

February 6, 2006

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Who Manages Your Asset Allocation?

"If you want to build a top-performing mutual-fund portfolio, you should start by hunting for top-performing funds, right? Wrong", writes Jonathan Clements in a recent Wall Street Journal article. "If you just buy the best-performing funds at one particular time, you'll end up with a lot of funds that look quite similar. You end up with what's recently worked well. But the funds may not fit with your investment objective and they won't make any sense as a portfolio."

We've all heard of someone who bought stock or held real estate at the right time and made a lot of money. We may have dreamed of finding the next hot investment and retiring early in style. This one-shot hope to hit it big strategy is for the gambler. On the other hand, a savvy investor's primary, or core, strategy will involve asset allocation. Over time, most gamblers will not succeed; however, most savvy investors will.

As a concept, asset allocation is a strategy whereby investors have their assets broadly diversified among many asset classes so that whatever happens in the economy, there will be some asset class or classes that they will be able to gain value from.

If you're a gambler type, don't worry, I'm not trying to convert you. But if you're a gambler because you don't know that you are, then this is a must read article! Remember, we don't know what we don't know!

Money is often a scary issue for many to deal with, especially for those who have never worked with it in detail before. Investing for the future can be even scarier. Still, people at every age and certainly those preparing to retire need to know the basics of investing to insure their financial freedom and future. For the do-it-yourselfer, developing an understanding of the breadth and extent of asset classes or investment types, as well as the various strategies to exploit them, can be a daunting task. And, for those who employ investment management professionals to help, developing an understanding of the differences between them can be challenging as well.

As readers of my newsletters well know, wealth management is the ultimate goal of all that we do at Hoffman, White and Kaelber. Yes, we promote our services; yet, you will find that we always seek to present thought provoking topics that are relevant to our wide audience.

This month's newsletter will discuss the various types of investment manager specialties, as well as the concepts of diversification and asset allocation. So, fasten your seatbelts and get ready to learn one of the more useful lessons to successful investing. And, as we consider ourselves expert asset allocators, be sure to look over how we've performed at the end of this month's letter. You might find the results surprisingly good!

February 6, 2006

Investment Manager Specialties

From the book *Money Managers & Mutual Funds*: "Money managers have served pharaohs, kings, emperors, popes, and merchant traders - and now are available to average investors. One of the most significant modern developments in money management was the creation of the "*Prudent Man Rule*" in 1830, setting a standard that managers must conduct themselves honestly and discreetly and carefully... Mutual funds were born in America in 1924, with the incorporation of the Massachusetts Investor's Trust. Combining the features of professional management and portfolio diversification, mutual funds grew in popularity among small investors looking for convenient access to different investment markets. In the 1970's, the advent of the no-load mutual fund changed things forever. By 1990, there was more money in mutual funds than in savings institutions; by 1996, there were more mutual funds than stocks on the New York Stock Exchange."

I'm often surprised to find that a number of investors are unaware that money managers can be hired in a number of ways. Yet, of greater concern, many investors don't realize that there can be significant differences in the investing styles, as well as, the risk and return profiles from manager to manager.

As opposed to mutual fund, hedge fund or other types of pooled investor-manager relationships, some relationships allow for managing one's investments in one's own individual or separate account. It is believed that, one of the primary advantages of this type of arrangement is the ability to manage an investment portfolio for the maximum tax efficiency, but I think this understates the bigger picture. This arrangement offers the highest level of personal and fiduciary service available to most investor clients. Yet, as you might expect, a relationship like this usually requires a much higher minimum investment versus what you might expect from the average mutual fund.

What should be of greater importance to an investor is an understanding of the differences between the various types of investment managers and their strategies - because all are not the same! In fact, one's expectations for investment returns, volatility, and risk can vary enormously from manager to manager.

While I had originally planned to discuss various types of mutual fund, hedge fund and other alternative investment strategies, as well as their potential risk profiles, I think I'll save that for a later article. What may be more important to convey is that most investment managers use a unique methodology to decide which shares, bonds, commodities or other assets to buy and sell. While there are as many approaches to investment management as there are managers, most managers tend to fall into one of several categories or styles. Why is this?

