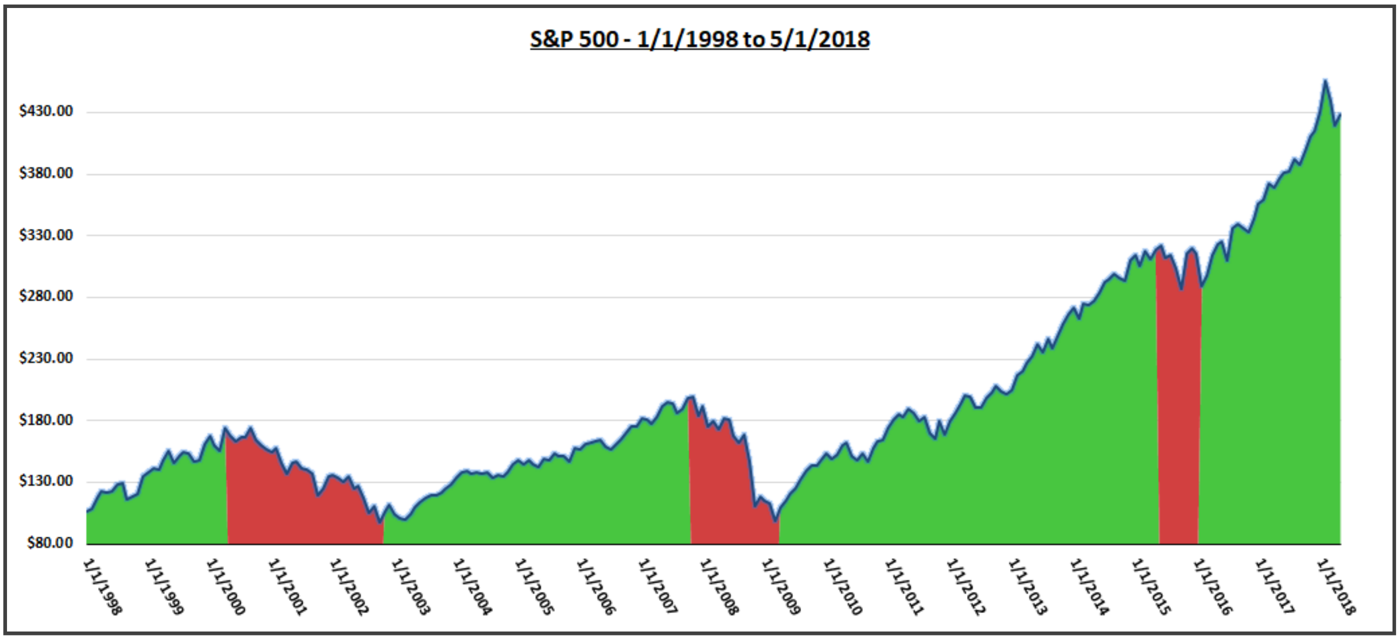
Why WDC Advised Portfolios?

Volatility in financial markets has presented investors with significant opportunities for growth as well as significant risks of loss. Even a cursory overview of the price movements of the S&P 500 index throughout the past 20 years shows that investors who owned stocks had large gains during some periods of time and large losses during other periods of time.



If you had a marker which identified transitions from green to red, would you have stayed fully invested or would you have made changes in your portfolio?

How much further ahead would an investor have been who managed to avoid most of the crushing losses associated with the red periods?

The typical **Asset Allocation** approach to investment management promotes managing risk through broad diversification, seeking to "optimize" a portfolio for an investor's risk tolerance, and then simply holding that portfolio throughout periods up, down, or sideways. This approach typically makes changes to portfolio allocations as the result of a change in an investor's age or feelings (e.g. a change in Risk Tolerance) rather than making changes in light of current market dynamics and conditions. Consequently, investors have often underperformed the broad market during periods of upward trends and experienced significant losses during periods of downward trends.

The goal of WDC Advised Portfolios is to realize investment growth and employ effective downside risk controls through up, down, or sideways market cycles.

Think of the Market being like a game of Jenga.

Have you ever played the game Jenga? The game starts with a tower made of 54 specially crafted hard wood blocks. Each player takes a turn removing a block from the middle of the tower and placing it on the top of the tower. As more and more blocks are removed from the middle of the tower, the tower becomes less and less stable. At some point, when enough blocks are removed, the tower is no longer able to stand and it comes crashing down. At that point the tower is rebuilt and the game starts over again.

