

Quarterly Report and Commentary

April 2011

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Portfolio Rebalancing

Rebalancing your portfolio is an ongoing process. When we mutually created your Investment Policy Statement (IPS), we considered a number of factors. These included: the risks you were willing or unwilling to take, the objective of the portfolio (such as growth, income, preservation, leaving a legacy), and the time frame to achieve these goals.

We then used a fairly sophisticated group of programs to arrive at a mix of as many as 20 asset classes to include in your portfolio. Examples of asset classes include: domestic large or small or mid-cap funds, international classes, and long or short fixed income investments. The result is a target portfolio designed specifically for you.

Some of the investments in your account will perform better than others. They should. International small cap value funds have historically outperformed domestic large cap growth funds. They also are more volatile and have greater risk from one quarter to the next. Should I mention Tsunami? We do not weigh each asset class the same. Generally, large cap domestic funds receive the biggest percentage allocation of your equity funds, and real estate asset classes are among the smallest.

Rebalancing is restoring your asset mix to your original target allocation (unless personal considerations have changed). We don't micro-manage these changes, and look for a discrepancy of 10% or more from the target mix before we rebalance. For example, if large cap value funds are a 15% target we may not rebalance if, because of appreciation, they are now 22% of your portfolio, but we may rebalance if the percentage hits 25%. The underperforming asset classes, of course, receive some or all of this money.

This is where naïve investors put their foot in their wallet. Frequently, do-it-yourself investors base investment decisions on emotion. Emotional decision-making often results in selling underperforming asset classes and adding funds into the best performing ones. Emotions may also cause someone to sell during historical market lows and buy during raging bull markets – thus the phrase “buy high and sell low”.

These emotional responses are one reason, according to a University of Michigan study, that investors may find their investments significantly underperform average market returns. The U of M study found that, over a 20 year period, the return investors had achieved by attempting to time the market was 55.2% less than fund returns over the entire period. Worse yet, in a recent four-year period, the study showed that an average fund generated a 5.7% annual return while the average individual investor earned just 1%.

Fixed Income Management

Pity the souls who retired early and expected to live comfortably on their fixed income portfolio. Current yields for two-year investment grade corporate bonds are around the 1.25% level and sell at a premium to the maturity price. A May 2013 Toyota bond yields 1.24%. Interim maturities don't fare much better. An investment grade Procter & Gamble bond maturing November 2015 yields only 2.4%. Even many junk bonds of 2015 yield less than 3.5%; in our opinion, not worth the risk.

Unfortunately, there isn't much of a yield on corporate or government maturities of ten years or less. Those investors who "need" yield may take significant market risk if rates rise. A 20 year 5% bond will decline nearly 15% in face value if yields rise to 6%. If inflation does return within the next 24-30 months, long-term bond buyers could see significant erosion of their principal. Will the growing national debt, officially listed at about \$14 trillion, force us, as a country, to pay more to borrow? No one knows exactly, but our bet is that inflation in 2013 will be higher than the current core 1.1%. We are keeping your bond maturities short term.

Prolonging Life

As many of you know, my wife has Multiple Sclerosis. She gets around for a few hours a day in a battery operated wheelchair. Kathleen tried some of the MS drugs, but they are primarily for the relapsing/ remitting MS patient. She has progressive MS and has not found meaningful benefit from taking the \$300-\$400 a day drugs that are currently available. Even though the cost was paid for by our insurance, she opted out of using them.

But what do you do if you have metastatic melanoma? Bristol-Myers announced in late March that the FDA had approved YERVOY for treatment of inoperable melanoma. The median overall survival rate was 10 months vs. 6 months without the drug. The 2 year survival rate is estimated at 24%. The treatment is four infusions given over three months at a cost, according to Bristol-Myers, of \$120,000.00.

Perhaps you are noticing that many drug prices are on the increase. The MS drug Copaxone has recently increased by 50% (from about \$30K per year to \$45K). Your insurance company is currently paying for these drug price increases. I really can't fathom how much our health insurance premiums may rise as a result. If the price trends continue, many folks will be paying more for health insurance than they do for their mortgages, unless they defaulted on their mortgages. What happens when they are forced to default on their health insurance payments?

I am older than Derek, Dawn, and Sue and wonder what price we would be willing to pay to prolong our lives for five or six months. (Fortunately, we have no known needs to do this.) It is a rhetorical question. Do the drug companies benefit, do lobbyists benefit, do our elected officials get more PAC contributions? Just food for your thoughts!

