



Financial Resource 2007

Investment & Financial Planning Insights

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Short Selling As An Asset Allocation Tool

Short selling was once too exotic and dangerous for individual investors. And while most investors should continue to avoid selling short individual stocks, there are a number of short selling strategies that can help reduce portfolio risk.

For example, today's investors can obtain short exposure through mutual funds or ETFs that sell a portfolio of stocks or indexes short. By combining this diversified short exposure with their long equity holdings, investors can create a hedged or even market neutral portfolio. An actively managed short strategy that is able to limit losses in market rallies can make the long/short mix even more attractive.

But why would an individual investor deviate from a long-only buy and hold strategy?

Certainly investors would have benefited from short exposure during the 2000-2003 market downturn. But some indexes, including the widely following Dow, have gone on to all-time highs. Still, some short exposure may be appropriate for several types of investors. That includes equity investors who want a hedge against a sharp market correction. Others may think the rally off the 2003 bottom has run its course and want to prepare for a resumption of a bear market. Historically long bull markets are followed by long bear markets, and the bull market that ended in

2000 was one of the longest and strongest on record.

It's particularly important for new retirees to avoid losses. Negative returns early in the distribution period will cause savings to run out sooner than if losses are suffered prior to or well into retirement. As a result, new retirees may want to sell stock, or temporarily hedge against stock market losses. An explanation of this phenomenon is presented in online version of this article, along with reasons why we think the long bear market is long overdue.

The fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling 800.711.1848, or visiting www.prudentbear.com. Read it carefully before investing.

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Subset Investment Policies May Enhance Financial Gains

Successfully integrating the client's investment policy with a thoughtful financial plan should make each asset class more productive given the legal and tax objectives of the subset or 'tool' into which it is placed. Successfully executing this strategy can provide substantial 'bottom line' family gains.

While there should be an overall investment policy statement and a corresponding allocation of assets, it is also true that various planning 'tools' should have disproportionate concentrations of certain asset classes. Some examples: 1) High yield bonds or high return, yet tax inefficient

hedge funds are well suited to an IRA. 2) An asset with a higher than average anticipated appreciation and some income would help maximize the ultimate value to one's family from a Testamentary Charitable Lead Annuity Trust. 3) Even more aggressive growth would be a good choice for a short-term Grantor Retained Annuity Trust. 4) An array of high current return, yet tax inefficient hedge funds might be considered inside Private Placement Life Insurance.

Having discussed disproportionate weightings in components of a thoughtful plan, we would reiterate the basics of sound investment planning.

Since 92% of returns come from proper allocation, we suggest obtaining the 'best in class' when creating an allocation where the total risk of the whole (as measured by standard deviation) is less than the average risk of the parts. To oversimplify, assume 20 asset classes each with a standard deviation of 10%. Although the average standard deviation of this allocation is also 10%, a portfolio with the same asset classes constructed with attention paid to high, low and negative correlations may have an overall standard deviation of 5%.

It is valuable to pay attention to the investments of individual plan components or 'tools'. This individual attention should always be exercised within the discipline of proper overall asset allocation.

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Portfolio Diversification vs Bucket Diversification

Individual investors often fall into the trap of chasing performance by jumping into the latest trendy investments. Unfortunately, most advisors are more than happy to oblige them, but the result is usually being late to the party. The latest trend is to allocate portfolios among several different investment “buckets.” Investors now boast about exposure to large, mid, and small cap, growth, value, sector specific, international, and emerging market stocks, and probably an “alternative” investment or two.

The “bucket” approach is largely a reaction to the bear market of 2000-2002. No one wanted common stocks any more, so advisors divided their clients’ portfolios

among many different investment products to insure that their assets would be diversified and protected.

What sounds good is often not in the best interest of investors. Diversification is crucial. However, there is a difference between having all of your eggs in one basket (bad), having all of your animals on one farm (good) and having too many animals on too many farms (bad). With the “bucket” approach, the overall result is over-diversification, average returns (at best) and above-average fees. It is also common for individual investors to only have access to unproven specialty money managers. The “star” managers serve large institutions.

We recommend individual investors use a multi-

cap “core” investment strategy. Diversification occurs within one portfolio of individual stocks, not by creating many separate portfolios. Investments in companies are made based on their relative valuation and prospects, not their size, style or industry. This strategy is more transparent, less expensive and leads to better investment results.

International investments are important. However, “core” managers can invest in numerous foreign companies whose ADRs trade in the U. S. In addition, the average U.S. company generates over 40% of its revenues outside of North America.

