

Structured Investing

In An Unstructured World

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An Unstructured World

By Meir Statman, Glenn Klimek Professor of Finance, Santa Clara University

In late November 2008, I was among many at the Reagan Library, listening to Henry Paulson, the Treasury Secretary, describing the financial and economic crisis engulfing us now. "Why didn't you see the crisis in time?" asked one audience member. "Why did you let Lehman Brothers go bankrupt?" asked another.

Later, I spoke about investor psychology to a smaller group of executives who found it hard to believe Secretary Paulson's assertion that he did not foresee this crisis. I believe him because I know the power of hindsight to mislead us into thinking that we have known in foresight what, in truth, we know only in hindsight. I also believe Ben Bernanke, Chairman of the Federal Reserve, who said he was "mistaken early on in saying that the subprime crisis would be contained." And I believe Alan Greenspan, the previous Chairman of the Federal Reserve, who testified before Congress that, "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief."

The motto "*Structured Investing In An Unstructured World*" has never been as true as it is today. The world is unstructured, even scary, and your financial advisor, following the *Structured Investing* methodology, provides crucial structure in guidance and investing. The government's role in structuring an unstructured world is crucial as well.

Changes in laws and regulations over time reveal continuing attempts by society, through its legislative process, to find the right balance between free markets and regulated markets and between free choice and regulated choice. A tug-of-war is forever fought between proponents of more freedom and more regulation. Historical events, such as stock market crashes and economic recessions, tip the balance toward one side or the other. This was true when regulations were enacted after the 1929 stock market crash, and it is true today, especially when it comes to the regulation of financial leverage.

In hindsight, we can see that there would have been no 2008 crisis if not for leverage. There would have been no housing defaults and foreclosures if home buyers paid for their houses in full with their own cash, rather than leverage their houses through mortgage loans to the tune of 90, 95, or even 100 percent. There would have been no 2008 crisis if financial institutions did not multiply mortgage leverage in securities backed by

leveraged mortgages. But the costs of eliminating leverage altogether are enormous. Few people would be able to buy houses if not for the ability to leverage their down payments through mortgage loans. The leverage debate is not about whether leverage should or should not be allowed — instead it is about what limits and regulations should be enacted.

Speculation, facilitated by leverage, is among the factors blamed for the 1929 crash. As President Franklin Roosevelt wrote to Senator Duncan Fletcher on March 26, 1934: "The people of this country are, in overwhelming majority, fully aware of the fact that unregulated speculation in securities and in commodities was one of the most important contributing factors in the artificial and unwarranted 'boom' which has so much to do with the terrible conditions of the years following 1929."

Two concerns underlie the drive to limit leverage: the damage investors can inflict on themselves and the damage they can inflict on others. Homeowners who borrow more than they can afford inflict damage on themselves as they are forced into foreclosure. Such homeowners also inflict damage on banks which are left with houses worth less than the outstanding loans. But does damage extend beyond homeowners and their banks? Discussions about "systemic risk" have been with us for years. Richard Farrant, deputy head of banking supervision of the Bank of England and chairman of the Basle Supervisors Committee on Off-Balance Sheet, argued in 1992 that, "Different markets are being tied more closely together, greatly increasing the potential for shocks in one market to be transferred to others in ways that are not fully understood."

But the dangers of systemic risk seemed remote in recent years, and the benefits of leverage seemed high. We know today, in hindsight, that we should have heeded warnings about the systemic hazards of excessive risk taking facilitated by leverage.

The financial crisis of 2008 has shifted power from promoters of free markets to promoters of regulated markets. We will see laws and regulations that limit leverage among homeowners and financial institutions, and we will see more vigorous enforcement of laws prohibiting predatory lending. In time, the 2008 crisis will fade from memory, replacing fear with exuberance, and we

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Five Compelling Reasons To Invest With Structure In 2009

