Lassus Wherley ...a view from the top

Building Better Futures

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Taking Deep Breaths Really Does Help!!!!

Food for Thought

I have had a few people comment that since I'm not sending these commentaries out quite so often, it must mean I'm not as worried about the markets. The reality is this newsletter was originally intended to be distributed on a quarterly basis. When the insanity took over last year, it became more of an "as needed" means of communicating with clients. So…….I guess the answer is yes, I am less stressed about the economy and the markets, and I have reduced the frequency of distribution.

My decision on when to send it out is driven by a couple of factors including: important information that you need to know, a change in tactics or even our strategic approach to an asset class, or just because it has been a while. The last newsletter was in September, so it was time and we have important information we wanted to share.

I don't believe we are looking at a rosy forecast or that we have solved all the existing problems, but I do believe we have made significant progress. The last few months have actually been kind of fun. The fact that we have gotten back a lot of the dollars lost in the previous six months is really good. The negative is that we are all still waiting for the other shoe to drop. As one of our clients (who used to be in this kind of business) said to me the other day, "When the market is climbing a wall of worry, I can sleep at night. When all the talking heads believe the world is a happy place and the market is going straight up—I begin to have sleepless nights."

I certainly agree with the sentiment. When everyone believes the world is a great place and that the markets will go up forever (as they did in 1999), I get really nervous. Right now I think we have a very healthy underlying nervousness that will keep everyone's feet on the ground and keep people from getting "carried away" with enthusiasm. October was a good grounding experience as the first month that could have been negative turned out to be kind of a non-event. We ended up the month of October slightly down or pretty much breaking even after a few ups and downs.

Does the Good Outweigh the Bad Yet?

This is a question we will continue to ask ourselves on a weekly basis. Let's review a few of the headlines we have been seeing lately.

Regulatory reform seems to have been slightly derailed due to the time and energy being spent on health care reform. They are both incredibly important but I doubt that the solutions we will get are going to make many of us very happy. The brokerage industry is trying to weaken the Fiduciary Standard. This standard means that we, as investment advisors, are required to always put our clients interests first. The brokerage industry really doesn't want to have this standard applied to them because it would potentially reduce the profit margins. So……..they are spending millions of dollars trying to convince people that a weaker standard will be better for them because it will eliminate confusion. It is hard for me to believe that people are actually

buying that argument. However, we are currently losing some of these battles in Washington. We are fighting many right now, but the defense of the Fiduciary Standard is critical for the protection of the consumer and the building of the financial planning profession. I will keep you posted because we may need your help. I have included on page 5 of this newsletter a copy of a letter addressed to our Congressional Leaders from the coalition of organizations I have been working with. It is one of many that we have sent to try to slow down a "Bill" that could cause much damage if passed as it is currently drafted.

There is some light at the end of the tunnel. As we go to press with this newsletter, Senator Dodd has brought out the discussion draft of the Senate "Bill", and it does correct many of the things that the Congressional "Bill" did not do well.

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The economy is growing, although it is still growing slowly. The third quarter reflected the first positive growth since the recession ended with a 3.5% annual rate.

Starbucks earnings surged in the last quarter which bodes well for the economy. I definitely cut back on my lattes for a while, and many other folks did the same.

Productivity surged in the third quarter. According to the Department of Labor, output per hour for nonfarm workers rose at an annual rate of 9.5% in the quarter. This was more than four times the average productivity growth of the past quarter-century. The good news is that companies continue to pay attention to costs, but the bad news is we haven't yet reached the turning point when they have to start hiring again.

These productivity gains also show that inflation is probably still a long way out for us since one of the primary drivers of inflation is wage increases. We aren't going to see those anytime soon.

The dollar continues to decline in value, but no one seems to be too worried about it at this stage. We seem to have a link between the dollar and the US Stock Markets right now. The dollar goes down and the markets go up—an interesting development that we will continue to track. We are also continuing to add to our Global Bond Fund positions to take advantage of this situation.

There is an open question about how the Federal Reserve will begin to remove the huge stimulus they have pumped into the economy. That will mean that eventually we will have to deal with rising interest rates, but at this point they don't really know what their approach will be. Another area to keep our eyes on for now since they may have to move relatively quickly in order to head it off is inflation.

One area that is currently bad news but may be very good news in the future is the amount of cash that corporations are hoarding. After encountering so many issues with getting loans last year, many companies have really focused on building cash reserves. According to the *WSJ*, the 500 largest nonfinancial firms in the US held about $994 billion in cash and short-term investments in the second quarter of this year. So……….as the economy improves and companies gain confidence, they have the dollars to begin to add capacity which is very good news.

