Passive
Capital Management

The Re-Balancing Act of Investing

At Passive Capital Management, we believe that owning a globally-diversified portfolio of asset class funds is the best strategy for having a successful investment experience. One of the core tenets of our philosophy is that markets are generally efficient; therefore, investors who commit money to the capital markets will be rewarded over time according to the amount of systematic risk that is taken. We believe that stock market performance is completely random and unpredictable over short periods of time. Please see the Callan Periodic Table below, illustrating the performance of various asset classes over the last 10 years. This randomness convinces us that investors should own as much of the market as possible within their own risk parameters. We spend considerable time helping clients understand their personal risk profile so that together we construct an appropriate investment portfolio of asset class funds that will help them meet their long term investment objectives.

The first thing to determine is what percentage of a portfolio should be in fixed income versus equities. Fixed income is used to manage risk while equities are used for capital appreciation. Passive Capital utilizes fixed income as a way to dampen volatility and lower a portfolio's overall risk profile. Once the ratio of fixed income to equities has been established, the equity portion is allocated over various global asset classes.

Now the really hard work begins. As I have already mentioned, we believe that capitalism works and that investors are rewarded over time for committing funds to the capital markets. We encourage investors, when possible, to focus on the long term and, more importantly, to be disciplined in the investment process. Once the portfolio has been constructed, the percentage allocations to the various individual components of the portfolio will diverge from their target proportions as the markets fluctuate and prices move up or down. As this happens, investors need to have a disciplined process in place for rebalancing the investments back to their targets and sticking to their original asset allocations. If the portfolio is left to just drift with the markets it will likely evolve into one with a very different risk profile than was intended or is suitable for the client. ***A disciplined rebalancing process will prevent emotions (fear and greed) from altering your previously established asset allocation.***

As a simple example, consider a portfolio with a 60% allocation to equities and 40% to bonds. Over time, as the value of the equities increases, that allocation may look more like 70% equities and 30% bonds. As that shift in allocation happens, the portfolio is assuming more risk because equities are generally riskier than bonds. The investor is now taking on more risk than they originally felt comfortable with. Rebalancing is done not necessarily to improve returns but to manage portfolio volatility and maintain a consistent level of risk throughout all phases of the market cycle.

T. Rowe Price recently looked at the effects rebalancing had on a portfolio starting at the end of 1984 through June 2007. Using the same portfolio with an asset allocation of 60% equities, 30% fixed income and 10% cash, one model was rebalanced whenever there was 5% deviation from the original asset allocation while the other model was left unchanged. The returns were nearly identical at 9.0% and 9.1%, respectively. However, the rebalanced portfolio was 18% less volatile. The study also showed that during periods of market downturns, rebalancing helped protect against losses. During the bear market of March 2000 through September 2002, the portfolio that was never rebalanced fell 34%. The rebalanced portfolio dropped only 19%.

Rebalancing ensures that investors ***buy low and sell high***. That's really the secret to successful investing, isn't it? It's a simple directive but not so simple to actually do. According to a recent Hewitt Associates study, only 18% of employees with 401(k) accounts rebalanced their portfolios in 2006 compared to 17% in both 2005 and 2004. Often, investors just forget to pay attention to their investments.

Sometimes, however, it becomes a question of emotions. The typical investor doesn't want to buy when the markets are depressed and everyone else is selling. They are more likely to buy when the markets are soaring – chasing performance. Look again at the Callan Periodic Table. It demonstrates clearly that the top performers in any given year are likely to be among the bottom performers in subsequent years and vice versa. The Russell 2000 Growth had a positive return of 43.09% in 1999 but in 2000 it returned a negative 22.43%. Rebalancing means trimming some of your best performers and buying more of the underperformers. ***Buy low and sell high.***

When to rebalance is a question we are often asked. Since rebalancing may result in capital gains being realized and often involves transaction costs, these expenses must be considered. For taxable accounts, it is advantageous to rebalance by investing new money. As investors add to their accounts, the new funds should be used to bolster positions that have underperformed and drifted away from their target allocations, thus rebalancing the portfolio as part of the process of investing the new monies. Rebalancing is simpler for non-taxable accounts such as IRAs and 401(k)s, as there are no capital gains taxes to consider.