According to the Frank Russell Company: "The concept of [investment] style originated in the U.S. in the 1970s when industry observers, including Russell, began to research managers in a more disciplined fashion. Russell realized that managers tended to fall into one of the following styles - growth, value, and market oriented. As the industry developed, managers became more specialized and used the concepts relating to style to differentiate their products in the marketplace. A manager's investment style describes the way a manager invests...manager investment styles are vulnerable to periods of under-performance as

February 6, 2006

market trends shift and move...any single manager will have a bias towards one style and performance may suffer when that investment style is out of favor. “

The key points to be made here are that, since the 1970s, most investment managers have migrated towards specialization and, of this group, the odds are that any single manager will have a bias towards one style and their performance may suffer when that investment style is out of favor. Additionally, not only might performance suffer when an investment style is out of favor, but the magnitude and duration of the suffering can vary significantly also. Even in the hedge fund world, where one or more specialized strategies may have been blended or combined in some unique way, much specialization occurs in that arena too.

Enter the era of professional asset allocators.

But before we go there, I want to distinguish the differences between diversification and asset allocation. You might be surprised how these two words are often confused – even by financial professionals.

Diversification

How many times have you heard the saying: “Don't put all of your eggs in one basket”?

This age old saying has been passed down from generation to generation to generation... Yet, in the investment world, diversification can be achieved in a number of ways. Let's look at how this may mean different things to different people:

Diversification within a specific investment type. For this scenario, let's consider junk bonds for example. Junk bonds are also known as high yield bonds. For our example, let's say that junk bonds are a specific investment type within the asset class comprising fixed income securities.

Junk bonds are, most commonly, corporate bonds having a high yield and high risk. This is an oversimplified definition. They are bonds issued by companies that carry a speculative credit rating. To compensate for this risk, junk bonds will generally pay a higher interest rate yield than their investment grade brethren. The most substantial risk with junk bonds, is that the issuer could default (not fulfill) on its payments of interest, principal or both. When a bond goes into default, significant loss in value of that investment is almost certain.

With this being the case, an average investor buying individual junk bonds might be in for quite a gamble. Yet in a portfolio of 25 or more junk bonds, if one bond drops in value for reasons specific to that bond, the effect on the whole portfolio will be limited. In this case, diversification lessened the impact of default risk within this narrow classification of bond funds.

Diversification within a specific class of assets. For this scenario, let's consider stock funds as an asset class. Not all stock funds are alike. In this category, funds invested in stocks of established companies with under-valued stock prices are considered value style funds. Investment managers with a value style bias are bargain hunters anticipating that, once the under-valued stocks they've discovered become more noticed, the stock prices will

February 6, 2006

rise toward their expected market value.

On the other hand, investment managers of growth style funds select stocks of companies with fast growing earnings. These managers anticipate that, as long as the companies they've identified continue to exhibit above-average earnings growth, the stock prices will grow above-average as well.

Additionally, one fund may invest in stocks of large U.S. companies, while another may invest in stocks of smaller U.S. companies. Some funds may invest in stocks of international companies in the biggest industrialized nations, such as Japan, Germany and France; and, others may invest in stocks of companies in less developed, emerging markets such as India, South Africa and Mexico.

When combined into a portfolio, these various "styles" of stock funds – which typically react differently to economic and market changes – may work together to lower your overall risk.

Diversification amongst asset classes. For this last scenario, diversification simply means dividing your investment dollars between different types of investments – like stocks, bonds, real estate and commodities, to name a few – to lower your risk. In this case, diversification can work as a safety net when investor sentiment or economic events favor one or more asset classes to the detriment of others. A short-term setback or negative market change in one investment option may be offset by a positive gain in another.

Herein lays the groundwork for why asset allocation is an important concept for investors seeking to insure their financial freedom and future. This brings us to our next discussion point...asset allocation.

Asset Allocation

The term asset allocation means different things to different people. The goal of some asset allocation funds is to maintain a static asset allocation mix, while others vary the asset allocation mix as market opportunities change. Although the trend of thought, by most professionals studying this concept, is that varying the mix will produce better year-over-year results for investors.

Some investors equate asset allocation with short-term market timing – which, by many, is considered very risky. Others view it as a dynamic process of identifying longer-term valuation discrepancies between asset classes and taking advantage of these to either increase return without increasing risk, or to manage risk without sacrificing return. Some use technical analysis (models of price and volume data) to time shifts from one asset class to another – this type of analysis is often used by the market-timers. Others combine numerical analysis and qualitative judgment (making comparisons based on different qualities). Finally, like I mentioned above, some take a very long-term view of asset allocation and advise static allocations to various asset classes based on investor risk tolerance. There is no single “best” way to allocate assets. Yet, we don't advocate short-term market timing or sole reliance on technical analysis.

