Droms Strauss Advisors White Paper: "Investing for 2009 and Beyond."

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The market crash of 2008 and the unprecedented levels of market volatility have left most investors unsettled and worried. It is no secret that economies and markets move in cycles, some of which are driven by underlying economic issues and others by events totally unrelated to the markets. However, letting our emotions and fears drive our investment decisions undermines everything we know about investing. In the words of Charles Schwab Chief Investment Strategist Liz Ann Sonders, "Panic is not an investment strategy." The purpose of this document is to take a rationale look at the economy, the markets and investment ideas based upon proven market strategies and ideas.

As a result of the world wide stock market devastation last year all of our investment portfolios were left over weighted in cash and fixed income securities and under weighted in equities. A typical balanced portfolio that was 60% invested in stocks and 40% invested in bonds at the beginning of 2008 would have finished up the year at approximately 50% in stocks and 50% in bonds. Investing for 2009 and beyond must therefore address when and how to rebalance to targeted asset allocations and, just as importantly, determine strategic investment planning changes that are appropriate in response to the unprecedented worldwide market volatility experienced during the past two years, the continuing credit crisis and ongoing deep recession, and the inevitable increase in taxes which will be necessary to fund the explosion in deficit spending that is the cornerstone of the government's efforts to stimulate the economy.

On December 1, 2008 the National Bureau of Economic Research officially dated the beginning of the current recession as December 2007. Prior to the current recession, there have been twelve recessions since the Great Depression of 1929 to 1933. These recessions lasted from 6 to 16 months with the two longest recessions in the post-World War II period each lasting 16 months (in 1973-74 and 1981-82). It appears likely that the current recession will break this record, but recessions do end. If the current recession drags on until the third quarter of 2009, it will have lasted for about 20 months. There is certainly no guarantee that the recession will end in the third quarter of 2009, but it seems highly likely that that massive fiscal and monetary stimulus package planned by the Obama Administration will propel the economy forward sometime before the end of 2009. No one can predict how long it will take for the market to recover or whether or not the market will decline further before it turns around. However we do know that the market ultimately will improve. In all prior recessions, the single most reliable predictor of economic upturns has been the S&P 500 Index, which usually turns up about four to five months ahead of the economy. If history is any guide at all, this puts the stock market on the road to recovery sometime in the second or third quarter or 2009.

Once on the road to recovery, the stock market should have a huge wind at its back. Bloomberg News recently reported that the percentage of stock market value held in cash is equal to 75% of the total value of the U.S. stock market (at $8.85 Trillion, this "sideline" cash is over 100% of the value of the S&P 500). A report by the Leuthold Group points out that on the eight previous occasions that cash peaked in comparison to the stock market value, the S&P rose an average of 24% in the following six months. In a recent interview, Warren Buffet stated, "You need to be greedy when others are fearful… when people talk about cash being king, it's not king if it just sits there and never does anything. There are times when cash buys more than other times and this is one of [them]."

It is important to remember that while stock prices declined nearly 43% in 1973 and 1974 they were back to peak values in two years. During 2000, 2001 and 2002 stock prices declined by nearly 45% and were back to peak values within one and one-half years. Average annual returns from stocks for the five year period after 1974 were 23.7% and for the five year period after 2002 average annual returns were 17.7%. Recoveries have occurred after every stock market decline in our county's history and there is no good reason to assume that stock prices will not recover now. Although stock prices declined during bear markets they advanced to higher levels during subsequent bull markets. After all the ups and downs, stocks have generated an average annual return of about 12% since the end of World War II.

Fundamentally, as of the end of 2008, stocks are cheaper than they have been in fifty years – Price/Earnings ratios are at fifty year lows, Price/Book ratios are at less than 1.0 (stocks are priced at less than the underlying value of company assets) and the dividend yield on stocks is higher than the yield on the 10-year U.S. Treasury bond. These are all clear signs that stocks are a great buy – the question that remains is when they will begin to reflect their true values.

