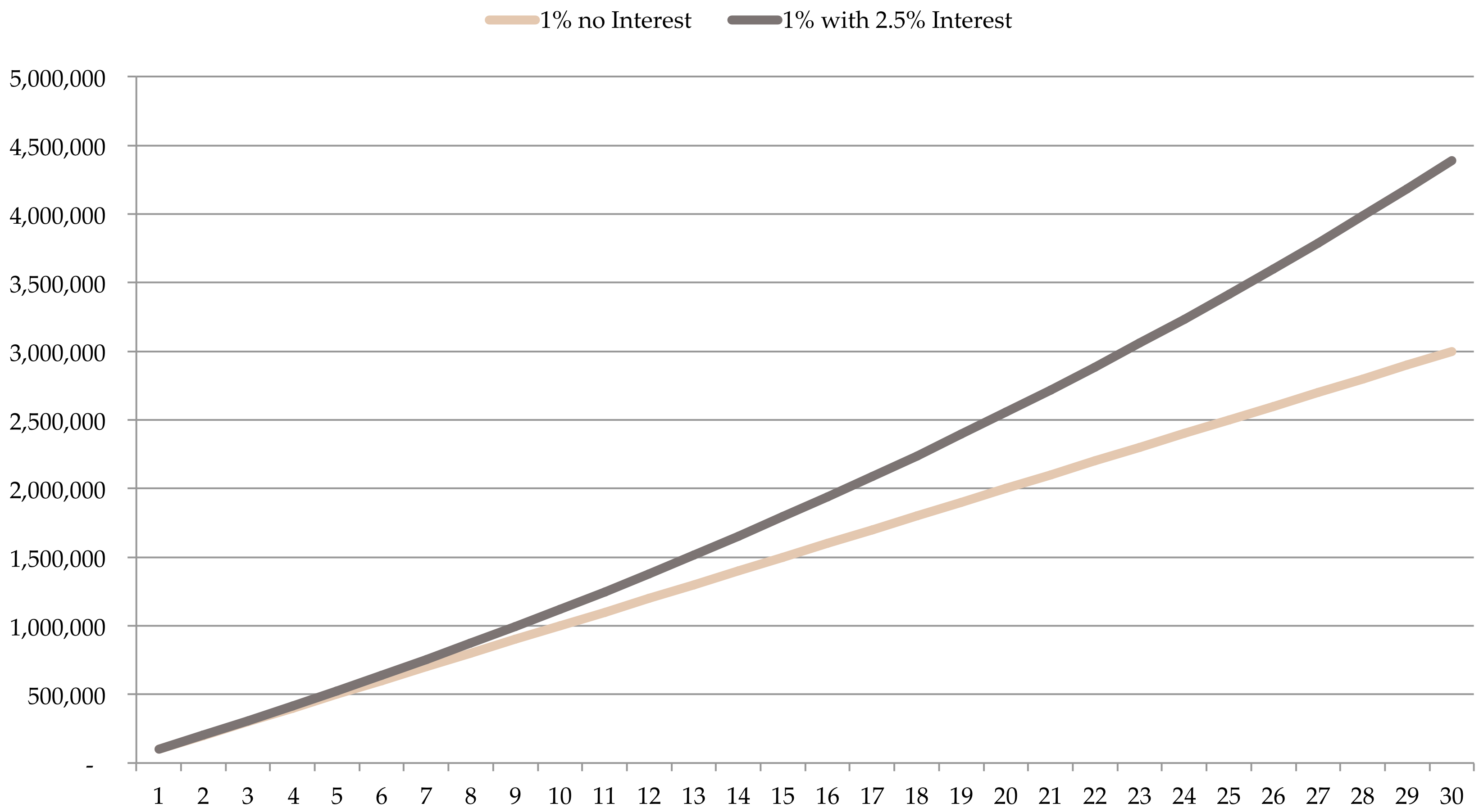
- **Unavoidable Dilution**
  - Vehicle access fees
  - Transactions costs
  - Custody fees
  - Trust, administrative and/or other structural fees

