

Investment Perspective

Second Quarter 2006

“There are risks and costs to a program of action. But they are far less than the long-range risks and costs of comfortable inaction.”-- [JFK](#)

SFP Core Strategies*	Quarter 2	
	2006	One Year
US S&P 500 (Enhanced)	-1.69%	7.22%
US Large Value	1.79%	15.77%
US Micro Cap	-7.11%	15.48%
US Small Value	-3.40%	19.77%
US Equity Real Estate	-1.49%	20.48%
International Large Value	0.10%	31.08%
International Small Cap	-2.46%	27.97%
International Small Value	-2.70%	28.16%
Emerging Markets	-6.45%	28.84%
Emerg Mkts Small Cap	-7.53%	28.16%
Emerging Mkts Value	-3.95%	37.52%
Ultra Short Fixed Income	1.09%	3.34%
Shrt/Inter Global Fixed Inc	0.88%	0.45%
SFP Model Portfolios		
SFP Income Portfolio	-0.24%	8.18%
SFP Balanced Portfolio	-0.93%	11.70%
Non SFP Std Balanced	-0.98%	4.19%
SFP Aggressive Growth	-1.51%	15.30%

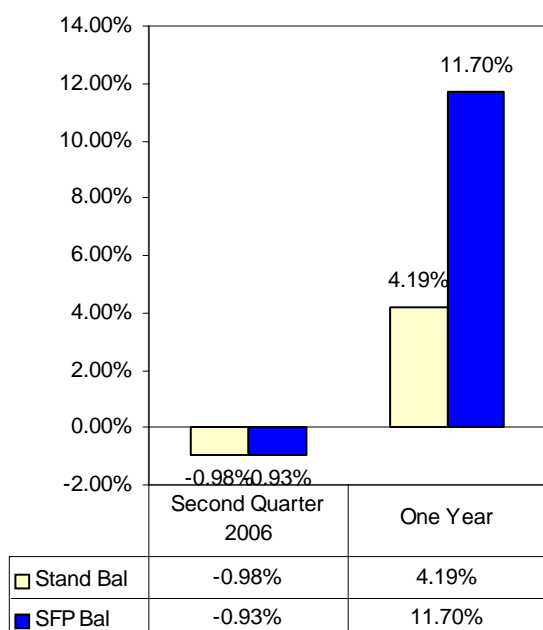
With investing there are always risks, and we certainly felt that during the second quarter of 2006. But while we took a little heat, we certainly weren't singed by the flame.

Ben Bernanke took over the reigns of the Federal Reserve from Alan Greenspan in February and appears poised to continue raising interest rates, perhaps a bit more than the market was expecting. Along with continued inflation fears - driven mainly by high energy prices and a few signs of a slower economy - market volatility was up and stock performance was poor. This led to a decline of our model portfolios for the quarter. Despite some of the volatility, though, any negative overall results were fairly mild. This ranged from a loss of 0.24 percent for the SFP Income Portfolio to 1.51 percent loss for the SFP Aggressive Growth portfolio. (See the performance table.)

Most of the individual strategies that make up our portfolios sustained losses and reflected the volatility typical of the later part of the quarter. U.S. large value stocks were the only bright spot, returning 1.79 percent, a 7.34 percent annualized return - not too bad. U.S. small stocks lost some of their luster as they declined just over 7 percent, as compared to a loss of about 1.5 percent for large U.S. stocks (as measured by our associated strategies). This was the first underperformance by small stocks since the first quarter of 2005. In fact, the second quarter of 2006 looked much like the first quarter of 2005 except that the international companies participated in the losses.

This was particularly true in the historically turbulent emerging markets. They were lower by about 7 percent as well. They haven't experienced a losing quarter in the last two years, however, and have returned over 85 percent since then! With the profits we have taken off the table in this area during the last two years, we're not complaining about the 7 percent drop off. Besides, we really can't complain given our overall portfolios' relative stability.

Standard Balanced vs. SFP Balanced



With our relatively strong focus on small companies and our significant international weighting, one would expect our SFP portfolios to be relatively weak. However, they continued the two-year streak of out-performance (but just barely). As you can see from the performance table, the SFP Balanced portfolio eked out a 0.05 percent advantage by declining 0.93 percent, versus 0.98 percent for the Standard Balanced Portfolio. This was due to a relatively strong tilt toward value stocks and also the relatively short maturities in our bond portfolios, which insulated us against some losses caused by inflation fears.

The out-performance during the trailing one year are still phenomenal at 11.70 percent for the SFP Balanced Portfolio, versus 4.19 percent for the Standard Balanced Portfolio (see the relative performance chart), and year-to-date performance is still strong at 5.1 percent (not shown).

As investors, we recognize that there will always be volatility, but we often underestimate the downside potential. For example, if you had made a \$1 million investment in a conservative portfolio evenly split between 5 year Treasury Notes and the total U.S. stock market (CRSP Market Index) in November of 1968, six years later in 1974, the nominal value of your portfolio would only be \$70,000 higher, about a 1 percent annual return, less taxes. During this time you would have experienced quarterly losses as much as 10.73 percent and annual losses as high as 19.73 percent. And remember: this is a portfolio with only 50 percent invested in stocks. Most of us invest more aggressively.

But in fact, we are subject to many different types of risk; there is Market Risk, Timing Risk, Tracking Risk, Default Risk, Interest Rate Risk, and Currency Risk to name a few. So let's say you just gave up on the markets, put your \$1 million in a very safe coffee can and buried it in a secure place. Six years later, you dug it up to find the full \$1 million and felt relieved you never had to deal with all that risk. Then you go spend it, though, and you have a rude awakening. With the inflation that occurred from November of 1974 through October of 1976 (based on the CPI), your \$1 million in 1980 has the same purchasing power as \$575,000 in 1974. You lost nearly half of your money, and considering that deflation has been virtually nonexistent since the 1930s, you were essentially guaranteed a loss the moment the money was buried.

While this is an extreme example, most of us overlook this risk primarily because it does not show up on any statements. Here's another area to think about: we also takes risks because we underestimate our life expectancies. Consider this: according to the National Center for Health Statistics, the average 50-year-old should expect to live another 30.6 years, a 60-year-old should expect 22.2 more years of life, and an 80-year-old can expect another nine years. And these are just averages; many individuals with healthy lifestyles will live much, much longer; certainly this makes purchasing power and inflation a real issue for nearly everyone. And that's some everyone needs to plug into their investment strategies.

Some folks face the challenges risk poses by peering into their crystal ball and making timing and selection choices. They avoid this stock while buying that one, they get in the market, they get out, they buy gold, they buy foreign currency, they "hedge" and all the while, they incur great costs to do something we all intuitively know is impossible in life - avoiding risk.

In fact, risk is a source of return and should be embraced - carefully. We will continue to focus on balancing risk, reducing some while accepting other forms in the hope we can better help you meet you goals and live according to your values as we understand them.

Have a great and safe summer,

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 subtracted from model portfolio performance at 8.3 points per month. 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.**