Balanced, Global Portfolios

Using MUTUAL FUNDS

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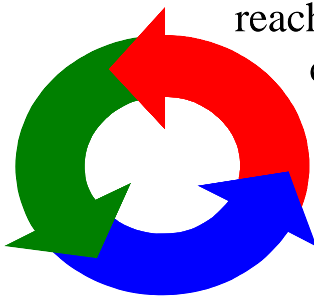
A REGISTERED INVESTMENT ADVISOR

Beacon Financial Advisors, Ltd. (**Beacon**) is a "balanced, global" portfolio manager. Rather than focus exclusively on a single asset class (stocks or bonds, etc.), we inclusively use multiple asset classes when building portfolios for clients. BALANCED because we diversify across asset types with different risk / reward profiles. GLOBAL because assets span the investment world's borders to take advantage of attractive investment opportunities wherever they present themselves.

Money managers are often categorized by the investment "style" used such as growth, momentum, value, indexing, etc. In our role as portfolio manager, **Beacon** is free to use various money managers (via mutual funds), thus enabling clients to enjoy the diversification benefit of multiple styles in their portfolios. We're not locked into a single investment world-view, allowing for flexibility in our decisions.

Portfolio management is an evolving process that is also ***iterative***. After reaching the final step in the process, changed circumstances may dictate a re-trace of earlier steps. This booklet, *Balanced, Global Portfolios Using Mutual Funds*, describes the thoughtful investment process **Beacon** uses to manage clients' money. We highlight the major aspects of each step to offer clients' clearer insight and full disclosure into our investment management methodology and perspective. We welcome any questions or comments about *Balanced, Global Portfolios Using Mutual Funds*.



At the heart of Beacon's financial advisory service to our clients is our portfolio-planning approach and process. This publication, BALANCED, GLOBAL PORTFOLIOS, demonstrates how we construct our clients' portfolios by joining together the unique situation and needs of the client and his or her family to our capital-markets expectations. Beacon's approach and process addressed in these pages focuses on how various mixes and types of stocks and bonds, both domestic and foreign, are likely to behave in providing income and growing and protecting capital over the long term under different market conditions. Clients are better able to help construct their own Investment Policy Statement (IPS), that is, determine the risk profile best suited to their own personal investment objectives and constraints.

A couple important points bear noting. These pages present the planning approach and process for a hypothetical client…JOE Q. INVESTOR. In fact, there aren't "typical" Beacon clients as each client is unique. Also, Beacon is not clairvoyant. Our forward-looking analysis puts forth our best research, thinking and judgment, but is never a prediction.

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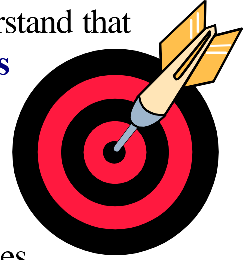
APPENDIX

Why MUTUAL FUNDS? The PROS Trounce the CONS 16



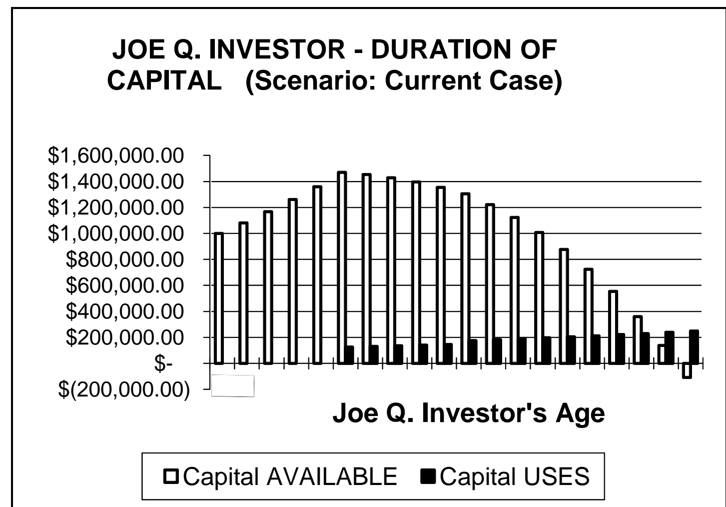
"If you aim for nothing, you'll probably hit it!" The successful investor will understand that **measurable, verifiable targets** (goals) are essential to marking progress. **Beacon's** approach to helping clients make investment decisions is goal-driven and involves, among other things, a financial goal plan analysis and a written investment policy statement (IPS).

Financial Goal Plan Analysis, a subset of our **financial planning services**, evaluates the client's ability to successfully accomplish all their financial objectives from existing resources and those resources acquired in the future, to plan for adjustments and contingencies, and to make the necessary tradeoffs inherent in setting funding priorities.

How Much is Enough?

Not everyone will have sufficient capital to achieve all conceivable goals such as maintaining purchasing power throughout their retirement years. A key question is "How much is enough?" The variables are multiple and are interdependent. Although not all inclusive, some key planning variables are listed below:

- How long might retirement last?
- Estimated Investment Return - both before and after retirement
- When will retirement begin?
- Annual living expenses during retirement years, and how might expenses change
- Financial commitments - education, new cars, vacations, planned giving, etc.
- Annual savings capacity until retirement (Personal, IRAs, debt reduction, etc.)
- Inflation and future income tax rates (plus other possible taxes on assets)
- Social Security and other income sources



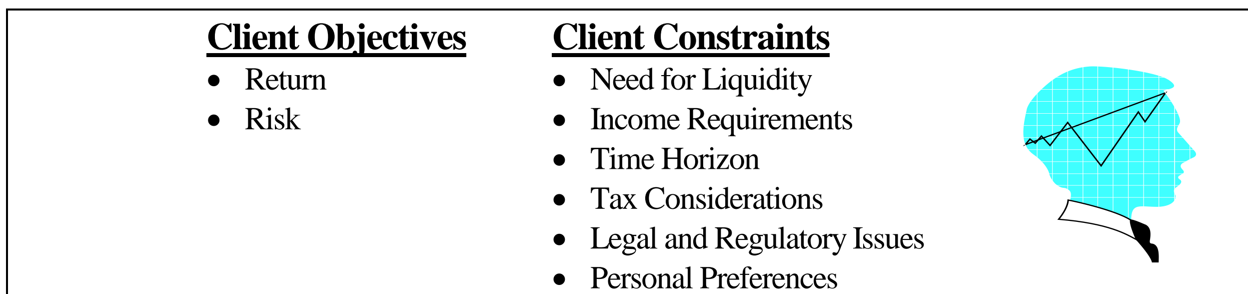
Beacon works with the new client to develop a current scenario. A key assumption in the current scenario is the estimated rate of return on invested assets. To arrive at this number we use the estimated future rate of return on the client's current portfolio. Clients want to know if their current investment plan will get them where they want to go. We assume that, without advice to alter their investment plan, clients will make investments in the future in much the same way they have done so in the past. The results of the current scenario are sometimes unsatisfactory. **Beacon** develops a "simulation analysis" to help clients choose the most attractive options from among a number of alternative actions over which they have some control (spending, investment risk, retirement age, etc.). Changes made to the current scenario result in the client's recommended scenario. Among the alternatives generally changed is the required rate of return on invested capital. The development of this number is critical to the investment planning process, and is a key consideration in the client's written investment policy statement (IPS).

