

PORTFOLIO WATCH



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Fee **FO** Only

NAPFA-registered Financial Advisor

Keep Loses Small

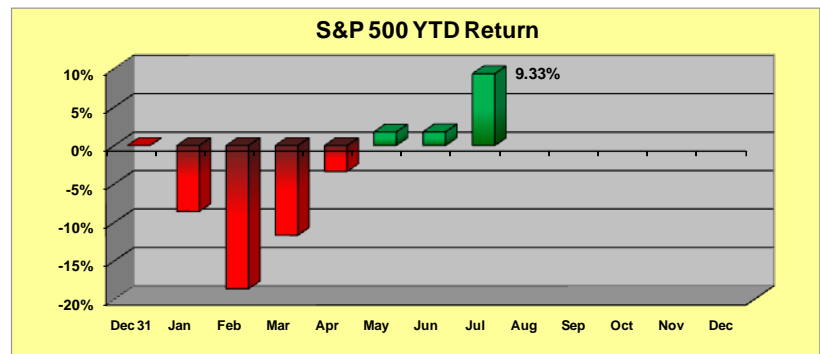
The verbal war regarding buy-and-hold versus pretty much any other investment strategy continues to rage on the Internet, and I've enjoyed participating. Unfortunately, as a participant in this discussion I need to get used to arguers (as opposed to debaters) questioning my competence, motives, and parentage, but that comes with the territory. There have been some positive experiences, though.

Same Idea; Different Implementation

One of the positive experiences came last month during a family trip to Maui. I had the opportunity to have lunch and play a round of golf at the Wailea Golf Club with Tom Schwab, Chief Investment Officer of The Collar Fund (COLLX). This fund uses a technique called "Collars" (you probably guessed that by the name), which uses stock options to limit risk to a predefined level. I've known Tom and been familiar with his strategy for a couple of years, but until recently Tom's company, Summit Portfolio Advisors, only managed individual private accounts. In June of this year, Summit Portfolio Advisors transitioned from individual accounts to a mutual fund, which is available to anyone with \$2,500 to invest.

Tom and I spent quite a bit of time discussing investment strategy, and what we agreed on (among other things) is that we have a similar objective: make a good return and keep losses small. One of the things that got driven home last year is the fact that a 10% loss requires an 11.1% gain to get back to even. A 50% loss requires a 100% gain to get back to even. Since the market moves in cycles of ups and downs, there will be more bear markets in the future, possibly the very near future. Therefore, the objective is to participate in the majority of gains and avoid a good chunk of the losses. The strategy I am using to do this is to use Stop Loss

2006 return: 13.62% 2008 return: -38.49%
 2007 return: 3.53%



sell and buy orders, which I describe in detail on my website as well as past issues of Portfolio Watch. The Collar Fund has a similar objective, but goes about it quite differently.