Investment advisors earn their fees by helping investors determine their risk tolerance, customizing an investment portfolio to fit their individual profile and financial objectives and adhering to a disciplined methodology. Control those things you can control (risk, asset allocation, diversification and costs) and don't spend your time or money on those things you cannot control (market fluctuations). Passive Capital Management can help you build an appropriate investment portfolio and adhere to your strategy throughout all phases of the market cycle for a successful investment experience.

Callan Periodic Table of Investment Returns

Annual Returns for Key Indices (1997-2007) Ranked in Order of Performance

1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
S&P/Citi 500 Growth **36.52%**	S&P/Citi 500 Growth **42.16%**	Russell 2000 Growth **43.09%**	Russell 2000 Value **22.83%**	Russell 2000 Value **14.02%**	LB Agg **10.26%**	Russell 2000 Growth **48.54%**	Russell 2000 Value **22.25%**	MSCI EAFE **13.54%**	MSCI EAFE **26.34%**	MSCI EAFE **11.17%**
S&P 500 **33.36%**	S&P 500 **28.58%**	S&P/Citi 500 Growth **28.25%**	LB Agg **11.63%**	LB Agg **8.43%**	Russell 2000 Value **-11.43%**	Russell 2000 **47.25%**	MSCI EAFE **20.25%**	S&P/Citi 500 Value **5.82%**	Russell 2000 Value **23.48%**	S&P/Citi 500 Growth **9.13%**
Russell 2000 Value **31.78%**	MSCI EAFE **20.00%**	MSCI EAFE **26.96%**	S&P/Citi 500 Value **6.08%**	Russell 2000 **2.49%**	MSCI EAFE **-15.94%**	Russell 2000 Value **46.03%**	Russell 2000 **18.33%**	S&P 500 **4.91%**	S&P/Citi 500 Value **20.81%**	Russell 2000 Growth **7.05%**
S&P/Citi 500 Value **29.98**	S&P/Citi 500 Value **14.69%**	Russell 2000 **21.26%**	Russell 2000 **-3.02%**	Russell 2000 Growth **-9.23%**	Russell 2000 **-20.48%**	MSCI EAFE **38.59%**	S&P/Citi 500 Value **15.71%**	Russell 2000 Value **4.71%**	Russell 2000 **18.37%**	LB Agg **6.97%**
Russell 2000 **22.36%**	LB Agg **8.70%**	S&P 500 **21.04%**	S&P 500 **-9.11%**	S&P/Citi 500 Value **-11.71%**	S&P/Citi 500 Value **-20.85%**	S&P/Citi 500 Value **31.79%**	Russell 2000 Growth **14.31%**	Russell 2000 **4.55%**	S&P 500 **15.79%**	S&P 500 **5.49%**
Russell 2000 Growth **12.93%**	Russell 2000 Growth **1.23%**	S&P/Citi 500 Value **12.73%**	MSCI EAFE **-14.17%**	S&P 500 **-11.89%**	S&P 500 **-22.10%**	S&P 500 **28.68%**	S&P 500 **10.88%**	Russell 2000 Growth **4.15%**	Russell 2000 Growth **13.35%**	S&P/Citi 500 Value **1.99%**
LB Agg **9.64%**	Russell 2000 **-2.55%**	LB Agg **-0.82%**	S&P/Citi 500 Growth **-22.08%**	S&P/Citi 500 Growth **-12.73%**	S&P/Citi 500 Growth **-23.59%**	S&P/Citi 500 Growth **25.66%**	S&P/Citi 500 Growth **6.13%**	S&P/Citi 500 Growth **4.00%**	S&P/Citi 500 Growth **11.01%**	Russell 2000 **-1.57%**
MSCI EAFE **1.78%**	Russell 2000 Value **-6.45%**	Russell 2000 Value **-1.49%**	Russell 2000 Growth **-22.43%**	MSCI EAFE **-21.44%**	Russell 2000 Growth **-30.26%**	LB Agg **4.10%**	LB Agg **4.34%**	LB Agg **2.43%**	LB Agg **4.33%**	Russell 2000 Value **-9.78%**

Source: Callan Associates
T Rowe Price
Hewitt Associates

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