

Our Approach to Investing

Our investment policy focuses on using asset allocation and diversification as the primary means of achieving a client's desired investment goals. We recognize the preponderance of academic evidence that the capital markets are highly efficient. Given this, we construct portfolios primarily using securities that are cost-efficient, diversified, and tax efficient. Our strategy seeks to maximize after-tax risk-adjusted total return for the client.

Several academic studies indicate that investment policy and asset allocation explain from 90% to 100% of a portfolio's return. Therefore, our policy focuses on the allocation of several asset classes as the determinant of investment results rather than individual security selection. Money market funds, fixed income, domestic equities, real estate, and international equities are all integral components of a suitably balanced portfolio.

Index-based securities and funds are well suited for asset allocation since they are more style specific in terms market capitalization and sector exposure than most actively managed mutual funds which are prone to "style drift". For example a large cap value fund may buy growth stocks in order to improve performance. Regardless of the correctness fund manager's judgment call, the risk and return profile of the fund can change substantially from the time the investor initially invested in the fund. Using indexed-based securities allows the investor to select the appropriate value/growth mix knowing that the underlying securities bought will be more stylistically consistent over the life of the investment.

Based upon considerable academic evidence that value stocks and smaller capitalization stocks outperform over the long term, we seek to add value by judiciously increasing the value bias and smaller company bias in the weighting of the equity portfolio. We also seek to add value by including international equity investments (when appropriate to the client) that offer broad global exposure and have a low correlation to the U.S. equity markets.

We recognize that taxes are often one of the largest expenses to an individual investor and will be tax sensitive in the decisions made in asset selection, asset allocation, and trading strategies.

Prudent Investor Rule

In 1992 The American Law Institute published *Restatement of the Law & Trust, Prudent Investor Rule*. This is meant as a guideline for the prudent management of trust assets. The rule sets forth a high standard of investment policy, which we think is applicable to all investment portfolios whether or not held specifically in trust. In California it became law in 1996 under the title of the *Uniform Prudent Investor Act*. *We manage client portfolios using a prudent investor standard and views managing a client's portfolio as a fiduciary responsibility where all portfolio decisions are to be made in a fiduciary context.*

The Prudent investor rule states:

1. Sound diversification is fundamental to risk management and is therefore ordinarily required of trustees (investors).
2. Risk and return are so directly related that trustees (investors) have a duty to analyze and make conscious decisions concerning the levels of risk appropriate to the purposes, distribution requirements, and other requirements of the investments they administer.
3. Trustees have a duty to avoid fees, transactions cost and other expenses that are not justified by the needs and realistic objectives of the trust's investment program.
4. The fiduciary duty of impartiality requires a balancing of the elements of return between production of current income and the protection of purchasing power.
5. Trustees may have a duty as well as having the authority to delegate [to an investment advisor] as prudent investors would.

Asset allocation, diversification, tax- and cost-efficiency, and prudent investment standards are the distinguishing characteristics of our investment policy.

Asset Allocation

We recognize asset allocation as the largest determinant of return in an investment portfolio. We determine asset allocation on a client-specific basis taking into consideration return requirements, risk tolerance, liquidity and marketability requirements, time horizon, tax considerations, asset location (placing assets in the most suitable account when possible), legal constraints, and the unique needs or preferences of the client. Mean variance optimization may be used as a tool, however, we also consider practical experience, client preferences, and professional judgment in determining the appropriate allocation for the client.

Asset classes used are money market mutual funds (“Cash”), fixed income securities and fixed income mutual funds (“Fixed Income”), equities, equity mutual funds and exchange traded funds (“Equity”), real estate index funds and exchange traded funds (“Real Estate”), and international equity mutual funds and exchange traded funds (“International”) and an institutional enhanced commodity futures index fund (“Commodities”). Real Estate and International are sub asset classes of the Equity asset class. We will continue to research various asset classes and security types and may include new asset classes and investments into the strategy (the commodities asset class was recently added after considerable research). Given that clients may come into the relationship with existing assets, often with unrealized capital gains, we will make efforts to incorporate existing assets into the asset allocation and portfolio management process

where appropriate. Clients may also want to hold specific securities, possibly in large concentrations, for various reasons and we will attempt to honor that request while maintaining as much diversification in the portfolio as possible.

Often, as a part of our asset allocation, we use mutual funds offered by Dimensional Fund Advisors (DFA). DFA mutual funds are offered only to institutional investors and a select group of fee only advisors. DFA funds are passively managed no load mutual funds based upon the research of Eugene Fama of the University of Chicago and Kenneth French of Dartmouth University. DFA funds are created to capture the value and small company segments of the domestic and international equity markets. DFA funds also offers fixed income funds, which we may use in client fixed income allocations. DFA mutual funds are no-load, low expense funds, and we receive no financial compensation for using DFA mutual funds in client portfolios.

Cash

Money market funds with sound credit quality ratings will be used. Money market mutual funds will be selected on the basis of credit quality, diversification, yield, and tax benefits.

Fixed Income

The fixed income portion of the portfolio will incorporate bond funds and will diversify along types of debt (corporate, government, and municipal) when appropriate, and will diversify along varying maturities. Fixed income mutual funds will be selected on the basis of credit quality, diversification, yield, duration, and tax benefits. Index based funds will be primarily used. International fixed income securities or funds may be added to the portfolio to improve diversification.

Equities

The equity portion of the portfolio seeks broad market exposure in terms of market capitalization (Large Cap, Mid Cap, and Small Cap) and in terms of sector and industry exposure. Considerable academic evidence indicates that value stocks (as determined by the price-to-book ratio) and small capitalization stocks outperform the market in the long-term. While the standard deviation of returns of value and small capitalization equities are higher than the broader market, their correlation with the broader market is lower. Thus increasing the weights of value and small capitalization stocks may offer increased return, while the risk profile of the portfolio due the increase in value and small capitalization stocks is moderated in a prudently diversified asset class portfolio due to the lower correlation of these asset classes to the broader market.

