

September 30, 2004

Dear clients,

I hope this letter finds you and your families all well. This has been a busy quarter indeed so let me get right to it. As promised I have made some visually subtle but meaningful changes to the summary report I prepare for you each quarter. Starting with the **Income Projection and Probability** area I have reduced this to just one Before Tax and After Tax “Very Likely” amount. These amounts are the only ones that deserve real focus. Please also heed the note that asks that you make sure all assumptions I am using are accurate and still timely. For those of you whose **Retirement Nest Egg Analysis** section is incomplete, please call me anytime and I’ll be happy to customize one for you as well.

Within the **Portfolio Statistics** section, the biggest change is that two new fields have been added; “Futures and Real Assets” and “Non-Diversified Assets.” I expect that within the next twelve months you will be hearing much more from me regarding the merits of committing a relatively small percentage of your portfolios to futures and real assets, but for now, that field will show 0% for everyone. Non-Diversified assets is a very meaningful field for some of you and insignificant for others. Suffice to say, if that percentage is 10% or higher, we should be, or hopefully are, talking about the risk/reward tradeoff further.

Although there are several other “behind the scenes” changes that allow me to analyze your portfolios more precisely than in the past, the last noteworthy change is in the **Pre-Fee Return** section. I have added a row called “Since Inception IRR.” The IRR stands for Internal Rate of Return. Time Weighted Return (TWR) and IRR are both accurate and true ways of reporting portfolio performance but depending upon cash flows and timing within a portfolio, startlingly different results can be produced. I often find it easiest to illustrate by example. Here goes:

*If you invest \$100,000 on January 1 and it grows to \$110,000 by December 31 of the same year, with no subsequent deposits or withdrawals, not surprisingly your IRR or TWR is exactly 10%. However, let’s say on the next January 1, being pleased with your 10% return, you decide to add \$1 million to the portfolio. This is where it gets interesting. If the second calendar year’s return is a loss of 5%, at the end of that year your portfolio would now be worth \$1,054,500. This is of course \$45,500 less than the total of your deposits and therefore producing a loss over this time frame.*

*To sum up two fairly complicated mathematical formulas as simply as possible, in the above example the annualized TWR is actually +2.23% while the annualized IRR is -3.80%. The negative IRR is fairly intuitive in that the investor indeed lost money over this two year period. However, the positive TWR is actually somewhat intuitive also in that if you gained 10% in the first year and lost only 5% in the second year shouldn’t you have a positive return for the two years combined? This is the heart of the issue. In absolute terms, the amount of a 10% gain on \$100,000 is less than the amount of a 5% loss on \$1,110,000 (\$10,000 vs. \$55,500). Thus, I hope you now see the relevance in me reporting both your TWR and IRR. TWR accurately reflects the performance of your investments while IRR accurately reflects the performance of your portfolio. There is a difference as this example illustrates.*

And now you see the difference between TWR and IRR. In plain English, TWR reflects the performance of your investments while IRR reflects the performance of your portfolios, (i.e. takes into account actual deposits and withdrawals that occur inside most portfolios after their initial fundings).

That’s all for now. Be well and don’t forget to vote on election day. Peace, health, and happiness to all!!

*A7*