

Timeless Advice on Recessions and Bear Markets

Whenever headline news from the financial media screams recession, many investors react by selling stocks. As our client, you understand the importance of remaining steadfastly diversified according to your unique risk profile rather than attempting to chase — or flee — returns. Patience is the key to achieving your long-term objectives.

Still, practical investment methodology can be sorely tested when the reality of a recession actually hits, and you may find yourself tempted to join an exodus. To test whether this is a good strategy, consider equity premiums — that is, the extra (premium) returns over “risk-free” investing — surrounding the past 11 recessions.¹

During Recessions — The general equity premium has actually been positive on average during recessions (0.20 percent per month). Thus, even if you had somehow known a recession was about to begin, there would have been no good reason to move from stocks to bonds.

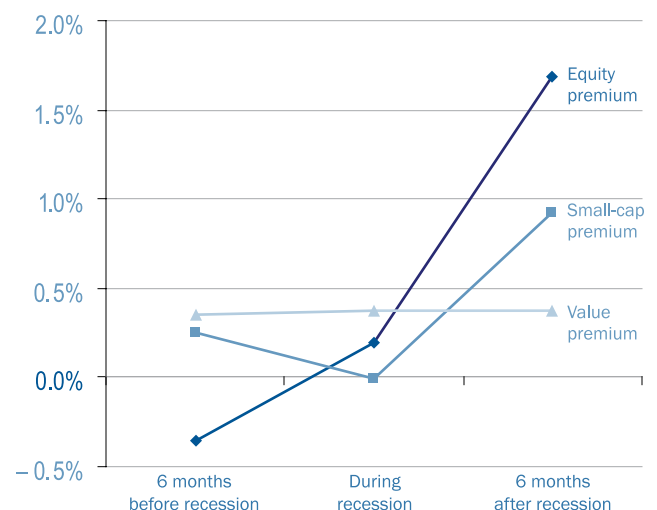
Following Recessions — The premiums gained during the six months *following* recessions have been significantly more than the losses suffered during the six months *preceding* recessions (1.69 percent versus -0.35 percent per month for general equities). Because it’s impossible to predict the timing of a recession, it would seem the prudent course is to stay the course throughout.

¹ “Recession” as defined by the National Bureau of Economic Research (NBER) is “a significant decline in economic activity spread across the economy, lasting more than a few months.”

Small-Cap and Value Risk Premiums —

What about remaining within equities but shifting to less risk by moving from small-cap/value to large-cap/growth? Our analysis of shifting from small-cap to large-cap during recessions indicates the move would generally have been a wash. And there is no indication that value stock premiums were affected by the recessions one way or another, thus there would have been no reason to move in and out of value in reaction to the news.

Equity Risk Premiums Before, During and After Recessions



On average, during the past 11 recessions, premiums from taking on equity risks — i.e., the extra returns over “risk-free” investing — have either significantly increased, or at least held firm following the recession. To avoid missing out, it’s best to maintain your equity allocations throughout. (See Data Sources on back page.)

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In short, while the data indicates that stock prices may provide early indications of where the economy is headed, the reverse is untrue. You cannot rely on the state of the economy to indicate where the stock market is headed. If anything, by selling out of stocks during times of weak economic performance, you are more likely to miss out on substantial gains that may follow a recession than to benefit from seeking “safe harbor.”

Fortunately, another key element within our investment methodology — **disciplined rebalancing** — helps you continue to seek long-term growth throughout market vagaries. During bear markets you can rebalance by buying stocks “low” to raise your equity allocation to its appropriate level. During bull markets you can sell stocks “high” to reduce your equity allocation to its appropriate level.

Buying low and selling high? Sounds simple. The hard part is ignoring all the noise and emotions surrounding you, and actually carrying out the strategy. One of our most important roles as your advisor is to help you do just that.

Last Year's Lessons

While we have no textbook for the future, one resource accessible to us all is the past. Following are some lessons learned from recent markets.



Lesson 1: Stay the Course

Despite much bad market news in 2007, the markets actually performed well overall.

- ▲ With the exception of junk bonds and other risky credits that we do not recommend for our investors' portfolios, fixed income investments produced positive returns.
- ▲ Both the S&P 500 Index and Vanguard's Total Stock Market Index Fund produced returns of about 5.5 percent.
- ▲ Many global equities provided good returns (such as international large-cap, international value and emerging markets).

