ROCKWOOD WEALTH MANAGEMENT

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THE FOLLY THAT IS UNCOMPENSATED RISK

While economic and market volatility have been on the forefront of many investors minds in recent times, we think it's time to step back and revisit why your investment portfolio is engineered in the manner that it is. The mark of a professional advisor is that he or she focuses upon aligning a client's assets with their goals and ensures that the client earns the returns to which they are entitled for the risks that they bear. In the course of that alignment, we have worked systematically to eradicate any sources of uncompensated risk in your portfolio.

Uncompensated risk rears its ugly head in many forms—here is just a small sampling:

- Large positions in a single stock.
- Over-concentrations in a particular sector (i.e. biotech, energy, etc).
- Undue weighting in a particular country or countries.
- Fixed income that contains excessive credit risk or interest rate risk.
- Too many highly correlated assets or duplicate holdings.

Avoiding these types of risk while positioning your portfolio to harness the greatest risk-adjusted returns is accomplished via structured investing. Structured investing means using institutional asset classes designed to capture market rates of return and provide quantifiable diversification. We use consistently maintained market segments of multiple asset classes to diversify globally, invest in thousands of securities, and invest in high-quality short-term fixed income instruments.

So what?

Let's put that practice to test in the real market and see what it means to you. We wanted to relate a recent and relevant time period where structured investing, meaning adhering to a consistently maintained portfolio of asset classes, has served to benefit you substantially.

It is perfectly reasonable to assume the following: The asset classes of **Global Real Estate**, **Emerging Markets**, and **Value stocks** (those companies with weaker balance sheets), will lag the rest of the equity market as a recovery unfolds. The global companies that derive their revenue from the sale or operation of real estate will have to wait for real estate prices to recover before they prosper, emerging market economies lack the cash reserves and capital raising ability to lead a recovery, and value companies struggle to find financing for their operations in a tight credit market. Surely, that makes perfect sense.

If your strategic investment plan was not anchored with a structured investing

methodology, you would be likely to exclude these three asset classes from your portfolio because common sense and intuition tells us to do just that. Maybe we would even be tempted to exclude stocks all together?

Global stock prices have moved decisively higher from their low point in early March despite an avalanche of discouraging financial news. It would be premature to announce the beginning of a new bull market, but the dramatic recovery over the past two-months offers a powerful illustration of the unpredictable nature of stock returns. The table below lists the results for the two-months ending April 2009 for Dimensional equity mutual funds with fifteen years or more of data. You will want to pay particular attention to the asset classes that common sense would have told you to exclude from your portfolio.

Two-Month Return as of April 30, 2009 vs. Rolling Two-Month Returns since Inception

Dimensional Portfolio by Asset Class	Inception Date	Number of Two-Month Periods	Total Return (%)	Rank[1] see explanation below
Real Estate Securities	01/05/1993	194	35.95	1
US Small Cap Value	03/02/1993	192	32.10	1
Emerging Markets	04/25/1994	179	31.36	1
International Value	02/15/1994	181	31.22	1
US Small Cap	03/19/1992	204	30.78	1
US Micro Cap	12/23/1981	327	28.63	2
US Large Cap Value	02/19/1993	193	27.61	1
US Large Company (S&P 500)	12/28/1990	219	19.13	1

[1]Rank of the latest two-month return against all two-month periods in the portfolio's history. Past performance is no guarantee of future results.

Structured investing works because it captures market returns while minimizing volatility for a selected level of risk. It prevents investors from missing the returns we are due by providing portfolio discipline and risk control to avoid making the wrong decision at the wrong time.

To be fair, we should offer a real world example of the introduction of active management and uncompensated risk and demonstrate how it can magnify losses in a troublesome market. We are not suggesting that experts always fail when it comes to forecasting the future. After the fact, we can always see that some got it right and some got it wrong.

FISHER INVESTMENTS
Read Ken Fisher's Exclusive Report
Forbes "Portfolio Strategy" columnist reveals his Stock Market Outlook
FREE! Click Here
just published

There is no better real-world example of uncompensated risk than the king of self-aggrandizing, Ken Fisher. He is also known as the Fisher Investments CEO, Forbes Columnist and Bestselling Author. You cannot have helped but to see an advertisement for his firm since he markets with the subtlety of a full volume, no-money-down, late night infomercial.

