

EDUCATED INVESTOR

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(N)avigating a Volatile Market...

If the market were a river on which the investor rides, periods of low volatility are when the banks are wide and the current smooth. These are the times you can sit back and float. Then there are the rapids — the periods of higher volatility. Your journey accelerates and may turn wild.

Recent markets might be compared to medium-level rapids. For example, projected volatility (as measured by the Chicago Board Options Exchange Volatility Index) jumped by roughly 100 percent between early May and mid-June, reaching its highest point since August 2004. The Federal Reserve continues to raise funds rates

(for the 17th consecutive time) and the S&P 500 Index has been twirling around like a stick caught in an invisible eddy. While we've seen much worse, we've also all been enjoying a relatively long, mild run leading up to this spring.

Those who overreact to turbulence may find themselves needing swimming lessons fast. In contrast, rely on prudent advice to guide you through, and you can expect to remain on course — onward toward your long-term goals. Following are three key navigation techniques to employ, all along your journey.

- **The Academic Wisdom of Diversification**
Page 2

- **Year-Round Tax-Loss Harvesting**
Page 3

- **Rebalancing for Well-Designed Growth**
Page 4

“ Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in corrections themselves. ”

— Peter Lynch

“ We are all swimming on an investment beach roiled by waves of noise. Be very careful you don't mistake a line of rogue waves for the turning of the tide. ”

— Bill Bernstein

“ You should welcome price declines as a way to add stocks more cheaply to your portfolio. ”

— Warren Buffett

The Academic Wisdom of Diversification

What happens when you apply the rigors of peer-reviewed academic scrutiny to the practical, entrepreneurial world of investing? The combination can be invaluable in guiding long-term, prudent individuals and institutions toward successful investment expectations.

Two such practical investment tools include the **1992 Restatement of Trusts, Third (Prudent Investor Rule)** and the **1994 Uniform Prudent Investor Act**. Each incorporates academic wisdom embodied within the **Modern Portfolio Theory (MPT)** and the **Efficient Market Hypothesis (EMH)**. Advisors, trustees and investors can use these tools to identify and adopt a prudent investment strategy.

A fundamental tenet of MPT is that effective diversification reduces the volatility and dispersion of returns — without reducing expected returns. In other words, with proper diversification, you can maximize expected returns for a given level of risk.

Academic theory aside, most of us intuitively sense that diversification makes good sense. But too often we've seen the concept

ill-defined as sitting on a lot of eggs, without the sufficient number of baskets — or asset classes — to contain them.

It's not just how many securities you hold. It's holding them across an appropriate range of asset classes. Economist Harry Markowitz was among those who were instrumental in developing MPT; for his efforts, he was one of three who was co-awarded the 1990 Nobel Prize in economics. In the 1952 *Journal of Finance*, Markowitz observed that effective diversification depends not only on the number of assets in a portfolio, but also on the ways and degrees in which their responses to economic events tend to reinforce, cancel or neutralize one another.¹

For example, depending on each investor's objectives and risk tolerance, we first suggest an appropriate allocation between stocks (equities) and bonds (fixed income). Within equities, we typically recommend diversifying across the domestic equity asset classes of small-cap and large-cap companies, as well as into value (distressed) companies depending on the individual's risk profile. When appropriate, real estate and commodities asset classes are blended into the mix. To achieve global diversification, it is often prudent to add a significant allocation to international equity asset classes, sometimes including emerging markets.

Over time, portfolios that were designed to consistently capture this level of broad, global diversification have benefited, and have typically done so with less volatility.

This is not to say that a globally diversified portfolio is always outperforming a more concentrated approach at any given point in time. For example, between 1981–2005, there were 10 years out of 25 in which a more concentrated portfolio (60 percent S&P 500 Index/40 percent bond index) outperformed, *for as many as four years in a row*, compared with a portfolio containing significantly more diversified index-based allocations. Yet, over the 25-year period, the diversified portfolio yielded a measurably higher annualized return and less volatility.

It is precisely when diversification may not seem to measure up that a trusted advisor can play a particularly crucial role. The academic evidence captured by MPT and EMH demonstrates why markets are largely efficient over time, and generally favors a broadly diversified approach. It's why the Prudent Investor Act has been adopted by most states as a recommended guide for managing trusts. It's why we recommend the same for our clients.

¹ Trone, Allbright and Taylor, *The Management of Investment Decisions*.

“There is no other proposition in economics that has more solid empirical evidence supporting it than the Efficient Market Hypothesis. ... In the literature of finance, accounting, and the economics of uncertainty, the EMH is accepted as a fact of life.”

— Michael C. Jensen

“Diversification is an established tenet of conservative investment.”

— Benjamin Graham

Year-Round Tax-Loss Harvesting

Sometimes you *can* win by losing — and in fact savvy investors do so year-round. One way we add significant value to your investment experience is by keeping a continuously vigilant eye out for tax-loss harvesting opportunities, and helping you appropriately act on them when they occur.

What Is Tax-Loss Harvesting?

Tax-loss harvesting is the practice of selling securities when they have incurred losses, and then typically repurchasing them after an appropriate waiting period. Within guidelines defined by U.S. tax code, both short- and long-term capital losses can be used to offset current or future short- and long-term gains, respectively; in some circumstances, the losses can even be used to offset ordinary income.

Implemented properly, tax-loss harvesting can be a win-win situation. But “implemented properly” is key. Following are just a few considerations that we factor in as we assist clients with this valuable service.