by Joni Clark, CFA, CFP®, Chief Investment Strategist, Loring Ward

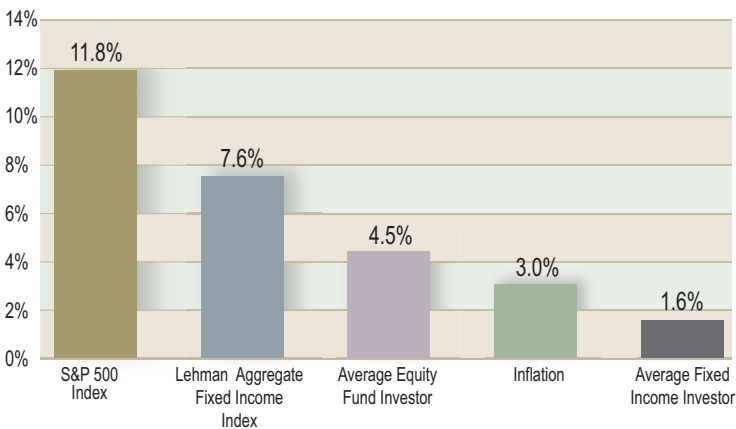
Following one of the steepest stock market declines in history, some investors are feeling ready to move everything to cash or chart a new course for their investment portfolios. While it is prudent to review your investment plan with your financial advisor on at least an annual basis, changes to your investment policy should not be based on recent market performance or expectations — or doubts — about the markets in the future. Instead, any adjustments should be based on changes to your financial circumstances, goals or even a re-evaluation of your personal risk tolerance.

For example, if you are considering a greater allocation to fixed income because you have discovered, through recent investing experiences, that your tolerance for risk and short-term volatility is not as high as you may have previously thought, then this may be a prudent change. On the other hand, if you are considering a greater allocation fixed income because the equity markets have suffered steep declines and you do not expect a quick recovery, then the purpose and timing of this change may be counterproductive to your long-term investment plan. Consider this: more conservative asset allocations will likely take longer to recover previous losses than portfolios with higher allocations to equities, if and when equity markets rebound.

If you are considering a change in your investment plan, take a moment to consider these compelling reasons to stay the course in 2009:

1. Long-Term Investment Success Is Highly Dependent On Investor Behavior

Investors who react emotionally to short-term movements are at risk of making ill-timed decisions that compromise their long-term performance.



Average stock investor and average bond investor performances were used from a DALBAR study, *Quantitative Analysis of Investor Behavior (QAIB)*, 12/2007. QAIB calculates investor returns as the change in assets after excluding sales, redemptions, and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses, and any other costs. After calculating investor returns in dollar terms (above), two percentages are calculated: Total investor return rate for the period and annualized investor return rate. Total return rate is determined by calculating the investor return dollars as a percentage of the net of the sales, redemptions, and exchanges for the period. The fact that buy-and-hold has been a successful strategy in the past does not guarantee that it will continue to be successful in the future.

DALBAR'S 2008 Quantitative Analysis of Investor Behavior found that over the twenty year period ending December 31, 2007, the S&P 500 Index has posted impressive returns, yet the "average equity fund investor" earned only a fraction of these results. In this study, the average investor's returns are measured by the change in the total mutual fund assets in the United States, after excluding sales, redemptions, and exchanges. It does not account for the dollar

amounts an individual investor may have invested or the timing of those investments. The study examined the aggregate amount invested in mutual fund assets in the United States as a whole; therefore the change in the aggregate amount during this time frame is considered the return.

One of the principle reasons for this shortfall is that investors are motivated by fear and greed — not by sound investment practices. Close examination of investor behavior and tracking the dollars going into and out of mutual funds reveal that as markets rise, investors pour cash into mutual funds. Then, when markets decline, investors tend to sell their holding in mutual funds, driven by the fear that the markets will not recover — even though broad indices show that, historically, markets have indeed come back over time.

2. Investors Attempting To Avoid Market Declines Are Just As Likely To Miss Out On Market Gains

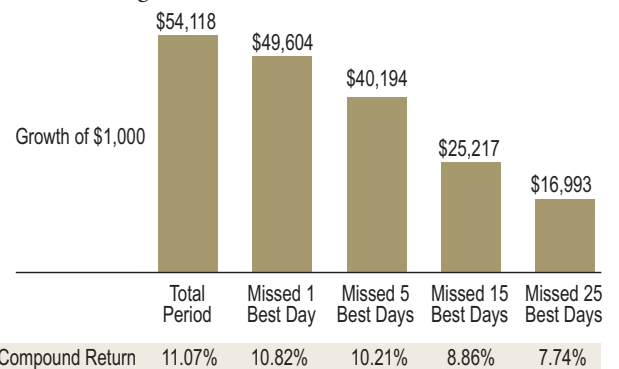
Market timing offers a seductive prospect — by predicting market direction, a trader might capture only the best-performing days and avoid the worst. But this requires being right twice: when you sell and when you buy.