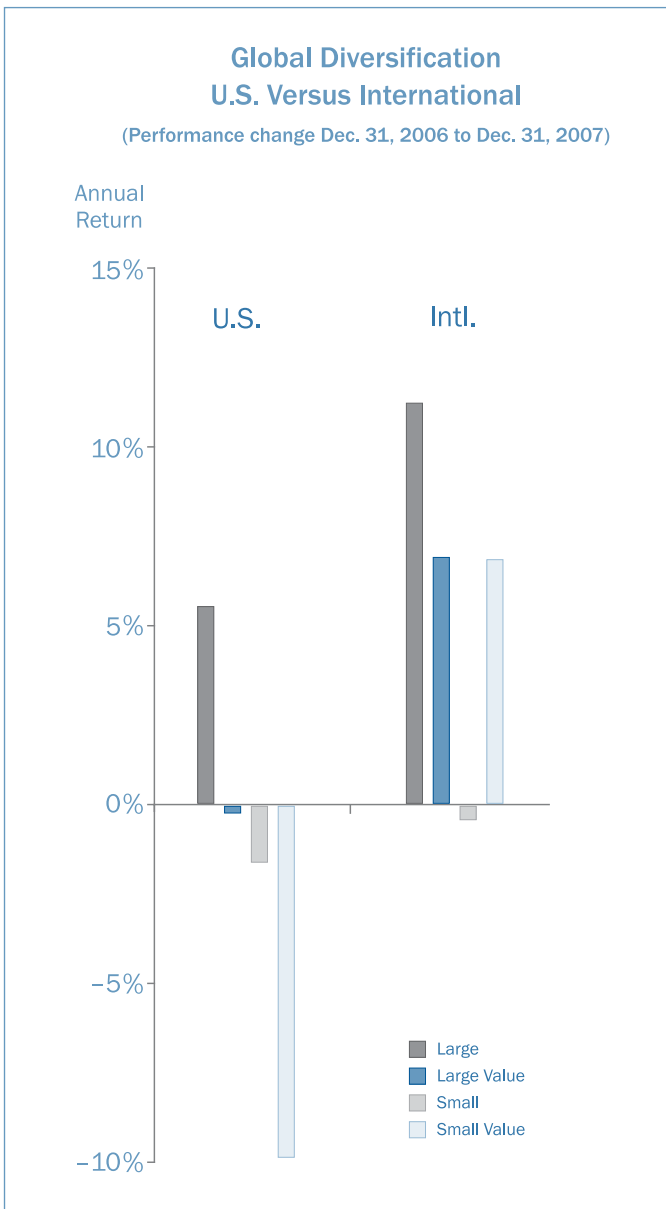
We advise investors to ignore economic forecasts. Even if they prove accurate, they don't necessarily lead to good investment decisions. Investing should instead be based on your carefully crafted plan that reflects your unique ability, willingness and need to take risk.

More recent news included unsettling events within the investment banking industry, which have led some to question whether their assets are properly safeguarded. Your investments are protected for up to \$500,000 by the Securities Investor Protection Corporation (SIPC), and your custodian maintains significant excess SIPC insurance beyond that. In addition, the custodian at which your assets are held is focused on investor-centric financial services. This is in contrast to a focus on significant investment banking activities of the type that contributed to the recent chain of events (such as holding large trading portfolios, proprietary positions or exotic debt instruments). While nobody can guarantee absolute safety in our world, we remain confident in our selection of custodians.

Lesson 2: Diversify Globally

A common (and we feel flawed) argument we have heard of late is that the world has grown so homogenous, it is no longer necessary to globally diversify. Instead, some propose, invest in U.S. multinational companies, such as those that dominate the S&P 500, and you will in effect have invested in the world.

Whether international asset classes out- or underperform U.S. asset classes in any given year is random. However, we feel the chart at right speaks for itself in demonstrating that marked differences remain between them in this not-so-small world after all.



Sources: See Data Sources on back page.

Lesson 3: The Importance of Portfolio Diversification

Insurance plays an important role in managing threats to financial security from various risks to your health, property and well-being. Prudent risk management also applies to an investment portfolio. Two asset classes — collateralized commodity futures (CCF) and Treasury inflation-protected securities (TIPS) — can provide a form of “portfolio insurance,” because their returns are expected to remain

negatively correlated with the returns of stocks and nominal return bonds (bonds whose returns are not indexed to inflation). The addition of negatively correlating assets to a portfolio dampens the volatility of the overall portfolio and reduces volatility’s negative impact on compound returns. (“Negative correlation” between two assets means one tends to produce above-average returns when the other is producing below-average returns, and vice versa.)

Both TIPS and CCF provide hedges against inflation risks, and CCF also provides a hedge against some event risks (such as an interruption of oil supplies). Academic research and historical evidence suggest that adding these assets will likely produce less volatile and more efficient portfolios (portfolios with higher risk-adjusted returns). We saw a recent illustration of this in 2007. The TIPS Vanguard Inflation Protected Securities Fund returned 11.6 percent and the CCF PIMCO CommoditiesRealReturn Fund returned 23.2 percent.