Here are some of the more common asset allocation strategies out in the marketplace today:

February 6, 2006

Multi Strategy Approach: This approach focuses on diversifying by employing various strategies simultaneously to realize short- and long-term gains. Others may include systems trading such as trend following and various diversified technical strategies. In this style, the manager will seek to overweight or underweight different strategies to best capitalize on current investment opportunities.

Opportunistic Approach: Here, the investment theme changes from strategy to strategy as opportunities arise to profit from events such as initial public offerings, sudden price changes caused by an interim earnings disappointment, hostile bids, and other event-driven opportunities. This type of manager looks for special situations, or opportunities, may utilize several investing styles at a given time and is not restricted to any particular investment approach or asset class.

Macro Approach: This group, often found in the hedge fund world, aims to profit from changes in global economies, typically brought about by shifts in government policy. They usually participate in all major markets (equities, bonds, currencies and commodities), often rotating their investment exposure based upon how they perceive the policy shifts will create an impact. They sometimes utilize hedging techniques, but leveraged directional bets tend to make the largest impact on their performance. As such, because they often use leverage and derivatives to accentuate the impact of market moves, you can expect your investment risk to be very high.

Fund of Funds Approach: This style mixes and matches mutual funds and or other pooled investment vehicles. This blending of different strategies and asset classes aims to provide a more stable long-term investment return than any of the individual funds. Returns, risk, and volatility can be controlled by the mix of underlying strategies and funds. Capital preservation is generally an important consideration. Volatility depends on the mix and ratio of strategies employed and, more often than not, the risks are low to moderate.

Multi Strategy Fund of Exchange Traded Index Funds Approach: This approach not only offers an efficient way to invest in whole baskets of stocks, bonds and other asset classes, both in the US and abroad, it makes managing risks an easier task. Portfolios are adjusted to take advantage of relative attractiveness among industry sectors and economic factors that may influence stock, bond and other markets. Capital preservation is the primary priority and much emphasis is placed on properly diversifying portfolios and coordinating risks. Expect your investment risk to be low. Hey! Wait a minute! That's what we do here at our firm...

Concluding Thoughts

Professional asset allocation managers take the burden off investors by incorporating the basics of smart investing (asset allocation, diversification and reallocation) into a single relationship. Using a multi-style approach that incorporates complementary investment styles ensures investors are not exposed to 'style cycles' as different investment approaches or styles move in and out of favor.

February 6, 2006

Hoffman, White & Kaelber Financial Services Investment Performance Update

The US stock markets rallied higher in January and sold off significantly in the first few days of this month. Can you say roller coaster?

Fourth-quarter GDP growth came in at only 1.1%, the slowest growth rate in three years, far below expectations of 3.0% that most economists had looked for. While it was widely expected that Fed Chairman Greenspan, in his last day on the job, was going to raise the federal funds rate by another 25 basis points to 4.50%, the markets began to believe that the Fed might pause after that move. US stock markets rallied as a result.

But this past week, the household survey showed the unemployment rate dropping to 4.7%, from 4.9%, hitting its lowest level since July 2001. Alongside that drop in unemployment, average hourly earnings rose 0.4%, taking its year-over-year advance to 3.3%, the strongest gain since February 2003. The increase in earnings, combined with stronger employment, suggests that wage income began 2006 on a strong note. If this is so, the consumer may not be done buying and the potential for wage inflation exists.

After this news, economists began to assess, with assumed robust growth prospects and hints of inflation that the Fed, under new Chairman Bernanke, will need to raise interest rates to 4.75%, at the end of March and, perhaps, beyond. Sensing the risk that the Fed will have to do more rather than less, the markets have begun to give back January gains.

Things are already stacking up to be an interesting year...

Our performance continues on a positive note! For the month ended January 31, 2006, our one-month performance is up 2.28%, our rolling twelve month return is up 12.11%, and our average annualized return since inception is up 10.38%. We are one month shy of having a full three year performance record! Our since inception risk profile remains very conservative at +/- 5.58% and our Sharpe Ratio (reward for risk taken) is an enviable 1.50. For more performance information, please see our web site for details.

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