Van Hulzen Asset Management

Risk Managed Solutions

January 17, 2011

Dear Client:

Greetings and Happy New Year!

The letter is a bit longer than normal as we have put together a long-range view on some key trends. It is my hope that some of the primary reasons our clients choose us as their advisor is trust and a sense of personal care. While most of this industry is set up for volume and scalability, we strive to provide quality personalized advice and investment management. We work hard to provide straightforward, objective thinking. In the spirit of that kind of relationship, it is important to have a candid conversation about a (potentially) large shift in return and risk possibilities in stocks and bonds. The letter is abnormally long, but it also carries a message of importance to our allocation decisions in the coming years. I hope that you will read through this letter, and as or when needed, contact us to review the specific implications to your investments.

During the summer months when the stock market momentarily came unglued and stocks "crashed." Some of the largest, most respected companies in the world dropped by over 90%. The entire market dropped by 10% in a matter of two hours. In fact, from May to August, US stocks declined by over 20%. During this time, the accounts that we oversee barely moved. There were very minimal losses at a time when the markets literally stopped working (albeit briefly). It was perhaps the most gratifying moment in 2010.

But, it was the actions in the stock and bond markets in the fourth quarter of 2010 that are the reason for this letter's topic on risk management and asset allocation. If we are right, then the fourth quarter was perhaps a signal that some things have changed.

For assets that were allocated heavily toward fixed income and underweight a volatile stock market, it was a tough time. Not only did stocks move higher (following the Fed's announcement on quantitative easing), but bonds fell by over 5%. This was odd because interest rates rose dramatically during the time that the government was actively buying Treasuries in the open market. The stated intention of quantitative easing is to reduce interest rates to stimulate economic activity. But rates went up instead. So did food and energy commodity prices and the price of precious and industrial metals. All around, inflation was sparking and rates were rising.

Herein lies the issue: **The risks** (volatility; real and implied) **in stocks and bonds are now both larger than normal.** In fact, despite a positive year in stocks, the volatility of price movement was 50% larger than normal

(historic average). Price volatility is the result of 1) leverage, or 2) unknown or unquantifiable outcomes, or 3) real underlying problems. 2010's volatility was perhaps some of all three but at least due to #1 and #2.

But now we need to consider a risk that has not been a problem for nearly three decades, rising interest rates. Prices of bonds drop when interest rates rise. If rates rise dramatically, the price drop can be more than the income yield on the bonds.

The current quantitative easing program is causing some very large moves in rates, stocks and commodities. The implications cause us to consider just how much exposure to take on as we work to generate positive returns from our investments.

Implication: In order to achieve desired returns (historically normal), we will likely need to take on additional loss exposure. Or, if we have a limited amount of risk tolerance *(most of us have a risk tolerance limited by retirement, a fixed income, a future expense, or some combination of future needs that require us to avoid losing a substantial amount of capital)*, we may need to accept more moderate returns.

And so I get to the heart of our discussion. We have an established "risk budget" that guides the allocation of portfolio assets. With the negative bond performance in Q4, we have a very real need to control risks and also be properly allocated. We have an allocation plan to address the risks we have outlined. However, it is important to communicate the genesis and process in which we arrived at the risk budget, and to have a conversation about how it impacts the portfolio.

In the following pages, I outline our process on risk management and how we are using it to quantify your downside risk, and therefore allocate your assets properly.

Warm regards,

Craig Van Hulzen
President

Let me begin with the conclusions and then come back to the process:

- Exposure to rising interest rates will be controlled through a bond allocation that has short maturities (1-5 years) so that we can buy the bonds and hold them to maturity (takes away price risk).
- US corporations are well capitalized, many have large amounts of cash. We can own companies with quality products, good innovation, and in industries with economic tailwinds.
- Growth can be achieved through an allocation to international economies (largely in Asia)
- Income can offset lackluster price gains and reduce exposure to price volatility.