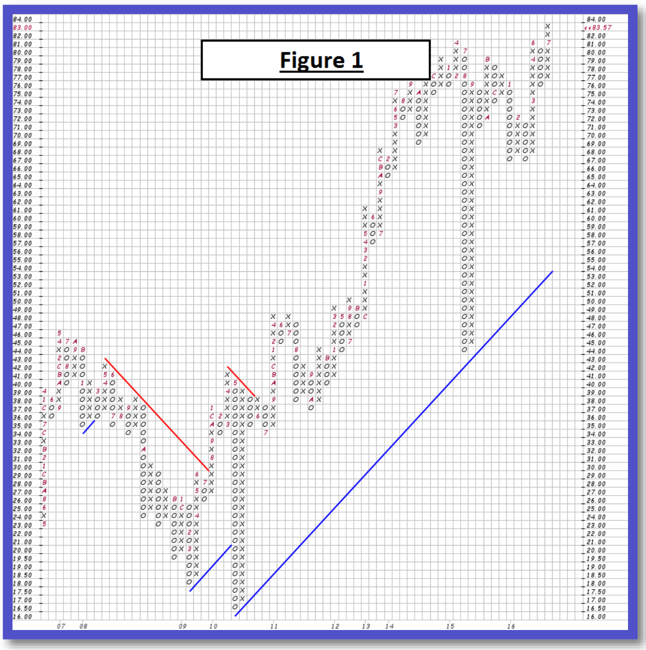
Broad market indices and broadly diversified portfolios are like the game of Jenga. What we know as "indexes" are made up of dozens, hundreds, and even thousands of individual stocks. If enough stocks are going up, the index and the portfolio will continue to go up. If enough stocks begin going down, however, the index or the portfolio will begin to decline and may even come crashing down.

So, What Makes a Stock Price go Up or Down?

Supply and demand.

If you have ever been to an auction, you understand what happens when something is put up for sale. The auctioneer begins by saying something like "ladies and gentlemen this is a fine antique dresser. Look at how well preserved it is. In fact they don't even make these anymore. This is an amazing piece. Now who will start the bid? Anyone for $1,000?" If no hands go up, the price usually goes down, and then continues going down until hands start going up to bid.

The price at which buyers begin to bid is called support. Once hands start going up, the price usually goes up, and then continues going up until nobody wants to pay a higher price for the antique. The price at which buyers are not willing to pay more is called resistance. What many investors are slow to accept is that the very same forces that cause price movement at an auction also trigger price movement in the financial markets. When all is said and done in a free market of any kind, if there are more buyers than sellers willing to sell, the price will move higher. If there are more sellers than buyers willing to buy, the price must move lower. If buying and selling are equal the price will remain the same.



Keeping Track of the Prices

Suppose we sat in this auction and kept a record of each bid. As long as the bid was going down, we would keep track of those bids by keeping a column of "Os". If the bids started going up, we would change our record to a column of "Xs". In the world of financial markets, where bids can go up and down throughout time, this kind of record looks like the one in Figure 1. Using this method it is possible to identify points of investor support and investor resistance, just like an auction.

Another viable method of keeping track of this information is to average the prices over time. Keeping track of prices in this way results in a record which looks like the one in Figure 2.

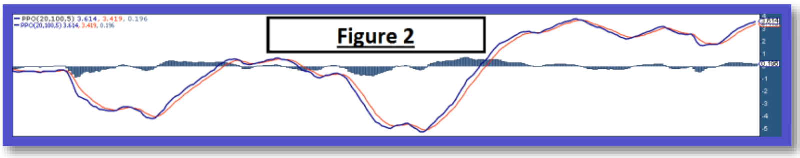


Figure 2

With this in mind, it is easy to see that during the time period of 2000 to 2002, many more investors wanted to sell securities of the S&P 500 (figure 3) rather than buying them. However, not all investments were "unloved"; consider Kellogg (figure 4), a company with publicly traded stock. During this time period, investors who held shares of Kellogg actually realized a profit, even though the S&P 500, and many broadly diversified mutual funds all lost money. There was simply enough investor demand for Kellogg to continue to support its share price. In fact, nearly 20% of all stocks in the S&P 500 continued in an uptrend in the 2000 - 2002 time period. “The Market” went down because a greater percent of stocks were going down than were going up.

