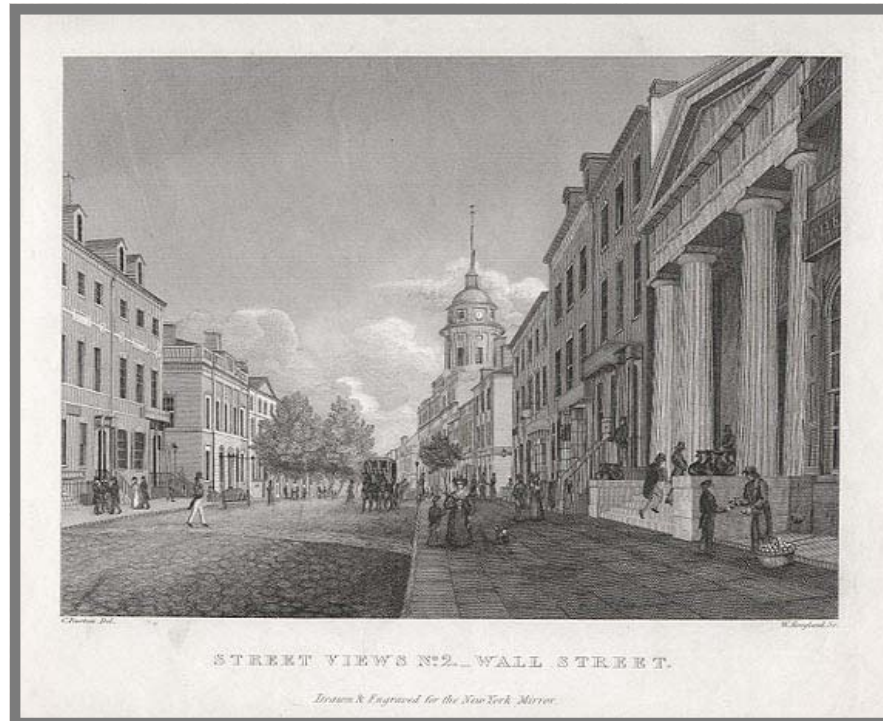


# THE INVESTMENT JOURNAL

VOLUME 7, WINTER 2004

STRATEGIC  
CAPITAL  
ADVISORS

REGISTERED INVESTMENT ADVISORS



"STREET VIEWS No. 2 - WALL STREET/DRAWN AND ENGRAVED FOR THE NEW YORK MIRROR."  
ENGRAVING, CIRCA 1830

To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.

[From the preface to Benjamin Graham's *The Intelligent Investor*]

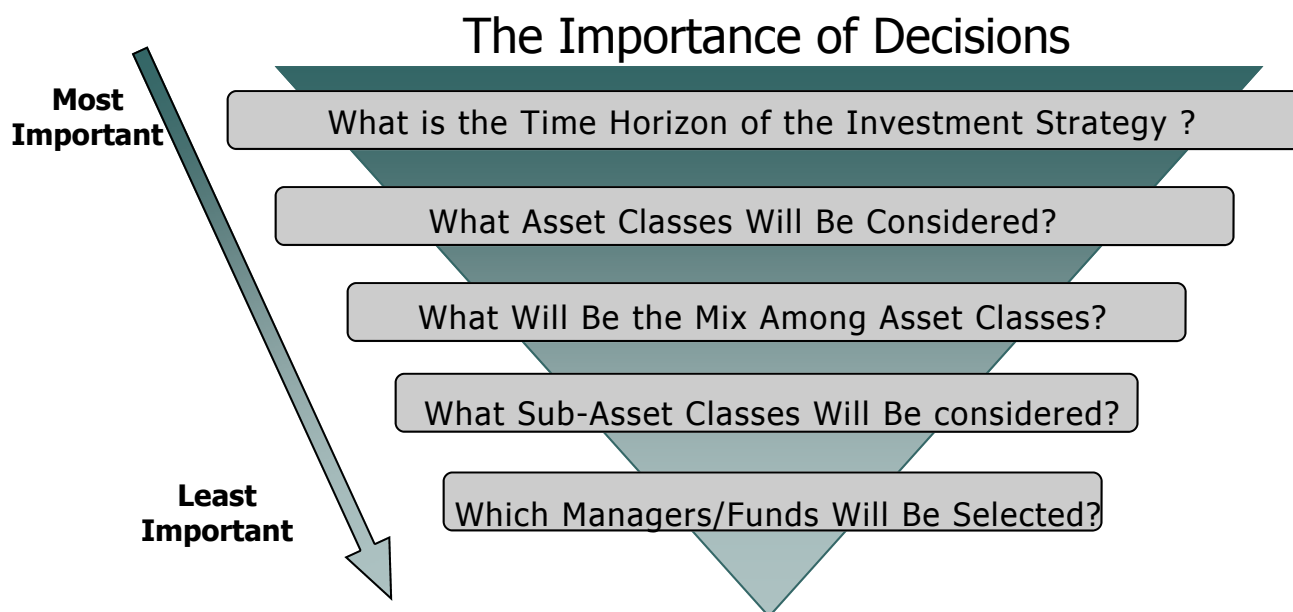
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## “PRUDENT INVESTMENT PRACTICES”

