

### SIMPLE? YES. EASY? NO.

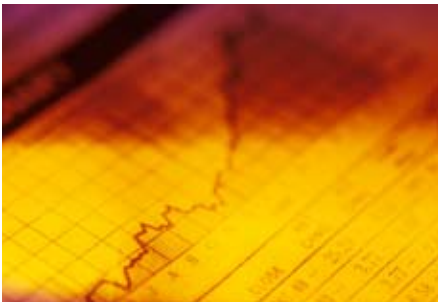
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We often poke fun at ourselves for how often we mention the importance of diversification, patience and discipline when managing an investment portfolio. Our clients sometimes mock us about this, too. We make no apologies for repeating this theme. We believe that a lack of diversification, a lack of patience, or a lack of discipline will almost inevitably result in inferior results unless there is simply good luck involved.

Fortunately, for the stability and health of our economy at large and the security of individuals, more and more people are understanding the importance of broad diversification. They see great value in holding asset classes that produce good, long-term returns and that are not well correlated to each other. Unfortunately, patience and discipline are too often still missing. Too many people chase returns or try to improve upon market conditions by hiring managers to try and outsmart the market.



Asset class returns fluctuate in the short term. It is simply foolish to think otherwise. Underperforming asset classes are frequently offset to some degree by outperforming asset classes, making for a more consistent return over time. Additional return can be obtained by playing the fluctuations of asset classes off of one another. We call this "rebalancing."



When one or more asset classes post a strong enough performance, we will reduce our position in that asset class and put the proceeds into one or more asset classes that have been under performing. We sell at a relative high and buy at a relative low. Remember the saying, "Buy low, sell high."

Doing this has two important effects. One is that we systematically reduce risk after we have enjoyed the benefits of taking the risk. The other is that when the underperforming asset classes become strong performers again, we will own more shares of that asset class and reap more of the reward of the newfound strength.

Conversely, pulling money from an underperforming asset class to put into an out-performing asset class is a very effective way to increase the portfolio risk without increasing the odds of a superior return. We call this "chasing returns" and it has the opposite effect of rebalancing. Return chasers are selling at a relative low and buying at a relative high. At some unknown—and unpredictable—point, all strong asset classes end up weakening at some point and all weak asset classes end up strengthening. Chasing means one is taking money from the asset classes that will strengthen and putting it into the asset classes that will weaken. That increases portfolio risk. It does not manage it.

Lack of discipline and lack of patience can have unwelcome effects at much more micro levels than that of an asset class. Many investors who understand the folly of chasing hot asset classes and appreciate the benefits of diversification still want to hire someone to try to outsmart the market. People seek mutual fund managers they hope will outperform their peers or they'll subscribe to a newsletter written by someone to help them pick just the "best" stocks, free from the perceived constraints of running a mutual fund.

Study after study from the last three or four decades clearly indicate that most mutual fund managers have not beaten the market. As a result, some have turned to newsletters. From a purely academic standpoint, the newsletter purveyor should have a slight advantage over a mutual fund manager. Both are trying to beat the same market but a newsletter can move quicker and may incur lower trading costs. According to a February 19, 2007 Business Week article, the academics are wrong. Newsletters actually underperformed mutual funds.

Two publications, Hulbert Financial Digest and the Timer's Digest, track the performance of investment newsletters. All these newsletters claimed to be able to help you beat the market. Timer's Digest looked at results of these newsletters for calendar year 2006. Only 9% of these publications made recommendations that produced a result better than one would have received simply by owning an S&P 500 index fund! Hulbert took a longer term view and examined the 103 newsletters that were in continuous operation for the last ten years. Many more had come and gone during the period. Only ten of these 103 newsletters topped the index fund. Please note these results are pretax. The trading required in most of these newsletters would have resulted in significant taxation. Though certainly not tax-free, an S&P index fund is inherently tax efficient.

Newsletters are clearly not the answer to how to beat the market. Most people simply aren't going to want to, or be able to, follow the trading strategies. Mutual funds are still the most convenient access point to the markets for most people. Still, patience and discipline are absolutely required.

No one likes to fall behind and mutual fund investors are not immune to this aversion. Many like to watch the relative performance of their funds versus peer groups. Almost always they have selected their funds based on superior relative performance in the past. Their expectation is that this performance was the result of skill, not luck, and therefore, they should be rewarded in the future. Should the performance of one of their funds lag their peer group by a significant amount or for a significant period of time, they usually move the money to another mutual fund that's had good recent performance so as not to fall too far behind. This approach is almost destined to fail as a portfolio management strategy. A recent study by research firm, Litman/Gregory, illustrates one reason why.

The research showed that virtually all the funds that provided "superior" performance over the 10 years ended 12/31/2005 experienced slumps that would test the patience of most fund owners. Depending on the asset class, 88%-100% of these superior funds had a 3-year period in which they lagged their peer group by more than 2% annually. Three years!!! If we keep the three-year duration in tact but increase the severity to 5% annually, the percentage of funds that experienced that type of lag is still between 50% and 72%. Remember, these are only funds that ended up with a "superior" rate of return during the period. The study completely ignores the poor performers who, by definition, finished behind the funds in the study.



Despite these statistics, mutual funds remain a terrific investment vehicle for most Americans. To be successful, however, it is clear investors need to a) know what it is that they own; b) exercise discipline and patience; and, c) expect discipline and patience from their fund managers. It sounds simple, but it isn't easy.