Benefits of a Written Investment Policy Statement (IPS)

An IPS has a plethora of benefits for both **Beacon** and our client. An IPS is to investing what a road map is to the vacationing family on a cross-country trip, serving to plot the ultimate destination as well as the course. Perhaps the chief benefit is that an IPS helps avoid misunderstandings and paves a path for clear and open communication. Next, a client is confronted with the realities of investing versus simply relying upon wishful thinking or unreasonable expectations. **Beacon** must get ***"in our client's head"*** right from the start, and we spend time educating and informing clients as necessary. After all, many of our clients are physicians, attorneys, business professionals, etc., not investment experts. **Beacon** benefits from the IPS in that we increase our understanding and appreciation of client concerns. We are able to move away from vague ideas and onto concrete, measurable targets. We learn our client's expectations and are better able to meet them through confident initial investing and ongoing management in accordance with their IPS.

Features of a Written Investment Policy Statement (IPS)

The key areas for information gathering can be categorized as *objectives* and *constraints*:



Client Objectives	Client Constraints
• Return	• Need for Liquidity
• Risk	• Income Requirements
	• Time Horizon
	• Tax Considerations
	• Legal and Regulatory Issues
	• Personal Preferences

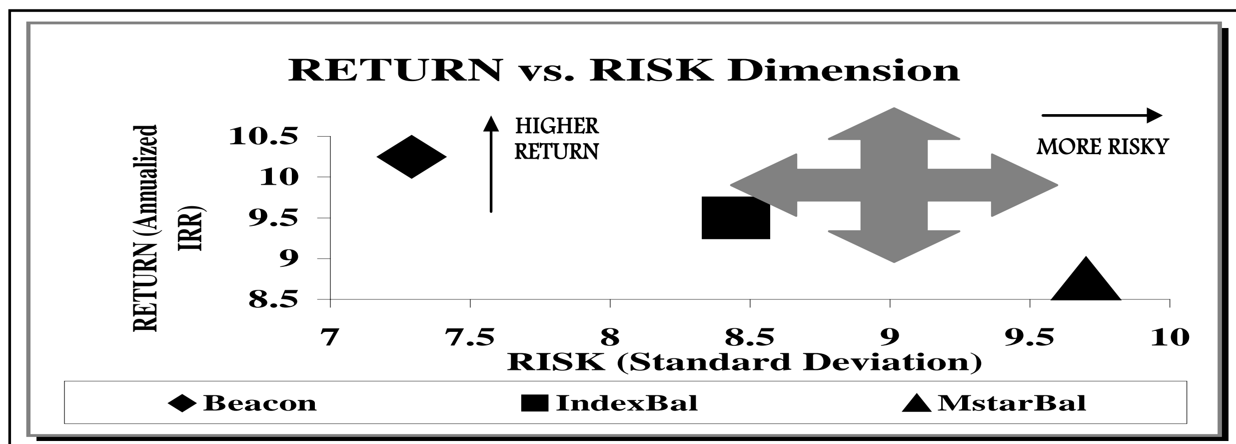
Within each of these areas reside multiple layers of items that are discussed and documented. An IPS is not cast in concrete. We constantly review financial considerations with our clients that can impact and change the IPS. A client with an IPS has some terrific benefits. He or she can use the business cycle to their advantage and avoid the emotional swings of the differing winds of opinion. He or she will develop expectations aligned with goals set, and the investment climate in place. Circumstances will change, and surely there will be bumps in the road. After all, financial markets can be volatile and investing affords few assurances. However, the **Beacon** client who makes investment decisions based on reasonable goals will find that a road map makes the ***journey*** a lot more enjoyable to the ***destination*** of successful investing and financial independence.

Asset allocation is to investing as interior painting is to home decorating. Homemakers take care to tastefully coordinate furniture and room accompaniments with the color of drapes and walls. The painter is able to mix and match paints and thinners to get *just the right shade*. Similarly, **Beacon** works hard to determine exactly what our client wants from his or her financial and investment plan. Afterwards, our asset allocation work signals our attempt to get ***just the right mix*** of investment risk and return suitable to our client's tastes.

The basics of asset allocation reveal three dimensions of a diversified portfolio --- *return, risk* and *correlation*, all within a RETURN v. RISK sphere. Let's define our terms.

Three Dimensions of Asset Allocation

- *return* - the rate of *return*, or *total return*, is the sum of all income, gains and losses in the period (realized and unrealized); *return* is generally the most commonly understood dimension among investors.
- *risk* - the measure of volatility in the portfolio from period to period, usually measured by the standard deviation of returns. **Beacon** pays lots of attention to managing *risk*.
- *correlation* - the degree to which assets in the portfolio move in concert with, or opposite of, each other. By selectively deploying and mixing weakly correlated, "risky" assets in a portfolio, the overall result to the entire portfolio can be something *"less risky."*



