

Investment Perspective

First Quarter 2004

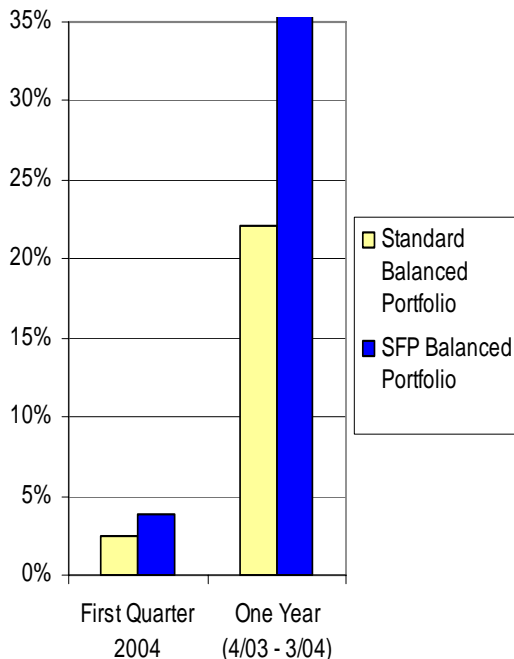
“In mathematics you don’t understand things. You just get used to them.”-- [Johann von Neumann](#)

SFP Core Strategies*	Quarter 1	
	2004	One Year
US S&P 500 (Enhanced)	1.93%	35.42%
US Large Value	3.90%	48.00%
US Micro Cap	6.46%	78.19%
US Small Value	7.37%	85.24%
US Equity Real Estate	12.01%	49.45%
International Large Value	7.24%	74.03%
International Small Cap	13.11%	79.84%
International Small Value	13.95%	89.95%
Emerging Markets	7.01%	77.24%
Emerg Mkts Small Cap	9.12%	88.90%
Emerging Mkts Value	10.77%	98.40%
Ultra Short Fixed Income	0.54%	1.63%
Shrt/Inter Global Fixed Inc	3.78%	4.76%
SFP Model Portfolios		
SFP Income Portfolio	3.84%	24.57%
SFP Balanced Portfolio	4.71%	36.08%
Non SFP Std Balanced	2.52%	22.44%
SFP Aggressive Growth	5.55%	48.59%

The year had a nice start with the Dow marching up from a value of 10,454 to reach 10,737 by mid-February. Unfortunately, these gains were short-lived, as they were erased by the remaining trading sessions. The Dow ended the quarter at 10,358, down by about 97 points. Similarly, the NASDAQ Composite was unable to maintain the beginning-of-the-year-levels just above 2,000, ending the quarter down 9 points. The bright spot for the major indexes was the S&P 500, which was able to close out the quarter with a gain of just over 1-1/2 percent. In general, it was a fairly subdued quarter for the widely followed U.S. market segments.

Fortunately, SFP portfolios fared much better due to broader exposure to the world’s capital markets. Our small cap, value, real estate, and foreign exposures paid off handsomely, with many individual holdings returning in excess of 10 percent. The SFP Balanced Model Portfolio was up 4.71 percent (see figures below). While not as exciting as recent quarterly returns, this translates into a terrific annualized return of 20.23 percent. Considering the portfolio’s moderate exposure to stocks (60 percent), we are especially pleased with these results. Additionally, the portfolio nearly doubled the 2.52 percent return of the similar standard balanced portfolio that your neighbor is likely to hold. No advisor expects out-performance every quarter, but we are nonetheless delighted. The one-year returns are even more exceptional. Take a look (and please don’t pinch me).

Standard Balanced vs. SFP Balanced



As IRA and retirement-plan season wraps up, many investors are wondering where to put new money. While we do not think there is a one-size-fits-all answer to this, we can address some concepts we use to build your portfolios and add new positions.

A truly free lunch may not exist, but applying one principle in investing comes close. It's quite simple: Given the same average return, a portfolio with lower volatility will provide a higher actual realized return. This may sound confusing at first, but take a look at the following straightforward illustration:

Table 1

	Year 1 Return	Year 2 Return	Average Return	Total Return (2 yr)
Investment A	10 percent	10 percent	10 percent	21 percent
Investment B	30 percent	-10 percent	10 percent	17 percent

Both Investment A and Investment B have the same average annual returns, 10 percent. However, if you invested \$100 in each, Investment A would have left you with \$121 while Investment B would have returned only \$117. Why? Investment A's returns do not fluctuate as much from year to year - they are less volatile. Feel free to put in your own numbers in to further demonstrate this principle. As long as the average returns are equal, the actual money in your pocket will be greater with the less volatile portfolio.

In fact, let's look at the actual historical results below to see this. We will use two of our strategies with the same average returns over a 10-year frame, from 1994 through 2003. As you can see, the Real Estate fund with identical average returns, but lower volatility, had a higher realized return.

Table 2 1994 - 2003

	Avg Annual Return	Volatility (std dev)	Realized Return	Value of \$1 Invested
Real Estate Port.	12.1 percent	17.6	10.8 percent	\$2.79
Emerg Mkt Value	12.1 percent	37.8	7.2 percent	\$2.00
Average	12.1 percent	27.7	9 percent	\$2.40

While this is all interesting, we're still left with a fundamental problem. We do not know future returns or volatility. However, we do know that by combining diverse investments and holding them in equal weights, volatility will be dampened. This is a mathematical certainty. Let's expand our example to understand this a little better.

It is now 1994 and an investor is trying to decide between the investments above. The investor may choose Real Estate, which will return \$2.79, or Emerging Markets that will return \$2. Since the investor does not know the future, we would expect the investor to earn \$2.40, the average of both. However, our investor understands the above principle, ignores experts recommending the "best" choice, and instead chooses 50 percent in each fund, rebalancing quarterly. Here are the results:

Table 3 1994 - 2003

Avg. Annual Return	Volatility (Std Deviation)	Real Return – Annualized	Value of \$1 Invested
12.1	19.1	10.1	\$2.61

Our investor earns \$2.61. The average return for the two investments is \$2.40, but the combination of the two earned an extra 21¢, a full 1.1 percent higher realized return. I can assure you the figures are correct. While the extra 21¢ may not seem exciting, consider this. With only \$100,000 invested during a 30-year time period, a 9 percent return would provide \$1,326,800, while 10.1 percent would return \$1,793,200 - an extra 35.2 percent, or \$466,400. Now this is a free lunch to enjoy!

While there is not a simple answer to where new money should be deployed, adding diversity and rebalancing is a step in the right direction. The more diverse (less correlated) a new position is to an existing portfolio, the greater the above effect will be. This is part of the rationale for adding some of the less common positions to SFP portfolios and it's one way we strive to serve you, our long-term investors, in endeavoring to realize your financial and life goals.

Best wishes for renewal and growth this spring ,

Brian J. Skaggs, CFP

The information in this newsletter should not be construed as investment advice. Investment advice is only given in the context of individualized interactions that ideally result in the development of a continually evolving financial plan. *Total returns as measured by the performance of associated DFA funds - advisor fees not included in strategy performance. Advisor fees are not subtracted from model portfolio performance. This information is believed to be reliable, but we do not guarantee the accuracy of the information. **Past performance is not an indication or guarantee of future performance.**