the EDUCATED INVESTOR

Fall 2004

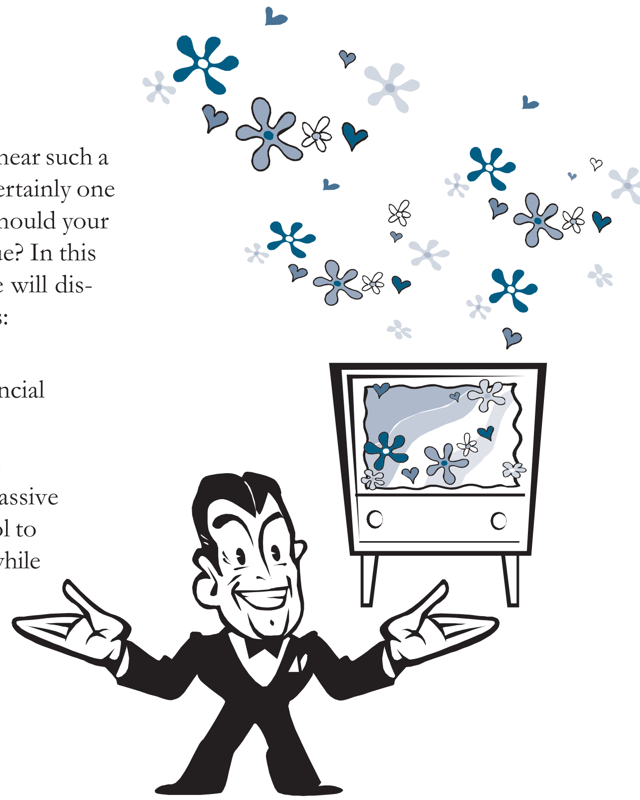
The Games People Play

Imagine you're playing Jeopardy! and Alex Trebek says, "We help investors achieve their long-term financial objectives via a passive asset class investment approach and fee-only advisory services." For $200, how would you respond?

If you said, "What does my investment advisor do for me?" then you win. For most contestants, the more likely response would be a quizzical stare.

In reality, you're unlikely to ever hear such a query on a game show. But it's certainly one that *we* hear almost daily. How should your investment advisor add real value? In this issue of *The Educated Investor*, we will discuss these three key components:

1. Focusing on long-term financial objectives
2. Implementing a disciplined investment strategy using passive asset class investing as a tool to achieve desired objectives, while managing risk through meaningful diversification
3. Remaining cost conscious



Advice for the Long Haul

Imagine trying to play a game that has no rules and no way to know when you've won. Or what if all the rules were to suddenly shift halfway through? How would you know what your score is, how you're doing compared to others, or when it's time to collect your prizes and go home?

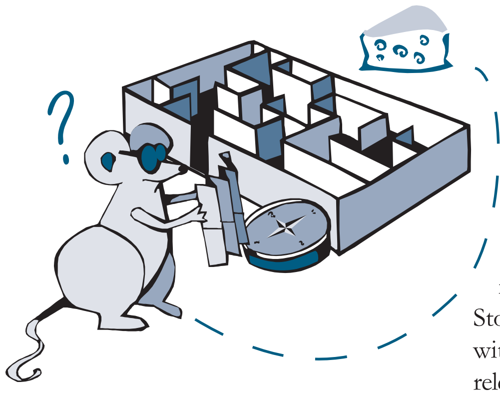
A worthwhile game requires consistent rules on how to play and win; a successful contestant knows when to take some risk and when it is better to play it safe. Although achieving your financial goals is no game, too many individual investors end up feeling as if they are playing Pin-the-Tail-on-the-Market amidst a mound of potential investment options, strategies and advertising noise that can easily be mistaken for advice. Your advisor should work with you to bypass the chaos and establish prudent guidelines for your investment experiences:

- Defining clearly stated, personal long-term objectives
- Forming specific plans for achieving those objectives, typically documented within an Investment Policy Statement
- Adhering to *your* chosen strategy (regardless how others are playing the game)
- Developing a thorough understanding of your ability, willingness and need to take investment risk