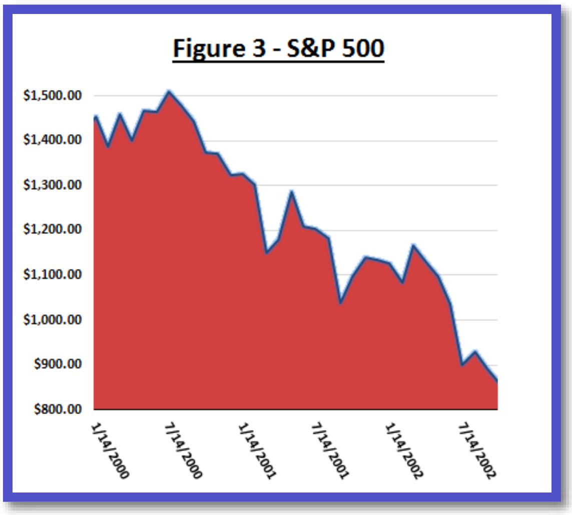


Figure 3 - S&P 500

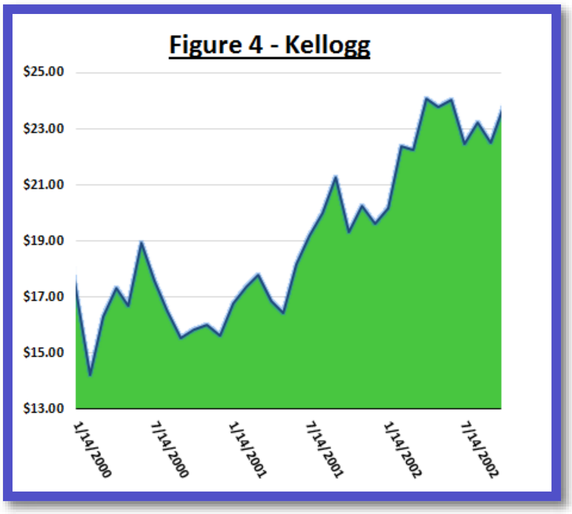


Figure 4 - Kellogg

Relative Strength

To date, the most effective way that we have discovered to gauge areas of investor demand is Relative Strength. Relative Strength is simply a comparison of one investment possibility to another investment possibility. Think about Relative Strength as you might think about your favorite sports team or player. Sports teams and players are ranked based upon how well they perform against their opponents; the more games, matches, or races won, the higher in the rankings the team or player will go.

