Financial Alternatives

Integrated Wealth Management

Jim Freeman, CFP® / Chris Jaccard, CFP®

January 2010

Review of 2010

2010 was another year of vindication for the markets and for those investors who were willing to stay invested when the ride turned bumpy.

As you can see from the *2010 Short-term Returns* graph below, most asset classes provided meaningful returns in 2010. Our allocation to US Stocks, Emerging Market Stocks, REITs, and Commodities boosted portfolio performance in a year that ended on a relatively calm note.

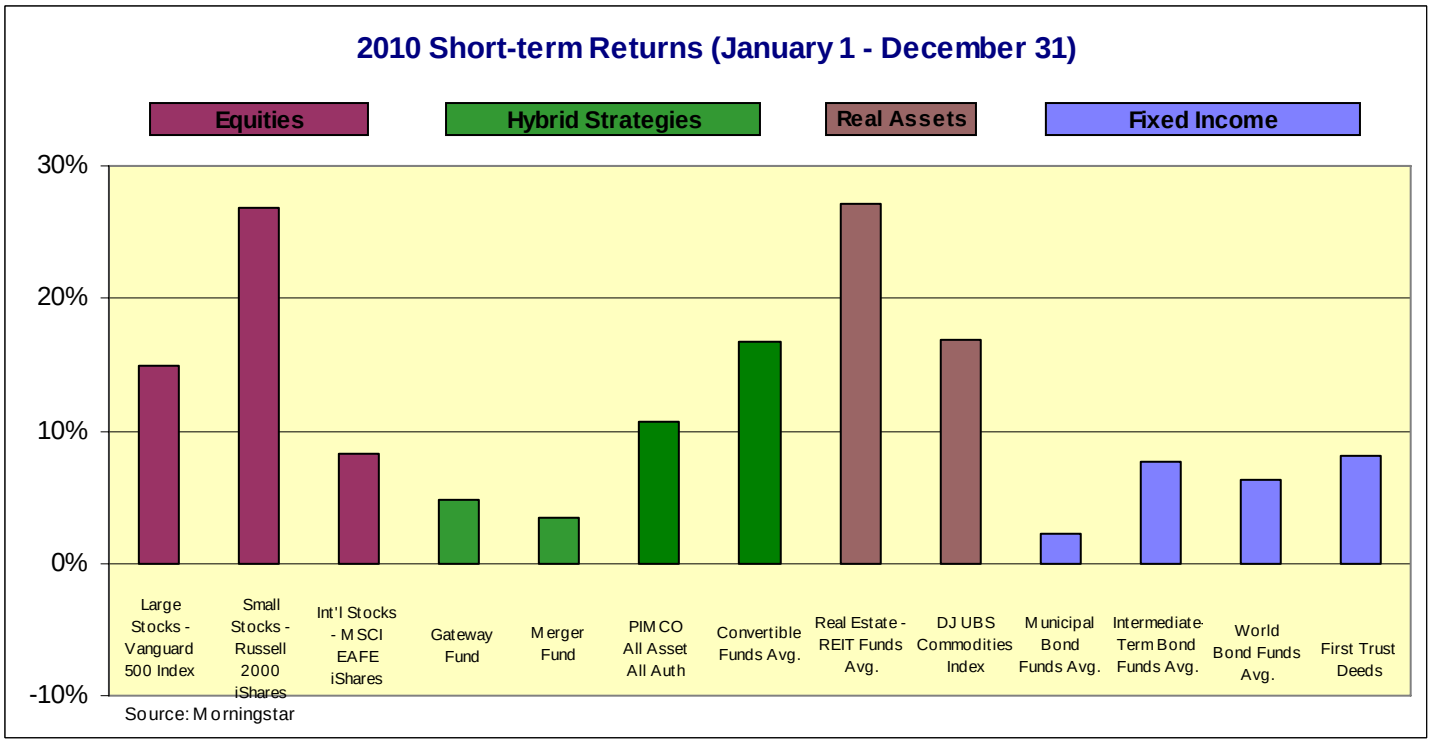
Although 2010 ended well, we experienced some turbulence during the year. International stock markets dipped significantly in the early part of the year, but recovered. Domestic stocks and commodities followed a similar pattern, but advanced more aggressively in the last quarter.

These stock market swings are very normal and should be expected. One of the best ways to describe how stock market returns are earned over time is something we mentioned in a prior newsletter called the "Wall Street Two Step". Think of a dance that moves two steps forward and one step back. To earn higher two-steps-forward returns, one has to be willing to weather one step back. At the same time, it's comforting to know that over time, the forward steps have vastly outnumbered the back steps, and rewarded patient, long-term investors.