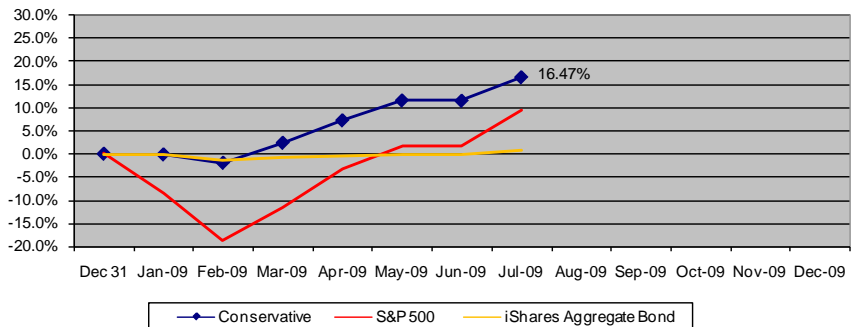
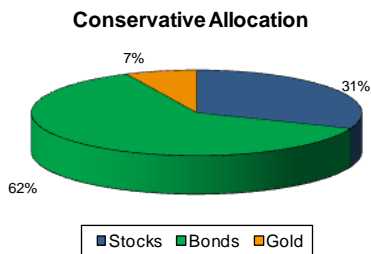
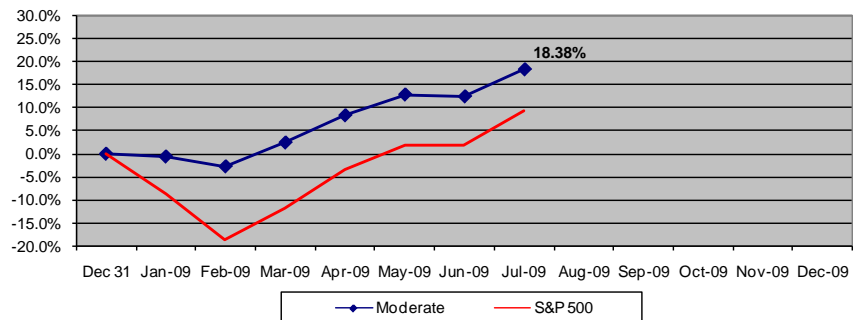
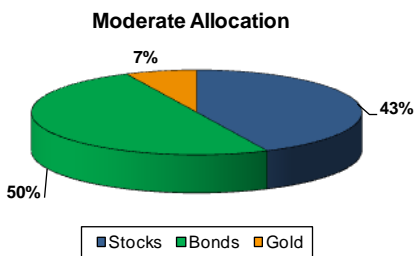
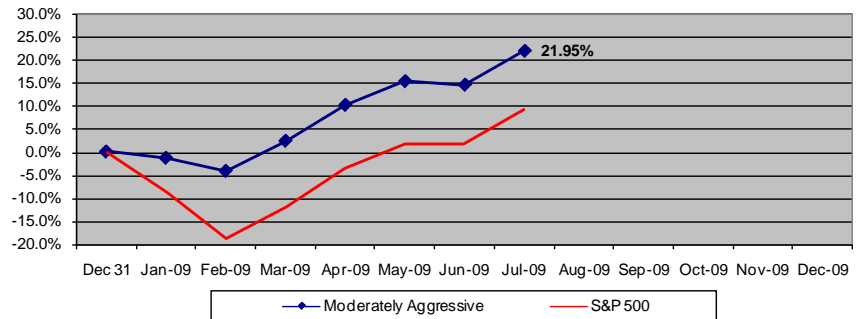
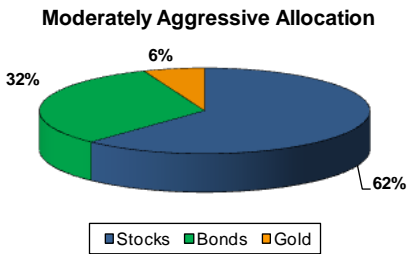
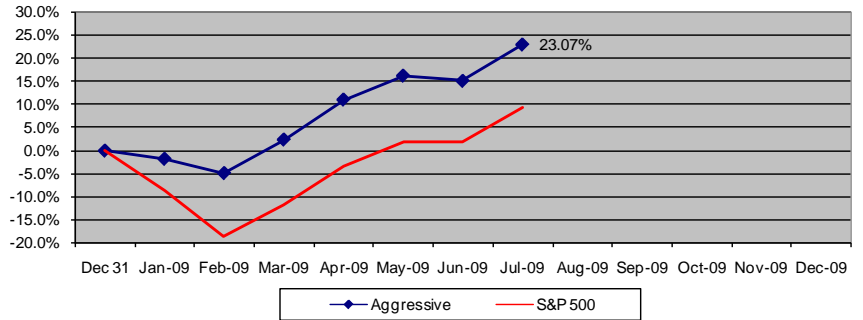
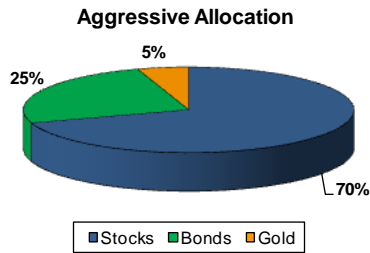
Stock Insurance