In early 1995, at a time when almost all major investment strategists were offering gloomy predictions on stocks for the year, Fisher said that year will shock everyone with a huge run up in prices. He was *absolutely right*; at the time, it was the best year since 1958 for the S&P 500. Apparently, he is one of the gifted few that can predict turn in the market. It makes sense then, that while we are all wondering which way the market will go, we should tune into Mr. Fisher to see what we should do with our nest egg.

In late 2007, he was telling us that the credit crunch was phony and would be forgotten in a few months. *"Don't you be fooled by the unrest in the market. This is a speed bump. Time to buy stocks, in Asia."* says Fisher in his Forbes Magazine article in September of 2007. The rest of 2007 was not as spectacular as he had postulated. To his credit, in his Forbes column in early January of 2008, he admitted his forecast was off the mark.

However, his amplifying folly was to insist that 2008 would still be a good year for stocks, though foreign stocks would do better than US stocks. It turns out that, as we know that 2008 was a dismal year for stocks, and US stocks outperformed international stocks. In that same column, he selected **one stock** for investors to buy in order to participate in the US stock market. That one stock was *American International Group*, know better as *AIG*. It was also the **single worst performing stock in the entire S&P 500** index for the year. AIG stock lost 97% in 2008.

Comically, we cut and pasted the image to the right and the text in blue below from the Fisher Investments Website:

Mistakes Can Seriously Reduce Portfolio Value Over Time
Common mistakes can add up. Ultimately they diminish the value of your portfolio. If you can learn what the most common mistakes are and how to avoid them, you can begin reducing your error rate and improving your overall success.

All poking fun aside, Ken Fisher is not an unintelligent person. He was not truly brilliant in 1995 and suddenly moronic in 2007 & 2008. Fisher Investments has billions of dollars of high-net worth investors' money. Our point is that he, like everyone else, is as likely to choose the worst of 500 stocks as he is likely to choose the best. Just like all of us (should we be foolish enough to try), he is as likely to choose the worst time to "jump in" the market as he is to choose the best time. Making short-term market and short-term stock predictions leads to uncompensated risk. You cannot afford a **-97%** return—no one can. As careful stewards of our clients' assets, we are dismayed with the frequency with which reckless predictions are proffered to those who are unable to distinguish professional advice from wanton speculation.

In the end, uncompensated risk is the archenemy of well-educated, well-advised, and patient investors whose focus is squarely on their goals. That notion is precisely why we work so hard to ensure your portfolio is designed to eliminate risks for which you are not compensated in the form of expected higher long-term returns.

THE INTRINSIC VALUE OF A TAX LOSS

Tax loss harvesting is an often overlooked; yet crucially important component of wealth building. If you are not familiar with the basics of tax loss harvesting, it is the systematic process by which careful planning can reduce income taxes without substantially disrupting your portfolio allocation.

When an investment is sold for less than you paid for it, you realize a capital loss. We use those capital losses to offset—or net out—capital gains in your portfolio to reduce your tax bill. Capital losses are deductible dollar-for-dollar against capital gains. Moreover, individuals may deduct up to $3,000 in capital losses each year against their taxable income. That means in addition to netting out any like capital gains, a high-income taxpayer in the 35% marginal federal income tax bracket saves $1,050 per year until the capital losses are exhausted. While no one likes losses in their portfolio, those losses have a real economic value that must be harvested in the pursuit of responsible wealth management.

We use three pieces of information to ensure proper harvesting of losses:

1. What are your unrealized gains/losses in investments you are still holding?
2. What are your realized gains/losses to date?
3. Do you have any losses from prior years that has yet be completely netted out by gains? (These are called capital loss carryforwards).

As we rebalance your portfolio to maintain the risk/return characteristics outlined in your investment policy statement, it is those loss carryforwards that help reduce future tax liabilities. For example, when one asset class exceeds its required weighting in your portfolio, we will need to pare back that position for diversification reasons. Selling shares of that security at a gain would normally invoke capital gains taxes due—but, loss carryforwards from previous years could net out those gains helping us rebalance your portfolio in a tax-efficient way.