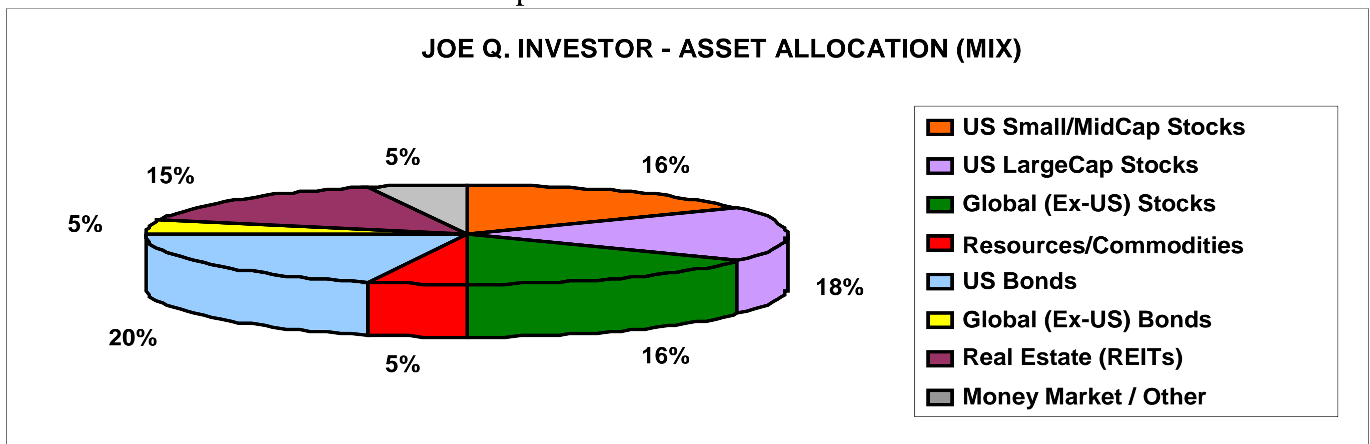
Asset allocation (mix) involves a systematic effort to construct and re-balance a diversified portfolio. **Beacon** defines asset allocation as the efficient investment of capital among a carefully chosen set of asset classes to pursue the companion goals of a target return with managed risk, a truly diversified portfolio. True diversification represents a practical challenge, and has as its goal to avoid the *"all eggs in one basket"* dilemma. The practical challenge for investors is that not just any eggs or baskets are enough for a diversified portfolio, and too many investors are placated by an illusion of diversification; *"I have several investments, therefore I must be diversified."* This is a common misconception among new **Beacon** clients, and is one principal reason we spend time educating clients as necessary.

Just how important is asset mix in the investment decision making process? Though somewhat debated, it is generally agreed by theoreticians and practitioners that the asset mix decision is by far the most important decision made by the investor, accounting for most of the portfolio return. Other important decisions such as security selection, currency hedging, or market-timing account for less of the portfolio return, demonstrating that investment returns are determined by markets, not by individual issues. *Restated*, while good security selection is additive, over time it is more important to have the right proportion of US Stocks in a portfolio than it is to worry about Ford vs. General Motors.

Not surprisingly, **Beacon** concentrates on the asset mix decision in rendering investment advice to our clients and sub-contracts security and currency selection to fund managers. A "typical" portfolio under our management may have 80%-90% of the assets dedicated to *strategic* asset classes, defined as those we will use all the time. The research leading to our recommendations involves "long-run" historical capital market conditions (three dimensions of *return*, *risk* and *correlation*), as well as forward-looking forecasts. Our research may lead us to maintain a particular weighting with our *strategic* assets (under, over or neutral weights). The 10%-20% of a "typical" **Beacon** portfolio not dedicated to *strategic* assets is devoted to its cousin, *tactical* assets. **Beacon's** basic goal in making periodic *tactical* decisions is to use those alternative asset classes that temporarily suit the economic or cyclical landscape.

Beacon employs eight (8) asset classes in our asset allocation models. As each of our clients is unique, **Beacon** maintains several client *risk profiles* designed to capture each client's own objectives and constraints per their IPS (see p. 5). We pursue equalization between a clients' *current* allocation and his or her *target* allocation. Excesses and shortfalls appear with the passage of time, and it is through ***re-balancing*** that we restore the intended equalization (more about re-balancing in STEP 6, p. 12).

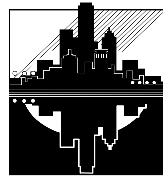
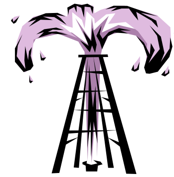
Every homemaker has different tastes and preferences, as one favors shades and hues of pastels, another prefers bold, bright colors; the painter must satisfy each of these preferences. So also, every client has different objectives and constraints, and it remains **Beacon's** high calling to fashion each client's asset allocation plan to these ends.



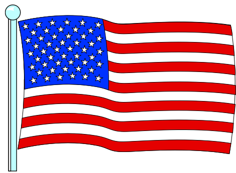
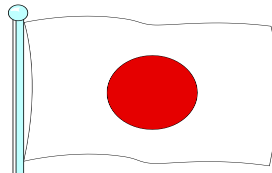
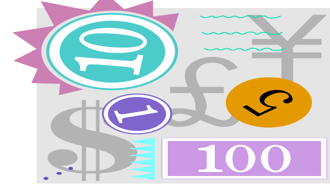
As pointed out in STEP 2, **Beacon** uses at least 8 asset classes. What makes asset classes special and useful is that each are impacted differently by changing economic events and stimulus, resulting in the first level of diversification in a client's portfolio. But **Beacon's** portfolio management method results in several levels of diversification, which we call the ***4-Fold Safety Net***, designed to manage risk while pursuing target returns.

Levels of Diversification - Beacon's 4-Fold Safety Net

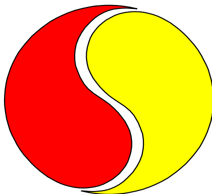
Level 1: ***MULTIPLE ASSET CLASS DIVERSIFICATION***, including the following: US Small Cap Stocks, US Mid Cap Stocks, US Large Cap Stocks, Foreign Stocks-Developed Countries, Foreign Stocks-Emerging Markets, Real Estate, US Bonds, Foreign Bonds, Inflation-Sensitive Resources, and Cash/Equivalents.

Level 2: ***GEOGRAPHY AND CURRENCY DIVERSIFICATION***: As noted in Level 1, assets include those from both US and foreign sources.

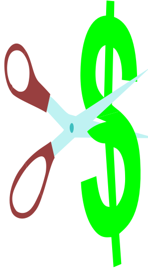
Level 3: ***SECTOR (INDUSTRY) DIVERSIFICATION*** among stocks and bonds: The stocks include companies with size (capitalization) differences and are spread across many different industry groups. The bonds include corporates, municipals and governments (sovereigns) and span the term structure of interest rates from short, intermediate and long maturities, as well as credit-quality from high, medium and low.



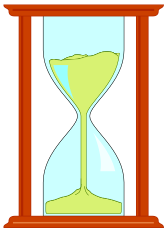
Level 4: ***MANAGER-STYLE DIVERSIFICATION*** within asset classes: **Beacon** uses different assets to blend and compliment manager styles in stock selection, such as value and enhanced-indexing, to enhance the chances of exploiting market trends. In taxable portfolios, tax-aware strategies are key to our selection.

