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## UNDERSTANDING THE CHARACTERISTICS OF YOUR PORTFOLIO

Although I normally use this space to ruminate about various economic indicators and their implications, smartly advancing asset prices have encouraged me to instead discuss a primary analytical tool we use to manage the various portfolios we oversee. That primary tool is the “Portfolio Snapshot.” At least one such Snapshot was included with this letter.

### **BUT FIRST ... WHAT IS A PORTFOLIO?**

If you think back to the beginning of our relationship, you may recall that we executed an “Asset Allocation Agreement.” This agreement serves a number of purposes.

First, it specifies how many accounts we regard as being part of a given portfolio. In some cases, we may have agreed to view and manage each account as if it were a separate portfolio. In other cases where the investment objectives for multiple accounts are similar, we may have agreed to manage those accounts as if they are a part of a larger whole. From the standpoint of our/your custodian (Shareholders Service Group), each account remains legally separate and is reported upon separately. From *our point of view*, however, we may manage a given cluster of accounts as if they were a part of some greater whole. Consequently, tax considerations might lead us to concentrate the holdings of one type of security (e.g., equities) in one account and another type of security (e.g., bonds) in another account. Please be mindful of this when you review the holdings within a given account.

Second, the Asset Allocation Agreement specifies the permissible percentage ranges for three broad asset classes: equities, fixed income, and cash. These ranges provide us with some latitude to adjust the risk profile of a given portfolio while still providing some firm boundaries.

Third, the Asset Allocation Agreement specifies the investment objective for each portfolio in a manner that is devoid of confusing technical jargon. For instance, one portfolio might have an investment objective of “Increasing Income with Modest Growth of Capital” while another portfolio might specify “Growth of Capital Foremost with Limited Income” as its objective.

Fourth, the Asset Allocation Agreement may also specify some level of cash we have agreed to try to maintain for you in one or more accounts.

If you can't recall how we've agreed to view and manage your portfolio(s), refer to your Asset

Allocation Agreement. Or, contact us and we'll tell you. If it's been several years or more since we last agreed upon an asset allocation strategy, a review might be in order.

**LOOKING AT THE PORTFOLIO SNAPSHOT**

**PORTFOLIO VALUE** (see page 1)

This value represents an *approximate* total value of the various accounts that comprise a given portfolio. Several factors help to cause this value to not match the sum of the values on your official statements, so don't expect these figures to match.

**Portfolio Value**  
\$522,924.34

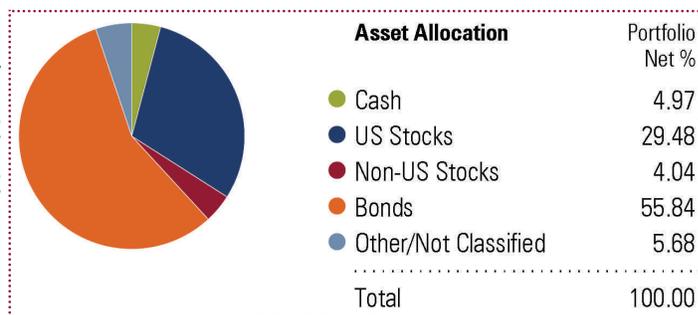
**BENCHMARK** (page 1)

Our portfolio analysis software is constructed to compare a given portfolio's profile to some objective investment index. In this example, we've selected the Standard & Poors 500 Total Return™ Index (denoted as "S&P 500 TR"). This index is similar to the ubiquitous S&P 500 Index except the "total return" index includes the impact of dividends. For comparative purposes, this index would be most relevant to the extent a portfolio were 100% invested in large, domestic equities. Since this is *not true for any of our clients*, comparisons to this (or any) index may be instructive, but it would be incorrect to assume that a portfolio's performance ought to match the performance characteristics of this index.