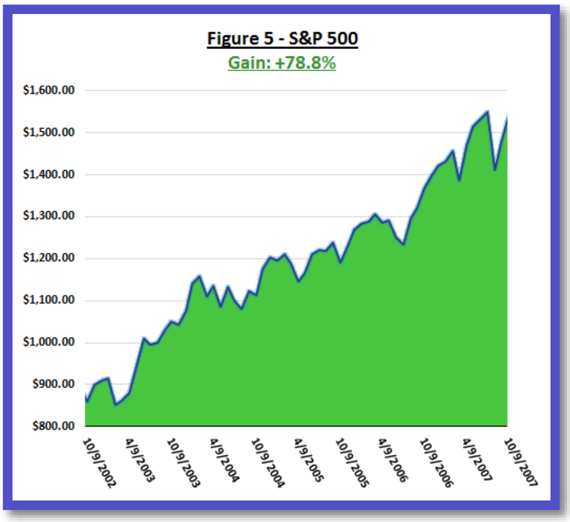


Figure 5 - S&P 500
Gain: +78.8%

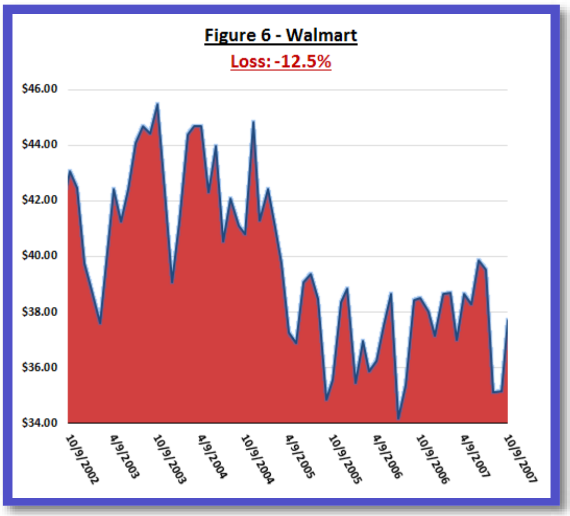


Figure 6 - Walmart
Loss: -12.5%

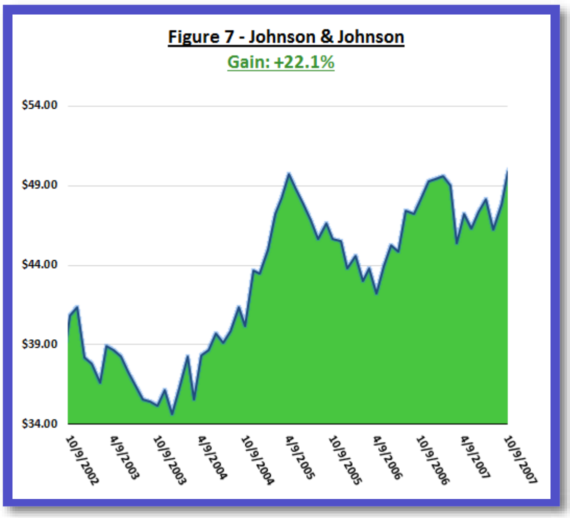


Figure 7 - Johnson & Johnson
Gain: +22.1%

Relative Strength is a similar kind of ranking in the financial markets. Each day in the financial markets a “contest” occurs between buyers and sellers. If buyers are bidding and prices are going up, then there is more demand than supply, and there is support in the market. If sellers are selling and prices are going down, then there is more supply than demand, and there is resistance in the market.

Relative Strength simply compares the price movement of “Investment Possibility A” to the price movement of “Investment Possibility B”, just like you would compare the performance of sports teams and players to each other. If the price movement of Possibility A is more positive or less negative than Investment Possibility B, then the result of the comparison swings in favor of Possibility A. If the price movement of Possibility A is less positive or more negative than Possibility B, then the result of the comparison swings in favor of Possibility B.

In the Kellogg and S&P 500 figures on Page 3, it is easy to observe that Kellogg held much more investor support than the S&P 500 from the years 2000 through 2002. During this period of time, the Relative Strength of Kellogg vs. the S&P 500 Index was positive.

Now consider some additional companies through the time frame of October, 2002 to October, 2007. The S&P 500 Index (figure 5) increased in price during that period of time. However, just as not all company stocks decreased in price while the S&P 500 went down, not all company stocks increased in price while the S&P 500 went up. Walmart stock (figure 6) can be observed decreasing in price during that time period. Since Walmart did not do as well as the S&P 500, Walmart’s Relative Strength vs. the S&P 500 was negative.

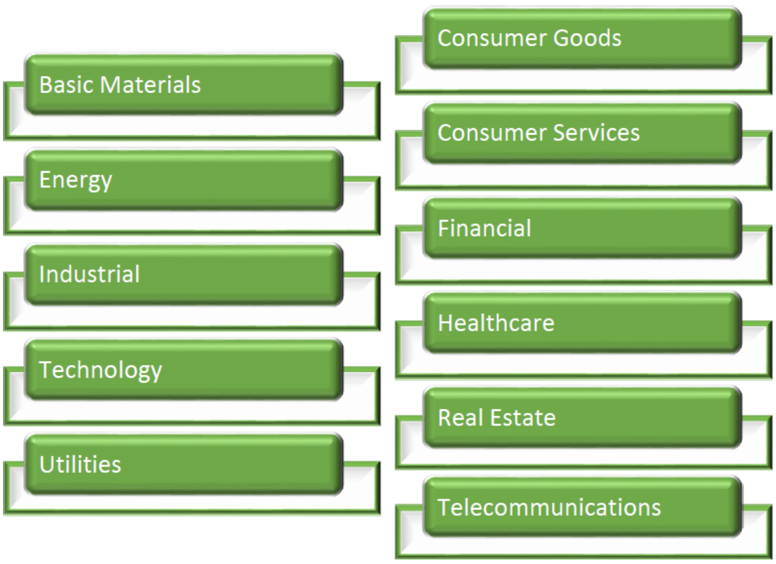
Johnson and Johnson stock (figure 7) did increase in price over the time period, so its Relative Strength vs. Walmart would be higher. But Johnson and Johnson did not increase as much as the S&P 500 index. Even though Johnson and Johnson’s stock price increased, its Relative Strength vs. the S&P 500 was also negative, since it also did not do as well as the S&P 500.