Today, there are nearly 30,000 mutual funds listed in Morningstar's database. **Beacon** employs a highly disciplined set of criteria, using today's sophisticated software technology, to screen asset candidates. From this list, we interview the fund managers before making final selections to recommend for client portfolios. Academic and empirical studies have demonstrated that risk reduction benefits are realized as more mutual funds are deployed in a portfolio. At **Beacon,** it is typical that a fully invested client portfolio will have from twelve (12) to twenty (20) separate funds in the various asset classes to meet our ***4-Fold Safety Net*** standard.

At this STEP, **Beacon** is ready to begin investing for our new client. With the investment policy statement (STEP 1), capital market study (STEP 2), and investment selection (STEP 3) all is ready. But we have two more key tools to use which each simultaneously impact investment return and risk...*low investment costs and time*.



Low Investment Costs: **Beacon's** clients enjoy the benefits of being considered "institutional" investors at Schwab Institutional by virtue of **Beacon's** client relationships and assets under management. As such, **Beacon** is able to pass on cost reductions directly to clients in the form of substantially reduced transaction fees (no-load funds) and commissions (stocks, bonds, etc.). As an institutional manager, **Beacon** is also able to acquire for clients load-funds at no-load terms, or institutional-only funds, when appropriate.



Time: **Beacon** sometimes uses several months to fully deploy a new client's portfolio, not to target higher returns, but to mitigate near-term risk. We simply don't want the possibility of a "Black Monday" occurring just after committing all the capital. Combined with **Beacon's** ability to invest with low costs, we can use time to manage near-term risk while deploying a new client's portfolio.

Beacon's new clients approve a detailed **Investment Recommendation Matrix** before any funds are initially invested. The matrix covers an extensive array of information including:

- Beginning Investment "Pools" (personal, IRA, Keogh, etc.)
- Asset Class % and $ Targets
- Keep/Sell Recommendations of existing holdings
- Specific Investments to buy:
  - According to "Pool" (personal, IRA, Keogh, etc.)
  - Identify Investment Source (Schwab, other...)
  - Total $ and # of monthly purchases
  - Broker commissions / transaction fee estimates
  - Footnotes relevant to plan implementation
  - Client signature authorization

Investment Recommendation

PORTFOLIO MONITORING

This part of STEP 5 involves performing a continual review of the assets and mutual funds in a client's portfolio. In STEP 3, **Beacon** made specific investment recommendations that were implemented in STEP 4. As noted in STEP 3, **Beacon** interviews money managers prior to selection. Afterwards, we regularly continue our ***manager conferences*** to make certain we can continue to recommend the fund with confidence.

Beacon also briefs clients concerning these conferences as follows:

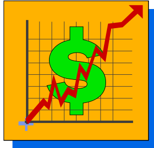
- **Investment MEMO**: no change recommended; a MEMO is informational only.
- **Investment ADVISORY**: an ADVISORY involves decisions by **Beacon** other than selling the fund; for example, a rights offering, tender offer, proxy vote, etc.
- **Investment ALERT**: an ALERT signals a buy or sell of an asset by **Beacon**, and states rationale, timing and procedure, and for taxable clients, the tax implications.

Our basic tenet in selecting mutual funds is that we are selecting research *partners* (see Appendix, Why Mutual Funds). Our perspective is that we intend long-term holds of each fund in a *strategic* asset class (see STEP 2). However, there *are* times that mutual funds need to be replaced, and **Beacon** is careful to maintain a culture of independent thinking in our selection and retention of mutual funds. The criteria we use for ongoing evaluation are the same as those referenced in STEP 3 for initial selection. This process helps assure that current, objective thinking goes into the decision to keep or replace a fund.

FACTOR FORECASTING

There are both client-specific factors and global (non-client specific) factors that can affect our portfolio management decisions. During and after completing STEP 4, implementation, **Beacon** monitors the capital markets to take action we deem necessary to enhance or protect client portfolio values. We also monitor changed client circumstances through our **financial planning services, our "value-added" way to enhance our investment management services to many of our clients**. The factors that can affect financial assets and investment results are multiple, and the resulting impact is never mutually exclusive. Some major (though not exhaustive) factors are listed on page 11.

Global (non-client specific) Factors

***Economic*:** There exists a multitude of economic news that arrives as a torrent of information  every day, literally overwhelming individuals and professionals alike. One day the headlines offer dour forecasts of economic indicators that cause financial markets to react poorly, only to be reversed the very next day. Or, articles in "leading" consumer finance magazines offer up a multitude of ways for investors to "beat the market," as though that alone was the Holy Grail of investing (it's not). At **Beacon**, we think most short-term economic news is mainly *statistical noise* that must be filtered out to arrive at longer-term, logical economic scenario forecasting. Economic scenario forecasting is important to portfolio management. An economic scenario describes the phases of the business cycle, per the factors below, and considers the impact on expected returns of different asset classes. However, rather than predicting which specific economic scenario will occur, **Beacon** assigns probabilities to possible outcomes in order to deal with uncertainty. A truism is that no portfolio manager can be clairvoyant regarding future economic scenario outcomes, but we are paid to have an opinion and take action accordingly. Economic indicators or signals that **Beacon** pays most attention to include domestic inflation and interest rates, US trade relationships, foreign currency exchange rate changes, consumer spending patterns (i.e. consumer confidence), corporate profit forecasts (by independent sources), and central bank policies (US and foreign).

***Fiscal*:** The tax policy of the US (federal) government, as well as the fiscal issues of state and local governments, must be considered in our portfolio decisions. Investment income takes many forms (interest, dividends, capital gains of many types, passive income, etc.), and is taxed differently. **Beacon** must make asset allocation decisions regarding which asset classes to put into taxable accounts and which into tax-favored accounts like IRAs, ROTH-IRAs, profit-sharing plans, etc., with due consideration to the tax consequences today and in the future. Also, the selection of specific assets is impacted by tax (fiscal) considerations. For example, in taxable accounts we must evaluate the fixed income yield curve to assess "spread" relationships between government bonds and corporate or municipal issues, and superimpose that information over each clients marginal tax rate before making a specific recommendation. In selecting stock mutual funds, we must consider factors such as portfolio turnover or tax-aware portfolio accounting for example, in order to evaluate the tax efficiency and after-tax returns of client investments.