**Benchmark**  
S&P 500 TR

**ASSET ALLOCATION** (see page 1)

This pie chart and legend are of particular importance to us. If you look at the asset allocation pie chart that appears on the first page of your official monthly statements, you'll find that it lists "Mutual Funds" and



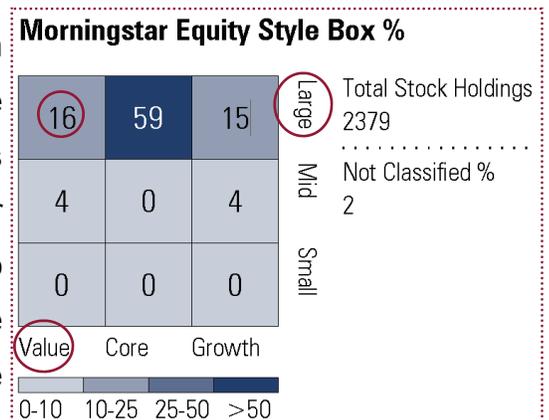
"Exchange-Traded Products" as separate asset classes. While these instruments represent ways of obtaining exposure to different asset classes, *they are not asset classes in and of themselves*. Since custodians lack the ability to apportion the holdings within a given fund to the proper asset classes, they simply report them separately and let investors try to figure out what their asset allocations really are. From a portfolio management point of view, this type of information is not only useless, it can be misleading, as well. Therefore, we track our portfolios using dedicated portfolio analysis software that allows us to see how a portfolio is invested with a high degree of

resolution. In that same vein, I encourage you to *ignore* the asset allocation charts that appear on your regular monthly statements.

With respect to a given portfolio, the percentages shown in the “Portfolio Net %” column will generally fall within the asset allocation percentage ranges set forth in your Asset Allocation Agreement.

**MORNINGSTAR EQUITY STYLE BOX %** (see page 1)

With respect to that portion of a portfolio that is invested in “US Stocks” and “Non-US Stocks,” the 9-box grid to the right indicates the relative percentages of the portfolio’s equity holdings that are considered to be “Growth” or “Value” in nature. In general, value stocks have tended to be less volatile and have provided more income than have growth stocks. The “Core” column simply represents the percentage of those stocks that don’t neatly fit into either of the other two categories.

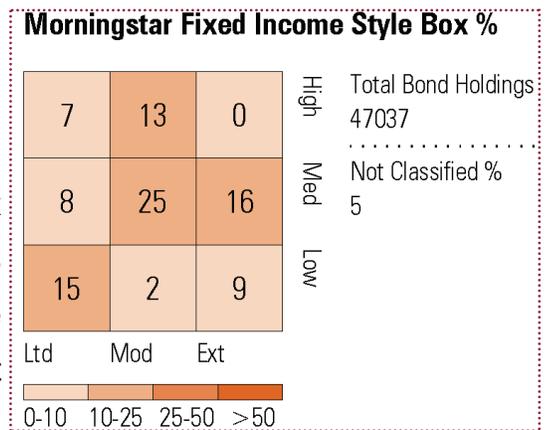


The three rows of this grid labeled “Large,” “Mid,” and “Small” represent the “capitalization” classification into which the various stocks in the portfolio fall. “Capitalization” refers to the total value of a given company’s outstanding stock. Since larger companies have historically been less volatile/risky than smaller-cap stocks, these three rows provide more granularity regarding the riskiness of the equities within the portfolio.

In this example, 16% of the equities (circled) within the portfolio are classified by the software as having a “Large” capitalization *and* a “Value” orientation (also circled).

**MORNINGSTAR FIXED INCOME STYLE BOX %** (see page 1)

Similar in concept to the “Equity Style Box” discussed above, the style box shown to the right addresses the fixed income portion of a portfolio. In this example, the style box addresses the 55.84% of this example portfolio that is invested in bonds and other bond-like instruments. The three rows labeled “High,” “Med,” and “Low” represent