During the financial crisis most investors experienced a couple of big steps back. As the graph on page two illustrates, many of the assets that experienced the biggest losses during the downturn were

Executive Summary

- Strong returns were earned in 2010 with US Small stocks and REITs leading the way.
- The *Wall Street Two Step* (two steps forward and one step back) best describes how stock investment returns are earned over the years.
- We are making minor allocation changes and replacing certain funds in a tax sensitive manner for clients.
- Consensus economic forecasts predict solid economic growth for the next year, but structural problems remain.
- Bullish pundits claim the market is undervalued, bearish pundits claim it is overvalued. One certainty is that it is risky to make big bets on either forecast.
- Our client's portfolios are designed to perform well in a variety of markets.



the biggest winners in the subsequent 18 months. A step back in 2011 would not be entirely unexpected. We design our clients' portfolios in an effort to reduce the risk and size of the back steps while still participating as fully as possible in the forward steps.

Our approach combines a variety of investments that do not step forward or backward at the same time. A strategic combination of these investments reduces overall portfolio risk and helps strike the proper balance between capital growth and capital preservation.

In this newsletter we will review the role, performance, and adjustments being made for each of the four asset classes we utilize.

Review of The Four Broad Asset Classes

I. Equities

Role: to provide long-term capital appreciation and currency diversification with international equity holdings. Volatility/Risk: High over short periods, moderate over long periods.

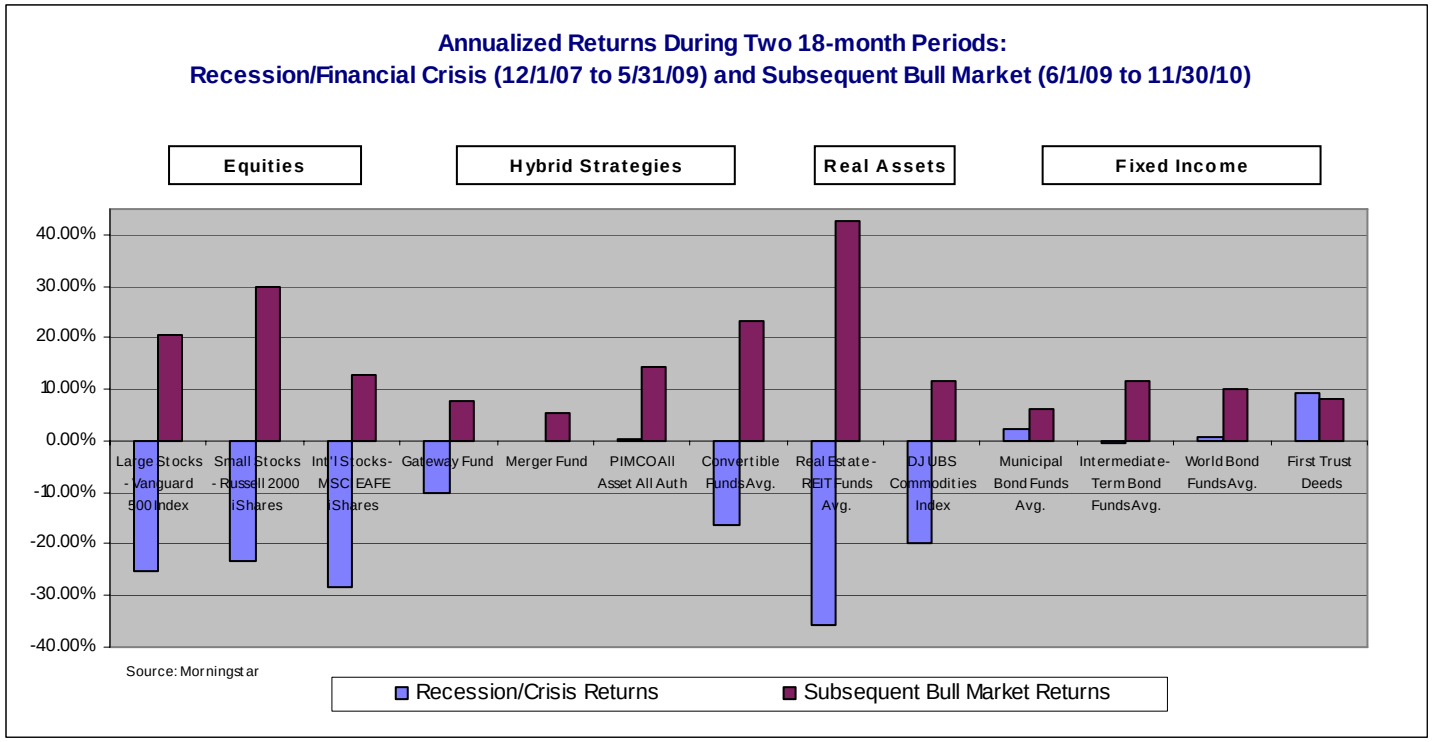
Stock investments represent ownership in companies. Shareholders earn their return through stock dividends and capital appreciation. Stocks have historically kept pace with inflation and outperformed bonds over long periods of time. Stock gains and losses however are very unpredictable in the short term and often come in rapid bursts and sudden declines – as we saw over the past three years. Stock investments typically do poorly in recessions and periods of slow economic growth.