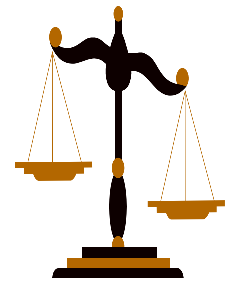
Client-specific Factors

Financial (Quantitative & Qualitative): Our clients are *unique*, and their personal and financial circumstances are *dynamic*. Our investment management services consider material changes from the baseline case for the financial independence analysis and investment policy established in STEP 1. These could include changes in employment status, family circumstances, discretionary goals, personal health, education outlays and countless other factors affecting our clients.

As a result of monitoring the capital markets and keeping abreast of changes in our clients' financial and tax circumstances, **Beacon** is continually ready to change the asset allocation, if appropriate, and ***re-balance*** the portfolio as described here in STEP 6.

Beacon is not a strict buy-and-hold portfolio manager, nor are we active traders or market-timers. Our balanced approach, using integrated asset allocation, falls somewhere in between and involves a key portfolio management technique known as ***re-balancing***, our "secret" to buying low(er) and selling high(er).

What do we mean by ***re-balancing***? We start with the assumption that the portfolio was initially ***in-balance*** after STEP 4. With the mere passage of time, the portfolio will become ***out-of-balance*** as asset classes perform differently, or in two other general instances that we've mentioned in STEP 5 (Times Are a' Changing):



- Important changes in personal, client-specific factors have taken place and require reevaluation of the portfolio mix (STEP 5, pg. 11) or,
- The financial market's risk-attributes or return prospects for individual asset classes change due to global economic factors (STEP 5, pg. 11). In this simplified illustration, let us assume there are no important changes other than the passage of time.

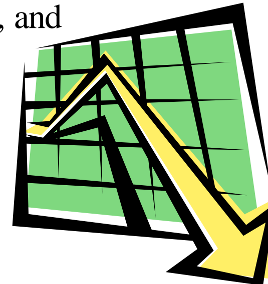
Our ***in-balance*** portfolio will change with the mere *passage of time*, and we are faced with a choice between three opposing strategies:

(A) Do nothing or,
(B) Increase the bet on a (hitherto) winning hand or,
(C) Shift from the winner(s) to the laggards and ***RE-BALANCE***.

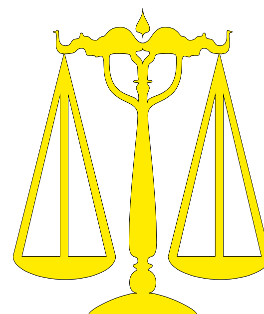
Why would an investor choose (A), the do-nothing alternative? The most obvious reason is inertia…doing nothing is easy. There may also be external reasons such as transaction costs. Buying and selling costs money, and brokerage houses are about the only winners when portfolio turnover is high. There may also be tax-motivated reasons for doing nothing, but generally doing nothing results in a different risk profile than the client began with, or intends.

Strategy (B), going with the winner, sounds tempting and even prudent. But the trouble is anyone can follow the strategy of buying "last years winners". After all, investors, like most others, crave the benefits that companionship affords and sometimes think that what has been working will continue to work, and that failure heralds failure. But, **Beacon** believes the statistical principal of "mean reversion" applies to investing. *Translated*, good companies deteriorate while bad companies get better because of powerful forces that induce these changes. Successful investors know that "trees don't grow to the sky" and that the *Greater Fool Theory* and the *Herd Theory* were coined for those who believe and behave otherwise.

Strategy (C), otherwise known as ***re-balancing***, is the choice of the investor who believes, as **Beacon** does, that good investments are made when they don't seem like good investments. ***Re-balancing*** seeks to exploit the *principal of mean reversion* by buying those assets while they are less expensive and selling those that have become more expensive (through appreciation). We believe that out-performers will not remain out-performers forever, and vice versa for under-performers. We are not market-timers, and we believe that legitimate chances to improve on diversified portfolios are rare. We must accord investment markets the respect they deserve, and in doing so, help our clients achieve investment results in accord with their investment policy goals.



Beacon's approach to ***re-balancing*** is NOT one that typically results in many significant adjustments over short periods of time. Rather, asset mix or ***re-balancing*** changes tend to be gradual and often occur only once or twice each year. As part of our quarterly reporting to clients, **Beacon** prepares a MODEL PORTFOLIO REPORT comparing the *target* allocation with the *current* allocation to assess the client's risk v. reward profile and consider the ***re-balancing*** decisions.



More about MEAN REVERSION: In his 1982 bestseller, In Search of Excellence, author Tom Peters featured many US companies that were "excellent" on the basis of outstanding financial performance as ranked by several measures of profitability and growth. In a subsequent study published in a 1987 issue of Financial Analysts Journal, financial analyst Michelle Clayman found the financial health of most of the "excellent" companies began to decline virtually across the board starting right from the date they were featured as "excellent" in Peters' book. Moreover, many of the companies that ranked on the bottom ("unexcellent") by the same factors Peters' used showed widespread improvement over the next five years.

Clayman's study demonstrated that *past* financial performance is not a key to *future* investment success. As Clayman wrote, *"What could explain these disappointing results from supposedly 'excellent' companies?…there is a phenomenon in nature called 'reversion to the mean,' which asserts that, over time…groups tend to converge to…average…economic forces tend to move things toward equilibrium…[by] attracting new entrants to attractive markets and encourage participants to leave low return businesses."* In **Beacon's** restatement: Good investments are often made when they don't seem like good investments!

> ***"Good investments are often made when they don't seem like good investments."***
> **Beacon Financial Advisors, Ltd.**

In STEP 1 we helped our client to establish a target rate of return on the investment portfolio. After the portfolio has been fully implemented (STEP 4) and has experienced a full investment period (usually 1 year), we now turn to the task of MEASURING investment performance.