And to further complicate things, large gains have often, in the past, come in quick, unpredictable surges. An investor who misinterprets events may leave the market at the wrong time. Missing only a small fraction of days — especially the best days — can defeat a market timing strategy.

For example, as the chart below shows, \$1,000 invested in 1970 in the S&P 500 would be worth \$54,116 in 2007. However, missing just five of the best days would have cut these returns by about \$14,000 to \$40,194.

No one knows when those "best days" will happen, yet many people prefer to try and ride out a bear market by pulling out of the market or just staying uninvested on the sidelines.

Even if you'd missed just one day — the single best day — between 1970 and 2007, you'd have made a \$4,514 mistake. For a \$100,000 portfolio, that mistake grew to \$451,400.



Source: Standard & Poor's Index Services Group (January 2008). Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Values change frequently and past performance may not be repeated. There is always the risk that an investor may lose money.

3. Market Downturns And Recoveries Are Part Of The Normal Course Of Investing

History has demonstrated repeatedly that stocks are prone to sudden declines in value. Sometimes they recover their value quickly. Other times the decline lasts for quite a while.

As measured by the S&P 500 Index, the most severe downturn in modern times marked the start of the Great Depression, with stocks losing over 80% of their value. In this case, the recovery period was over 12 years. More recently, stocks lost 44.7% of their value during the early 2000 bear market. This recovery period, which took four years, was the second longest in history.

Market Downturns & Recoveries — 1926-2007

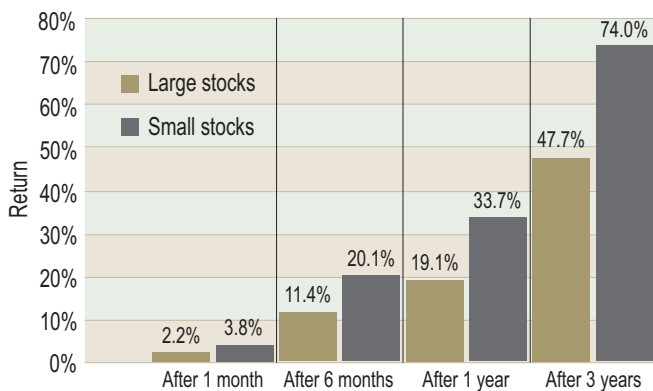
Downturn	% Loss	Recovery
34 months	-83.4%	151 months
6 months	-21.8%	35 months
7 months	-10.2%	5 months
5 months	-15.0%	7 months
6 months	-22.3%	10 months
8 months	-15.6%	6 months
19 months	-29.3%	9 months
21 months	-42.6%	21 months
14 months	-14.1%	5 months
20 months	-16.9%	3 months
3 months	-29.5%	18 months
5 months	-14.7%	4 months
2 months	-15.4%	3 months
25 months	-44.7%	49 months

Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Large stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. Downturns in this example are defined by a time period when the stock market value declined by 10% or more from its peak, while the recovery period indicates the number of months from the trough of downturn to the market's previous peak. An investment cannot be made directly in an index. The data assumes reinvestment of all income and does not account for taxes or transaction costs. © 2008 Morningstar, Inc. All rights reserved. 3/1/2008.

No one can predict market declines or recoveries with certainty. In addition, every bear market is punctuated by a number of rallies; and only in hindsight do we know whether a rally is temporary or the start of a lasting recovery. This is another argument for remaining invested and avoiding market timing.

4. Performance Of Stocks After Recessions Has Historically Been Strong, Especially For Small Company Stocks

Stock Performance after Recessions 1945–2007



Large stocks in this example are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. Small stocks are represented by the fifth capitalization quintile of stocks on the NYSE for 1945–1981 and the performance of the Dimensional Fund Advisors, Inc. U.S. Micro Cap Portfolio thereafter. An investment cannot be made directly in an index. Recession data is from National Bureau of Economic Research (NBER). The average cumulative returns are calculated from the end of each of the 10 recessions in U.S. history. NBER does not define a recession in terms of two consecutive quarters of decline in real GNP. Rather, a recession is a recurring period of decline in total output, income, employment, and trade usually lasting from six months to a year, and is marked by widespread contractions in many sectors of the economy. The data assumes reinvestment of income and does not account for taxes or transaction costs.

This pattern is not guaranteed to repeat itself, but it illustrates the market's potential and one of the reasons to stay focused on your investment plan. Throughout history, stock market recoveries often lead recoveries in the economy, so not being invested during economic and market downturns may deprive you of future opportunities.