Consumer spending has remained slow but exports have continued to be relatively strong. With the falling dollar, companies are able to export and be competitive with their pricing due to the lower value of the dollar.

Possible bad news items which could limit the economic recovery include:

Continued high rates of joblessness—job losses appear to have stabilized but have

not begun to move the other way yet. We know this is a lagging indicator but would like to see some more positive news here.

Expiration of the Bush tax cuts—with everything else that is going on in Congress, it is really hard to tell what is going to happen with taxes. However, we are counting on them going up and hoping they won't.

Continued pressure on small business—there is continued pressure on small business with availability of loans, competition and now worries about the cost of health care. It is not going to get easier anytime soon. It will be a while before we see what will really come out of health care reform in the Senate. I haven't made it all the way through the current "Bill", but it appears to pretty much guarantee increased costs for most of us.

Weakness in commercial real estate—there is a continued weakness in commercial real estate that is compounded by banks' unwillingness to lend. The good news here is that there are many well capitalized REITs that are able to buy some of the properties that are in trouble.

All of these factors will contribute to the growth of the economy and the health of the financial markets. We continue to believe that we are seeing a recovery that is a little slower than we have experienced in the last few recessions.

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Here are some of the representative returns for the 12 months ending 10/31/2009.

US Large Cap	11.71%
US Small Cap	11.69%
Intl Large Cap	24.91%
Global Real Estate	21.92%
Short-Term Bonds	9.58%
Inter-Term Bonds	17.85%
Muni Nat'l Inter	11.13%
Muni Nat'l Short	5.18%
Long Short	6.02%

Source: Morningstar Fund Category Returns.

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We continue to review asset allocation and asset classes to determine if we need to make changes. Recent changes have been made to fine-tune and focus on risk management. We have increased our allocation to emerging markets slightly and added to our global bond fund. We recognize the risk in emerging markets but believe they offer higher potential returns for a reasonable risk at this time. We aren't making a major bet but just slightly increasing our target. We have increased our target for global bonds for yield in the short-term bond sector and to defend against the falling dollar. We are also paying close attention to interest rates as we make decisions on bond funds. We will begin to move more dollars to short-term funds when we become concerned about rising rates but we aren't there yet.

Here are some of the questions you have asked over the past month.

Question: *I noticed that you were trading quite frequently for a while but haven't seen any trades in my account for a few months. Have you changed your philosophy concerning trading?* ***Answer:*** We haven't changed our philosophy about trading. We make trades when we believe it makes economic sense, we are concerned about something specific, or there is a need for cash. In the period from September last year through April of this year, we were rebalancing more frequently for all three of those reasons. The volatility of the markets

meant portfolios became much more out of balance more quickly. At the same time, we were making tactical changes such as adding more dollars to hedge strategies funds and increasing cash. Our objective in a more sane environment is to review monthly but rebalance only if it makes sense in terms of trading costs, tax consequences and bringing the overall portfolio in line with where we believe it should be. Most portfolios will be rebalanced every 2 to 4 months depending on the size of the portfolio and whether there are either ongoing cash needs or cash deposits which must be accounted for in the trading.

Our objective is to trade less, not more, but we will trade more often when we believe it is in the client's best interests to do so.

Question: *I noticed that in my last trade you were adding to the Global Bond Fund. Have you increased the target allocation and if so, why would you increase it?* **Answer:** We have increased our basic target allocation to Global bonds from 3% to 5%. Our reasoning is based on the continuing fall of the dollar. This allocation gives us some protection by having exposure to other currencies. It also helps to diversify the risk of the U.S. bond market.

Question: *This is the time of year when funds are making their capital gains distributions. Some years I really get clobbered with these distributions. Is there anything we can do to minimize the tax impact of these distributions considering the market losses so far?* **Answer:** Capital gains distributed out to holders of the fund are the result of trading activity within the fund during the year. The fund is required by law to distribute all capital gains both short- and long-term that they incur during the year. If you hold the fund on the record date, you are subject to these distributions. We are reviewing portfolios to see what makes the most sense in terms of either holding the fund and paying taxes on the distributions or selling the funds and avoiding the taxable distributions. This is a process we go through every year at this time.