Liar's figure and figures lie! We have all heard that well-worn expression in the context of statistical matters. But nowhere is that truer than in the area of investment performance measurement. According to Frederick L. Muller, the Vice-Chairman of the Association for Investment Management and Research (AIMR), *"The lack of standardization in performance reporting within the [investment] industry leaves the door wide open for practitioner misrepresentation and for confusion and mistrust among clients and potential clients."*

A simple illustration will demonstrate the method **Beacon** uses to present investment performance to our client, **Joe Q. Investor:**

Beacon Financial Advisors, Ltd.
Joe Q. Investor
PERFORMANCE REPORT
From 1/1/XX to 12/31/XX

Portfolio Value on 1/1/XX		$424,784
Additions to portfolio		5,579
Withdrawals from portfolio		(61,390)
Realized gains or losses		3,011
Unrealized gains or losses		25,629
Interest and dividends	34,335	
Portfolio Value on 12/31/XX	$431,948	
Total Fees		(4,500)
Internal Rate of Return (IRR) for period		14.80%

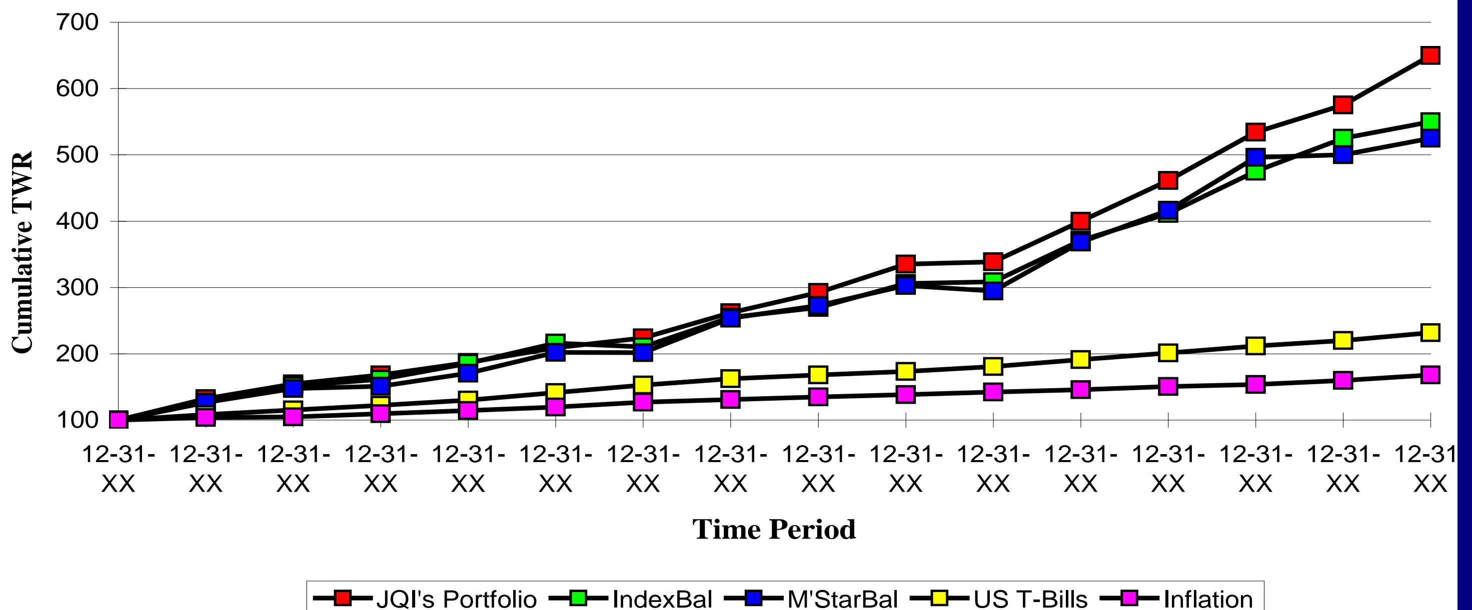
As can be seen, the IRR for a period consists of multiple types of transactions (for simplicity we did not include beginning or ending accrued funds). If all Joe Q. Investor knew from this case was the beginning and ending values, which are only $7,164 apart (or, less than 2%), he might be disinclined to believe the 14.8% IRR for the period. This illustration demonstrates the need to consider all of the *fund flows* in or out of the portfolio, AND the *magnitude and timing* of the fund flows. **Beacon's** systems capture all this information for our clients. We believe that **full-disclosure with education** is key to gaining and keeping clients' trust.

In our sample case, we further assume that Joe Q. Investor has been a client of **Beacon** for several years. We employ a method to track the **historical performance from inception** of the investment results for Joe Q. Investor. In addition to tracking the actual results v. the investment policy statement target of the client, **Beacon** shows Joe Q. Investor his actual results against relevant, financial market benchmarks, some samples are as follows:

- **IndexBal – Beacon's** synthetic composite reflecting a proxy for a balanced, global portfolio using widely accepted investment indexes.
- **MStarBalGbl** – a "real world" composite of actual mutual funds in the Morningstar "international hybrid" category dealing with *"How did* **Beacon's** *peers of balanced, global managers perform."*
- **US 90-Day Treasury Bills** – answers the rhetorical client question, *"How would I have done with the safest investment?"* (i.e. *'in the bank'*, if you will).
- **Inflation** – uses the Consumer Price Index to measure actual portfolio results v. the typical investment policy statement goal of *"inflation plus X% return"* target.

Since these indexes are *static*, and are not directly comparable against Joe Q. Investor's *dynamic* portfolio with the additions, withdrawals, fees, etc., **Beacon** uses an apples-to-apples method known as ***time-weighted return*** (TWR)**.** By linking Joe Q. Investor's period-to-period IRR's, we can achieve a direct comparison to our benchmarks for a realistic evaluation. After several years, Joe Q. Investor is able to evaluate results v. his personal target, market returns, etc., and is well informed and in position to make planning adjustments or course corrections.

Beacon Financial Advisors, Ltd.
PERFORMANCE HISTORY FROM INCEPTION
JOE Q. INVESTOR



In designing and managing balanced, global portfolios for our clients, **Beacon's** vehicle-of-choice are regulated investment companies, otherwise known as (open-end) mutual funds. We'll take a look at the origin of mutual funds, how they work generally, and a brief peek at the PROS and CONS of funds. This appendix to *Balanced, Global Portfolios Using Mutual Funds* offers a reasoned explanation to clients about why **Beacon** feels mutual funds are worthy as portfolio construction components for both equity and fixed income investments.

From Whence Cometh Mutual Funds?

Mutual funds originated from The Investment Company Act of 1940 (the "Act"). The legislators and investment industry leaders who crafted the Act lived through the depths of the Great Depression, and witnessed the stock market crash and scandals in the late 1920's in closed-end funds. Finance history records that, at that time, there were very unfavorable views among investors toward mutual funds owing to public distrust. Hence, drafters of the Act had to go to great lengths to ensure the investing public that protective, anti-fraud mechanisms were present and enforceable so as to promote the public policy of private investment.