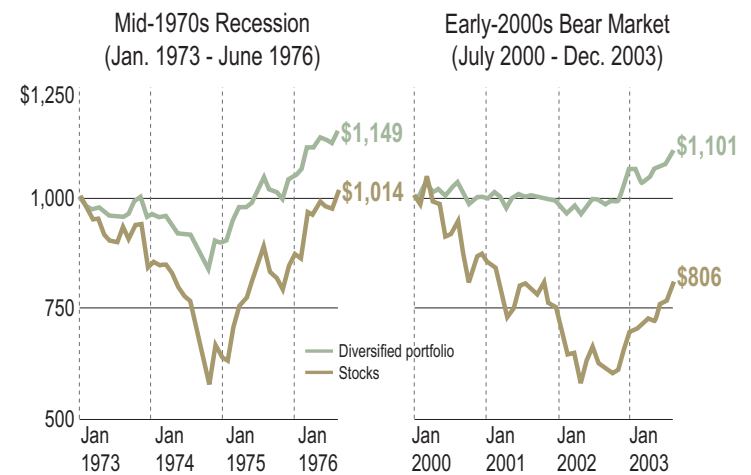
Also, many investors fear the volatility of small stocks. Their fears, however, may not justify overlooking the potential of this asset class. The chart shows that, on average, the cumulative returns of small stocks outperformed large stocks, one month, six months, one year and three years after the end of a recession.

Stocks are not guaranteed and have been more volatile than other asset classes. Furthermore, small stocks are more volatile than large stocks and are subject to significant price fluctuations, business risks, and are thinly traded. And small stocks haven't outperformed large stocks after every recession, yet on average their potential to lead the way out of recessions is significant. Diversifying into small stocks may benefit investor portfolios, especially when the market is emerging from a recession.

5. Diversification Works

Negative events such as credit crises or economic downturns may tempt investors to flee the financial markets. But diversification and a long-term perspective can help investors ride out the storm.

While diversification does not guarantee a profit or protect against a loss, the benefits of diversification are most evident during bear markets. These two graphs illustrate the growth of stocks versus a diversified portfolio during two of the worst market performance periods in recent history.



Past performance is no guarantee of future results. Hypothetical value of \$1,000 invested at the beginning of January 1973 and July 2000, respectively. Diversified portfolio: 35% stocks, 40% bonds, 25% Treasury bills. Stocks in this example are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. Bonds are represented by the 20-year U.S. government bond, and Treasury bills by the 30-day U.S. Treasury bill. The mid-1970s recession occurred from January 1973 through June 1976. The early 2000s bear market occurred from July 2000 through December 2003. An investment cannot be made directly in an index. The data assumes reinvestment of income and does not account for taxes or transaction costs. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Diversification does not eliminate the risk of experiencing investment losses. © 2007 Morningstar, Inc. All rights reserved. 3/1/2008

The gold line illustrates the hypothetical growth of \$1,000 invested in stocks during the mid-1970s recession and during the early 2000s bear market. The blue line illustrates the hypothetical growth of \$1,000 invested in a diversified portfolio of 35% stocks, 40% bonds and 25% Treasury bills during these same two periods.

Over the course of both time periods, the diversified portfolio lost less than the all-stock portfolio. Over longer periods of time, the more volatile single asset-class portfolio is likely to outperform the less volatile diversified portfolio. However, keep in mind that one of the main advantages of diversification is reducing risk, not necessarily increasing return, over the long run.

A disciplined and diversified investment approach is often the best strategy for handling market downturns. The key to participating in market recoveries and realizing market returns over time is working closely with your financial advisor and staying focused on your long-term investment plan.

Making Lemonade In 2009

By Joni Clark, CFA, CFP®, Chief Investment Strategist, Loring Ward

2008 handed many investors a bucket full of lemons as well as questions about what to do next.

Though it may take some time to erase 2008's steep market declines from our portfolios — and from our minds — as long-term investors, we have to keep moving forward to meet our financial goals. And that may mean turning some of our financial lemons into lemonade. Here are a few fresh ideas to discuss with your financial advisor:

Reposition Your Portfolio for Greater Tax Efficiency

The changing political landscape and the potential for federal tax increases, combined with an uncertain economic and market environment, illuminate the importance of tax-efficient investing. The tax implications of investing are all too often overlooked during periods of high portfolio returns, but the prospect of paying taxes on top of experiencing declining investments can be painful for investors.