- **Avoidable Dilution**
  - Active management costs
    - Fees
    - Admin costs
    - Turnover costs
  - Advisory fees

- **Destructive Dilution (Behavioral)**
  - Trading (TAA, manager switching)
  - Panic
  - Exuberance
  - Fads

The Worth of Sorrow (More Diagnosis)

Perhaps it's not important to pay a "little" more, if the results are "good". But 1% on a portfolio of $10mm is worth $1.0mm after 10 years, or $2.0mm after 20 years; with interest at 2.5%, these figures rise to $1.1mm and $2.6mm, respectively.



Unavoidable Dilution – Stuff You Need

Investors need **basic "structural" components** and **investment vehicles** for the implementation of their strategies. These include banks or custodian organizations to hold the assets and execute transactions (basic "structural" components), and the assets themselves (investment vehicles). Investors will, hence, incur one or more of the following:

1. **Vehicle access fees** – Total expenses associated with the passive vehicle(s) investors need to acquire in order to participate in the returns of a specific asset class or sector.

2. **Transaction costs** – Commissions, bid/ask spreads and market-impact costs of acquiring any investment vehicle; also costs associated with the maintenance of the securities purchased/sold by the passive vehicle (typically not calculated or shown).

3. **Custody fees** – Fees payable to banks/custodians hired by investors to hold their investments.

4. **Trust, administrative and/or other structural fees** – Costs associated with the ownership structure of the assets.

Avoidable Dilution – Stuff You (Likely) Don't Need

Avoidable dilution consists, for the most part, of costs incurred by investors when they try to **obtain results better** than the market's or the corresponding passive vehicle's. While this is possible, it is a rare phenomenon and in general the costs associated with it are not worth it.

1. **Active management costs:** Total expenses associated with the vehicle(s) selected by the investor, with the objective of obtaining a superior return. Important embedded (and unreported) transaction costs are associated with the turnover underlying the chosen vehicle/strategy, with the size of the vehicle itself, and with the type of market it operates in.

2. **Advisory fees:** Costs associated with the hiring of one or multiple investment advisors to help in the management of the client's wealth. Often understood to have the same role as active managers (see previous point), the advisors' role is actually much boarder and "disciplinary" in nature: they are the ones who should keep every aspect of the investment strategy in line over time.

Destructive Dilution – Stuff That May Kill You

The main types of **destructive dilution**, so called because it actually enhances wealth destruction, are:

1. **Behavioral costs**: Costs associated with the investor's ability – or lack thereof - to control emotional and psychological reactions during the normal evolution of any investment cycle.

2. **Market timing:** Investors' attempts to buy at the "bottom" and sell at the "top" of market ranges within relatively short periods of time (below two years). Similar, and carrying equally destructive effects, to buying and selling mutual funds based on their past performance.

3. **Transaction costs:** Costs incurred in the execution of trades, whether to implement a strategy or to disinvest; the more active an investor is, the more transaction costs will impact performance results.

What To Do?

"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in the corrections themselves."

Peter Lynch

Staying Healthy – Know Why You Need Money

To remedy – or minimize – dilution of returns the first step is to clearly **divide one's wealth according to its objectives**, and sticking to that division. This will help the investor focus on what is really needed from each of the different pools of capital. There are typically three reasons for having money: to live, to build and bequeath, and – perhaps – to have fun.