The Foundation for Fiduciary Studies has recently released its *Prudent Investment Practices*, a Handbook for Investment Fiduciaries. It is written for any person who has the legal responsibility for managing someone else’s money. The handbook is addressed to trustees, investment committee members, directors, investment advisors, and other fiduciaries. Yet all of the guidelines in the *Prudent Investment Practices* (the “*Practices*”) should be followed by all wealth managers and affluent investors regardless of the title or ownership structure of the account. The most successful family offices are structured to operate similarly to the principles outlined in the *Practices*. These *Practices* are fundamental to how we approach the money management issues of our clients. The most successful family offices are structured essentially as outlined in *Prudent Investment Practices*.

The *Prudent Investment Practices* are easily adaptable to all types of portfolios, regardless of size or use. Whether assets are held in trust or in an endowment or simply in a community property account, the same standard of care should be followed in developing, implementing, and monitoring a long-term portfolio. The twenty-seven *Practices* are intended to define a comprehensive approach to the investment process from beginning to end. The following page highlights a few of the *Practices* outlined in the publication that any investor or investment advisors should be incorporating into developing an appropriate investment policy. ■



**Investments are managed in accordance with applicable laws, trust documents, and written investment policy statements.** As in managing any business decision, one has to set definitive objectives that are consistent with the portfolio's resources; the limits and constraints of applicable trust documents and statutes; and, in the case of individual investors, their own personal objectives for their personal wealth.

**A risk level has been ascertained.** An investment strategy can fail by being too conservative or too aggressive. A portfolio should not be implemented with a risk adverse strategy when a more conservative balanced strategy is sufficient to cover the identified objectives.

**An Investment return expected to meet investment objectives has been calculated.** There is no expectation that anyone can forecast future returns. Rather, the fiduciary is required to state the presumptions that are used to model the probable outcomes of a given investment strategy given historical data.

**Selected Investments are consistent with the identified risk, return, and time horizon.** The fiduciary's role is to choose the appropriate combination of Investments that optimizes the identified risk and return objectives, consistent with the portfolio's time horizon. The fiduciary's choice of Investments and their subsequent allocation will have the most significant impact on long-term performance.

**The investment policy statement defines diversification and rebalancing guidelines.** One of the challenges of writing a complete investment policy statement is to create investment guidelines specific enough to clearly establish the parameters of the desired investment process, yet provide enough latitude so as not to create an oversight burden. This is particularly true when establishing the portfolio's asset allocation and rebalancing limits. The strategic asset allocation is a specific mix of asset classes that meets the risk/return profile of the investor.

**The investment strategy is implemented in compliance with the required level of prudence.** The prudent fiduciary is strongly encouraged to follow the time-proven maxim of doing what one does best and delegating the rest to professionals. Whether investment decisions are delegated to professionals, which is strongly encouraged, or retained by the fiduciary, due diligence must be demonstrated in implementing and monitoring a portfolio.

**Periodic reports compare investment performance against appropriate index, peer group, and IPS objectives.** The fiduciary should acknowledge that fluctuating rates of return characterize the securities markets, and will cause variations in performance. The fiduciary should evaluate performance from a long-term perspectives.

In conclusion, a fiduciary is subject to substantial scrutiny from multiple sources. Fiduciary liability is not determined by investment performance, but rather by whether prudent investment practices were followed. ■

<sup>1</sup>Prudent Investment Practice, A Handbook for Investment Fiduciaries by the Foundation for Fiduciary Studies, 2003

## CURB YOUR ENTHUSIASM

We would like to thank our respected colleagues at Harris Associates in Chicago and Edward S. Loeb, their Director of Institutional Portfolio Management, in particular for providing our Investment Commentary this quarter.