Trends come and go, and we see “bucket” investing being replaced by core investing over the next several years as investors seek to simplify, clarify and improve their investment strategy.

To read the full report, go to www.financial-resource.com/dcla.asp



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Differing Benefits – Housing and Investment Real Estate

Many individual investors and their advisors believe that they have a significant investment position in real estate, based solely on the value of their own home. Indeed, real estate comprises a major portion of household net worth in America. Residential real estate assets have grown from \$6.6 to \$20.3 trillion between 1990 and 2006, rising to 34% of all household assets and 77% of tangible assets. However, investors often blur the distinction between residential and commercial real estate, leaving a hole in their financial plans.

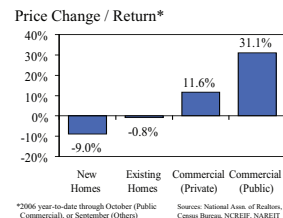
Differing supply–demand and investment cycles create major differences in real estate investment per-

formance. The neighboring chart shows that home prices have declined during 2006, while commercial real estate returns remain positive. This indicates that the residential market has probably hit a relative peak, while several commercial sectors are just hitting their stride.

The investment natures of residential and commercial real estate are fundamentally different as well. Cash flow is a primary driver of investment returns for commercial real estate, providing investors with an income stream and a basis for property valuation. In contrast, residential price discovery is more subjective and less transparent, pos-

ing challenges for financial planning.

Commercial real estate ownership can be accomplished through a variety of vehicles, including direct investment in assets and ownership of REIT shares. These options enable investors to create portfolios with different sizes, investment objectives, and degrees of liquidity. By owning commercial real estate, investors enhance their portfolios much more than through the simple inclusion of a home in a financial plan.



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Four Reasons to Invest Internationally

To provide a steady return, an investor should diversify over a broad range of asset classes. As you diversify, consider the following reasons to invest 10-25% of your assets internationally:

1) The Inevitable Explosion of Growth in China and India - The US will remain the world intellectual center, but the world center for capital accumulation and growth will move to Asia. A mere 5% increase in consumption of any product, such as energy, cars etc., in China and India equals in size to a 40% increase in America simply because China and India have eight times as many people as the US (*The Complete Investor*, Winter 2006).

2) International Value Funds and International Bond Funds - A generational shift is occurring, which will have a long-term impact on both the stock and bond markets in the next decade. As the general population ages in the US, Europe and Japan, retirees will seek income from both the stock and bond markets. Value stocks generally pay a higher dividend (income) than growth stocks, both domestically and internationally.

3) Downward Pressure on the US Dollar - The US Market experienced strong growth in the late 80s and 90s, supported by low federal and

trade deficits, low inflation and oil prices, no major wars and a strong dollar. Today, the opposite has occurred. Greater federal and trade deficits generally increase the downward pressure on the dollar. Historically, international stocks and international bonds outperform if the dollar is weaker. Past performance is not an indication of future results.

4) Lower P/E Ratios in both Europe and Asia vs. the US - According to Hammond Associates, the P/E ratio of the S&P 500 Index is 17.4, while the P/E ratio in Asia/Emerging Markets is 13.8 and 13.7 in Europe (September 2006). P/E ratios determine stock valuations. Generally, the lower the P/E ratio, the more favorable the valuation or purchase price of the stock.

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Value and Valuation Focused Investing

In the search for superior returns, investors have tried many approaches. Most have been disappointing because they fail to deliver expected higher returns or only work for brief periods or under special circumstances. On the other hand, the value approach to investing has produced better than market results over many decades in both academic tests and professional use.

What is the value approach? In the classic form it involves selecting stocks for investment from those selling at low prices versus some observable metric such as book value. This concept is at the core of the approach made famous

by Benjamin Graham many years ago and continues to be used by many investors today.

A simple price/book value approach has obvious limitations because a significant amount of a business' value may reside in intellectual capital, trademarks or other assets that do not appear on the balance sheet. So the next logical step is to incorporate additional measures of value into a multi-factor model to more realistically assess potential investment opportunity.

Many attractive, growing companies are excluded from consideration by an absolute valuation process, whether single or multi-factor in

nature. Because of higher historic or prospective growth rates, most growth companies seldom reach necessary absolute discounts to the broad market. A further refinement is to move from an absolute value concept to one that incorporates relative value. This approach greatly broadens the potential field of investment, to include growth as well as value stocks.

Utilizing relative value concepts in a multi-factor model has resulted in portfolios with solid long-term performance and low volatility, compared to the general stock market. These portfolios are well diversified by investment style and market capitalization with excellent long-term absolute and risk-adjusted returns.

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