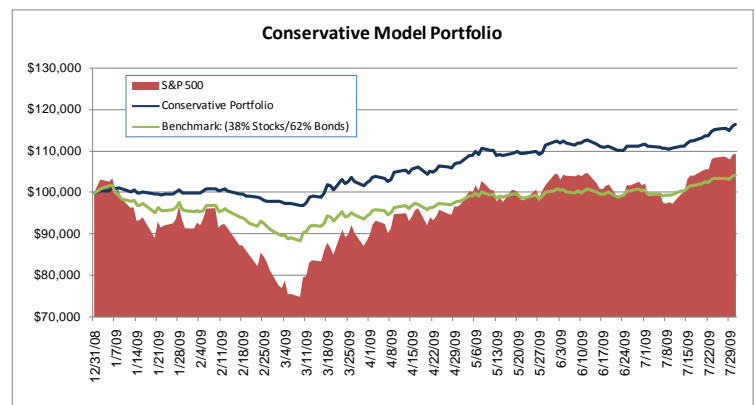
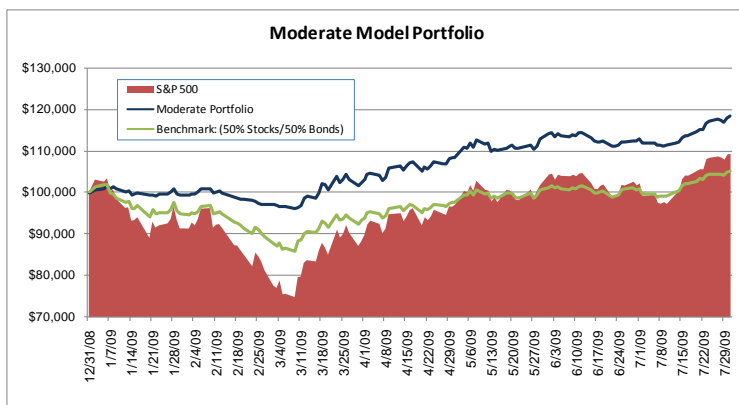
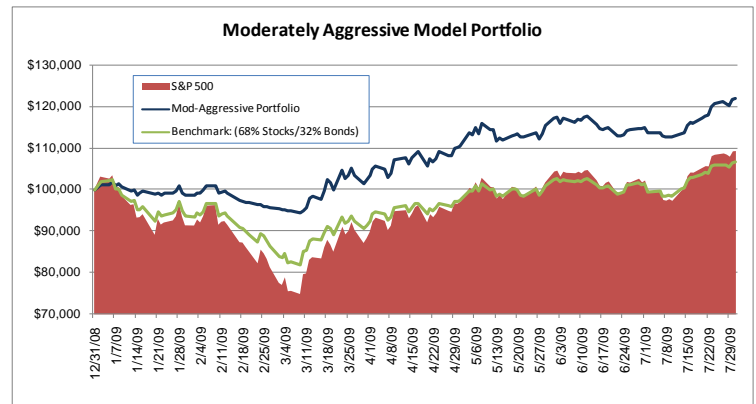
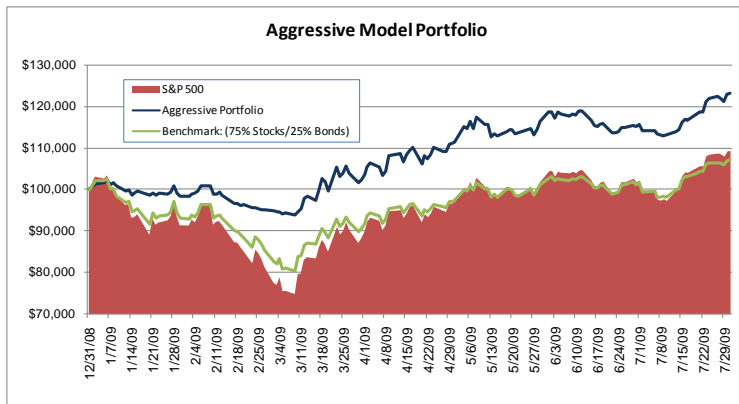
A Put option is essentially insurance on a stock. When a Put option is sold, the seller agrees to buy the stock from the buyer of the Put option at a certain price (the Strike Price). This is similar to a Homeowner's Policy seller agreeing to pay for your house if it burns down. The problem, of course, is that this costs money. Therefore, to pay for the insurance, The Collar Fund *sells* a Call option, which gives the buyer the option to buy the stock at a higher strike price. Under some market conditions and for certain stocks, Call options can become more expensive than Put options. For example, a Put option that limits a stock's loss to 10% may cost the same as a Call option that allows the stock to be purchased after a 20% gain. A 2:1 reward-to-risk ratio like this is interesting, but a 3:1 or 4:1 ratio would be even more interesting. These are the kinds of conditions that Tom and The Collar Fund search for. Although the upside is limited by the Call option, the maximum loss is firmly established by the Put option. No matter how bad the market gets, the stocks in The Collar Fund portfolio will never fall below their Put option limits. Therefore, the upside potential depends on stock appreciation and option prices, but the downside risk is absolutely limited (and kept small).

Because of the downside limit, the performance graph of The Collar Fund ends up looking very much like a bond fund (i.e. steady but boring), but with a long-term return that looks more like a conservative stock fund. Now that this fund is available, it will likely have a role to play in client portfolios in the near future.

Model Portfolio Performance

The following allocation models and Year-To-Date performance graphs represent the preferred investments in Veripax Financial Management's target portfolios. Investment allocation for each model is determined based on time horizon and risk tolerance. In most cases, individual client portfolios will contain slightly different investments and allocation mixes based on individual financial goals, investment priorities, and tax considerations. The Model Portfolios invest primarily in Exchange Traded Funds and no-load bond funds.





Benchmarks: The Benchmark for each of the above graphs utilizes the Russell 1000 Index for stocks and Total Bond Market Index for bonds. The ratio of stocks and bonds in each Benchmark matches the ratio of the associated VFM model portfolio.

Portfolio Construction: Each Model Portfolio consists of up to 8 stock sectors, 7 bond sectors and gold. Buy/Sell decisions are based on VFM's proprietary algorithm and are consistent across all portfolios. Each Model Portfolio and the associated Benchmark are rebalanced quarterly.

Portfolio Comments

Wow, July was a great time to be an investor. Most companies have now reported earnings for the 2nd quarter, and many reports were positive. The market responded with a great rebound, and the S&P 500 closed the month 44% higher than its low point on March 6. That's quite a recovery, even though the year-to-date number is not nearly as good.

Four sectors in the model portfolios were in cash at the beginning of the month. All four of these sectors hit their buy points shortly after the beginning of the month and tracked the overall market on its way up. Although a few clients noticed the buying and selling activity, the net result (including transaction costs) was positive and allowed all portfolios to increase their leads over their respective benchmarks.

Every sector made gains last month. The big winners for the month were Basic Materials (12.87%) and Real Estate (10.77%), both of which were purchased just off their lows. Basic Materials overtook Technology as the largest *stock sector* gainer for the year, at 28.06% and 27.84% respectively. I need to highlight "stock sector" because High-Yield Bonds is the sector with the highest annual return at 36.81%.

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