In doing so, your advisor adds value by helping you with the following steps:

- Understanding how and why to select one investment over another
- Confidently assessing your overall progress
- Making appropriate, carefully implemented adjustments if significant life events (such as births, deaths, marital changes, career changes and similar events) alter your long-term goals

Passive Aggressive Investing



Among the first steps to a successful investment experience is establishing an investment policy that accurately reflects your long-term objectives. How should your advisor help ensure that your desired policy is implemented and maintained? Simple — an "aggressive" application of passive asset class investing. Well, maybe not so simple. What exactly is "passive asset class investing"?

Passive Versus Active

One way to define our investment approach is by comparing it to what it is *not*, that is, it is the opposite of "active" investing. Active investors assume that the market is generally "inefficient." If the market were inefficient, it would mean that clever individuals (or their clever brokers) could regularly exploit opportunities when holdings were trading for more or less than they were actually worth. Opportunities would need to be of sufficient frequency and value to cover the costs of consistently seeking and executing such trades.

There is overwhelming academic evidence indicating that the collective wisdom of all market players (especially in today's electronic era) results in highly efficient markets that reflect fair pricing almost instantaneously upon release of any news (good or bad) that might affect a holding's price. For example, a study published in the spring 1996 *Financial Management* observed that price adjustments for stocks within the New York Stock Exchange and the NASDAQ occurred within the first few trades following a news release.

A passive investor assumes that the opportunities to exploit inefficiencies are too few and far between to effectively pursue. It would be like spending one's day trying to find lost dollar bills on the sidewalk. It's fun if you have such luck, but it's no way to earn a living.

That is why your advisor should recognize that the markets are generally efficient and help you pursue a passive rather than an active investment approach. He or she should explain why, despite the evidence supporting a passive approach, active investing remains so popular, and why articles such as "The 10 Hottest Stocks for 2004!" continue to be published. The field of behavioral finance has shed much light in recent years on many otherwise logical human survival traits that can fool us into making illogical investment decisions. Your advisor should be able to familiarize you with these traits so that you can learn to control them, and your investments.

Asset Class Versus Indexing

Another way to describe passive asset class investing is by comparing it to "indexing." A good advisor can add even more value not only by introducing a passive approach, but by taking the extra step to incorporate holdings that capture the higher expected returns of *asset class* funds rather than simple *index* funds.

Indexing shares some important similarities with passive asset class investing, but there are also some key differences, presented on page 3 at right.

Passive Risk Versus Active Risk

Let's also dispel a myth that we frequently combat: a passive approach does *not* necessarily mean a conservative approach. A passive investor can still be quite aggressive in pursuing long-term exposure to demonstrated risk factors in the market. For example, a passive portfolio can (and often does) contain components from these riskier asset classes:

- Small companies' stock (U.S. and international)
- "Value" (distressed) companies' stock (U.S. and international)
- Emerging markets

Over the years, these riskier asset classes have delivered excess returns when compared to large-cap and growth stocks, as compensation for taking added risk over time. As advisors, we:

- Help you assess how much risk is appropriate for your objectives
- Build and maintain your portfolio using passively managed investment vehicles that are expected to cost-effectively capture that degree of risk
- Remain in touch with you over the years to periodically revisit your objectives and risk profile, and to help you maintain the discipline that is an essential component to successful investing

An advisor can (and should) passively but aggressively manage your portfolio — yet another way that a good advisor adds value.

Passive Asset Class Investing and Indexing: They're Similar ...

- ✔ **Passive Approach —** Both passive asset class and index investing are considered "passive" — in contrast to an "active" approach of trying to outsmart the collective wisdom of the market.
- ✔ **Efficient Market —** Both are based upon academic evidence and the Modern Portfolio Theory premise that markets are generally efficient at setting prices, and that active attempts to outsmart the market can't be expected to consistently provide excess returns over the long-term.
- ✔ **Asset Class Focus —** Both are designed to capture a particular asset class such as large-company U.S. stocks, value international stocks and others.
- ✔ **Cost Controls —** Both enable investors to focus on minimizing return-damaging costs by seeking to buy, hold and periodically rebalance in a disciplined manner.