Comparing Multiple Securities

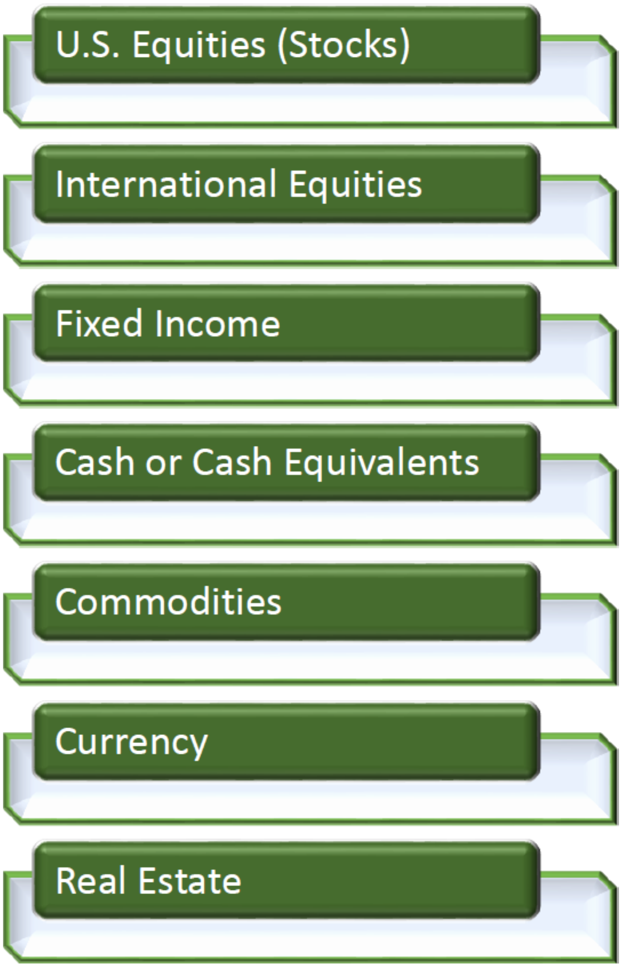
By applying this process many times over, any security or group of securities can be ranked by how they are doing relative to other securities or groups of securities, similar to the way one ranks sports teams. Ranking a broadly diverse universe of possibilities can help to identify areas of investor demand. Our process routinely compares many securities and groups of securities to each other and ranks the results from the strongest to weakest and ranked in a journal similar to the one depicted below.

	6/1/2001	1/1/2002	6/1/2002	1/1/2003
1	Microsoft	Walmart	Kellogg	Microsoft
2	Honda Motor Corporation	Johnson & Johnson	Honda Motor Corporation	Kellogg
3	Exxon	Microsoft	McDonalds	Berkshire Hathaway
4	Johnson & Johnson	Kellogg	Berkshire Hathaway	Johnson & Johnson
5	Berkshire Hathaway	Berkshire Hathaway	Johnson & Johnson	Exxon
6	Walmart	Honda Motor Corporation	Disney	S&P 500
7	Disney	S&P 500	Exxon	Disney
8	Kellogg	Exxon	Walmart	Walmart
9	S&P 500	McDonalds	S&P 500	Honda Motor Corporation
10	McDonalds	Disney	Microsoft	McDonalds

Broad Economic Groups



This kind of ranking approach can be applied to broad economic groups & broad asset classes as well. A study of the broad equity market could divide stocks into groups called sectors. Whether in up, down, or sideways markets, some sectors are usually doing better than others. Each sector is made up of individual stocks, and each sector works in a similar way that the broad market works. When a greater percent of individual stocks in that sector are going down instead of up, that sector will go down as a whole. Conversely, when a greater percent of individual stocks in that sector are going up instead of down, the sector will go up as a whole.