No Pattern for Emerging Market Returns

Equity Returns of Emerging Markets

Annual Return (%)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Highest Return	Russia 152.92	Turkey 118.05	Korea 141.15	Turkey 252.41	Czech Rep. 1.62	Russia 55.85	Czech Rep. 44.16	Thailand 144.56	Colombia 132.95	Egypt 161.59	China 82.87	Peru 94.74	Morocco -10.87	Brazil 128.62	Thailand 56.27
	Hungary 107.21	Russia 112.12	Morocco 24.57	Russia 247.06	Poland -4.04	Korea 48.71	Indonesia 42.83	Turkey 125.88	Egypt 126.23	Colombia 107.52	Indonesia 74.83	Brazil 79.99	Colombia -25.10	Indonesia 127.63	Peru 53.35
	Egypt 58.86	Hungary 95.21	Philippines 13.45	Malaysia 114.33	Brazil -11.37	Colombia 45.77	Hungary 30.69	Brazil 115.01	Hungary 92.49	Russia 73.77	Morocco 68.58	Turkey 74.81	Chile -35.37	Russia 104.91	Chile 44.81
	Poland 58.88	Mexico 53.92	Thailand 11.56	Indonesia 93.46	Chile -15.14	Peru 19.92	Peru 30.50	Peru 94.32	Czech Rep. 87.25	Korea 58.00	Peru 62.55	India 73.11	South Africa -37.89	India 102.81	Colombia 43.41
	Brazil 42.50	Colombia 41.76	Czech Rep. 0.54	Korea 52.42	Malaysia -15.95	Mexico 18.55	South Africa 27.99	Egypt 91.84	Poland 61.52	Brazil 57.05	Philippines 59.65	China 66.24	Peru -40.11	Turkey 98.49	Malaysia 37.01
	Taiwan 40.30	Morocco 35.46	Poland -6.69	Egypt 88.40	South Africa -17.19	Taiwan 10.47	Thailand 27.59	China 87.57	Indonesia 52.21	Turkey 56.94	Russia 55.93	Egypt 58.43	Chile -41.21	India 86.73	Philippines 35.49
	China 37.46	Egypt 31.23	Hungary -8.16	India 87.35	Mexico -20.49	Thailand 5.25	Colombia 25.36	Chile 84.41	Mexico 48.32	Mexico 49.11	India 51.00	Czech Rep. 55.93	Czech Rep. -42.76	Colombia 84.35	Indonesia 34.62
	Turkey 36.90	Brazil 27.34	Taiwan -20.64	Mexico 80.07	Morocco -21.55	Malaysia 4.56	Russia 15.71	India 78.36	South Africa 44.91	Czech Rep. 46.20	Brazil 45.80	Indonesia 55.03	Mexico -42.94	Taiwan 80.25	South Africa 34.21
	Morocco 36.08	Peru 20.50	India -21.24	Brazil 87.23	India -21.74	Czech Rep. -2.01	Korea 8.62	Indonesia 78.20	Turkey 42.03	India 37.57	Poland 41.93	Morocco 48.15	Taiwan -45.88	Hungary 77.81	Mexico 27.81
	Czech Rep. 30.52	India 11.27	Egypt -27.00	South Africa 57.20	Peru -23.82	Chile -2.83	India 8.38	Russia 75.94	Brazil 36.47	Peru 35.00	41.44	Thailand 46.63	Thailand -48.27	Thailand 77.31	Korea 27.15
	Indonesia 27.51	Chile 5.62	South Africa -27.56	Taiwan 52.71	Hungary -26.80	Indonesia -8.49	Egypt 1.59	Colombia 66.93	Chile 29.01	South Africa 28.34	Malaysia 37.14	Malaysia 46.07	China -50.83	Korea 72.06	Taiwan 22.73
	Malaysia 25.55	Taiwan -6.29	Chile -28.50	Thailand 47.16	Russia -30.03	Hungary -9.16	Poland 1.26	Czech Rep. 66.20	Philippines 26.58	Poland 24.98	Czech Rep. 34.69	Philippines 41.68	Philippines -51.87	Peru 72.06	Turkey 21.24
	Mexico 18.70	South Africa -8.18	Malaysia -30.81	Chile 39.01	China -30.54	Morocco -13.70	Malaysia -0.66	Morocco 49.03	Korea 22.86	Philippines 23.92	Hungary 33.70	Korea 32.58	Egypt -52.35	Philippines 67.98	India 20.95
	Philippines 17.75	Poland -22.39	Indonesia -31.53	Poland 31.50	Colombia -38.85	Brazil -16.99	Morocco -8.42	South Africa 45.86	Chile 22.56	Chile 21.62	Poland 29.33	Chile 25.79	Poland -54.49	China 62.83	Russia 19.40
	Colombia 11.08	Czech Rep. -22.69	Mexico -33.53	Peru 18.88	Egypt -43.71	South Africa -17.21	Mexico -13.31	Philippines 42.76	India 19.11	China 19.77	Taiwan 20.90	Russia 24.79	Korea -55.07	South Africa 57.82	Poland 15.86
	Peru -0.47	China -25.25	Brazil -39.82	China 13.33	Taiwan -44.90	Philippines -19.29	China -14.05	Taiwan 42.55	Malaysia 15.17	Hungary 18.50	South Africa 20.53	Chile 23.68	Brazil -58.06	Mexico 56.63	Morocco 15.33
	India -2.17	Philippines -62.59	Peru -40.22	Hungary 11.66	Philippines -45.01	India -19.45	Korea -19.81	Chile 35.94	Taiwan 9.83	Indonesia 15.78	Egypt 17.08	South Africa 18.14	South Africa -56.20	Malaysia 52.06	Egypt 12.42
	Chile -13.54	Korea -66.67	Colombia -41.71	Czech Rep. 5.35	Turkey -45.65	China -24.70	Taiwan -24.45	Poland 35.48	Russia 5.69	Morocco 13.97	Colombia 13.76	Hungary 16.80	Hungary -61.53	Poland 42.51	Brazil 6.81
	South Africa -18.06	Malaysia -67.96	China -42.37	Philippines 3.32	Korea -49.62	Poland -27.44	Philippines -28.98	Mexico 32.81	Peru 3.16	Thailand 9.16	Korea 13.19	Colombia 15.00	Turkey -62.10	Egypt 39.74	China 4.83
	Thailand -36.59	Thailand -73.43	Turkey -52.51	Morocco -11.92	Thailand -56.27	Turkey -32.66	Brazil -30.65	Hungary 32.31	China 1.89	Taiwan 7.25	Thailand 11.61	Mexico 12.15	India -64.63	Czech Rep. 27.77	Czech Rep. -1.66
Lowest Return	Korea -38.14	Indonesia -74.06	Russia -32.99	Colombia -14.38	Indonesia -61.90	Egypt -41.30	Turkey -35.70	Malaysia 26.61	Thailand -0.92	Malaysia 2.29	Turkey -6.97	Taiwan 9.13	Russia -73.83	Morocco -4.98	Hungary -9.58

