

September 2, 2004

This is the September 2004 monthly Wealth Management newsletter from Hoffman, White & Kaelber Financial Services, LLC. If you do not wish to be included in our circulation, please reply indicating your desire to be removed and we will be happy to oblige. Alternatively, any of your friends or colleagues may receive this on a regular monthly basis by sending their name and email address to info@hwkfs.com. Feel free to forward this to any of your friends who may find it useful. Thanks for your interest and I hope you enjoy the letter.

Don't Just Stand There, Sell Something!!

Rebalancing - using new cash or shifting money to bring your investment portfolio's target allocations back in line annually - is one of the simplest and soundest investment strategies around. This, of course, supposes that you're following some sort of asset allocation policy to begin with.

Let's say that you've already come to the realization that asset allocation is the most important portfolio decision you can make. Let's go one further and say that you've already consciously settled on target percentages for stocks and other investments. Congratulate yourself! You are several steps ahead of most individual investors.

Now, are you also aware that you should be periodically rebalancing your portfolio allocations? Unfortunately, too many investors don't. Some chalk it up to ignorance, forgetfulness or laziness, but it's more than likely just human nature. After rotten years, many investors tend to lick their wounds and pay less attention to their investments. Or after a super year, one might figure, why fix what isn't broken?

Here's why: When you rebalance annually, you build discipline into your investment plan, adding money to laggards and shaving shares of leaders. This boils down to buying low and selling high, while also helping you avoid the natural but wrong-headed tendency to chase performance.

As mentioned in our prior newsletters, we strive to provide articles on various aspects of wealth management to assist your understanding of why planning for the present and for your future has importance. Yes, we also promote our services; yet, you will find that we always seek to present thought provoking topics that are relevant to our wide audience.

In this letter we will try to help you develop an understanding of the benefits in having an asset allocation policy and how this simple advice can improve your chances for success when making investment decisions. Lastly, and as always, we will finish with an update on our investment activities.

Could It Really Be That Simple?

Rebalancing is one of the few free lunches out there. Why is it? Because, you're generally selling things that have gone up the most and buying things that have gone down the most. Someone who doesn't rebalance is likely to fall victim to the "small investor theory".

As the theory goes, a "small investor" buys – purchases investment assets – when prices are high and sells when prices are low. This is because the "small investor" is more likely to follow the crowd rather than follow a disciplined approach. They invest when they hear of the successful experiences of friends and neighbors – usually after a significant run up in the

September 2, 2004

market – and sell when they hear that market prices are falling. This is the parenthetical opposite of what investors need do to create wealth – to do so, one needs to buy low and sell high.

Rebalancing also keeps your portfolio in line with your target allocation (which should be based upon your risk tolerance and goals). Consider the case of two investors, Bruce and Mike, who owned the same stock and bond funds in tax-deferred accounts back in early 1997. Both are the same age, have the same goals, share the same risk tolerance and have their desired 60%-40% split between stocks and bonds, respectively.

Emboldened by the stock market's heady gains, Bruce doesn't touch his portfolio. He lets stocks grow into a nearly 70% stake at the end of 1999. Mike, on the other hand, dutifully rebalances his portfolio at the end of each year, shifting money from stocks to bonds to maintain that 60-40 split.

As you might expect, Bruce rode stocks' streak to some heady gains in the late 1990s. But he also let the market skew his portfolio far from his target allocations. And just when stocks were most expensive, he had the most money riding on them -- the equivalent of piling heavy bags of money further and further out on a shaky limb.

In the end, Mike averaged an annual gain just under 6.25%, compared with 5.67% for Bruce. Along the way, Bruce had a somewhat bumpier ride. His worst 12-month return was a 13.8% loss in September 2001, compared with a 11.4% fall for Mike – according to our calculations using the Standard & Poor's 500-stock index and intermediate term US Treasury index funds.

Given the modest difference between Bruce and Mike's returns, you might wonder if rebalancing is worth the trouble. If we all could behave like Bruce, coasting can sometimes work out. But not everyone is as steely as Bruce. The "let it ride" approach requires staying the course through volatility. Unlike Bruce, many folks tend to sell out after taking a beating, effectively selling low and later buying higher when things seem better.

Boston fund-tracker Dalbar Inc. recently found that stock-fund investors earned a paltry 2.6% annualized gain from 1984 through 2002, compared with more than 12% for the S&P 500 index. The reason – cash consistently flows to funds that have performed well over the past 12 to 18 months, and not to those that have trailed. Rebalancing has the opposite effect of in-the-moment decisions. It allows you to make prudent investment decisions based on your long-term needs rather than momentary emotion.