2010 was a very good year for stock markets, particularly in the US and emerging markets. The S&P 500 Large Stock Index was up 15.06%, while the MSCI Emerging Markets Stock Index was up 18.88% and the Russell 2000 Small Stock Index rose 26.86%. Even though consecutive forward steps in the stock market are often followed by back steps, we do not necessarily expect 2011 to be a down year for stocks.

Developed country international stocks generally lagged domestic stocks. Eurozone countries in particular may face additional challenges in the coming two years as they grapple with sovereign debt issues among "peripheral" countries such as Italy and Spain. We remain committed to international investments due to anticipated growth, diversification benefits and foreign currency exposure. We are slightly expanding exposure to the more volatile emerging markets and to international small company stocks with the addition of a new Vanguard fund: VSS – Vanguard FTSE All World Small-Cap. This fund was up 25.61% in 2010. Emerging economies are growing faster than developed nations and are not hindered by large amounts of debt.

US small company stocks outpaced large ones in 2010 with the Russell 2000 up 26.85% for the year. While this trend may continue, larger companies will likely hold up better to external shocks - this is one reason why we are maintaining our current weightings.

We have started to utilize new funds for US Large Value (PowerShares RAFI 1000), US Small/Mid Stocks (PowerShares RAFI US 1500), and



International Large Cap Stocks (Matthews Asia Dividend). We believe these value oriented funds use effective strategies to obtain exposure to their respective markets and outperform within their peer groups. We will replace existing funds with these funds in retirement accounts to avoid realizing capital gains, but may roll them out to all accounts in the future.

II. Hybrid Strategies

Role: non-traditional investment strategies intended to mitigate losses in down markets, while providing income and growth potential. Volatility/Risk: Moderate

Formerly referred to as "Reduced Risk Growth", this is a very broad asset class encompassing many strategies. The investments in this class use non-traditional approaches to reduce losses in down markets.

The managers in this category employ a variety of strategies including merger-arbitrage, covered call option writing, short sales and convertible security investment strategies. This combination of investments has less upside potential than regular stock funds in a bull market and more downside protection in a bear market. Compared to bonds, these investments have more growth potential and are more immune to the interest rate risk that causes bonds to lose value when interest rates rise. See the *Annualized Returns* graph on page two and note the relative returns during the 2007 to 2009 Recession/Financial Crisis.

In 2010 the Gateway Fund was up 4.83%, the Merger Fund 3.41%, and the Pimco All Asset All Authority Fund gained 10.67%. These funds employ complimentary strategies in pursuit of superior risk-adjusted returns. As a group, these funds played a role in mitigating losses during the crisis.

While the Gateway Fund provided significant downside protection during the crisis, it has struggled to meet our expectations on the upside. Much of this is due to the increased cost of its hedging and covered call-writing strategies. We decided to trim this position slightly, but expect that it will perform better as interest rates rise – particularly when compared to the bond market.

With mergers and acquisitions expected to pick back up with the economy, we expect the Merger fund to resume providing meaningful risk adjusted returns. We are trimming it slightly but still consider it a worthwhile holding.

The Pimco All Asset All Authority fund performed very well during the early part of 2010 in the face of a looming sovereign debt crisis. We are expanding this position slightly as the potential for external geopolitical shocks remain (such as a conflict between North/South Korea), and the market continues its upward trend.

We believe the additional holdings in this asset class such as convertible securities and high dividend yielding utility stocks still provide a solid risk/reward trade off; thus we continue to maintain these holdings.