In that backdrop, the Act has certainly passed the test of time as an extremely important piece of legislation. With few exceptions, the mutual fund industry has remained free of major scandals that have occurred in other segments of the financial services industry. As Americans have come to trust the integrity of the mutual fund industry, it has become the bedrock investment vehicle for many individuals and institutions alike. Congress has given supervisory authority for the mutual fund industry to the US Securities and Exchange Commission (the "SEC"). As such, each and every mutual fund is required to submit a full prospectus to shareholders, which serves as a legal investment policy statement about how it will invest shareholder funds.

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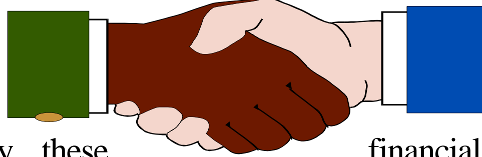
Beacon Financial Advisors, Ltd.

A significant feature of the Act is that mutual fund shareholders are to be treated as *owners* of fund shares and not merely as *customers* of the mutual fund company. As *owners*, fund shareholders are entitled to vote proxies on all matters of fund governance. This is an extremely important consideration, and acts as a form of "checks and balances" in the mutual fund industry. The Act requires that each mutual fund also have a board of directors charged with acting as the independent voice of the shareholders with the mutual fund management and advisors.

Just What ARE Mutual Funds?

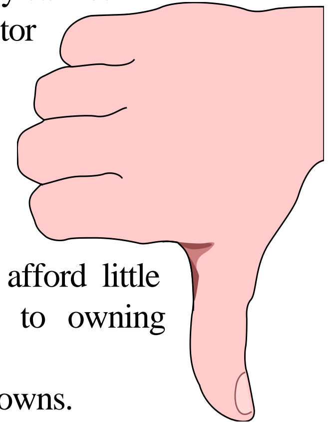
As a basic primer, mutual funds are vehicles for like-minded investors to pool resources and hire professional portfolio managers, financial analysts, market strategists, economists, and other professional staff for the combined purpose of managing money and providing "back-office" administration. A mutual fund allows investors with modest sums, as well as those with substantial financial means, to enjoy these financial services in a way that few could individually due to cost constraints. This pooling together does not require that investors know one another, as this is rarely the case.



As noted earlier, mutual fund prospectuses spell out which assets the fund invests in. Virtually every major asset class today has been securitized, and mutual funds are available to allow investors to participate in all of them. Moving from the more traditional assets like common stocks, bonds, and US Treasury securities, mutual funds now allow investors to own shares in real estate companies, commodity-linked assets, venture capital funding and foreign (non-US) holdings in both major, developed countries as well as emerging market countries.

Criticism of Mutual Fund Investing

Despite the obvious benefits of mutual funds as solid investment vehicles, they cannot escape criticism from some in the investment management and investor communities, as well as some in the financial media.



*The **major points of criticism** or concern **Beacon** hears are as follows:*

- Mutual funds incur costs that range from modest to downright expensive. These costs include operating and regulatory expenses, marketing expenses, management fees and the costs of trading.
- Mutual funds generate tax consequences (for taxable investors) that afford little control for the buy-and-hold shareholder, especially as compared to owning individual securities.
- Unlike individual securities, a mutual fund is able to "hide" what it really owns.

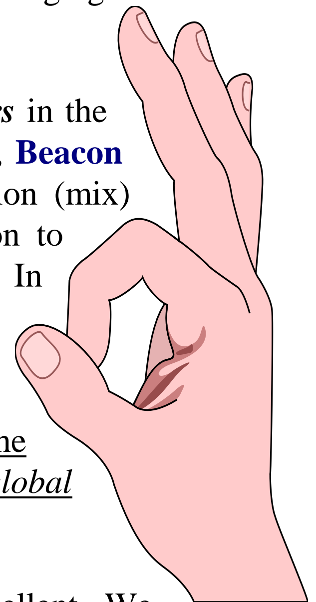
Presently, there are nearly 30,000 mutual funds available to the investing public, compared with just about 2,800 companies traded on the New York Stock Exchange. A quick study of the mutual fund section of Barron's shows *thirty-five (dual-column) pages* of mutual fund listings! Fidelity Investments alone is responsible for one of those pages, with about 250 or so different funds. Are the product needs of investors so diverse and complicated as to require so many different funds? Certainly not! **Beacon** believes *a large segment of the mutual fund industry is more about marketing than about quality, professional money management*. **Beacon's** task is to seek out fund investments that represent good investment value, and discount the superfluous marketing hype and fluff. At present, **Beacon** has only about 25 mutual funds on our core and secondary list for all eight (8) asset classes we use. That is 25 out of a universe of 30,000, or restated, there are

about 29,975 funds we are not using. While there are undoubtedly good mutual funds in the list not used by **Beacon**, we think the majority of mutual funds are unworthy of our clients' hard-earned money. Nonetheless, we think the PROS of mutual fund investing outweigh the CONS, and we'll tackle these points of criticism plus cover new ground.

The Case for Mutual Fund Investing

A Case of Mistaken Identity:

Historically, many people have considered mutual funds as appropriate only for small, unsophisticated individual investors, and that is still the contention of some today. But that crowd would do well to learn of the growing use of mutual funds among institutional investors, those traditionally thought of as the "smart money" investors. There are ***good reasons*** that institutional investors, like **Beacon**, use mutual funds in managing investment portfolios. Here are just a few.



First, in using mutual funds **Beacon** is able to select ***world-class partners*** in the joint duty of managing our clients' money. As noted in STEPS 1 and 2, **Beacon** concentrates on clients' financial planning issues and the asset allocation (mix) decision, and sub-contracts the duties of security and currency selection to ***partners*** that range from global powerhouses to specialty boutiques. In addition, mutual fund supermarket stalwarts like Schwab Institutional enable **Beacon** and our clients to enjoy substantial economies of scale in asset trading and custodial services. **Beacon's** clients are considered "institutional clients" with these ***partners***, and we believe strongly that the combined breadth available from this method of building *balanced, global portfolios* is unmatched by any single service provider.

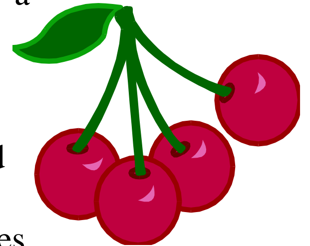
Second, the availability of ***historical information and track records*** is excellent. We can study virtually any aspect of the fund's historical activity, current holdings, statistical makeup, tax-aware strategies, etc. We can evaluate the funds operating costs to evaluate comparative efficiency of the organization, and enjoy vast economies of scale.