Capital to Live	This portion of an investor's wealth should cover living expenses in the broadest sense of the definition (not just "essentials"). Its size depends heavily on one's style of life. It is replenished with the flows generated by the current business/work activity, and/or excess cash flow from Permanent and Fun capital, if any. It should be invested exclusively in cash instruments or bonds for the portion of outflows with a known deadline.
Permanent Capital	This is the portion of an investor's wealth which is dedicated to more lasting long-term objectives. It is the portion of the capital which will never be "redeemed", unless severe unexpected circumstances occur. It will be bequeathed to future generations, and it is topped-up by excess cash generated from current business/work activity or from fun capital. It is the most important part of the overall wealth of any individual.
Fun Capital	This "keep-your-broker-happy" portion of the capital is not mandatory. It can be invested in a more esoteric and active fashion. In this category of capital the investor can indulge in specific bets or ad hoc trading strategies, perhaps following the advice or ideas from any number of sources. It should be by far the smallest of the three types of capital.

Staying Healthy – Know Your Strategy and Stick to It

The second step consists of **matching each previously-defined pool of capital with a suitable investment strategy**. An investment strategy can vary in some particulars, but in general they will tend to have at least the following elements:

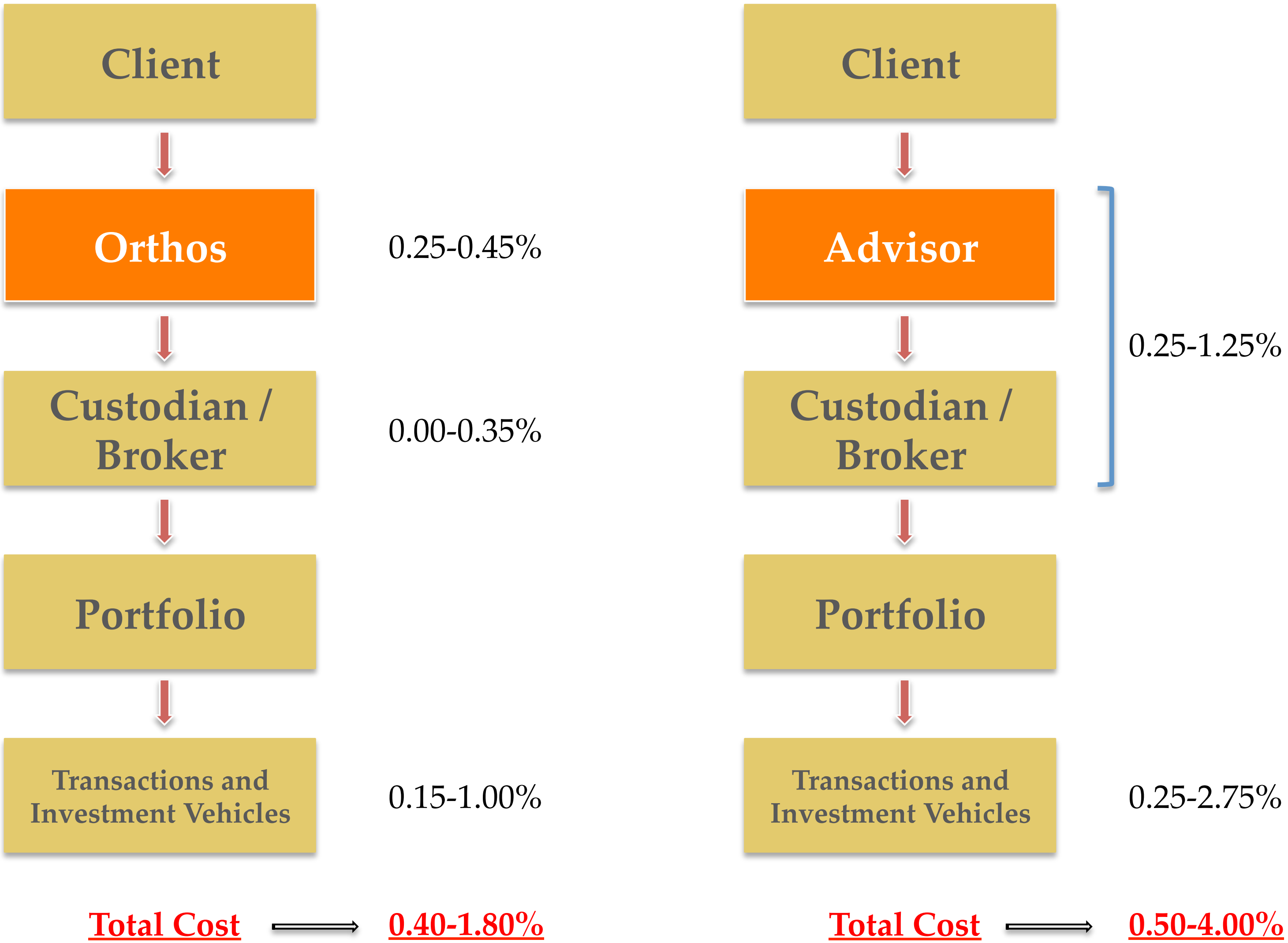
Time Horizon	Time Horizon is an essential derivative from the purpose of the pool of capital to which it applies. For Capital to Live, either a very short- (cash) or a medium-term (bonds, for specific outlays with defined deadlines) horizon is appropriate. For Permanent Capital, a very long-term horizon (ideally, in perpetuity) is ideal. For Fun Capital, anything goes (but here too one needs to define at least a theoretical target).
Target Risk	Determining a Target Risk level involves several elements, some of which are tied to behavioral characteristics of the specific investor. I have purposefully left out a "target return" precisely for this reason: some investors will understand the risk implied in a strategy with a given horizon, but may not have the psychological capacity to sustain it, no matter what the prospective return.
Investment Process	The Investment Process consists of the methodology used to take investment decisions, and of the vehicles employed in implementing those decisions. A simple, clear-cut and parsimonious approach is the key to obtaining results which are close to the target markets or indices. Active management should be employed when an exceptional opportunity is found, not as a rule.