III. Real Assets

Role: to provide capital appreciation and complimentary diversification relative to financial assets while also offering inflation protection. Volatility/Risk: High.

When real assets such as commodities and real estate are added to a diversified portfolio of stocks and bonds, they have been shown to reduce the overall long-term volatility of a portfolio. This beneficial effect is primarily due to the dissimilarity in patterns of returns of real assets (commodities) compared to financial assets like stocks and bonds; commodity returns fluctuate differently from stock and bond returns. The same events that hurt stocks, like higher energy costs, benefit many real assets. Furthermore, commodities provide some protection against inflationary shocks, which have the capacity to hurt both stocks and bonds.

The most widely owned real asset is real estate, including real estate stocks (REITs), and residential real estate. Unlike residential real estate, REITs had a fabulous year; the average gain exceeded 27.08 % in 2010.

We plan to bring this asset class back to its target allocation and at the same time may place a portion of clients' remaining domestic REITs into international REITS to add additional diversification. We are now including Vanguard Global ex-US Real Estate and Cohen & Steers International Realty in client portfolios and will selectively replace existing funds to avoid realizing large capital gains.

We hold commodities in most client accounts primarily through the Pimco Commodities Real Return Strategy fund. Depending on client variables, we may also include other alternative natural resource and commodity investments.

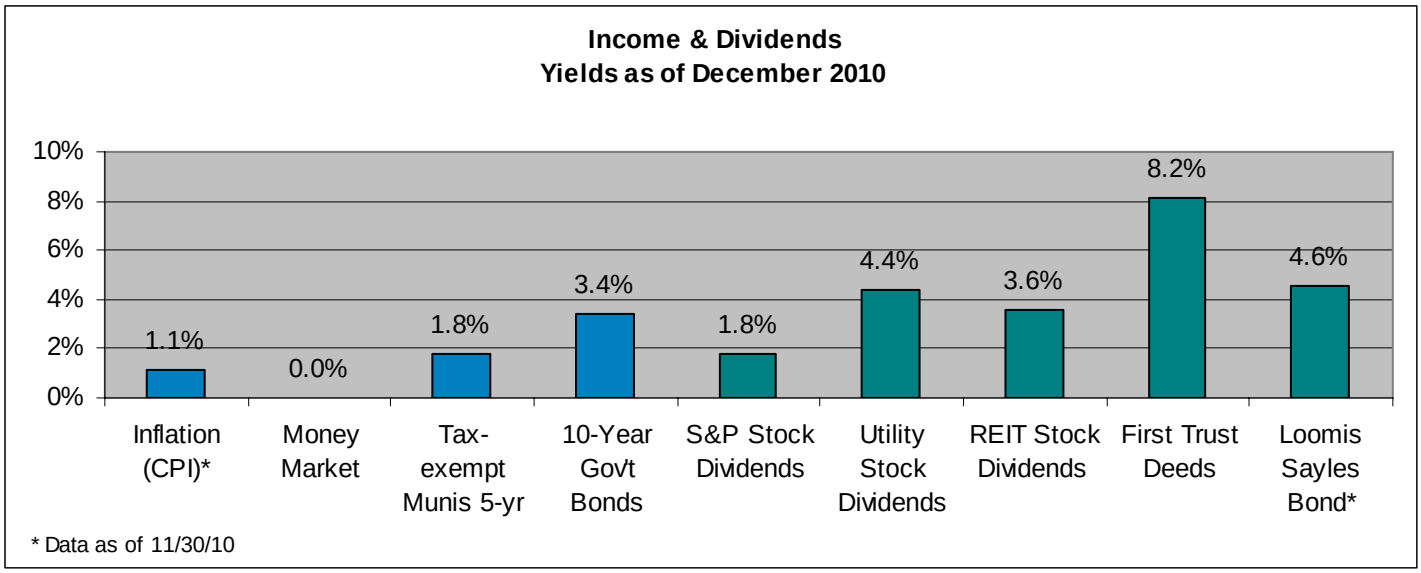
Rising precious metals and agricultural products have boosted returns of commodity funds. One reason we include commodities in client portfolios is the often negative correlation with other asset classes; in colloquial terms, it is not unusual for commodities to zig when other investments zag.

Studies have shown that combining asset classes with low return correlations reduces overall portfolio risk and may increase returns over the long term.

IV. Fixed Income

Role: to provide an income stream and a cushion to reduce overall portfolio risk. Volatility/Risk: Low to Moderate.