Finally, there are unexpected consequences to the Bruce method. An investor with a 60%-40% stock-bond mix 25 years ago would've let stocks appreciate to a nearly 90% stake, for example. The result – as he or she aged, he or she'd be increasing risk, rather than decreasing it, as most experts recommend.

One big issue we haven't touched yet is Uncle Sam. Of course, it's important to be mindful of tax consequences if you're moving money around – perhaps when you're booking more profits than losses – in a taxable account. However, be warned that managing your investments based upon the potential tax impact alone is a recipe for disaster. The market could easily deliver greater losses than your planned tax savings. Yet, if you rebalance

September 2, 2004

annually, you might be able to use new money to get back in line with your allocation targets, rather than sell shares of funds that have risen highest.

If this sounds like too much work, don't despair. Little noticed but growing in popularity, investment managers and fund companies are making it easier for you to rebalance. Several providers offer management services or funds of funds that allow investors a given allocation that will automatically be rebalanced over time.

So, not only is rebalancing a no-brainer, but you can find someone to do it for you.

We're At Your Service

At Hoffman, White & Kaelber Financial Services, our focus is to help our clients achieve a more certain future. With an investment strategy, based upon strategic asset allocation research and principles, our risk profile falls well within most investors' tolerance for risk. This means we set your allocation and rebalance for you as necessary. As such, our asset management clients gain comfort in our conservative strategy of seeking to control risk while carefully and methodically growing their investments.

Hoffman, White & Kaelber Financial Services Investment Performance Update

August 2004 was challenging for economists and investment professionals alike. The battle between whether we're entering an inflationary or "stag-flationary" period being the root cause. The Federal Reserve Bank again raised the Fed Funds rate by 0.25% - now at 1.50%; oil prices continued to hit new highs; and, price volatility increased even more in the US real estate, international equity and fixed income markets. By all accounts, the Fed seems uncomfortable with a fed funds target rate below the rate of inflation and appears to look through what they perceive as short-term economic weakness while they eliminate the gap. The last time the fed funds rate lagged the inflation rate was the Jimmy Carter era - when the rate of inflation and short-term interest rates ran into double digits as a result. Yet, it is also widely believed that a surge in energy prices, with oil above \$50, and a disastrous employment report tomorrow could dissuade the Fed from further near-term tightening.

For the month ended August 31, 2004, our one-month performance is up 0.13%, our three-month return is up 0.36%, our one-year return is up 6.67%, and our average annualized return since inception is up 11.01%. For the second consecutive month, while risk is increasing in most market sectors, our (since inception) risk profile has edged downward further to +/-6.99%. This risk level remains conservatively low and is consistent with our strategy. With our expectation that this statistic gains increasing importance, our Sharpe Ratio remains a very respectable 1.42.

About Measuring Risk and Sharpe Ratios

Investment pros borrow a tool from the statisticians—standard deviation—to measure investment risk. It shows the *range* of returns that investments are likely to earn over a given period of time and it has two sides, the out-performance and the under-performance of an average rate of return.

September 2, 2004

The Sharpe Ratio is a commonly used measure of portfolio earnings quality. In short, the Sharpe Ratio is a measure of return achieved per risk taken. Sharpe ratios can be better than just looking at performance because it incorporates the issue of risk. Some would say it is a measure of a manager's ability to perform consistently. The number by itself, however, is hard for many to understand without comparing it to something.

Let's take a look at the S&P 500 Index for a quick comparison. The Standard & Poor's 500 Index is usually considered the benchmark for US equity performance. As the name suggests, the S&P 500 consists of 500 companies from a diverse range of industries. Contrary to popular belief, the S&P 500 is not a simple list of the largest 500 companies by market capitalization or by revenues. Rather, it is 500 of the most widely held US-based common stocks, chosen by the S&P Index Committee for market size, liquidity, and sector representation. For the last ten years, the Sharpe Ratio for the S&P 500 is less than 0.40 and it doesn't look much better when looking over the past thirty years.

Are you familiar with Morningstar, Inc.? They are a Chicago-based, global investment research firm, providing information, data, and analysis on the mutual fund industry. They say that a Sharpe Ratio of over 1.0 is "pretty good" and outstanding funds achieve something over 2.0. Using this "yardstick", we are more than pleased with our accomplishment to date.

For most investors, the Sharpe makes good intuitive sense because they not only hate to lose money but they often compare the returns to risk free investing. You owe it to yourself to understand and consider this measure when making investment decisions.

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