



The Enduring Quality of Solid Principles

I had an interesting conversation with a new client recently. It flowed around the idea of “improvements to the asset allocation process.” That is, the decision on how best to blend asset classes together to achieve an appropriate level of return for a given level of risk. If you’ll remember from last quarter’s Compass, we suggested that there are four disciplines which can have a tremendous impact on one’s financial future. Point number four is to **“Create and adhere to a diversified investment allocation.”** We wanted to take this opportunity to expand upon that idea.

While there have been great strides taken in the realm of “portfolio design,” what strikes me in the discussion is the idea that Asset Allocation is, by its nature a supposedly rigid decision. Market Timing firms would disagree with that statement but as you are no doubt aware, we don’t believe in market timing.

I’m a curious guy and as I thought about this further, I wanted to double check my own historical record as it relates to Asset Allocation. The first place I went was to our file room where I pulled out the file for a long-term client, we’ll call them Mr. & Mrs. X. At the front of the file was their currently authorized allocation, constructed by yours truly: 37% fixed income, 6% real estate securities, 14% international equities and 43% domestic equities. Now the fun part. I worked backwards through their file, all the way to July 23rd, 1990. There on the last page was the then brand new Asset Allocation study done for the X’s by my father. It showed a breakdown of asset classes as follows: 38% fixed



income, 10% real estate securities, 18% international equities and 34% domestic equities with a portion in gold. At most, the changes were modest. It should be noted that the X’s were recently retired in 1990 and have obviously been so ever since. It should also be noted that the X’s Asset Allocation is specific to them and any similarity to any other allocation, living or dead, is purely coincidental ☺.

We operated then, and we operate today, on the principle that the largest impact to your future risks and returns is embodied in the decision of how you will split your investable assets across the various broad asset classes. In 1987, this data came to us in the form of a “White Paper” written by Gary Brinson, Gilbert Beebower and L. Randolph Hood. In 1987, my Dad and I (as a summer intern) were invited to a small presentation given by Mr. Beebower in the offices of SEI in Wayne, Pennsylvania. An excerpt from that study is shown below.

“Data from 91 large U.S. pension plans over the 1974-83 period indicate that investment policy dominates investment strategy (market timing and security selection), explaining on average 95.6 percent of the variation in total plan return. The actual mean average total return on the portfolio over the period was 9.01 percent, versus 10.11 percent for the benchmark portfolio. Active management cost the average plan 1.10 percent per year, although its effects on individual plans varied greatly, adding as much as 3.69 percent per year. Although investment strategy can result in significant returns, these are dwarfed by the return contribution from investment policy—the selection of asset classes and their normal weights.”

This was the inception of a study that has been reviewed numerous times with similar results. This is not to suggest that improvements to the process have not been made along the way. It is, however, to suggest that it is entirely likely that the Asset Allocation policy you have in place today may very well remain appropriate for many years to come.

Next quarter, we'll shed some light on the aspects of portfolio design that have made major strides in the last 15 years. They are many.

For me, Christmas and the New Year are a very special time and on reviewing 2005 and looking forward to 2006, I can't help but mention again how much we appreciate the faith you place in us and the opportunity you give us to know you better. Thank you for the friends and family you've recommended to our firm this year. We are successful because of your trust in us. This was a good year and I'm excited about the one beginning soon.

Todd H. Brand, President

In quiet moments when you think about it, you recognize what is critically important in life and what isn't. Be wise and don't let good things crowd out those that are essential."

R. Scott

With the New Year just weeks away, we would like to remind you to make the needed adjustments to take advantage of the increase in the 2006 401k contribution limit to \$15,000.

Maximizing Your Wealth – Part IV Location, Location, Location... A Primer on Asset Location



In the construction of your portfolio, asset allocation, investment selection, cost containment, and tax efficiency may be the most important decisions that you face. Each of these decisions affects the performance of your portfolio to varying degrees, some more significantly than others as described in Todd's article. Structuring a tax-efficient portfolio through asset location has the potential to maximize the after-tax return of the portfolio. The term asset location refers to the strategic placement of specific asset classes in either a tax-deferred account or a taxable account depending upon the tax efficiency of the asset class and the benefits provided.

A typical portfolio usually consists of taxable accounts and tax-advantaged retirement accounts funded with multiple asset classes. Asset location maintains that investments that tend to lose less of their return to income taxes should be placed in taxable accounts (trusts) while investments that lose more of their return to income taxes be placed in tax-deferred accounts (IRAs and 401Ks). Asset location achieves this objective by identifying the optimal location for each asset class. For simplification, the primary asset classes referenced in this discussion are stocks and bonds.

When implementing asset location, the factors to be considered for each client's portfolio range from their cash flow needs, tax bracket, prevailing tax laws, and the tax characteristics of the asset classes. This method of placement has the potential over time to add value over a pro-rata approach to funding each account within a portfolio. The pro-rata approach structures each account similarly, while the asset location methodology determines the location of each asset class based on where it provides the most after tax benefit to the portfolio.

