Overview of Portfolio Changes:

- Litman Gregory is further reducing exposure to the core investment-grade bond index ETF held in our index-based portfolios by adding the ETF version of PIMCO Total Return, the active core bond fund we use across our active balanced models.

- As part of our core investment-grade bond trades, Litman Gregory is eliminating its position in the Vanguard Short-Term Corporate Bond Index ETF in favor of Osterweis Strategic Income – the absolute-return-oriented fixed-income fund we own across our active balanced models.

- The following models are affected by the trades: Capital Preservation, Conservative Balanced, Balanced, and Equity-Tilted Balanced (ETF models only).

Trade Rationale - Adding PIMCO Total Return ETF (BOND)

Our rationale is that near all-time low interest rates make it likely that the core investment-grade bond index will generate very low returns in most five-year scenarios, while exposing investors to interest-rate risk when rates eventually rise. We have already incorporated an absolute-return-oriented bond fund into our index-based portfolios to complement our core fixed-income position in iShares Core Total U.S. Bond Market ETF (AGG). We are taking this diversification one step further based on our ongoing research into PIMCO’s Total Return ETF strategy (BOND) launched in March 2012. Despite the ETF being limited with respect to derivative use (as compared to the active fund that makes heavy use of options, futures, and swaps), we believe manager Bill Gross has sufficient tools, combined with PIMCO’s deep expertise, to outperform the iShares Core Total U.S. Bond Market ETF over full market cycles.

Despite the ETF’s short history, we don’t view BOND as a new strategy but rather a new implementation of the same strategy used to manage the PIMCO Total Return Fund (PTTDX), which we have held in our actively managed portfolios for over fifteen years. Our confidence in Gross’s experience and his distinguished track record extends to BOND, and the strengths of PIMCO as an organization are also applicable. We are impressed not only by Gross but also by his supporting colleagues, in particular the other members of PIMCO’s Investment Committee. They have consistently demonstrated a deep knowledge of their respective fixed-income markets, and we find them to be engaged, insightful, and intellectually honest. PIMCO’s risk-based approach to portfolio management is an advantage in an increasingly uncertain economic environment. While the firm will not be correct in every investment decision, Gross and his team have shown an ability to quickly assess and recover from short-term mistakes. We believe they have the talent and disciplined processes in place to continue delivering long-term performance that meaningfully exceeds the benchmark, and we expect PIMCO’s active management of BOND to mitigate the significant interest-rate risk of the index.

Beyond the typical structural differences of an ETF compared to a mutual fund, there are two notable distinctions between the two PIMCO vehicles for investors to consider. First, BOND cannot invest in options, futures, or swaps. These are often used by PIMCO in their funds to manage risk exposures; for example, Gross may extend or shorten duration through the use of interest-rate futures in the mutual fund. Within the ETF, he must adjust its positioning using cash bonds. (Currency futures are permitted
within BOND, so non-U.S. exposures can be managed similarly to the mutual fund.) This may become a relative disadvantage versus the fund as the asset base of BOND grows larger, but Gross has successfully managed his strategy across separate accounts for decades, some with restrictions on derivative use, so we don’t envision this as a significant hindrance to his ability to outperform the benchmark. Investors should be aware that while the risk factors of the ETF and the mutual fund will generally be quite similar according to PIMCO’s analytics, differences in their security-level exposures will result in performance deviations in certain environments. At times, their month-end portfolio statistics could even appear to be materially different, depending on the specific timing of purchases and sales. Since Gross manages both vehicles with the same objective and risk parameters (e.g., duration within two years of Barclays Aggregate Bond Index) we would expect performance to converge over longer periods of time.

Since inception, BOND’s nimble asset base (less than $3 billion in AUM as of 9/30/12) has offset the derivative restrictions. This is its other key difference versus the mutual fund, but investors should not assume it will be an advantage for the ETF in every circumstance, as the greater proportional impact of investor cash flows could work against BOND in certain market environments. Given persistent cash inflows (resulting in net share creation) during the months following its inception, BOND did enjoy a relative advantage as investor sentiment gyrated during the March-June 2012 period, when Gross quickly reduced the ETF’s exposure to higher-quality mortgage positions to fund purchases of more credit-oriented issues such as emerging-markets bonds. Fortuitous timing was also a factor, as having a blank slate at inception proved beneficial to BOND, whereas the mutual fund entered this volatile period with a higher allocation to emerging-markets bonds. Both finished the second quarter with similar weightings.

One of the issues that PIMCO examined carefully prior to launching BOND was the effect of an ETF’s disclosure requirements (T+1 versus a mutual fund’s 60-day window to report holdings), but the firm ultimately concluded this would not present a material opportunity for competitors to front-run trades or to take advantage of PIMCO when the ETF is selling. In PIMCO’s view, offering transparency into the ETF’s individual positions does not necessarily reveal their strategy. PIMCO uses proprietary risk-factor modeling to manage their exposures, so a competitor’s analysis would be unlikely to provide the same insight as PIMCO’s internal models. PIMCO has dozens of trading partners with incentives to maintain good terms with PIMCO, and a particular dealer can apply only limited pricing pressure if it wishes to remain competitive. PIMCO will also accept cash from (or remit cash to) the authorized participants of its ETFs instead of relying solely on creation-redemption baskets of individual securities (as do many competing ETFs), which can help reduce the volatility of premiums and discounts to BOND’s net asset value. Finally, we are satisfied the trading volumes in BOND provide adequate liquidity for investors.

We recognize that all of PIMCO’s strategies are influenced by the firm’s macroeconomic perspectives, as debated and agreed upon by the investment committee. Therefore, while our preference on a standalone basis is to replace 100% of the iShares Core Total U.S. Bond Market ETF position with the PIMCO ETF, we have limited the total PIMCO exposure to a maximum of 50% of each portfolio. We believe adding BOND to our index-based portfolios will help mitigate the risk posed by the very high proportion of the core bond index that is in very low-yielding Treasury and government agency (mortgage-backed) securities. More broadly, we continue to have confidence in PIMCO’s Total Return strategy—whether in ETF or mutual fund form—to enhance our portfolios’ performance over the long-term.

--Litman Gregory Research Team

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