

# 2007 INVESTMENT COMMENTARY

By Creg Ostler, CFA, Managing Partner

Enclosed in this month's report is a table that displays the performance of your portfolio for the most recent time period. We have provided this information so that you can get a feel for how your portfolio has fared in the investment environment during the past year.

As you know, our **objectives in managing your portfolio** are to:

**Preserve your wealth.** We work very hard to avoid taking the kinds of risks that would cause big losses in your portfolio and make it difficult to reach your financial goals. We accomplish this by:

- avoiding speculative stocks and bonds,
- diversifying your portfolio across many different sectors and industries, and
- actively managing the impact of taxes on your portfolio.

**Grow your wealth.** In addition to preserving your wealth, you have also hired us to grow your wealth by investing to take advantage of economic opportunities.

We do this by:

- ***Using a diversified strategy:*** By identifying several investment categories (asset classes) that have good investment potential and setting up an appropriate portfolio mix, we greatly increase the probability that you will reach your financial goals. All of these categories produce good investment returns, but they do so at different times; thereby reducing the impact on your portfolio of sudden downward moves in any one category.
- ***Following a disciplined methodology within each investment category:*** We use time-tested strategies for evaluating stocks, bonds and mutual funds based on the financial characteristics that lead to excellent investment performance.
- ***Rebalancing:*** We adjust the portfolio regularly to ensure that we are within our asset allocation strategy. We follow a strict discipline of harvesting gains (selling high) and using the proceeds in areas that have not done well recently (buying low). This prevents the classic mistake of becoming emotionally attached to an investment and not knowing when to sell.

## Using Benchmarks for Comparison

How can you tell how your portfolio is doing? One way is to compare the performance of your portfolio to relative market indices. This compares your portfolio with what is happening in the overall investment world. We have included index benchmarks along with the performance of your portfolio for several categories of your portfolio.

## **This is the Important Section!**

Sometimes people make the mistake of thinking that our strategies are designed to beat the benchmarks every year. This is not the case. **It turns out that there are no strategies that beat benchmarks every year. These strategies do not exist!** Every single strategy has times when it will beat a benchmark and other times that it will not.

Have you ever noticed that in advertisements, financial news shows and magazines there are always gurus who “know” how to beat the market? They show fantastic gains for a few years and they sound like they really know what is going to happen in the future. Then they quietly disappear from the news.

As we have studied this phenomenon it becomes clear what has happened. There are thousands of investment analysts that come up with theories each year about what is going to happen in the markets. Out of those thousands, there are a number who do very well. They do this by taking big risks—investing big portions of the portfolio in very few stocks or very few industries. Those hundred start to advertise and show up on news shows. If they do well for several years in a row they become “gurus.”

However, just as we know that 100 degree summer days are coming in Scottsdale, within a short period of time these gurus will lose their footing. Usually their portfolios are designed to chase current trends and end up suffering large losses as markets and economies turn and move.

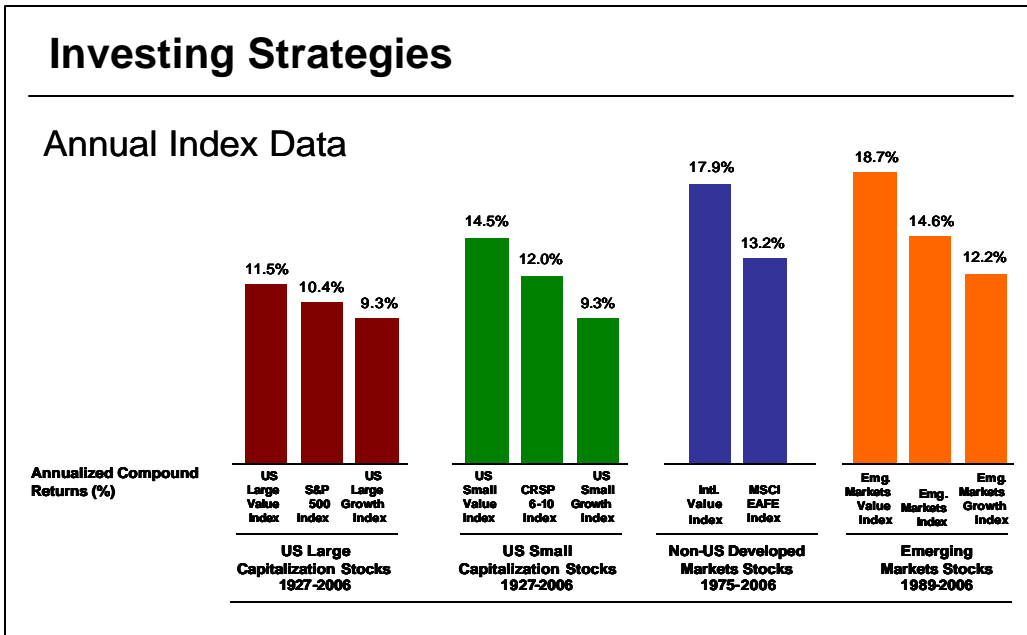
Normally one would think that this pattern of gurus losing a bunch of their clients’ money would discredit the whole game. However, we have a wonderful media industry that quietly “disappears” the stars of yesterday and quickly brings onto the public stage the next set of gurus who have the next big idea. This has been going on for many years. Currently, the most popular financial guru is someone who yells and screams and throws things while recommending his latest hot stocks.