Like Larry David, the main character on HBO's hit comedy series, we often find it uncomfortable to embrace good fortune: we've learned it often pays to be a bit paranoid when others are complacent. "Curb Your Enthusiasm" covers the mundane, daily life of a neurotic, angry Hollywood writer who seems perpetually dissatisfied even when times are fortuitous (in fact, Larry David co-created "Seinfeld", and his character is reminiscent of curmudgeon George Costanza). We at Harris Associates are not quite as anxiety-ridden (hopefully!) as Larry after all, we have been sensibly optimistic in the face of broad investor pessimism over the past year or so-but as our clients know, our investment process always includes a healthy dose of skepticism. So today, while most investors (and our clients) celebrate 2003's remarkable stock market performance, we want to exercise care; we are fully aware there are likely hidden bumps in the road ahead. The long-term story, as we will discuss, still looks pretty favorable for stocks, but the market's recent rise-the strongest year for the S&P 500 since 1998-creates greater short-term risk as valuations have risen and new buying opportunities have become more scarce. The market's strong showing since late 2002 reflects the favorable resolution of a number of issues investors found fearsome. As we have reminded our clients over the past few years, most investors have increasingly focused on headlines and short-term macro fears rather than long-term likelihoods. The list of concerns included: the approaching war in Iraq; terrorism; a weak global economy; possible deflation; corporate governance scandals; and most importantly, the painful memory of a three-year bear market for stocks. Despite today's enthusiasm, the mood in October 2002 was decidedly pessimistic. We wrote:

*...Most investors have felt enormous pain for the past several years. This pain has created an air of intense fear that has spread throughout the econ-*

*omy and our markets. Investors have responded by selling their stocks and mutual funds and heading for apparently greener pastures. But the argument for stocks today rests firmly on several foundations...Stocks look to be much more attractive than bonds...And investor sentiment is extremely negative, setting the conditions needed for market recovery.*

In fact, things turned out even better than we imagined. In Iraq and the Middle East, the worst fears never materialized: Saddam is in custody, Gadhafi has opened Libya to inspectors, and the vast majority of nations-France, Germany, Russia and China-have joined the antiterrorism campaign and proved helpful. At home, massive fiscal and monetary stimulus kept deflation and deep recession at bay. Strong productivity has boosted profits to an all-time high, capital spending is growing once again and consumer confidence is up. And so investors have decided to put to work some of their low-yielding cash reserves (about \$300 billion of net inflow to equity mutual funds in the past twelve months). With all this bright news, one would imagine we're jumping for joy around Harris Associates. In fact, our enthusiasm is muted: despite gratifying recent market performance, we have found the last several months to be quite *frustrating*. First, the market-in a broad sense seems to adequately reflect the improved earnings picture and favorable external environment. Depending upon the particular measure used, the P/E ratio for the S&P 500 (using consensus 2004 estimates) hovers near 20x, an above-average figure that clearly reflects positive investor sentiment. More importantly, we've had a more difficult time identifying individual stocks or even sectors that might offer new purchase opportunities-there seem to be few clear valuation anomalies given the breadth of market recovery over the past year. Many investors may prefer a high stock market to maximize their current spending power, but we

must admit that as long-term investors, we occasionally prefer an environment of uncertainty, pessimism, fear and thus low valuations. The idea, after all, is to buy low.

Even though we don't make economic forecasts, it's worth noting the long-term economic story remains pretty favorable. Worldwide GDP growth appears to have gathered meaningful steam over the past few quarters, and even the more sluggish European and Japanese economies are growing again. The U.S. economy in particular has proven to be remarkably resilient, and the case for further growth is strong, driven by higher profits, rising capital spending, additional stimulus from last year's Bush tax cuts, low inflation (the lowest in 40 years!), and a better-than-expected budget deficit picture. Many are worried the recovery is endangered by sluggish employment growth, but it would be risky to bet against improvement in the jobs picture. The headlines shout loudly about lost manufacturing jobs, but that trend has been in place for fifty years (and is even occurring in China right now!). The fact is that rising productivity and the migration of production and services to lower-cost sources raises living standards.

The U.S. economy's dynamism and adaptability remain important strengths, and the employment story is likely to continue to improve now that businesses are spending again. Overall, there are no obvious clues the economic fundamentals will disappoint, and so the economic backdrop looks as good as it has in quite some time. There is another support for investor enthusiasm: low tax rates. The recent tax law changes support higher P/Es, all else equal. With taxes on dividends and capital gains now at 40-year lows, the taxable investor earns a higher return on stocks, thus justifying higher prices at the margin. In fact, the stock market in the late 1950s/early 1960s (when interest rate and tax conditions were similar) supported fairly high P/Es for some time. In any case, today's P/Es don't look nearly as wacky as those seen in the nosebleed late-1990s.