It becomes a very complex analysis as we work our way through these decisions. We literally track the estimated capital gains distributions for all of our mutual funds beginning in October. We review right down to the wire to make decisions on whether or not there is a reason to sell. So far—it doesn't appear that many of the funds we are holding will be distributing large gains. That means we will probably not have a need to sell many of our funds to avoid capital gains distributions.

Looking Forward

The challenges in 2009 continue and we are beginning to look at 2010. The world certainly seems more positive these days as we go into the holiday season. We will need to continue to monitor both financial and non-financial factors in managing risk in investment portfolios.

Keep those questions coming in. If you are wondering about something, the odds are pretty good someone else may also be thinking about the same topic. When you ask—we get the chance to share our thoughts on the topic with others.

Please let us know if you have any questions or concerns. We are definitely looking forward to a continued recovery in the markets and the economy. Have a wonderful Thanksgiving and hopefully the Winter will be a good one!

Diahann

Letter from Friends of Fiduciary Coalition:

Consumer Federation of America
Investment Adviser Association
Shareowners.org
National Association of Personal Financial Advisors
Certified Financial Planner Board of Standards, Inc.
Financial Planning Association

November 2, 2009

The Honorable Barney Frank, Chairman
Financial Services Committee
The Honorable Spencer Bachus, Ranking Member Financial Services Committee
The Honorable Paul E. Kanjorski
The Honorable Scott Garrett
U.S. House of Representatives
Washington, D.C. 20515

Re: Investor Protection Act (to be reported as H.R. 3817)

Dear Chairmen Frank and Kanjorski, Ranking Members Bachus and Garrett, and Members of the Committee:

We are writing as representatives of organizations that support a strong, universal fiduciary duty for investment advice to express our grave concerns over the degree to which that goal is threatened by changes made to date during consideration of the Investor Protection Act. Unless these short-comings are fixed before final approval, the legislation could set a standard for advice by brokers that falls well short of the full fiduciary duty under the Investment Advisers Act.

We have written previously to express the following concerns: that, in describing standards of conduct, the phrase "when providing personalized investment advice" might be used to argue that "hat switching" by brokers is allowed; that the language requiring rulemaking by the Securities and Exchange Commission ("SEC"), which references personalized advice to retail clients, could be seen to narrow the existing fiduciary duty under the Investment Advisers Act, which does not vary depending on type of client served; and that the language which states that the standards adopted under the legislation should be "at least as high" as those currently applied under the Advisers Act is only included in that portion of the legislation that amends the Advisers Act, which could lead some to conclude that the rules for brokers could meet a lower threshold.

Fiduciary Duty Weakened in Manager's Amendment

None of these concerns was addressed in the manager's amendment. Instead, changes to the manager's amendment prior to the mark-up actually reinforced these concerns. There are now so many conditions and specific, potentially limiting, provisos in the amended language that it is unclear whether brokers that provide investment advice are truly fiduciaries subject to the full panoply of accompanying duties. Because we believe you intended to hold brokers that provide investment advice to the same overarching fiduciary principles applicable to investment advisers, we urge you to clearly confirm that this is the case in any Committee report language accompanying the legislation. One particularly troubling example of last-minute limiting changes to the legislation is the new section, added to the manager's amendment just before mark-up, which states that brokers who sell only proprietary products or an otherwise limited range of products can satisfy their fiduciary obligations by providing notice and obtaining "consent or acknowledgement" from the customer. While the sale of proprietary products and of a limited range of products

has long been permitted under the fiduciary duty, this provision could, under some circumstances, permit such practices regardless of whether they are in customers' best interests and may be read to limit the regulations the SEC would be permitted to adopt to address these significant conflicts of interest. Moreover, it appears to us to be in direct conflict with, and to greatly limit the benefits of, that section of the legislation that directs the agency to study conflicts of interest and adopt rules to address or prohibit such conflicts.

Pending Matter Could Further Eviscerate the Standard

These problems could be made far worse depending on how the bill's authors respond to an amendment by Congressman Hensarling that was offered and withdrawn, but with a commitment to continue to examine the issues raised as the bill heads to the floor. The problem the amendment purports to address – that discount brokers who offer limited, transaction-based advice not be held to a fiduciary duty to provide on-going monitoring of the account – is a nonissue.

