Lassus Wherley ...a view from the top

Building Better Futures

Issue 6: December 2007

"It's That Time Again"

It is hard to believe that we are approaching year end and the holiday season. So far 2007 has been a very challenging year for investors. We almost need motion sickness pills with the fast up-and-down movements in the financial markets. This is truly a market where we have to keep reminding ourselves that the fundamentals of investing are more important than ever and……….. ***We are long-term investors***. We continue to be focused on looking for ways to more effectively manage the risk of your portfolio, but in a negative market period such as we have experienced in November, it becomes even more of a challenge.

We recognize how difficult it is to remember that the market won't go down forever even if it does feel like it during these volatile periods. It will recover with time. So……..take a deep breath when you review those November statements because the odds are that they will show some negative numbers.

At risk of sounding too optimistic, here are a few things we can be thankful for during the holidays.

- U.S. exports added more to Gross Domestic Product (GDP) in the third quarter than the slowing residential housing sector subtracted.
- Export-heavy U.S. companies report sales overseas, with Boeing recently announcing a surge in orders from Asia and the Middle East.
- The declining dollar has raised concerns about importing inflation to the U.S., but because of competition and a slowing economy, U.S. businesses have yet to pass on higher costs.
- Airlines expect a 4% jump in traffic this holiday season, driven in part by lower prices at hotels and car rental agencies.
- Small business lending is slowing only modestly. The credit crunch has raised concerns over small businesses' access to capital, but a recent Senior Loan Officer Opinion Survey from the Federal Reserve showed that less than 10% of such businesses reported tightening lending standards. This is 40-50% lower than the levels seen during the 1990 and 2001 recessions.
- Mortgage rates are trending downward, providing refinancing opportunities as ARM loans continue to reset. These lower mortgage rates will help cushion the falling housing market.

Thanks to everyone for providing the many thoughtful questions that make up our current issue.

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? **Answer:** First, 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. Here are examples of different situations to help you understand why we are doing what we are doing.

Assume we have Fund A with a current NAV per share of $10.00. This fund incurred and is going to distribute a short-term capital gain of $.50 and a long-term capital gain of $2.00 per share. The action we will take will depend on when we purchased the fund in your account and how much you actually paid per share or your cost basis per share. One more thing you need to understand is that whether you sell now or hold until the distributions are made you receive the same dollar value for the shares. The only difference is how and when they are taxed.

If you sell Fund A before the distribution you receive the current NAV or market value per share of $10.00. If we hold the fund and wait for the distribution, when the distribution of $2.50 is paid out the current NAV or market value becomes $10.00 minus the $2.50 distribution or $7.50.

Example 1: Your cost basis is $7.50 per share and has been held for 12 months so that it is all long-term capital gain which will be taxed at 15%. If we sell the fund the gain is a long-term gain of $2.50 which would be taxed at 15% plus the state tax. If we hold the fund there will be a short-term gain of $.50 which is taxed at ordinary income tax rates somewhere between 20% and 30% and $2.00 which is taxed at long-term capital gains rate of 15%. In this case, we will sell because it provides the most tax-effective return.

Example 2: Your cost basis is $5.00 per share and has been held for 12 months so that it is all long-term capital gain which will be taxed at 15%. If we sell the fund the gain is a long-term gain of $5.00. If we hold the fund the distribution would be as noted in *Example 1*. In this case, we will hold the fund because it provides the most tax-effective return.

Example 3: Your cost basis is 10.00 per share and has been held for only 6 months. If we sell the fund the taxable gain would be $0 which would generate no capital gains tax. If we hold the fund the distribution would be as noted in *Example 1*. In this case, we will sell the fund and avoid the taxes on the $2.50 distribution.

Example 4: Your cost basis is $12.00 per share and has only been held for 2 months. There is a penalty for selling the fund if held less than 90 days. If we sell the fund the tax loss would be -$2.00 plus whatever the penalty is (typically 1%). If we hold the fund the result would be the same as *Example 1*. In this case, we will sell the fund. We capture the loss to use against other capital gains to further reduce taxable income and we avoid taxable income of $2.50 per share.

With the proceeds from the sale of the funds, we will do one of three things: purchase a comparable fund that has already paid out their yearly distribution, purchase an Exchange Traded Fund (this type of fund does not typically make capital gain or loss distributions), or hold the proceeds in cash until the fund selected for reinvestment of proceeds pays out their year-end distribution. You may see sales of funds in your account occurring in stages since different funds have different distribution dates.

As you can see, 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 to sell. Please let us know if you have any questions concerning these transactions.