Why Orthos?

"The world of finance hails the invention of the wheel over and over again, often in a slightly more unstable version."

John Kenneth Galbraith

Orthos Investing versus More Common Alternatives



Orthos Business Model – A Partnership

Orthos Advisory AG is a registered investment advisor and offers two types of services:

A. Discretionary investment management services
B. Non-discretionary and advisory investment management services

Orthos operates in a fully independent manner, and receives all of its revenues from its clients, thereby maintaining full objectivity in the investment strategy and vehicle selection process.

Orthos strives to operate on a profitable basis and in complete partnership with its clients. This means that the results derived from any successful operating performance will, after a certain level, be shared between management and clients (losses, of course, are entirely borne by management). The split between management and clients will be determined by a formula, such that the portion of operating income accruing to clients will increase with its size. In essence, the advantages of scale will be shared with clients, and will increasingly accrue in the latters' favor.

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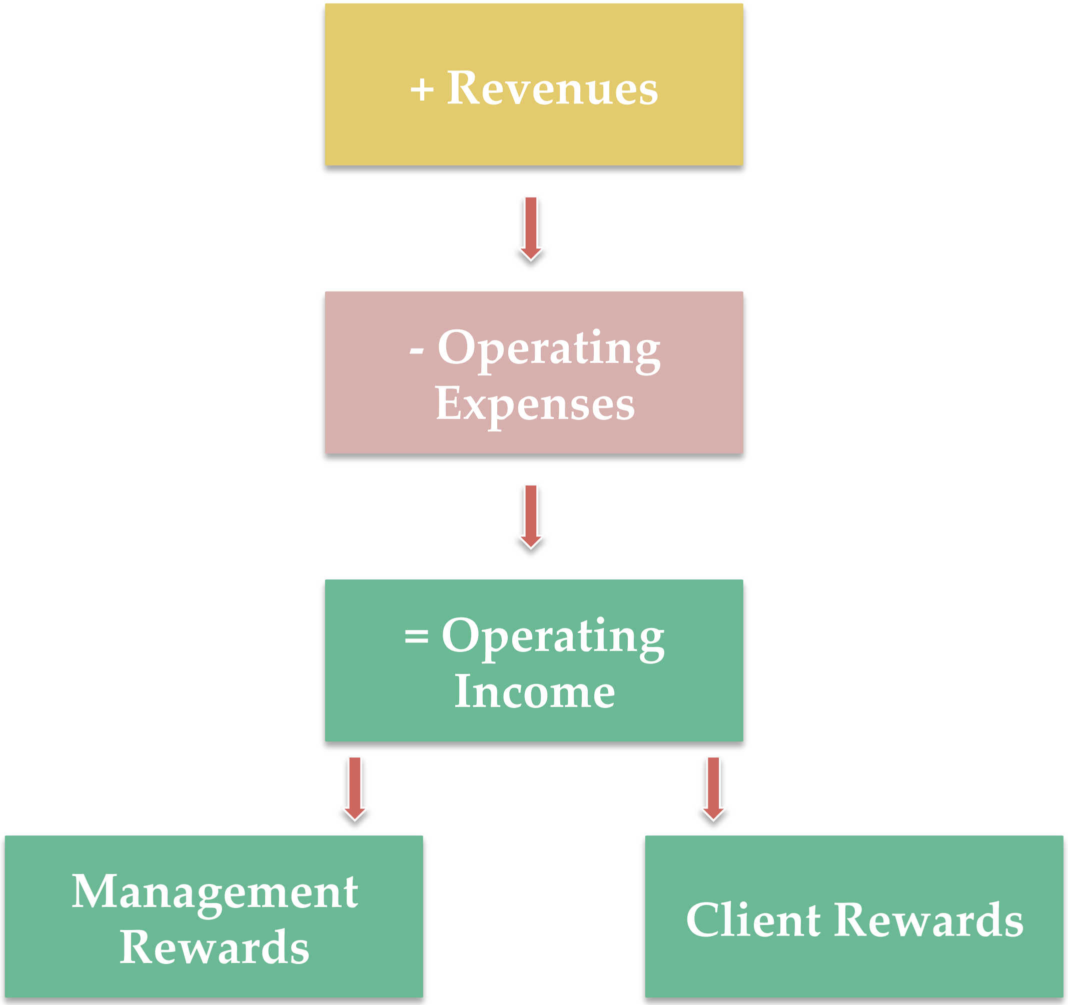

Orthos Business Model – Sample "Partnership" P&L

(all figures in 000s of Chf)

				Year 1	Year 2	Year 3	Year 4	Year 5
Revenues				300	600	1,200	2,400	4,800