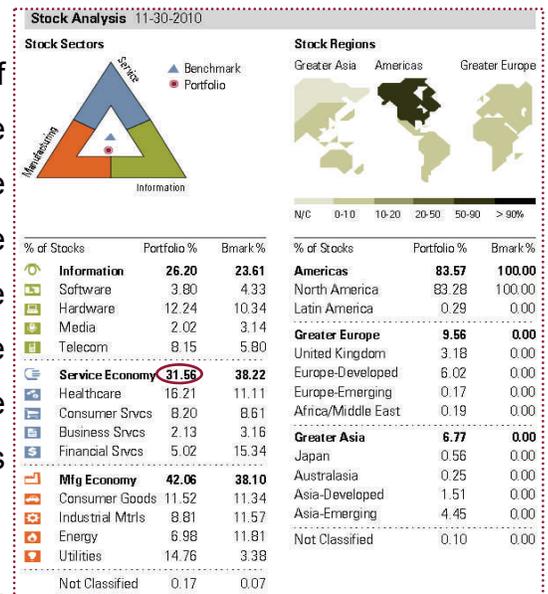
relative credit quality. The upper two rows represent securities that are considered to be of “investment quality.” The bottom row represents securities that either have some speculative element of credit risk or have not been rated by the major credit rating agencies. True or not, unrated debt is automatically mapped to the bottom row.

The three columns labeled “Ltd,” “Mod,” and “Ext” describe the relative maturity ranges with “Ltd” equating to shorter-term instruments, “Mod” equating to intermediate-term instruments, and “Ext” relating to longer-term instruments. In general, shorter-term securities have tended to generate less interest income than longer-term instruments, but they also have tended to vary less in price in response to changes in interest rates.

In this example, the funds owned within this portfolio have exposure to 47,037 different fixed income securities, 5% of which the software was not able to classify. Any individual fixed income securities that might be held within the portfolio are not addressed in this style box. However, we have access to information on those credits separately.

**STOCK ANALYSIS** (see page 1)

This section of the analysis further addresses the nature of the equities held within the portfolio. The software classifies companies as to whether they operate in the “Information Economy,” the “Service Economy,” or the “Mfg” (Manufacturing) Economy.” In the example to the right, 31.56% of the equities in this portfolio (circled) are invested in the service economy. If this portfolio were instead to have been invested in the benchmark index, this exposure would have been 38.22%.



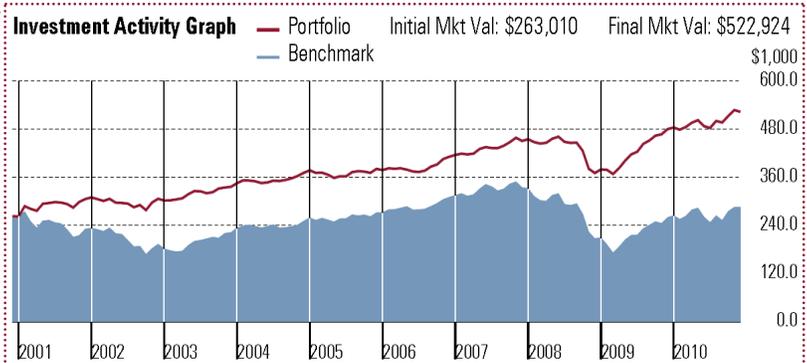
The software further divides each sector into sub-sectors.

Again, it compares the weighting of each sub-sector to that of the benchmark index. The “Stock Regions” section tells us how a portfolio’s equity exposure is geographically distributed with darker colors representing heavier exposure to those regions.

**INVESTMENT ACTIVITY GRAPH** (see page 1)

The red line on the chart shown on the next page indicates how the portfolio would have

performed over the previous 10 years *if it had been invested exactly as it is currently invested*. Since we make portfolio adjustments fairly regularly, the assumption of a static portfolio composition over a 10-year period is not likely to be a valid one. Nonetheless,



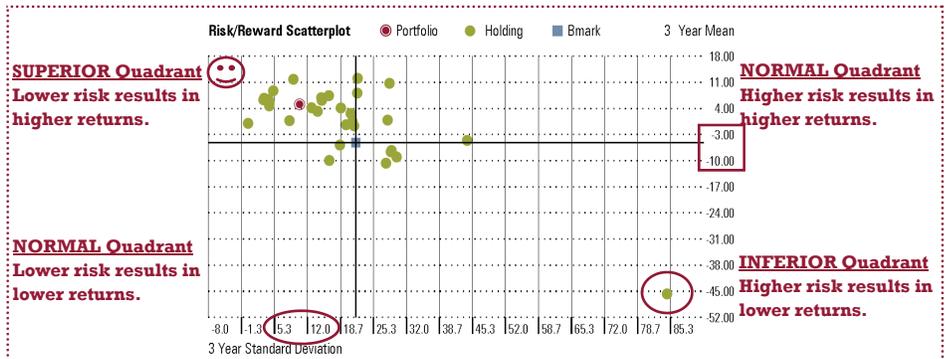
this graph visually depicts how the current portfolio would have behaved.