Based on the premise that the markets will begin to stabilize and recover during the second or early third quarter of 2009 and following Warren Buffets advice to "skate to where the puck is going," we believe that investment portfolios should be rebalanced to normal asset allocation targets by the end of the second quarter. Depending upon variance between actual and targeted asset allocations and individual circumstances, these adjustments may be done in one, two or more steps.

Human nature would argue that most of us are more risk averse after the crash than before. However, the main challenge (and opportunity) now is to not compound the damage of 2008 by bailing out of the stock market and turning paper losses into permanent capital depletions. Each of us needs to reevaluate our own risk tolerance and modify our asset allocation plan if warranted. If you believe that your risk tolerance has been permanently altered a change in your long-term asset allocation plan might be warranted. On the other hand, if you believe that once the markets stabilize and rebound your risk tolerance will be unchanged from its' pre-2008 level, then you should stay with your existing overall plan and focus on how your long-term investment plan might need to be altered to account for the debacle of 2008. This might include a re-evaluation of your spending (income) needs, increasing your savings (taking advantage of the historically low stock prices), re-thinking your targeted retirement date and making sure you have sufficient cash and short term fixed income securities to cover one, two or three years needs depending upon your personal financial situation.

The credit crisis that began in 2007 and the current long and deep recession will continue to have a significant impact on implementation of investment strategies going forward. For 2009 and beyond consideration should be given to looking at investment vehicles that provide more protection in declining markets and at the same time, be positioned to participate rising markets. In addition, it is almost certain that that the new Obama Administration will raise income taxes for higher income taxpayers. This impending rise in taxes makes tax efficient investing more important than ever before.

In order to make certain that portfolios are structured to be as tax efficient as possible, Droms Strauss Advisors has recently purchased the latest technology in portfolio rebalancing software which will allow us to make our rebalancing adjustments to investment portfolios as tax efficient as possible. We participated in "beta testing" this software last fall and will be the first firm in the country to be using this new technology. We will be installing the new software on our servers in late February or early March.

For our high net worth client portfolios, we plan on making several significant tactical changes in implementation of our overall investment strategy:

> In order to make portfolios more tax efficient we anticipate using more exchange traded funds (ETFs) where appropriate in portfolios. (See the attached summary of Exchange Traded Funds.) ETFs are highly tax efficient and have very low internal (operating) costs compared to actively managed mutual funds. We expect to use ETFs to replicate certain market components where, on an after-tax and after-cost basis, the value added by active managers is marginal. We will continue to use actively managed mutual funds and/or separate account managers for asset classes where we believe the managers can provide significant value added.

> Based on the available economic data and forecasts, we will tactically underweight certain asset classes by delaying or partially delaying reinvestment back to asset allocation targets until such time that we see a more positive likelihood for the rebound in those market segments. At this time, the asset classes that we plan on under weighting include international equities and international real estate. This should in no way be considered our attempt to "time the market" but rather, to be as prudent

as possible with the investment of client funds. We will counterbalance underweighting in international equities by overweighting short-term fixed income investments (including money market funds) and U.S. equities.

Where appropriate, we intend to expand the use of a long-short U.S. equity fund strategy. Adding or maintaining a two to three percent position in a long-short fund should reduce portfolio volatility and provide increased returns in volatile markets. Long short funds are mutual funds that take long (buy) positions in stocks they believe are undervalued in the market and short (sell short) positions in stocks they believe are overvalued by the market. Please note that our investments in long-short funds will be limited to mutual funds that employ a long-short strategy and that we will not be investing in any long-short hedge funds that are not publicly traded and do not have daily transparent pricing available.

In an effort to further reduce the market risk in portfolios we will expand the use of Structured Notes linked to equity indexes in client portfolios. These investment vehicles allow us to maintain a particular market exposure with some downside protection thus reducing risk in our accounts. (See attached summary of Structured Notes.)

Where appropriate, we will also be investing in "high dividend yield" funds and now that the commodity bubble has burst, adding commodity funds into portfolios as part of our alternative investment allocation. Although these investment vehicles might not have a place in everyone's portfolio there are many portfolios (based upon risk tolerance) where such investments make a great deal of sense.