**The effect of this media game is that we constantly think that someone, somewhere really does have a crystal ball—that someone knows when the market is going to fall and when it is going to rise.**

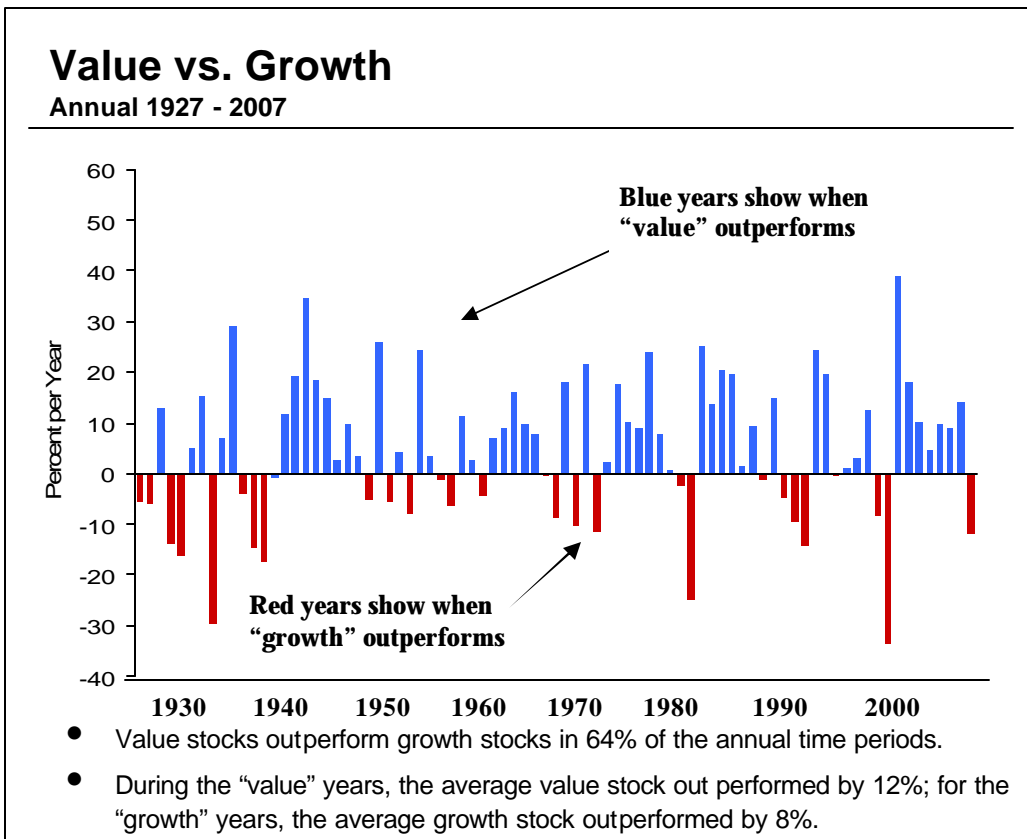
**In the real world of preserving and growing your wealth there are no crystal balls and no gurus. But there are consistent strategies that preserve and grow your wealth by making wise choices over long periods of time. These consistent strategies and wise choices will serve you well, but they are not glitzy and there are times when they do not perform as well as the overall market.**

For example, based on extensive academic and historical research, we use a “value tilt” to our investment portfolios. This means that a portion of the portfolio is dedicated to stocks that are selling for low prices relative to their peers. Using this value tilt we expect the portfolio will do very well over time compared to the benchmarks.

Please see the chart below, illustrating the benefit of this “value tilt” in several markets.



The benefit of this approach is not manifested each and every year. There are years when other approaches are more profitable. In the chart below, you will see how this has worked in the past. The blue parts of the chart show when “value” investing approach does better than the “growth” investing approach.



It is quite clear that value investing is the best place to be most of the time. In fact, 6 out of every 10 years value stocks have tended to do better than the overall market.

2007 was one of those years when this “value tilt” did not perform as well as its relative index in the large, small and micro cap categories. This is something we fully expect to happen from time to time. There is no way to predict when the value approach will outperform or underperform—just that it will do well over the long run. Being consistent in our approach will be the key to reaping the benefits.

## **Conclusion**

We are honored by the trust you place in us and take seriously our responsibility to help you meet your goals. We are confident that, by employing consistent long term strategies, your needs will be well served. Thank you for allowing us to serve as your financial advisors.