With a risk budget in place, we can boldly allocate to opportunities and capture profits knowing that we have allocated only the portion of our capital that we can afford to risk losing.

A (brief) essay on risk management

When considering how to allocate investments, it is important (one could argue, even imperative) to understand how much capital can be placed at risk (of loss). There is an investment term known as the risk-free rate. It is defined as *"the interest an investor would expect from an absolutely risk-free investment over a specific period of time."* Generally, the 3-month yield on US Treasuries is considered to be the risk-free rate. This rate is often reflected in money market funds and bank savings accounts. It is currently 0.15%. In 2006, the rate was 5.0% and in 1989 it was over 9.0%. If we were to expect stocks to return 8% and bonds to return 5%, we would also imply that they could lose money as well (since they are above the risk-free rate). The key question is "*how much risk can I afford to take?"*

A "risk of loss" exercise should be performed before any allocation into investments. Questions like *"what size loss would change my lifestyle?"* and *"if I lost ____%, could I stick with my long-term strategy?"* and *"how long until I will need some of this money?"* need to be answered.

Once the risk of loss exercise is complete and an analysis of historic investment risk and returns is applied, a "target asset allocation" profile is established. The target asset allocation reflects personal risk (loss) tolerances under normal market conditions. When market conditions are abnormal, adjustments are made to the target allocation.

Step 1: The "risk budget"

We use some of the best available tools to "model" future outcomes using historic data. We gather input from questionnaires, from our meetings and ongoing communications. The results provide what we call a "risk budget." The risk budget is the amount of capital that could be put at risk for the purpose of earning a positive return.

Step 2: Quantifying asset class risk

Since all long range modeling assumes normal returns and normal risks for each asset class, it is important to adjust for current conditions. The risk budget meets the real world. Volatility is expressed as standard deviation (the amount of up and down movement within a time frame). In 2010, the stock market (despite its rosy

finish) was a very risky asset class. The standard deviation was nearly 50% higher than average. The "risk-of-loss" was historically high. Likewise, in the fourth quarter, bonds had one of the worst quarters in 30 years. Together, we view the current market environment as abnormally volatile (see the enclosed graphs and the Statement of US Federal Government finances as data).

Step 3: Allocate the risk budget

Combine the risk budget with the current risk profile of each asset class and the result is a risk-based allocation strategy that reflects both life and market conditions.

Why is this process important?

A traditional asset allocation plan uses historic returns to create a target allocation, and as long as the normal historic returns suggest that future goals can be met, the plan is adopted and allocated. A risk-based allocation process, on the other hand, is designed to be fluid and continuous, to reflect market conditions AND life conditions. It makes complete sense that a portfolio should reflect the investor's current life and future goals. Under Wall Street methods, a portfolio would not consider risks outside the investments, and would rely on the investor to make the broker or manager aware of a desired allocation change. At best, there would be a periodic review that might adjust the allocation policy, but otherwise, the manager is allocating without regard for life conditions. Should a portfolio allocation change when a job loss occurs? Or when a family member needs a loan? Or when a person decides to start their own business venture? Each life event has risks and implications for the long-term investments. What good are long-term goals when short-term cash needs must be met? And what good is accomplished by taking on more risk than necessary? Sure, in good years the returns look great, but what would have happened under a different outcome? Is it worth a permanent life-long reduction in standard of living?

Achieving positive results within a risk framework

The point of investing is to receive back more than was invested at the beginning. And perhaps the greatest lesson of the global financial crisis is that a risk framework should be the guiding force in allocation decisions.

This emphasis on risk does not mean we will miss out on positive returns, they are still quite probable. In fact, a positive return that is achieved without risking a change to the quality of life is a superior result that a larger return that risked enormous losses. If there is capital that can afford to be lost (it would not impact the future lifestyle), then it can be invested in growth assets with the objective of achieving strong results. But, this capital should be allocated after all basic life needs are met and risks are identified.

Sincerely,

Investment Committee, Van Hulzen Asset Management