Third, mutual funds are accustomed to reporting investment performance to their shareholders and are ***intensely scrutinized***. While this may seem incidental, it has really

been a problem with other types of money managers, wrap-fee managers, bank common funds, etc. whose general lack of reporting has drawn the attention of the SEC and state securities regulators. As regulated investment companies, mutual funds are required to disclose lots of information in their prospectus, and they cannot radically depart from those disclosed practices without a vote of shareholders. **Beacon** can confidently invest in a fund without grave concern that the manager(s) will depart or drift from those practices.

Fourth, we can know about the fund decision makers' ***educational and professional backgrounds***. This includes the portfolio manager(s), strategists, economists and analysts. We can know about the current positions in the fund and the overall portfolio composition. This is true for stock (equity) funds and for bond (fixed income) funds.

Fifth, we can ***cherry-pick*** funds to meet a specific categorization in a client's portfolio. To illustrate, we can begin with the nearly 30,000 funds in Morningstar's universe and set up several pre-set screens to find a fund that matches our desired criteria as listed below:



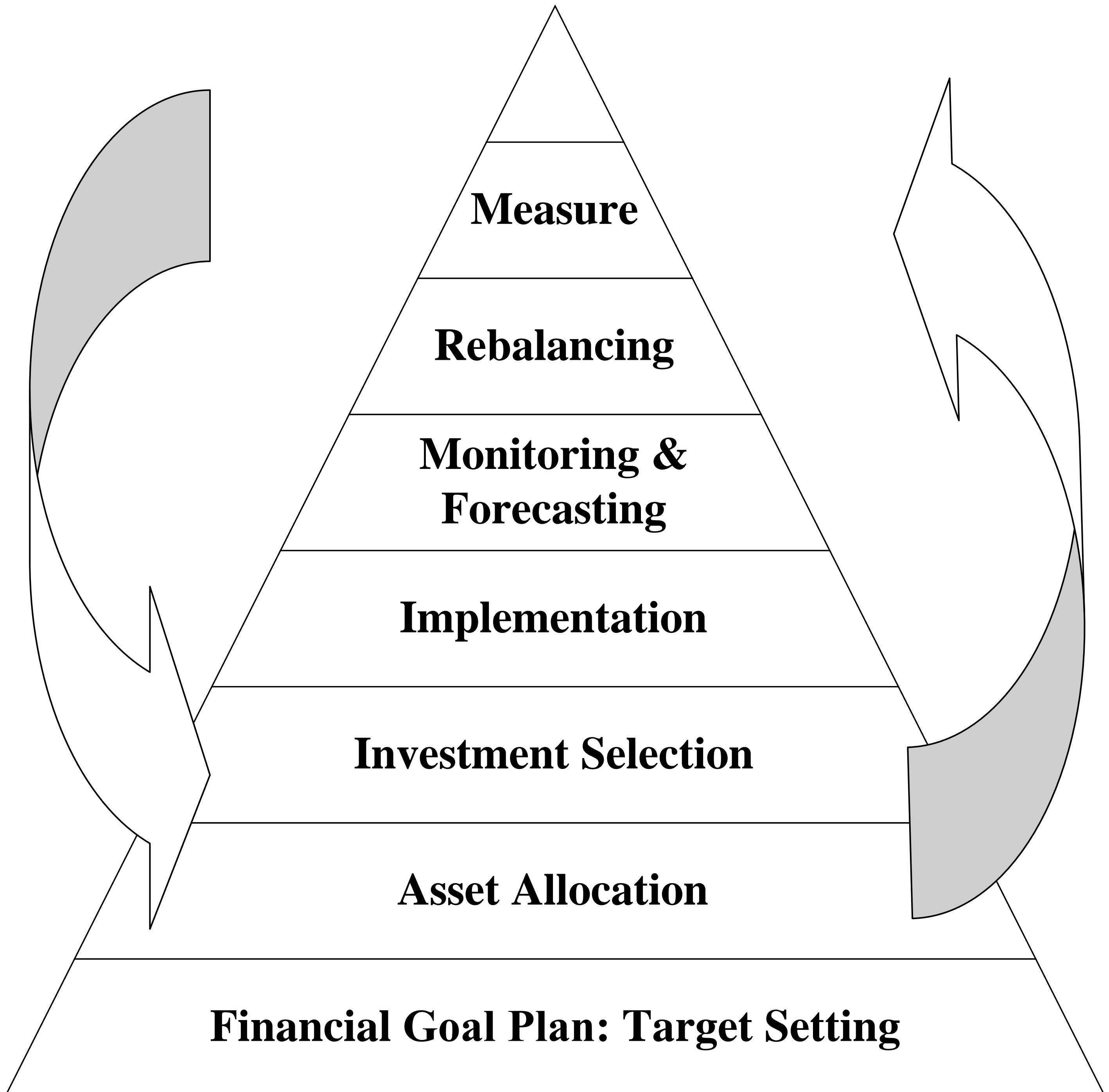
- maintains an average market capitalization of between $1 billion and $5 billion (mid-size US companies) and,
- has a selection method of acquiring stocks with low price multiples relative to net worth and cash flow such that the price/earnings ratio, relative to the Wilshire 5000 Index (the "market"), is less than 80% and,
- is a pure no-load fund and,
- has a historical, average Morningstar rating (risk-adjusted returns) of >= 4 and,
- has at least 20% of its holdings in financial stocks and,
- has an average annual portfolio turnover of <= 20% and,
- is available for purchase at Schwab Institutional.

The answer…***Tweedy, Browne American Value.***

Hence, we can zero in on our target and put together a portfolio of mutual funds that are *truly diversified*. With this powerful feature of mutual funds, we can literally ***cover the globe*** in terms of geography and asset type to search for investment value wherever we find it.

Finally, we can have the benefit of ***liquidity, marketability and divisibility***. Generally, mutual fund companies stand ready to redeem shares every business day for the ending Net Asset Value (NAV) without question and, with rare exception, without delay. This is a tremendous value in managing a portfolio of mutual funds, since we can respond in very timely fashion to changed circumstances of the markets or our clients. Unlike individual issues, mutual funds are divisible, allowing an investor to start with as little as $1,000 to $5,000 and own a part of as many stocks or bonds as the fund holds. This enables most investors, large or small, to enjoy the fruits of a smartly crafted, uniquely tailored, globally diversified portfolio.

In conclusion, there are PROS and CONS to using mutual funds as the vehicle of choice for constructing and managing balanced, global portfolios. But, at **Beacon**, we think the PROS easily ***outweigh*** the (surmountable) CONS.



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