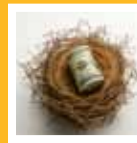




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July 2011

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WATERFORD ADVISORS
An SEC Registered Investment Advisor

Quarterly Newsletter

QUARTERLY INVESTMENT COMMENTARY: SECOND QUARTER 2011



*Gregory L. Kozerski,
CPA, CFP®, AIFA®
President, Waterford
Advisors LLC*

Momentum that carried stocks higher through the first four months of the year

fizzled in May as investors became increasingly concerned about a slowing economy (exacerbated by supply chain interruptions stemming from the Japan earthquake) and fears that a Greek default would spread contagion to other weak EU members and rattle the European and even global financial systems. Those concerns, particularly relating to Greece, intensified as the second quarter progressed, and a modest retreat in May worsened in June before we saw a late-month rebound as it became increasingly likely that the EU and IMF would manage to kick Greece's debt can down the road at least one more time.

When the dust settled, stocks wound up roughly flat for the quarter. Large-cap U.S. stocks were barely positive while smaller-cap stocks lost 1.6%. Growth did better than value across all market caps. Domestic high-quality,

intermediate-term bonds gained 2.2% for the quarter. Looking abroad, developed-market foreign stocks gained 1.1%, while emerging-markets equities fell 1%. **Local-currency emerging-markets bonds had a strong quarter, gaining 4%. Remember we have allocated approximately 10% to 15% in PIMCO's Emerging Local Bond fund in our balanced portfolios, a position taken when we reduced our overall equity exposure.**

Our model portfolio performance has been driven largely by our conservative bias (in all except our most aggressive portfolios), in which we are underweight to equities. This risk-averse positioning is the reason each model outperformed its benchmark in the second quarter while stocks were essentially flat. We talk more about our portfolio performance later in this commentary, including the reasons we believe it makes sense to take less risk at this time.

THE BIG PICTURE MATTERS—HERE'S OUR VIEW OF THE MACRO ENVIRONMENT

Our big-picture view of the economic and investment landscape did not materially change over the past quarter, but towards the end of the period, market volatility increased in response to disappointing economic data and

renewed fears of a European sovereign debt crisis (among other things). Our assessment of these and other factors and their impact on our portfolio risk and return expectations is ongoing and intensive.

(continued on page 2)

JUNE BENCHMARK RETURNS (PRELIMINARY)

Large-Cap Benchmarks	Jun	2Q	YTD
Vanguard 500 Index	-1.7%	0.1%	6.0%
Russell 1000 (iShares)	-1.7%	0.1%	6.3%
Russell 1000 Growth (iShares)	-1.4%	0.7%	6.7%
Russell 1000 Value (iShares)	-2.1%	-0.5%	5.8%
Mid-Cap Benchmarks			
Russell Midcap (iShares)	-2.1%	0.4%	8.0%
Russell Midcap Growth (iShares)	-1.6%	1.6%	9.5%
Russell Midcap Value (iShares)	-2.6%	-0.7%	6.6%
Small-Cap Benchmarks			
Russell 2000 (iShares)	-2.3%	-1.6%	6.2%
Russell 2000 Growth (iShares)	-2.1%	-0.6%	8.6%
Russell 2000 Value (iShares)	-2.5%	-2.7%	3.7%
Other Benchmarks			
Vanguard Total Int'l Stock Index	-1.5%	0.7%	3.7%
MSCI World ex USA Index	-1.4%	1.1%	5.1%
Vanguard Emerging Mkt Stock Index	-1.5%	-1.0%	0.8%
Vanguard REIT Index	-3.4%	3.5%	10.2%
Vanguard Total Bond Market Index	-0.4%	2.2%	2.5%
Merrill U.S. High-Yield Cash Pay	-1.0%	1.0%	4.9%
Barclays 7 Year Muni Bond Index	0.1%	3.3%	4.0%
S&P/LSTA Leverage Loan Index	-0.4%	0.2%	2.6%
Citigroup World Govt. Bond Index	0.2%	3.3%	4.0%
JPMorgan GBI-EM Global Div. Index	0.5%	4.0%	6.9%
DJ-UBSCI (Commodity Futures)	-5.0%	-6.7%	-2.6%



Investment Commentary

(continued from page 1)

Following are some of the key issues we are currently focusing on as well as a recap of the broader U.S. economic situation.

GREEK DEBT CRISIS FEARS (AGAIN)

It is easy to get caught up in daily media reporting about events such as the possibility of a Greek default and forget that we've been long concerned about the possibility of global shocks, like the European debt problem, and that our portfolio allocations already reflect these concerns. We are long-term investors but the risk management component takes into account the possible shorter-term downside risks.