For many of our smaller accounts, we have already instituted changes in the way we build balanced investment portfolios.

In smaller accounts where controlling costs is critical we have made Exchange Traded Funds (ETFs) our investment vehicle of choice. Using ETFs allows us to more broadly diversify investments among asset classes and across investment styles. ETFs offer an extraordinarily efficient and cost effective means to achieve wide diversification.

All accounts will be diversified across five major asset classes: Money Market Instruments, Fixed Income, U.S. Equities, International Equities and Alternative Investments (Real Estate Investment Trusts and Commodities). Based upon what we know about how size impacts returns we will also diversify your equity investments between large cap and small cap holdings. Since investment styles also perform differently, we will diversify holdings between growth-oriented and value-oriented investments.

In conclusion, we see no reasonable alternative to adherence to our underlying investment philosophy that has anchored our investment strategy since we began our practice over 15 years ago. As we noted in our last quarterly client letter, we had the rare privilege and pleasure to attend a dinner this month with Dr. Harry Markowitz, the 1990 Nobel laureate in economics and the father of modern portfolio theory. One of the points we took away from "Dinner with Harry" was that the father of modern portfolio theory has no plans to sell his equity investments in response to the market downturn. He pointed out that statistically, last year's experience can be expected to occur approximately once in 40 years. He explicitly stated that he does not believe that market timing will help investment performance and that the best response to 2008 is to hold a broadly diversified portfolio that is anchored in equity investments. In short, it does not make sense to build your long-term investment strategy on the basis of a scenario that has never occurred before and has a probability of reoccurrence of less than two percent. We continue to focus on the investment approach that we had consistently recommended for ourselves and all of our clients:

- Broad diversification across asset classes and within asset classes
- Maintenance of adequate liquidity to meet expected cash flow needs
- Adherence to an agreed-upon asset allocation and invest policy

- Avoidance of market timing

For 2009 and beyond, we will be adding some new tactics to help implement our investment strategy, but our strategy will continue to be anchored in these foregoing principles. Included in the new tactics we plan to implement in client portfolios where appropriate are:

- Tactically underweight international stocks and REITs and overweight short-term fixed income (including money market funds) and U.S. equities
- Expand use of ETFs and index funds to offer broad asset class exposure at low cost and increase tax efficiency for taxable accounts
- Integrate of high yield dividend funds into equity allocations
- Add Structured Notes to offer downside protection and upside participation
- Expand use of long short equity approaches to reduce portfolio volatility
- Enhance tax efficiency of rebalancing transactions

We believe that long-term success at investing requires discipline and a consistent commitment to an underlying investment philosophy. We will continue to exercise that discipline and commitment on your behalf and look forward with confidence to the future recovery of the U.S. and world economies.

Structured Note Fundamentals

Structured notes are debt instruments (bonds) issued by financial institutions such as JP Morgan, Deutsche-Bank, HSBC, Morgan Stanley, Credit Suisse and other major banks. However, these notes are different from typical debt instruments in that the returns are linked to an underlying equity index such as the S&P 500, the Russell 2000 or the EAFE (Europe, Australia & Far East) index rather than a stated rate of interest.

In order to create a structured note the issuer combines a zero coupon bond with financial derivatives such as call or put options or futures contracts and swap agreements. It is this strategic combination of the traditional investments with the derivatives that determines the investment payout at maturity. In perhaps its simplest form, a zero coupon bond is combined with a call option on an equity index, for example the S&P 500 Index. Consider the following example: you invest $10,000 which is used to purchase a two-year zero coupon bond from JP Morgan. Assuming an interest rate of 5%, this bond will cost approximately $9,000 to purchase. The remaining $1,000 is used to purchase a call option on the S&P 500 Index that expires in two years to coincide with the maturity of the zero coupon bond. JP Morgan also is paid a fee from this $1,000 spread. If the S&P 500 Index has declined as of the maturity date, the call option is worthless and you, the investor, receive the $10,000 principal value of the bond. You earned no interest on your money but had no loss of principal. However, if the S&P Index goes up in value by say 10%, the value of the call also increases by 10% and you would therefore receive the principal value of your investment plus a 10% return. This is an example of what is often referred to as a “principal protected note”. You have upside market return potential but no downside risk.