Knowing When To Act

We seek tax-loss harvesting opportunities whenever they may occur — not just at year-end. But it is also important to

accurately assess when a loss harvesting opportunity is likely to be advantageous, versus when the costs or risks involved are expected to outweigh the benefits. This takes a great deal more than just spotting a security with a price loss. A host of related assessments include the nature of the loss, the amount of the loss, transaction costs involved, current tax code and your individual profile.

Seeing the Big Picture

As losses are harvested, it is important to ensure that the transactions do not interfere with your portfolio’s carefully planned asset allocation policies. Because big market gains can occur very rapidly, we recommend even interim holdings remain as fully and accurately invested as possible, rather than sitting as cash or cash equivalents.

Following the Rules

At the same time, several steps must be taken to ensure that the IRS doesn’t disallow the loss. While interim holdings should resemble your original holding (to maintain the integrity of your overall portfolio), they must be different enough that they aren’t deemed “substantially identical.” In addition, the period of time between transactions must be carefully considered, to avoid what is known as the “wash sale rule.”

Short-Term and Long-Term Considerations

A more thorough discussion with your tax consultant and investment advisor is warranted, but another consideration when harvesting losses is whether they will be short- or long-term. Short-term losses are first deducted against short-term gains that would otherwise be taxed as ordinary income. Long-term losses are first deducted against long-term gains that would otherwise be taxed at the lower capital gains rate. For example, if you have (or plan to have) realized short- and long-term gains, and unrealized short-term losses, it might be advantageous to realize the losses before they become long-term.

Managing the Risks

As the harvesting occurs, adjustments and additional guidance may be warranted to achieve a positive outcome. In fact, in our unpredictable market, even when all steps are properly executed, results can and do vary. For example, what happens if you sell Fund A at a loss, place the proceeds in interim holding Fund B, and then end up facing a short-term capital gain if you sell Fund B to repurchase Fund A? Should you complete the transaction anyway? There is no one correct answer; the decision depends on what is best for your unique situation, and one of many reasons that our clients rely on us to provide expert guidance in making the most of their investments.

“Everything should be made as simple as possible, but not simpler.”
— Albert Einstein

“You shouldn’t spend much time on your investments. That will just tempt you to pull up the plants and see how the roots are doing, and that’s very bad for the roots.”
— Paul Samuelson

Rebalancing for Well-Designed Growth

Building a globally diversified portfolio is an important first step toward controlling volatility and achieving long-term investment objectives. But appropriate rebalancing is also an integral part of your prudent investment strategy.

The Fine Art of Rebalancing

Rebalancing is the process of restoring your portfolio to its original asset allocations and risk profile. Because each asset class within your portfolio is likely to shrink or grow by a different percentage over time, maintaining your portfolio's original design is an ongoing process, not unlike periodic maintenance of a carefully shaped topiary.

As an added bonus, rebalancing helps you develop sound, long-term investment habits. By trimming allocations that have been recently outperforming, and expanding on those that have been recently underperforming, you are naturally adopting a desirable "buy low and sell high" approach.

At the same time, rebalancing your portfolio too often or too severely can be costly. Doing so usually entails transaction costs and potentially taxable realized gains. A delicate balance is required to help your portfolio maintain its intended shape — without pruning too much of your wealth away. Following are some strategies that we help our clients implement.

Cash Is (Often) King

Rebalancing is generally most efficiently accomplished using new cash to purchase assets that have been the recent underperformers "on sale." Applying new cash to wherever increased allocations are needed (rather than having to sell existing holdings to purchase others) helps minimize trading costs and taxable capital gains.

One way to obtain "new cash" is from dividend distributions of securities you already hold. Consider requesting such distributions as cash rather than as automatic reinvestments. You can then use the proceeds to rebalance wherever is needed. (However, this tactic does not work as well if the dollar amounts are too small.)

Tax-Conscious Investing

Of course rebalancing can occur within your tax-sheltered accounts with more ease, since tax ramifications won't apply. In general, avoid rebalancing taxable accounts if doing so would result in realizing short-term capital gains, which are taxed as regular income. Instead, it may be prudent to wait until they become long-term gains, or until new cash can be used instead. For example, you may choose to delay rebalancing if you are expecting assets to become available within a relatively short timeframe — such as proceeds from a maturing bond or the planned sale of a security or other asset.

However, there are times when you may decide to incur taxable capital gains rather than wait to rebalance. If you have capital losses to offset your gains, you might proceed (although, first, a conversation with your tax consultant is warranted). Or, if you and your investment advisor determine that your portfolio is significantly out of balance, you may decide that the overall benefit to reallocating your portfolio will still offset the taxes incurred in doing so.

“When a thing has been said and well said, have no scruple. Take it and copy it.”
— Anatole France

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- ▲ Fee-only investment management
- ▲ A disciplined investment strategy
- ▲ Access to institutional no-load passive asset class funds
- ▲ Fixed income expertise

- ▲ An investment approach based on research by Nobel Prize-winning economists
- ▲ Continued access to academic research
- ▲ A tax-efficient focus, with valuable tax and estate-planning ideas
- ▲ Risk tolerance assessment
- ▲ Periodic portfolio rebalancing
- ▲ Regular communications and state-of-the-art reporting
- ▲ **MOST IMPORTANT ...**
A TRUSTED ADVISOR RELATIONSHIP