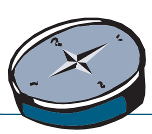
... But They're Not the Same:

Indexing

- ❍ Index funds seek to capture asset classes by tracking a popular index that, in turn, tracks a particular asset class. For example, Vanguard's S&P 500 Index fund is the first and best-known index fund.
- ❍ The S&P 500 is by no means the only index tracked by an index fund. However, there are several significant asset classes that cannot be captured via an index fund, simply because there are no popular indices available to accurately track them. Examples include the asset classes of emerging markets value, international value and U.S. microcap (very small) companies.
- ❍ So that an index fund continues to track its index, it must trade any stock that moves in or out of the index (at the same time that all similar index funds must do the same; this can negatively impact the prices at which funds must buy and sell the stocks).

Passive Asset Class Investing

- ✔ A passive asset class fund tracks the asset class itself, rather than an index. Any holding that falls within the definition of the asset class is "fair game" whether or not it is found within any index; this enables greater selection and thus greater flexibility for capturing the desired asset class.
- ✔ Asset class funds can be designed to have greater exposure to the risk factors of size and value than can similar index funds. This enables portfolio construction that provides opportunities for higher expected returns. With increased options, your portfolio also can be designed for greater diversification and lowered volatility (which in turn helps improve expected overall returns).
- ✔ Passive asset class fund managers are not obligated to trade based on changes to particular indices. This helps further reduce trading costs; it allows for more flexible trading protocols, with greater ability to negotiate pricing while still effectively tracking the asset class.



A Penny Saved

The best-laid plans incorporated into the greatest investment approach in the world are all for naught if the cost to implement them destroys the potential advantages. That is why a good advisor aggressively and continuously seeks ways to minimize expenses. Some ways in which we do so are as follows:

- **Passive Investment Approach —** As described in more detail in "Passive Aggressive Investing" on pages 2-3, passive investing avoids attempts to outsmart a generally efficient market. Because there is no need to pay high-cost "experts" to try to predict the next winning stock or sector, passive investing can facilitate the reduction of fund management expenses.

By having more flexible trading rules than its index fund counterpart, a passive asset class approach also can pursue certain cost reductions that an index fund typically cannot. A passive asset class fund manager can use techniques such as establishing wider hold ranges (to minimize turnover and its related trading costs), seeking block-trade (volume discount) opportunities and more.

- **Minimized Trading —** Besides using passive asset class funds that control costs at the fund level, your advisor should also help you avoid excessive turnover (and related costs) at the portfolio level. For example, your advisor should: (1) help you establish and adhere to a personalized investment policy that offers you a clear trading road map, (2) help you differentiate between substantial portfolio imbalances that may warrant adjustments versus fluctuations that are best ignored, and (3) offer you fee-only investment advice that eliminates commission-based trading, and instead aligns the advisor's incentives with your overall portfolio growth.

- **Tax Management —** It doesn't take a degree in financial economics to recognize that taxes can have a significant impact on your net returns. A good advisor continually seeks ways to plug the drain. One important tax-management component is to generally locate your least tax-efficient holdings in tax-free or tax-deferred accounts. Another focuses on the taxable portion of your portfolio by taking advantage of available passive asset class funds that specifically manage for tax efficiency. Finally, year-round "tax loss harvesting" can help, by seeking to offset realized (taxable) capital gains and certain amounts of ordinary income with realized losses.

Worth Repeating

Worth Repeating

> "Your chances of selecting the top funds of the future … are about as high as the odds that Bigfoot and the Abominable Snowman will both show up in pink ballet slippers at your next cocktail party."

— Jason Zweig
MONEY magazine senior writer

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 academic Nobel Prize-winning investment approach
- 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**