All of these factors argue for satisfactory long-term returns from equities, particularly compared to prospective returns from bonds or cash. With interest rates already near historical lows and the economy

in recovery, fixed income investors might be fortunate to simply earn the current low coupon on their bond investments. Stocks, on the other hand, offer the opportunity to piggyback economic progress while delivering rising and tax-advantaged dividends to a degree not seen for some time. Today, even if stocks as a group are close to "fair value", we believe long-term returns are likely to outpace most other major asset classes. We must remind ourselves there are no truly "safe" investments—even low yielding money market funds face inflation risk. But the short-term picture is less clear to us. Our analysts have found it challenging to identify new buy candidates in recent months. As we like to describe our investment philosophy, we aim to pay 60 cents or less for the stock of a business we think is worth \$1.00 (our sell target is typically in the range of \$0.90-\$1.00). While at any time the stocks in our portfolios cover the whole spectrum between our buy and sell targets, today our average holding trades near the *middle* of this range. While this level still offers acceptable returns—and easily justifies maintaining equity ownership—the upside is definitely less than we would prefer given our value-oriented roots and conservative demeanor. It does not support unbridled enthusiasm. The optimism reasserting itself in the stock market is certainly welcome news to those who suffered so greatly after the Bubble popped. But it is not, in our opinion, time to "Party Like It's 1999"; we worry that some areas of the market increasingly reflect outlandish growth expectations that will prove very difficult to achieve for the second time in the past half decade. The momentum players whose focus is rarely on company fundamentals or valuation face a demanding future if their assumptions are based on a continuation of the red-hot market of the past year. Such an outcome is certainly possible, but the market's rise offers little cushion should unexpected obstacles appear. Our position in this environment is to maintain exposure to equities as long as individual stocks trade below our value estimates. Obviously, we continue to look for new ideas for our portfolios, but we expect to maintain our well-known discipline. As much as possible, we also want to emphasize quality businesses for our portfolios: strong cash flow dynamics, sensible management teams and strong balance sheets. Thankfully, many such stocks remain among the most reasonably priced in the market

today, and so we feel well positioned for an environment that would bring out the best of Larry David or even George Costanza. To be clear, we see absolutely no evidence to support a breakdown in the long-term story for equities, but a bit of caution seems just right for today's market. ■

“Our research process employs both returns-based style analysis and holdings-based attribution analysis. Each methodology provides critical information that contributes to the integrity of our manager evaluation and selection process.”

Hal Peterson –  
Chief Investment Officer

“The vast majority of the nation's investable wealth is in the hands of fiduciaries—more than five million men and women are responsible for managing others' money. While corporate malfeasance has cost shareholders billions in losses, such damage may be far smaller than that resulting from investment advisers' and trustees' failure to competently manage client and trust assets.”

Donald P. Trone

*Donald B. Trone is an accredited investment fiduciary auditor. He is president and founder of the Pittsburgh-based Foundation for Fiduciary Studies, whose mission is to develop and advance fiduciary standards of care for trustees, investment committees and advisers.*

## Charitable Gift Account

At Strategic Capital Advisors, we are committed to searching for ideas for wealth management. Another approach to personal philanthropy is the Schwab Fund for Charitable Giving™, a national donor-advised fund. Schwab's Charitable Gift Account offers you a uniquely flexible way to manage your giving. It's simple, efficient and provides you and your family with a tax-smart way to support charities today and build a lasting legacy for tomorrow. This is an interesting option versus a private family foundation. For those interested in philanthropy, but want to fund less than \$1 million or avoid the administration complexities of a Private Foundation, a Charitable Gift Account may be an appropriate solution.



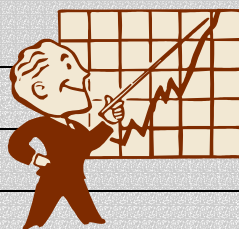
The first step is an irrevocable, tax-deductible contribution of cash or securities made to the Schwab Fund for Charitable Giving™ (the “Fund”). The Fund is then the owner of the assets and places them into an account that you name (for example, The Smith Family Fund). For donations of \$500,000 or more into a Charitable Gift Account, Strategic Capital Advisors will manage the account.

At any time, you can recommend grants of \$250 or more from the Fund to a bonafide charity. The Fund will maintain records of all account activity, and donors will receive contribution receipts, grant acknowledgments, quarterly statements, and other correspondence from the Fund.