Question: What is the difference between an international fund and a global fund?
Answer: International funds can invest anywhere in the world except the U.S. while global funds get to basically choose where they will invest, "anywhere" in the world including the U.S. market. We have utilized a small number of global funds because we prefer to control the allocation of funds between international markets and the U.S. market. An example of this type of fund is Tweedy Browne Global. We have used this fund as a conservative international choice and in smaller accounts where it is not cost effective to utilize the number of funds that are required to fully diversify between international and U.S. markets.

Question: What is the best way to measure my market and/or individual fund performance? **Answer**: We look at performance in a few different ways. First we monitor how our average fund is doing when measured against the comparable index minus estimated expenses. This means that in order to make a valid comparison, you must subtract estimated mutual fund expenses from the index performance. All other things being equal, if one fund has 1.2% in expenses and the other has .5%, I would choose the latter fund every time. The second part of performance is the risk analysis. How much risk is being taken in order to achieve the current rate of return? This is as important as the overall return. If you compare two funds and they have pretty equal performance, the next step is to review year-to-year volatility and to review expenses. The reason is that you are taking much less risk in order to achieve the same level of return. The first fund has to take more risk just to pay for the extra expenses. We also review for consistency of return. This is the main reason we don't recommend many actively managed mutual funds. They typically are very inconsistent in their performance over time.

What we focus on is how everything fits together in a portfolio. Is the asset allocation doing what we expect it to do based on the market? Is performance in line with targets and/or expectations based on current market volatility? What is the actual overall performance vs. the targeted return for the 12-month period?

Question: You recommend a lot of DFA Funds. What is DFA and why do you recommend them? **Answer:** DFA or Dimensional Fund Advisors is an institutional investment management company that does indexing and passive management of mutual funds. They currently manage $154 billion in assets in all of the major asset classes. Dimensional's investment management fees are positioned well below those of typical, traditional active managers. Their patience and price-conscious buy-and-hold approach to trading is designed to minimize costs. Another way they control expenses is by limiting who has access to their funds. You must be an approved institutional advisor in order to invest in their mutual funds. Lassus Wherley has been an approved investment firm since the early 1990s.

Question: You mentioned that you were looking for a better way to invest in commodities because you weren't totally satisfied with the Pimco Commodities Fund.

Have you found a better alternative yet? **Answer:** We have identified a replacement for the Pimco Fund, and we will be transitioning to this new fund over time. Our new recommended investment choice is the S&P GSCI™ Enhanced Commodity Total Return Strategy Index-Linked Note (ECN). This is the first-ever exchange-traded note to combine a standard market exposure with the kind of systematic trading strategy that hedge funds pursue at much higher cost. Goldman Sachs has registered this investment with the SEC.

We would be happy to provide more detailed information on how it works. The bottom line is that we believe that given the systematic nature of the strategy, this new ECN is the most attractive investment choice to use for the commodities exposure in our clients' overall asset allocation.

Question: I know you explained the subprime problems in the last issue, but could you give us an update? **Answer**: Subprime Mess—Part II. The reality coming out of this subprime fiasco is that brokerage firms and mortgage firms got reallllllllly greedy. The way they packaged these mortgages and had them rated as AAA should be a federal crime worthy of prison time. It continues to be a story of "when it seems too good to be true—it ***is*** too good to be true." It seems like folks just never believe it!

We will continue to see fallout from the brokerage firms and banks writing down these holdings. What that means is that on paper these investments were overvalued the entire time because of mispricing and what I call dream pricing. These firms are now revaluing all of these assets to really low levels to make sure they don't have to mark them to lower prices later. This means that many of them are probably worth more but currently no one is willing to pay a fair price for them. Longer term it will work its way through the system, and these firms will move on to their next new and creative product to generate profits for them. The latest quarter point cut by the Federal Reserve will help bolster confidence in the availability of liquidity, but most of the Wall Street folks were already looking past a half point cut. So….instead of a rally, we ended up with another down day in the financial markets.

Question: So where do we go from here? Are you going to be changing your investment allocations going into next year or adding any new asset classes? **Answer**: We will be doing some fine-tuning going into 2008. We are beginning to increase our international allocation and reduce the U.S. allocation because we believe that as the U.S. becomes a smaller part of the world markets, it will be more and more important to increase our exposure to the international markets. We will also continue to increase international real estate and reduce domestic real estate because of continued concerns about the U.S. market. Other areas under review are hedge strategies, commodities and emerging markets.

Our review will also include our allocation to the various types of international markets and revising our allocations based on increasing the diversification of our international investments. We currently include International Large Cap, International Small Cap, and Emerging Market Funds. We have been including the Emerging Market Funds in our more aggressive portfolio allocations but have recently begun to add small percentages to less aggressive investment portfolios. Emerging Market Funds are very volatile but do add diversification to a portfolio.

Please keep in touch and let us know if you have any questions. And have a safe, warm and happy holiday season and a prosperous, healthy and happy New Year!