The Tax Relief legislation of 2003 (JGTRRA) provided greater incentive and opportunity to implement asset location by reducing the tax rates on qualified dividend income from ordinary tax rates to a maximum rate of 15%. Broadly speaking, most, but not all, qualified dividends are generated by stocks held in your equity mutual funds. In the past, dividends from equities were not receiving preferential tax treatment. As a result, it made sense to hold equities in retirement accounts to avoid paying tax on the dividend income until that income had to be withdrawn. The reduction in tax rates for qualified dividends was a strong factor in the support of implementing asset location in the structure of your overall wealth to minimize tax ramifications. This adds value over time to the after-tax return of the portfolio.

Conversely, taxable fixed income investments and REITs generate non-qualified dividends making them more suitable investments for retirement accounts such as IRAs. Non-qualified dividends do not receive preferential tax treatment, which subjects the income to ordinary income rates regardless of where the assets are housed. With that being the case, placing these assets in retirement accounts such as IRAs provides the opportunity for tax-deferred growth and the deferral of tax on the income until withdrawn.

Roth IRAs are generally excluded from the general principles of asset location due to the fact that qualified withdrawals are tax-free. Therefore, assets that have the potential to generate higher returns make good candidates for Roth IRAs.

When reviewing your quarterly statements, if you have any questions as to the location of your assets, please give us a call or list it on your agenda for discussion at your next review.

Madaline Creehan, Vice-President

A New Manager for Missouri's 529 Plan?

TIAA-CREF has been the program manager of the Missouri 529 plan since its inception in 1999. That may be about to change.



The Missouri Saving for Tuition (MOST) Program now holds about \$750 million in assets for over 80,000 account holders. Both the 100% equity and age-based options make exclusive use of TIAA-CREF's institutional mutual funds, and the guaranteed option is funded by a product delivered by TIAA-CREF Life.

The current management contract, however, expires this coming May. So Missouri issued a request for proposals (RFP) in September for the management of the college savings program and expects to select the winning proposal by the end of the year. The RFP encourages submission of proposals that offer investment options from multiple fund families. The new contract will run for five years.

TIAA-CREF asked shareholders of their institutional funds, including the state treasurer's office on behalf of the MOST assets, to approve a four-fold increase in fees this summer. That didn't pass, but is being presented to shareholders for approval a second time this coming January. Mark Hughes, from the state treasurer's office, was quoted in the October 31 issue of Pension & Investments as saying that the timing of the vote was "very unfortunate" and that approving the fee increase "would send a message that (the treasurer's office and 529 board) were comfortable with a greater load on account holders" which "is not the position of the treasurer or the board, nor is that the message we want to convey to potential program managers as they formulate their bids."

It would appear that TIAA-CREF has an uphill battle to retain management of the MOST program given their continued desire to increase the fees on their institutional funds, which

Fidelity Lowers Expenses on Their Equity Index Funds

contrasts with Missouri's stated objective of providing a low cost program. According to Mark Hughes there were five responders to the RFP in addition to TIAA-CREF, those being American Century, Oppenheimer, Union Bank & Trust, Waddell & Reed, and Upromise.

We believe that the current Missouri 529 is a good program and are hopeful that the new contract will make it even better by lowering costs and offering more investment options. We look forward to learning how the program will change under the new contract and sharing the relevant details with you.

Phil Daniels

| Fund/Class Name | Expense Ratio |
|------------------------------------------------|---------------|
| Spartan 500 Index Fund - Investor Class | 0.10% |
| Spartan 500 Index Fund - Advantage Class | 0.07% |
| Spartan Extended Market Index Fund - Investor | 0.10% |
| Spartan Extended Market Index Fund - Advantage | 0.07% |
| Spartan Total Market Index Fund - Investor | 0.10% |
| Spartan Total Market Index Fund - Advantage | 0.07% |
| Spartan International Index Fund - Investor | 0.10% |
| Spartan International Index Fund - Advantage | 0.07% |
| Spartan U.S. Equity Index Fund - Investor | 0.10% |
| Spartan U.S. Equity Index Fund - Advantage | 0.07% |

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As many of you already know, Fidelity recently launched a new class of their equity index funds. This will result in lower mutual fund expenses within your account(s) that have adequate balances to qualify for these new funds.

The only difference between the old and new class of these funds is the expense ratio. Think of it as Fidelity giving you a discount in each of your accounts that maintain a balance above a certain threshold in any of these funds.

Please see the list of funds in the adjacent column affected by the change. For any of them listed, if you own the fund in an account, and the fund balance is below \$100,000 in that account, you will continue to own the "Investor" Class (with an extremely competitive expense ratio of .10%). If the balance in the fund in that account is above \$100,000, you are eligible to be converted to the "Advantage" Class (with an even better expense ratio of .07%). This is considered on an account-by-account basis. Fidelity will not allow a grouping of accounts to qualify for the new class.

Fidelity is automatically processing the conversion from Investor Class to Advantage Class, as many of you have already seen on your month-end statements. The conversion is not a taxable event, so it will not generate realized gains within your taxable account(s). If, after conversion from Investor Class to Advantage Class, your balance in the fund falls below \$100,000, Fidelity has the right to automatically convert you back to the Investor Class.

We like passing good news on to you, and are excited about Fidelity's decision. In this instance, less is more.

Merry Christmas

Jason Akridge