Another way these structured notes are often structured is with some downside risk and, in return for the investor taking some risk, the payout on the upside is enhanced. For example, we might want to protect against the first 10% decline in the equity market based upon the assumption that it is unlikely markets would decline much more than 10% from current levels two years from now. In exchange for taking on the equity risk of a decline of more than 10%, the issuer can construct a structured product that provides enhanced upside, for example 115% of the positive return on the selected equity. Again, assuming the bond is linked to the S&P 500 Index, in this example if the market declined in value (measured at maturity date compared to the note issuance date) by 15%, you would be protected against the first 10% decline and your investment would therefore only decline by the difference or 5% and you would receive back $9,500. If the market declines 10% or less, you are fully protected and you receive your full investment back. However, if the market goes up by 20% you would get an enhanced return, in this example, 115% of the increase or a 23% (20% x 115%) return. This is an example of what is often referred to as a "buffered note".

Structured notes, if used appropriately, can provide an investor with a predetermined amount of upside potential and decreased risk. Structured notes are certainly not risk free. The first and most important risk to assess is the credit risk of the issuer. Remember these are bonds and if the issuer fails you may not get your money back. To put this in perspective, Bear Stearns was an issuer of these structured investment vehicles. Had Bear Stearns not been purchased, holders of these notes would have waited for bankruptcy proceedings to determine how much, if any, money they would have recovered. A second risk is really more of a disadvantage: most structured notes do not factor dividend income into their return. For example, assuming the S&P 500 dividend yield is 2% per year and you hold a two year note and the value of the index is unchanged at the end of the two year term, your rate of return is 0%, compared with 2% per year had you held the underlying security – the S&P 500 Index. A third risk to consider is liquidity – these notes are relatively illiquid as the secondary market is limited and is usually provided by the issuer. To mitigate this risk, investments in structured notes should be limited to only funds that will not be needed during the term of the note.

Exchange Traded Funds (ETFs)

ETFs offer an extraordinarily efficient means to achieve wide diversification across investment styles and assets classes at a very reasonable cost. ETFs generally are structured to track an underlying index, such as the Russell 1000 Stock Index or the Lehman Brothers Aggregate Bond Index. ETF index funds have several major differences when compared to conventional indexed mutual funds. The biggest difference is that conventional mutual funds are bought or redeemed directly from the fund company at the closing net asset value (NAV) at the end of trading each day. ETFs, by contrast, trade all day long on an exchange, just like an individual stock trades. Thus, ETF shares can be bought and sold anytime during the day at market prices that reflect the supply and demand for the shares and the underlying NAV of the assets owned by the fund. At any given time, the market price of the ETF may be equal to, or more or less than, the underlying NAV of the shares owned. For broadly traded ETFs like the ones we use in our client portfolios, the ETF shares trade in a very tight range around the NAV.

Diversifying investments by using ETFs as an investment vehicle provides major cost savings because ETFs have significantly lower expense ratios than most mutual funds, particularly when compared to actively managed mutual funds. In addition, trading costs at Schwab for these investments also are very low as we have negotiated a flat $9.95 commission rate for each trade that we place in your account at Schwab – much lower than the $24.00 transaction fee charged on (some) mutual fund purchases.

For taxable accounts, another major cost advantage of ETFs is the fact that, since they do not have to sell securities to meet cash needs occasioned by investors redeeming funds directly from the fund company, capital gain distributions from ETFs generally are much less than capital gains distributions from conventional mutual funds.

Going forward in 2009 and beyond, we plan to make more extensive use of ETFs to gain broad exposure to investment asset classes and "anchor" some of our asset categories to an investment vehicle that tracks a broad-based, underlying index. We believe that this action will help reduce long-run portfolio volatility and enhance long-run returns.