Client Rewards				-	-	(49)	(331)	(1,016)
Operating Expenses				(100)	(105)	(110)	(115)	(120)
Operating Income				**200**	**495**	**1,041**	**1,954**	**3,664**
Management Rewards Calculation								
	Operating Income Range		**Mgmt Rate**					
	-	300	100%	200	300	300	300	300
	300	500	75%	-	146	150	150	150
	500	1,000	50%	-	-	250	250	250
	1,000	2,000	25%	-	-	10	239	250
	2,000	100,000	10%	-	-	-	-	166
Total Management Rewards				**200**	**446**	**710**	**939**	**1,116**
As % of Operating Income				**100%**	**90%**	**68%**	**48%**	**30%**
Client Rewards				**-**	**49**	**331**	**1,016**	**2,548**
As % of Operating Income				**0%**	**10%**	**32%**	**52%**	**70%**
As % of Revenues				**0%**	**8%**	**28%**	**42%**	**53%**

Appendix I

The Permanent Capital Strategy

"Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies."

Benjamin Graham

A Sample Philosophy for Permanent Capital – 1/2

Basic premises

- In the long-run, equities offer positive after-tax and after inflation returns;
- You are not "buying a product" but you are "entering into a partnership" when you hire a manager;
- Value is all-important in obtaining results over an investment cycle (5+ years);
- Keeping it simple and getting good approximations are sufficient to get you through (much better to be approximately correct than precisely wrong);
- Discipline and "contrarian" thinking are most valuable traits in a manager (this is a business where successful people need to be lonely).