**TOP 10 HOLDINGS** (see page 1)

The figures shown in this area simply represent the percent each holding represents of the overall portfolio. A complete listing appears later in the report.

**RISK/REWARD SCATTER PLOT** (see page 2)

This graph plots risk versus return over a recent 3-year period. The holy grail of investment management is to generate outsized returns while minimizing risk. Graphically, the goal is to get



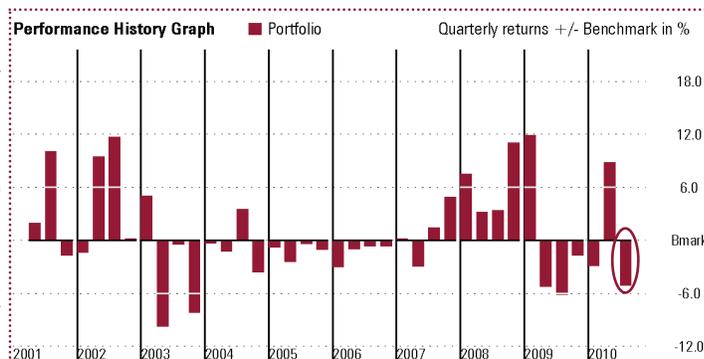
the performance of the overall portfolio (denoted by the red bulls eye) to appear in the “Superior” quadrant. By definition, the performance of the benchmark index (denoted by the solid blue rectangle) is automatically centered in the crosshairs of the graph. In this case, the benchmark index (the S&P 500 Total Return Index) generated average annual losses somewhere between 3% and 10% over this 3-year period (enclosed in a rectangle) versus a 3-year standard deviation of about 18. (Higher standard deviations represent a greater degree of historical risk.)

In contrast, the portfolio generated average annual returns of a little more than 4% versus a standard deviation that falls somewhere between 5.3 and 12 (enclosed in an oval). The green dots represent the risk/return performance of the individual holdings within the portfolio. Although most of the securities in this portfolio performed decently, this portfolio had one stinker (circled). That particular security has not only been very volatile, it declined materially in value. Since no

investor actually seeks high risk/negative return results, this quadrant of the graph is characterized as being “inferior.”

**PERFORMANCE HISTORY GRAPH** (see page 2)

The graph to the right compares the quarterly performance of the portfolio to that of the benchmark index. For example, if the portfolio were to have advanced 15% during the third quarter of 2010 versus a benchmark index gain of 20%, the portfolio would then have



*underperformed* the index by 5% during that quarter. The red bar for that quarter (circled) is then graphed to fall *below* the neutral line. Remember, unless the composition of a portfolio is similar to a given benchmark index, that portfolio should not be expected to mirror the performance of that index.

**MARKET MATURITY** (see page 2)

Instead of simply categorizing the equities within a portfolio according to whether they are foreign or domestic, this grid provides a slightly different view. Whereas “Developed Markets” would certainly include the U.S., it would also

Market Maturity		
% of Stocks	Portfolio	Bmark
Developed Markets	97.95	100.00
Emerging Markets	1.71	0.00
Not Available	0.34	0.00

include various foreign markets such as Canada and much of Europe and Asia. Alternatively, countries such as Russia, Brazil, China, and India might be regarded as emerging, in nature.

**VALUATION MULTIPLES** (see page 2)

With respect to the equities held within the portfolio, this grid provides insight as to some of the more commonly used valuation metrics favored by equity securities analysts. In general, figures smaller than those in the

Valuation Multiples	Portfolio	Bmark
Price/Earnings	12.65	14.66
Price/Book	3.44	2.04
Price/Sales	1.62	1.26
Price/Cash Flow	9.12	8.82

“Bmark” (benchmark) column suggest a lower-risk profile while larger numbers suggest the converse. In this case, the portfolio exhibits both higher (riskier) and lower (less risky) figures which is something of an anomaly.