Now may be a good time to work with your advisor to determine whether or not repositioning your portfolio toward greater tax-efficiency makes sense, especially if repositioning will result in the harvesting of losses, rather than the realization of capital gains. After an extended period of strong portfolio returns, the ability to reposition can be limited because of the tax consequences of realizing capital gains. Following a market decline, repositioning a portfolio can often be done with little or no negative tax impact.

Finally, when it comes to creating more tax-efficient portfolios, be sure to focus on properly locating investment assets in taxable and tax-deferred accounts to maximize the benefits of tax-deferral; in particular, use tax-efficient investments in taxable accounts.

Investment Asset Location

Asset location is a tax management strategy that takes advantage of the fact that different types of investments and accounts get different tax treatments to maximize the benefits of tax deferral and enable the most tax-efficient portfolio rebalancing. Asset location strategies consider the tax efficiency of each investment in your portfolio, the long-term return potential of the investments and the types of accounts available for holding the investments.

All other things being equal, how a security is taxed will determine where it should be located. What is the character and timing of tax recognition for each type of investment account? This includes ordinary income, short- and long-term capital gains, qualified and non-qualified dividends, foreign tax credits, etc. Under the current tax code, dividends and long-term capital gains get favorable treatment. While interest income gets taxed at a 35% rate for investors in the highest tax bracket, the tax rate for dividends and long-term capital gain is only 15%. Since most equity investments generate returns from dividends and capital gains, investors realize lower taxes when holding stocks or equity mutual funds within a taxable account, rather than holding taxable fixed income investments. Those same capital gains and dividends would be taxed at ordinary rates of up to 35% for investors in the highest tax bracket, if withdrawn from a tax-deferred retirement account.

Other important considerations are your investment time horizon, liquidity preferences and/or income needs, and sensitivity to short-term volatility in a taxable vs. tax-deferred account. Speak with your financial advisor to determine appropriate asset location strategies based on your personal financial circumstances.

Tax-Efficient Investments

When it comes to tax efficiency, clearly not all investments are created equal.

Because after-tax return is what really matters, understanding an investment's tax efficiency and using tax-efficient accounts are critical. Generally speaking, the funds used in the *Structured Investing* approach are managed to reduce capital gains distributions through low turnover strategies. However, some funds are more aggressively tax managed than others and may be more suitable for taxable accounts, while others may be more suitable for tax-deferred accounts.

Rebalance Your Portfolio to Your Target Asset Allocations

Over time, higher-performing asset classes may become a larger percentage of your portfolio, and lower-performing asset classes may become a smaller percentage. The purpose of rebalancing is to prevent "portfolio drift" and ensure that your portfolio remains aligned with your investment goals, risk tolerance and time horizon.

One potential benefit of rebalancing is that it can result in buying low and selling high. To restore the portfolio to your target asset allocation, it is necessary to sell the investments that have done well and are priced relatively high, and buy more of the investments that have not done as well and are priced relatively low. Please note that the buying and selling of securities for the purpose of rebalancing may have tax consequences.

Another critical benefit of rebalancing is that it helps keep emotions out of the investment decision process. Disciplined portfolio rebalancing helps investors stay focused on their investment policy rather than on the emotion of recent successes or failures.

Reinvest Earnings & Invest New Money at Lower Market Prices

As painful as a portfolio decline can be, it is an important and healthy process for the markets to adjust to economic fundamentals and reflect the proper risk premium for equity investments.

The return on the S&P 500 for the past decade (from 12/1/1998 to 11/30/2008) is now negative, with an annualized return of -0.93% compared to the U.S. Treasury Bill at +3.26%. The long-term return for U.S. equities has historically been approximately 8% higher than the return on the U.S. Treasury Bill. Though past performance is no guarantee of future results, with history as our guide, now may be a good time to invest long-term money in the stock market in anticipation of an eventual shift to a positive direction.

We don't know at this point when the markets will return to an upward trend or how long it will take to recover the losses from 2008. What we do know is that, as long-term investors, there are a number of proactive steps we can take today to better position our portfolios for tomorrow ... and seek to turn 2008's lemons into 2009's lemonade. ☺

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will hear again calls to foster free markets and eliminate regulations.

The world has been unstructured in the past, it is unstructured today, and it will be unstructured in the future. And while we can see the causes of previous crises perfectly, it is difficult to predict what might bring on the next bear market or recession. As investors, *Structured Investing* provides us with a rational, disciplined framework that helps diminish some of the uncertainty that is all too characteristic of markets and economies. ☺