Bonds typically hold up well when equities decline as we saw in 2008-9. However, when interest rates rise bonds can post negative returns in the short run. We



continue to hold bonds in client portfolios to mitigate economic and geopolitical risk. High quality bonds and First Trust Deeds are the most defensive investment in most portfolios, serving a prudent risk-reduction role. Note on the *Annualized Returns* graph on page two that the recession and financial crisis had a minimal impact on these assets.

At the same time, wise investors understand that all investments have some degree of risk. In fact, even "risk-free" U.S. Treasuries often lose money after adjusting for the negative impact of both taxes and inflation.

The benefit of principal conservation provided by fixed income assets must be weighed against expected returns given the coming headwind of rising interest rates. Bond funds which have a flexible mandate and experienced management will be needed to provide the balance of income and principal preservation that investors demand. Two such funds we use that continue to meet our expectations are the Pimco Total Return and Loomis Sayles Bond funds which were up 8.83% & 13.58%, respectively in 2010.

We also continue to recommend the First Trust Deed pool for many client portfolios in lieu of high quality bond holdings. This pool has continued to provide an excellent yield during the recession of approximately 8.2% and can still be redeemed at 100 cents on the dollar.

We continue to believe it makes sense to keep some of our clients' bond allocations in non-dollar denominated bonds due to the potential for further drops in the relative value of the US dollar. We are considering switching to a longer maturity emerging market bond fund but prefer to do this on weakness in these markets

Note that several variables influence clients' bond portfolio composition, including income needs, tax brackets, risk tolerance and the relative size of one's taxable and tax-deferred (IRA and other retirement) investment accounts.

Summary Perspective

As globally diversified investors, our clients, experienced strong investment returns in 2010, once again proving the benefits of strategically diversified holdings. Exceptional returns were earned with US Equities, Emerging Market Equities, Commodities and REITs.

The CBOE Volatility Index closed the year at 17.75 just below the median 19.48 – we believe this reflects the consensus opinion that we will not experience a "double-dip" recession and will benefit from solid GDP growth in the year ahead – thanks in part to the tax relief act signed last December. Despite this consensus, it would not be unusual to see stocks do the "Wall Street Two Step" and take a step back in 2011.

Every January, many very intelligent, bullish advisors and investors say the stock market is undervalued and poised for a continued rebound; while other equally intelligent, bearish investors say it is overvalued and due for a correction.

The **bullish** investors cite the following reasons for their forecast:

- Stimulus from the recently signed tax relief act will boost economic activity.
- Corporations are sitting on record levels of cash that eventually will be invested.
- Consumer sentiment/confidence is stable, setting things up for improvements in 2011.
- The Fed is continuing its quantitative easing program and is not expected to raise interest rates for another year.
- The extra slack in the economy will keep inflation

under control in the near term.

At the same time, **bearish** investors take the other side and cite competing reasons for their forecasts:

- Record high public sector debt and unfunded entitlement programs remain and difficult budget decisions will need to be made.
- Policymakers have done little to reform structural problems, and have 'kicked the can down the road' with the recent tax relief act.
- High unemployment persists and housing is still weak.
- Potential policy coordination problems in the Eurozone compound the already troubling sovereign debt situation.
- High inflation in emerging economies may result in market instability.

No one has a crystal ball. Each year some forecasts are right while others are wrong. By definition, the future is uncertain and often unpredictable with surprising and unexpected events. The only certainty is that it's always wrong to make big, risky bets on any forecast.

Instead, a balanced, prudent approach helps assure investors of the success they desire, downside protection and upside participation. By strategically combining a variety of investments and periodic rebalancing we can achieve significant investment rewards.

History demonstrates that investors with the discipline to maintain intelligently diversified portfolios and the patience to let diversification work over time achieve their financial goals with less effort and minimal stress. We take great satisfaction in helping our clients do just that.

As always, we encourage you to call anytime with questions or to apprise us of changes that may affect your financial objectives. Once again all of us here at Financial Alternatives, Inc. wish you and your family the very best in 2011.

Past performance is no guarantee of future results. All content in this newsletter is intended as general information, not specific advice. Performance data listed is for illustrative purposes only. Portfolios are personalized and often consider many variables, including investment objectives, age, time horizon, risk tolerance, and tax variables. Information contained herein has been obtained from sources believed reliable, but not guaranteed.

Financial Alternatives, Inc.

7734 Herschel Avenue / Suite L
La Jolla, CA 92037
Phone: (858) 459-8289
Fax: (858) 459-8258

jim@financialalternatives.com
chris@financialalternatives.com