**PROFITABILITY** (see page 2)

This grid is similar to the one just discussed except that these metrics focus on the relative profitability of the firms whose equities are held within the portfolio. With the exception of the Debt/Capital ratio, higher figures are generally more desirable. (Interpreting the Debt/Capital ratio

Profitability		
% of US Stocks	Portfolio 2009	Bmark 2009
Net Margin	14.11	12.74
ROE	43.13	21.04
ROA	12.23	8.56
Debt/Capital	48.54	—

is something of an art form.) “ROE” (return on equity) measures the percentage of each dollar received by the firm that falls to the bottom line for stockholders. “ROA” (return on assets) measures of the overall profitability with which a firm utilizes its assets.

**CREDIT QUALITY BREAKDOWN** (see page 2)

This grid provides insight as to the credit quality of fixed income securities that are held *indirectly* through mutual funds and exchange-traded funds. These credit ratings do not directly translate into default probabilities, but they provide valuable information nonetheless. Fixed income securities that are owned directly are not reflected in this breakdown. However, we see their credit ratings elsewhere.

Credit Quality Breakdown	% of Bonds
AAA	50.09
AA	4.90
A	11.46
BBB	11.40
BB	6.88
B	6.80
Below B	1.87
NR/NA	6.60

**INTEREST RATE RISK** (see page 2)

“Duration” is a statistic that is very helpful in quantifying interest rate risk. Since fixed income instruments tend to increase in market value when interest rates decline and fall

Interest Rate Risk	Portfolio
Maturity	7.58
Duration (total portfolio)	3.91
Avg Credit Quality	—

in market value when interest rates rise, it’s worth knowing how sensitive the fixed income holdings within a given portfolio might be to a given change in interest rates. In this case, a 1% increase in the general level of interest rates might be expected to trigger a decline in market value of approximate 3.91%. The converse would be true for a 1% decline in interest rates. In truth, the relationship between interest rates and bond prices is more complicated than this (it’s not a linear relationship), but this statistic is helpful in gauging the interest rate sensitivity of a given portfolio.

**FUND STATISTICS** (see page 2)

You are aware of the management fee we charge because we disclose it to you each quarter. Unlike many firms that have an incentive to place clients in costly third-party investments and to then receive payments from those third-parties, we have contractually committed to you to not behave that way. As such, we have an incentive to use low-cost instruments wherever it seems to make sense. However, we still have an interest in knowing how high the indirect costs of the funds we hold are. In this case, the weighted average cost of *all the funds* held in this portfolio amounts to .15% per year (circled).

Fund Statistics	
Potential Cap Gains Exposure	2.02
Avg Net Expense Ratio	0.15
Avg Gross Expense Ratio	0.15

**ANNUALIZED RETURNS** (see page 3)

This section of the analysis provides information on not only the historical returns generated by a given security, it provides information regarding the *indirect* costs associated with holding *each* fund within the portfolio. The net annual cost of owning a given fund is displayed in the “Net Exp Ratio %” (net expense ratio) column. To convert the net expense ratio for a particular fund into dollar terms, simply multiply its net expense ratio by the current value of that particular fund. The result is the dollar amount that is *indirectly* deducted from the value of that fund over the course of a year.

Annualized returns 09-30-2010 Standardized Returns (%)
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Although this analysis also displays the various sales charges (displayed as “sales loads”) that a given fund may impose, our practice is to bypass all such loads. Since there is no salesperson involved with the transaction (we *manage* investments, but we do not *sell* them), we simply code our purchase orders in such a way that instructs the fund sponsor to *not levy such sales charges in the first place*.

**IN SUMMARY**

If you have any questions about any of the holdings within your portfolio, remember that you have access to the same research we use by visiting the “Client Login” link on our website ([www.wesselinvestment.com](http://www.wesselinvestment.com)). Of course, you are always welcome to call or visit and we also have access to software that allows us to present analyses to you via the Internet through your own computer.

— Glenn Wessel