Source: MSCI emerging markets country indices (gross dividends) with at least fifteen years of data. MSCI data copyright MSCI 2011, all rights reserved. Indices are not available for direct investment. Index performance does not reflect expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.

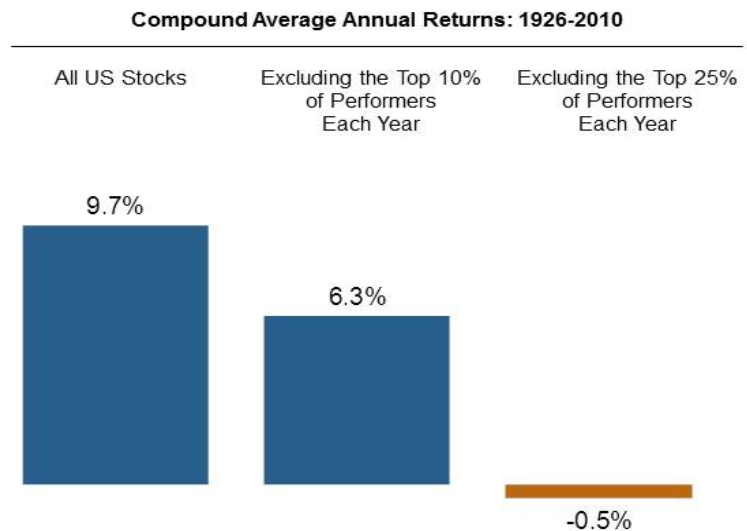
The above table ranks annual stock market performance for 22 different emerging markets. Notice the unpredictability of country year by year returns. This is another reason to invest in the emerging markets asset class as opposed to trying to pick which country will be this year's winner. Investors who follow a structured, diversified strategy and periodically rebalance to their targeted strategy are more likely to capture the returns, wherever they happen to occur.

Not all stocks rise with the tide

The following study was done by The Center for Research Security Prices at the University of Chicago. It covers an 84 year time period. I've never seen a chart like this before. On a long term basis, the top quartile of stocks account for almost all of the market's return. That explains why the majority of active fund managers underperform their index – it is impossible to reliably identify these top performers before the fact. This is another reason for broad asset class diversification and maintaining one's asset allocation through periods of uncertainty.

Missing Opportunity

- Strong performance among a few stocks accounts for much of the market's return each year.
- There is no evidence that managers can identify these stocks in advance—and attempting to pick them may result in missed opportunity.



Results based on the CRSP 1-10 Index. CRSP data provided by the Center for Research in Security Prices, University of Chicago.

Potpourri

I am more than pleased with the geo-thermal heating and a/c we installed a year ago. It looks like it will pay for itself in about 4-5 years. Sue Shank, our Operations Manager, is celebrating 6 months with us. We are lucky and pleased to have her. Have a wonderful Spring!

John, Derek, Dawn and Sue