Lesson 4: It’s Called Risk Premium for Good Reason

From 1927–2006, value stocks provided an annual return about 5 percent above that of growth stocks. However, value stocks and other investments offering risk premiums in this manner do so for good reason. They are stocks of riskier companies, and these risks periodically show up, as they have in 2007–2008, during which the subprime mortgage crisis has led to a flight to quality across all financial assets:

- ▲ Treasury bonds outperformed investment grade bonds
- ▲ Investment grade bonds outperformed junk bonds
- ▲ Large-cap stocks outperformed small-cap stocks
- ▲ Growth stocks outperformed value stocks

This type of performance is typical during a financial crisis. Thus, investors seeking to capture overall expected risk premiums must be prepared to accept the risk along with the premium — and stay the course when the risk is more apparent. If you feel you may be unable to do so, your ability to accept risk may be low, and you may need to discuss with us tactics for building your portfolio accordingly.

Lesson 5: Don’t Bet on the Market

Historical evidence demonstrates that many individual investors are performance chasers, buying yesterday’s winners

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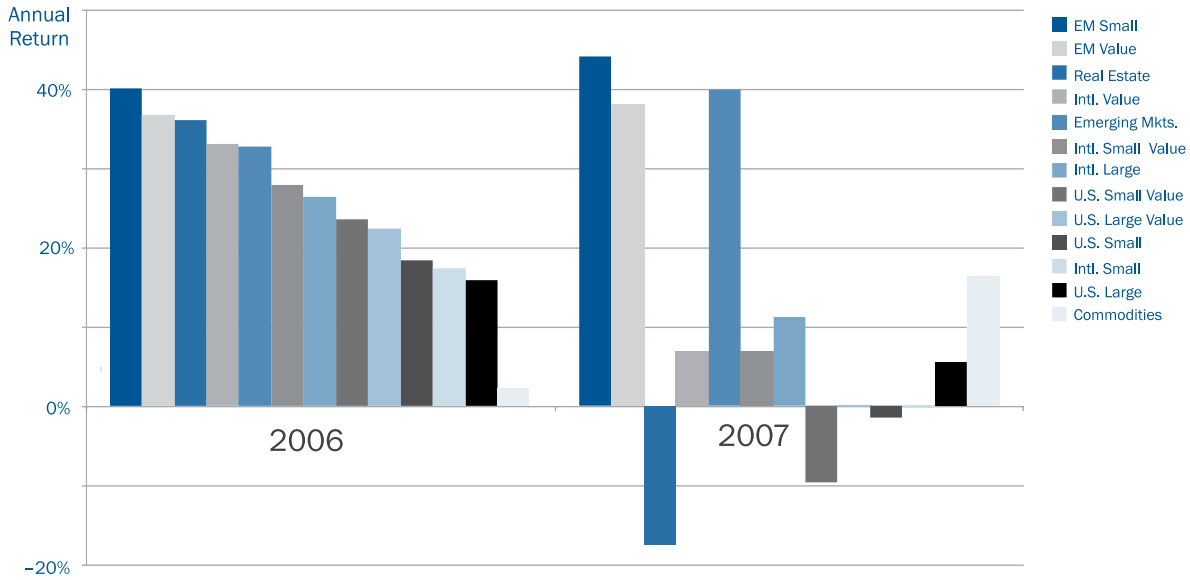
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and selling yesterday's losers. Unfortunately for those seeking to capitalize on past hot or cold streaks among asset classes, such streaks have no more meaning than those found at the casino. A good or bad return in one year does not predict that the same return will continue into the next year. (If anything, above-average and below-average returns actually lower and raise future expected returns, respectively.)

For example, consider the following illustration, which compares the returns of various asset classes in 2006 versus 2007. (The asset classes are arranged based on 2006's highest-to-lowest ranking performers.) As you can see, most of the asset classes performed — and ranked — significantly differently between the two years. We would suggest the data best indicates that we cannot predict positive or negative performance based on a previous year's ranking.

Asset Class Performance Ranking Varies

Asset class performance one year offers no useful prediction on how it will fare in the year following.



Sources: See Data Sources on back page.

Data Sources: Asset class returns cited herein are based upon the following indexes (per asset class): S&P 500 (U.S. large), Russell 1000 Value (U.S. large value), Russell 2000 (U.S. small), Russell 2000 Value (U.S. small value), MSCI EAFE net dividends (intl. large), Fama-French International Value (intl. value), MSCI EAFE Small Cap price-only (intl. small), Dimensional International Small Value (intl. small value), MSCI Emerging Markets Free Index gross dividends (emerging markets), Fama-French Emerging Markets Small (emerging markets small), Fama-French Emerging Markets Value (emerging markets value), Wilshire All REIT (real estate) and Dow Jones AIG Commodities (commodities). Asset class premiums calculated using Center for Research in Securities Prices (CRSP) and Fama-French databases.

Our Basic Tenets

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

- Fee-based 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