In constructing the equity portfolio for a client we start with a market neutral portfolio in terms of market capitalization (large cap, mid cap, and small cap) and increase the weight of the value, and smaller company (both mid cap and small cap) exposure. The increase in weights is determined by the client's risk tolerance level. Within the equity portion of the portfolio risk is reviewed on two criteria; risk tolerance for portfolio volatility, and reference risk or the client's comfort level with the tracking error of the equity portion of their portfolio with the S&P 500.

Real estate exposure in the portfolio will be gained through the use of real estate sector index securities. International exposure will focus on adding additional diversification and will incorporate countries with lower correlations to the U.S. market, and emerging markets into the strategy. Non-country specific international funds with low correlations to the U.S. Market may also be used.

Commodities

The commodities portion of the portfolio seeks to act as a unique inflation hedge, as displayed by positive relative historical performance during periods of unanticipated inflation. Commodities have low to negative correlations with both bonds and equities, warranting commodities to be truly a unique asset class. We use an institutional enhanced commodity index fund which invests in the Dow Jones commodity index using futures contracts. Collateral funds are invested in Treasury Inflation Protected Securities (TIPS), which further increases the opportunity to offer inflation protection. Due to the tax inefficiency we only use Commodities in tax sheltered accounts. The maximum allocation to commodities is 10 percent of total portfolio allocation. While a diversified commodity fund can be very volatile, a judicious allocation to commodities actually lowers volatility in a well diversified portfolio.

Alternative Assets

Alternative Assets, such as private equity investments, private debt investments, venture capital investments, hedge funds, precious metals and commodities, may be held in certain portfolios when appropriate to specific client circumstances, contributes to diversification, or when requested by the client. Currently, Alternative Assets are not a part of our asset allocation strategy, and will be used on an account-specific basis.

Taxes

In taxable accounts, taxes likely will be the largest portfolio expense. We work to minimize the affect of taxes on total return while maintaining diversification. Tax strategies include locating assets in the appropriate account based upon the account's tax status, harvesting tax losses, avoiding short-term realized gains, minimizing taxable gains, and deferring capital gains. The use of tax efficient investments will be emphasized when available and appropriate. However, less tax efficient securities may be used in order to improve diversification.

Our approach toward managing a portfolio allows for unrealized capital gains to grow in the account while maintaining adequate diversification. The client must realize that deferring capital gains delays the eventuality of taxation rather than eliminate taxation. Deferred capital gains will need to be paid upon liquidation of the account. However, certain estate planning strategies allow for securities with large capital gains to be passed on to heirs and charitable organizations without paying a tax on the security.

Currently, long-term capital gains rates are taxed at a lower rate than ordinary income and short-term capital gains. Deferring tax payment cash outflows maintains the current principle value of the portfolio and allows for greater compounding upon investment

returns. Index based securities in the portfolio, however, may incur short-term capital gains at times. Historically, the amount of taxable short term gains of index-based securities has been less than in most active strategies. This is primarily due to the lower turnover in the fund holdings of the indexed based security. We expect this difference will continue to hold true.

Certain securities used in our portfolio strategy use tax advantaged methods to defer or eliminate taxable gains. We cannot guarantee that these securities will always be allowed to use this tax-advantaged method of exchanging holdings. However, even if this tax-advantaged method is lost due to a change in law, these securities are still likely to be more tax efficient when compared to the average actively managed mutual fund.

Open-ended mutual funds, both active and indexed, also face the risk of having to distribute capital gains to existing fund shareholders when other fund shareholders liquidate. Many of the securities used in our strategy do not face this risk. When we do use open-ended mutual funds in our strategy, we look for funds that are tax efficient either by default or by design.

Currently the expense ratio of the securities used in our strategy is lower than virtually all other pooled asset alternatives. In order to adequately replicate this strategy using individual securities, the dollar amount would need to be much larger than what even most affluent investors are able to invest, and the cost to administrate would most likely be more than the expense of the securities used in our strategy.

We will apply certain strategies, such as tax loss harvesting, in order to maximize taxable losses when possible. In a constantly upward moving market, this strategy is not useable. Assuming moderate market volatility and continued cash infusions into the portfolio, this strategy can be used over the life of the portfolio. We cannot guarantee that this strategy can be implemented in all circumstances due to possible market trends and possible tax law rulings.

Due to the trading cost involved in this strategy, smaller sized portfolios that have recurring contributions may be better served using open-ended funds to achieve the best return. We will select most appropriate securities based upon the initial dollar contribution, and the expected frequency and dollar amounts of future contributions.

Portfolio Rebalancing

We monitor portfolios to insure allocations remain within target ranges. After the setting of the initial allocation, we will recommend to the client fairly broad target ranges for each asset class to allow for variability of asset class returns. The logic behind this is that a portfolio well diversified upon inception can better tolerate shifting in asset class weights.

Also, we do not want to change the portfolio allocation due to short-term shifts in market prices. We prefer to rebalance the portfolio as a result of secular rather than cyclical changes in value. Portfolio rebalancing will focus on being strategic rather than tactical.

While factoring in tax considerations and market volatility, portfolio rebalancing will also focus on maintaining the appropriate asset mix for the client based upon their risk tolerance, time horizon, and other client specific circumstances. Of course, we will always attempt to rebalance portfolios in a tax advantaged manner. Sub asset class weights and specific funds or securities within an asset class will be allowed to shift substantially due to price changes as long as target allocations are within range.

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