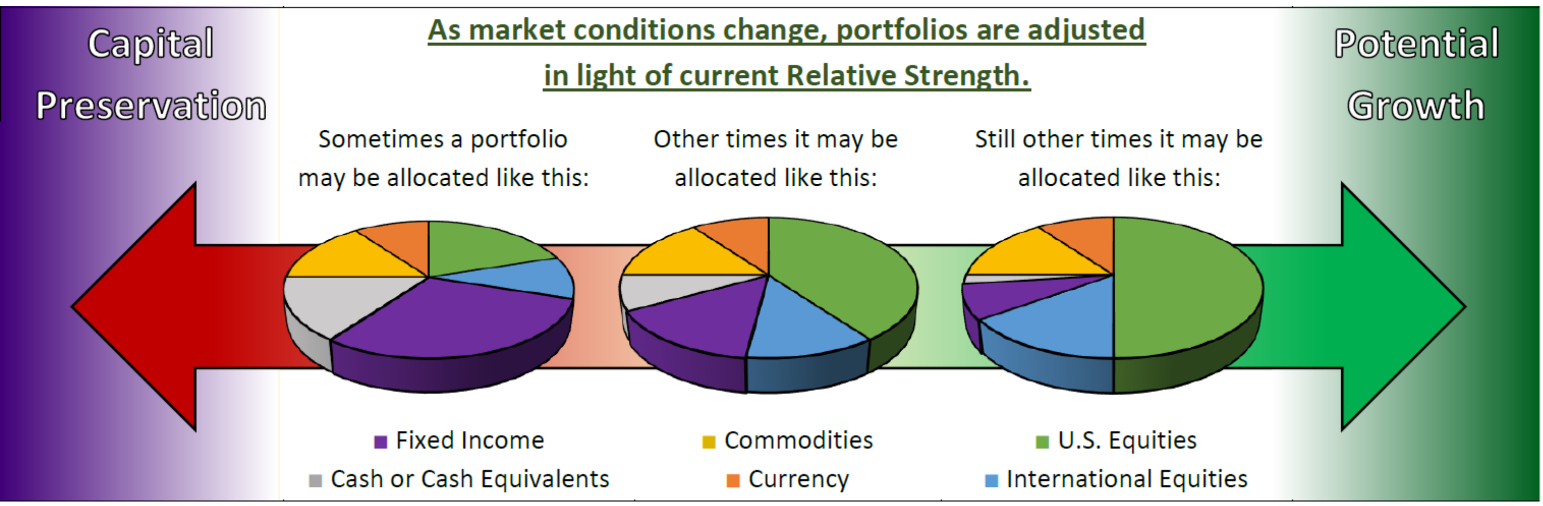
Broaden The Scope

Historically, many investors equated investing to buying stocks. But in recent years access to other asset classes, traditionally only available to large institutional investors, have become available to a much wider segment of the population. By broadening the opportunities for investment from just US stocks to other asset classes like international stocks, commodities, currencies, fixed income and even cash alternatives provides greater investment flexibility when US Equities are not in favor. Asset classes tend to rotate in and out of season just like sports teams are better some years than others. Historically, no one asset class has held the top performing spot forever. Sometimes US equities were at the top, sometimes they were at the bottom. Sometimes Commodities found their way to the top in terms of performance while in other years it was Fixed Income or Cash Alternatives.

Just as the coach of a sports team will rotate players in and out of a game based on the performance of that player, investors should be willing to adjust their portfolio based on the market environment and emphasize those assets and asset classes that offer the best opportunity to meet investment objectives. Making periodic adjustments like this is called a **Tactical Approach.**

A Tactical Approach to Portfolio Allocations

Sometimes the tactical portfolio can be skewed more toward equities, while at other times it may have an emphasis on alternative investments asset classes like commodities, or even be very defensively invested.



Putting It All Together

In conclusion, the primary objective of WDC Advised Portfolios is to navigate volatile markets using a tactical approach based on Relative Strength. Broad Asset Classes are over-weighted or under-weighted based upon current Relative Strength in the market. Within those Broad Asset Classes, specific holdings are also selected or rejected in light of current Relative Strength. Portfolios are constructed with the following typical ranges of exposure in each asset class:

Blended Model Portfolio					
	Aggressive Portfolio	Growth Portfolio	Moderate Portfolio	Conservative Portfolio	Income Portfolio
Equities Typically represented with Individual Stocks, Sectors, Exchange Traded Funds, Mutual Funds	0% - 100%	0% - 90%	0% - 80%	0% - 65%	0% - 50%
Inverse Positions Typically represented with Exchange Traded Funds	0% - 30%	0% - 27%	0% - 24%	0% - 21%	0% - 18%
Precious Metals and other Commodities Typically represented with Exchange Traded Funds, Exchange Traded Notes, or Mutual Funds	0% - 40%	0% - 35%	0% - 30%	0% - 20%	0% - 10%
Currency Typically represented with Exchange Traded Funds	0% - 10%	0% - 9%	0% - 8%	0% - 6.5%	0% - 5%
Preferred Stocks Typically represented with Exchange Traded Funds	0% - 30%	0% - 30%	0% - 30%	0% - 30%	0% - 30%
Bonds Typically represented with Exchange Traded Funds, Mutual Funds, Individual Bonds	0% - 100%	0% - 100%	0% - 100%	0% - 100%	0% - 100%
Cash or Cash Equivalents Typically represented with money market funds or actual cash positions	0% - 100%	0% - 100%	0% - 100%	0% - 100%	0% - 100%