As we have noted before, the fiduciary duty is a facts-and-circumstances-based standard. The obligation to provide on-going account monitoring is specific to those circumstances where a promise of on-going account management or on-going advice is made or implied. As long as clear disclosures were provided, no such obligation would be triggered in the circumstances described by discount brokers. If the amendment were as narrow as the author claims, it would likely be of little concern, since it would not change the existing standard. In fact, however, the amendment is far broader and would throw open the door to rules that allow "hat switching." By "hat switching" we are referring to the common practice where the same financial intermediary provides investment advice under a fiduciary duty and then executes the recommended transactions under a lower suitability obligation. Such an approach, clearly permitted under the Hensarling amendment, would leave brokers free to implement their advice by selling products with higher costs, poorer performance, and other characteristics that make them poorly suited to the client's interests but financially beneficial for the broker.

It is therefore absolutely essential that the legislation not be amended to restrict the fiduciary duty in this fashion. If it were, the bill would not only perpetuate existing abusive practices, it could make them much worse by promoting a false sense of security among investors who believe they are protected by a fiduciary duty when they are not.

Delegation of Authority to FINRA Undermines Protections

Perhaps the most serious threat to the fiduciary duty came on a seemingly unrelated amendment. That amendment by Ranking Member Bachus, which was adopted on a voice vote, would permit the SEC to delegate responsibility to the broker-dealer self-regulatory organization, FINRA, for enforcing compliance with the Investment Advisers Act for its members and persons associated with its members. Based on an analysis of IARD data, the authority to oversee "persons associated with members" could extend FINRA's jurisdiction to between 25 percent and 30 percent of all federally registered investment advisory firms. In aggregate, these firms manage almost 80 percent of advisory firms' total assets under management. In addition, according to the North American Securities Administrators Association, roughly 88 percent of all investment adviser representatives are dually registered as

representatives of broker-dealer firms. As a result, the amendment would appear to permit the SEC to designate FINRA as the de facto SRO for the majority of investment adviser representatives, including financial planners who combine advice and implementation services. The SEC could delegate this authority to FINRA with no further involvement of Congress and no prior analysis of the risks and benefits of that approach. Moreover, the amendment gives FINRA not only inspection and enforcement authority, but also rule-making authority under the Investment Advisers Act. Both are problematic.

In the first instance, this amendment appears to reward FINRA for its failures in the Madoff and Stanford cases, and its misleading statements about the causes of those failures, with a broad expansion of authority. While FINRA has brazenly claimed that a gap in its authority prevented it from examining Madoff's advisory operations, in fact Madoff was solely a broker dealer during virtually the entire duration of the scheme, and FINRA had full jurisdiction over its conduct. Moreover, although FINRA supporters claim this broadened authority is needed to supplement inadequate SEC oversight, separate provisions of the bill already address that resource problem by reducing the number of advisers that are subject to SEC oversight, by authorizing substantially increased SEC's funding, and by providing for user fees to support enhancement of the SEC's inspection program. Despite the SEC's failings, we believe that this approach is preferable to delegating broad investment adviser oversight responsibility to an organization with a broker-dealer mindset.

Even more disturbing than its expansion of inspection authority is the amendment's broad grant of rulemaking authority to FINRA. For years, FINRA and its predecessor organization, NASD Regulation, have sided with brokers in opposing efforts to hold brokers to a fiduciary standard when they provide investment advice. With the rulemaking and enforcement authority this amendment would provide, FINRA could become the main arbiter of how the fiduciary duty is applied to conduct by brokers, SEC-registered advisers with broker-dealer affiliates, and most financial planners. All of the concerns outlined above regarding weaknesses in the underlying legislation would be magnified if FINRA were given this rulemaking role and continued to adopt its industry-centric approach to the issue.

Conclusion

Unless these problems are fixed, we fear this legislation would give investors a false sense of security that they are receiving enhanced protections while in fact doing little to raise the standards that apply when brokers give investment advice. As the legislation moves to the floor of the House, we urge you to fix these severe shortcomings in the legislation so that it can fulfill the Administration's intent to apply the Investment Advisers Act fiduciary duty to all investment advice. We look forward to working with you to achieve that goal.

Respectfully submitted,

Barbara Roper, Director of Investor Protection, Consumer Federation of America
David Tittsworth, Executive Director, Investment Adviser Association
Richard Ferlauto, Chairman, Shareowners.org
Ellen Turf, Chief Executive Officer, National Association of Personal Financial Advisors
Kevin Keller, Chief Executive Officer, Certified Financial Planner Board of Standards, Inc.
Marvin W. Tuttle, Jr., CAE, Executive Director/CEO, Financial Planning Association

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