Investing style

- "Stable equity" management; equity driven investing, with focus on stability of underlying cash flows, and with a rough target of beating inflation by 4%p.a.;
- Extremely low turnover, close to 10% or below (trading frequently generates expenses, and expenses destroy value and add little benefits);
- Diversification not a concern; I have never met someone who got rich by diversifying a lot; in the past, max concentration in a single security was 20-25%; today max concentration is ~11% in an individual security and ~15% in an individual name.

Asset allocation

- Few and in between moves out of equities (direct sales or protection) when situations warrant it;
- Purchase of debt and preferred shares when value and opportunity arise;
- Historically, major asset allocations moves were 1997-1998 (sell 50% equities), February/March 2003 (buy equities to 100%), March 2007 (sell 50% equities), and March 2009 (buy equities to 100%).

A Sample Philosophy for Permanent Capital – 2/2

Principal drivers

- Valuation, both on markets and individual securities;
- Focus on cyclically-adjusted earnings ("Shiller 10-year" earnings, or similar);
- Individual equity security purchases focused primarily (but not exclusively) on large, global companies with the following characteristics:
    - names and products which are recognizable (brand value);
    - solid balance sheets;
    - consistent dividend payments for an extended period of time;
    - consistent increases in dividend payments over time (preferably with growth above inflation rate);
    - paid between 25-60% of earnings in dividends;
    - produce large free cash flows every year;
    - stable and good management team.

Other

- No leverage, except in exceptional circumstances;
- Implementation via individual securities, funds/ETFs (mostly passive), options;
- Minimize taxes via vehicles and investment plans.

Appendix II

Roberto Plaja, CFA

Before founding Orthos Advisory AG in 2013, Roberto spent the last three decades in the investment management industry, covering roles of responsibility in a number of global financial institutions.

A graduate from Cornell University (1976) and Harvard University (1979), Roberto worked in 1976-1977 at Morgan Stanley & Co. in New York as Corporate Finance Analyst; during this period, he was involved in various advisory, investment banking and mergers and acquisition deals for large corporate clients of the Firm.

In 1979, he joined Bankers Trust Company in New York where he held various roles in mergers and acquisitions, trade financing and private banking.

From 1984 to 1992 he worked at Continental Insurance Company Asset Management in New York, where his last position was Senior Vice President in charge of International Investments for all subsidiaries and affiliates of the Continental Insurance Company. At Continental, Roberto ran fixed income portfolios and monitored outside managers for equity mandates; he managed a team of 6 people in two offices (New York and London).

In 1992, he joined J.P. Morgan & Co. in New York, first as portfolio manager for the Private Clients Group, running fixed income portfolios. After a short stint in Proprietary Trading, Roberto headed Fixed Income in the Bank's Paris office, and conjunctively served as member of the Senior Global Fixed Income Team. In 1998, he became the Head of the Duration Team in US Fixed Income, and a member of the Global Macro Strategy Team.

In 2000, Roberto moved to Milano, and joined SanPaolo IMI Asset Management as Head of Fixed Income, responsible for managing a 17-people team running mutual funds, private banking client portfolios and insurance funds. Roberto was also a member of the Senior Asset Allocation Strategy Team of the Firm.

From 2003 to 2005, Roberto was an independent financial consultant to institutions and high net-worth individuals. For most of 2004 he was also CIO of ETRA SIM, an independent asset management firm based in Milano, with responsibility for structuring and running the investment process of the Firm, as well as its asset allocation decision-making process.

Finally, in 2005 Roberto joined Goldman Sachs International in London as Head of the Portfolio Advisory Group in Private Wealth Management. In 2009, he moved to Zuerich and became an Investment Professional at Goldman Sachs Bank AG, from which he retired in 2013.

Orthos Advisory AG

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