If you are interested in establishing a Charitable Gift Account, please contact Strategic Capital Advisors. ■

Below are relevant market indices for the quarter ended December 31,

Market Indices	4 <sup>th</sup> Qtr	2003	3 Year Avg	5 Year Avg	10 Year Avg
LB Credit Bond Index	0.32	4.11	7.57	6.62	6.95
Dow Jones World Index	14.14	35.74	-2.25	1.02	7.19
S&P 500 Index	12.18	28.69	-4.05	-0.57	11.07
Russell 2000 Index	14.53	47.25	6.27	7.13	9.46
Wilshire 5000 Total Market Index	12.43	31.65	-2.45	0.47	10.62
NASDAQ Composite Index	12.11	50.01	-6.74	-1.78	10.30
MSCI EAFE Index	17.11	39.17	-2.57	0.26	4.78
MSCI Emerging Markets Index	17.81	56.28	12.77	10.62	0.18
NAREIT Equity REIT Index (real estate)	9.91	37.01	17.46	14.33	12.04



The chart below provides the gross returns as of December 31, 2003 for structured Dimensional model portfolios that are used as benchmarks for client portfolios. The model portfolio illustration below provides a ten year history as to how diversified portfolios perform. The value of diversification can be observed by comparing the model portfolios to the various indices above. We structure portfolios for our clients with the objective of providing enhanced returns with lower volatility.

Diversified Portfolios	4 <sup>th</sup> Qtr	2003	3 Year Avg	5 Year Avg	10 Year Avg
Fixed Income (0% equity, 100% fixed)	-0.24%	2.31%	5.41%	5.42%	5.68%
Conservative (20% equity, 80% fixed)	2.81%	10.09%	6.62%	6.51%	6.92%
Balanced #1 (40% equity, 60% fixed)	5.90%	18.31%	7.69%	7.50%	8.07%
Balanced #2 (60% equity, 40% fixed)	9.05%	27.03%	8.66%	8.40%	9.15%
Aggressive (80% equity, 20% fixed)	12.27%	36.27%	9.47%	9.19%	10.16%
Equity (100% equity, 0% fixed)	15.53%	46.03%	10.15%	9.88%	11.08%

The model portfolios above are rebalanced monthly and do not take into account transaction fees, which differs from actual portfolio activity. Past performance cannot guarantee future results.



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**SCA News**

Everyone at Strategic Capital Advisors would like to wish you a very happy and prosperous New Year!

**FIDUCIARY CODE OF CONDUCT**

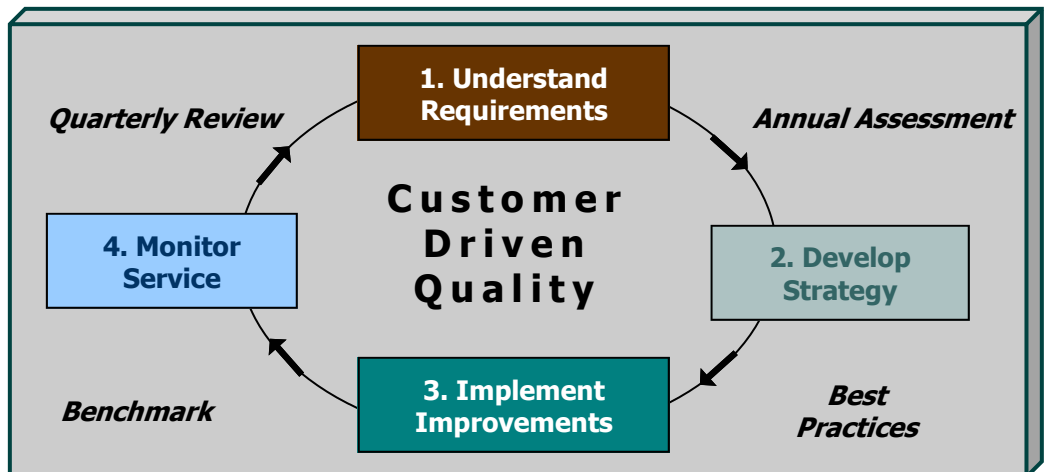
If you're going to do it -  
*Do it right.*

As you manage investment decisions:  
Document the process;  
Hire competent professionals; Monitor results; and  
*Always remember you have been entrusted  
with someone else's money.*

Never invest in something you don't understand  
or is difficult to value. Know what you're paying for -

Cautiously approach investments that promise  
Superior results. Believe in the statement -  
*The past is no indication of future performance.*

Relish the opportunity to be a steward of  
sound investment practices.



Source: Prudent Investment Practices