CHINA HARD LANDING

Greece isn't the only risk. We are looking closely at China to assess whether a "hard landing," in which their economy slows sharply, is increasing in likelihood. They have debt problems of their own, mainly relating to a sharp run up in real estate, and an unexpectedly large drop in their economy would be a big drag on global growth and could spook markets. China in our view does not have high enough per-capita incomes to absorb all the excess industrial capacity China likely has now.

THE U.S. ECONOMY AND DEBT CEILING DEBATE

Meanwhile, we've got big problems at home. Beyond near-term concerns about raising the debt ceiling (the government is expected to run out of money in early August) the clock is ticking on out-of-control deficits and debt and unless we address this within the next several years, at some point we would expect to see the economy and markets very stressed from what could be sharply higher interest rates and inflation along with sluggish growth (stagflation) that could take years to work through.

THERE ARE SIGNS THE ECONOMY IS SLOWING

Recent U.S. economic news has been disappointing, with sluggish GDP growth and continued weakness in employment and housing (which are important drivers of consumer confidence, income, and spending). In the first quarter, real GDP grew at only a 1.9% annual rate compared to 3.1% in Q4 2010. Despite massive fiscal and monetary stimulus, in the seven quarters since the recession officially ended in June 2009, real GDP growth has averaged only 2.8%. This compares to an average growth rate of 5.3% for the same period after the prior 10 recessions. As we've been saying, this is not a typical business cycle.

On the jobs front, the employment report for May showed growth in nonfarm payrolls of only 54,000 for the month and even less in June at 18,000. We have seen estimates (from various economists) that the economy must create anywhere between 100,000 and 200,000 net, new jobs each month just to absorb the natural flow of new entrants into the labor force and keep the unemployment rate flat. The unemployment rate in June ticked up to 9.2%.

On the housing front, the widely followed S&P/Case-Shiller National Home Price Index fell 4.2% in the first quarter of 2011, following a 3.6% decline in the fourth quarter of 2010. The index is now 5.1% below its year-ago level, 34% below its peak in the second quarter of 2006, and down to a level last seen in 2002.

DEBT REMAINS A PROBLEM

Finally, the ongoing headwind from very high debt levels in the United States has not materially lessened in aggregate. As we all know, government debt continues to climb, so the overall U.S. debt picture has not improved much. On the positive side, consumers have continued to reduce debt.

So, our tactical macro view has not materially changed since last quarter. We continue to

believe the range of potential outcomes over the next several years is unusually wide, reflecting the unusually high degree of uncertainty surrounding the current global economic and political environment. Considering these problems in the context of our portfolio allocations brings to mind another common phrase, which is that we don't want to be "picking up pennies in front of a steamroller." We believe they are material enough that when weighed against the low potential returns we see, it makes sense to reduce risk. It might be frustrating for stretches in the short term, but in the long term—which is what we care about—we are confident this "insurance" is not going to cost us much.

With that macro backdrop we will devote the remainder of this commentary to how the portfolios are currently positioned, and our performance expectations looking across various scenarios that we think have a reasonable chance of playing out over the next several years. ***We continue to remain underweight equities in all but our most aggressive portfolios as we have been for some time.***

Below, we briefly discuss the role of each of these asset classes in the overall portfolio. It is important to recognize that by construction, the portfolio includes asset classes that will perform better or worse depending on the scenario that plays out. There likely will always be at least one asset class that is lagging or not appearing to add value to the overall portfolio at any given point in time. That is the definition of diversification.

Investment-Grade Bonds: Our position in core investment-grade bonds (IGB) should perform best in a recessionary or deflationary environment (e.g., triggered by an economic shock from another financial crisis). We'd expect U.S. Treasuries and other high-quality U.S. debt to be in high demand as the "safe haven" asset class—as was the case during the 2008–2009 crisis—and therefore to experience price appreciation. That is the reason, despite the very low current yield for IGB and our expectation of unsatisfactory longer-term (five-year) returns, we retain a meaningful allocation in the portfolio as protection against a deflationary scenario. In such a scenario, we'd expect this asset class to generate a shorter-term (12-month) return in the mid- to upper single digits.

In the other scenarios, we expect interest rates to rise by varying degrees and speeds. In these scenarios the expected returns to IGB are poor because rising rates imply falling prices for these bonds.

Absolute-Return-Oriented/Unconstrained Bond Funds: While we don't have conviction forecasting the direction of interest rates or currencies over the short term, we believe the odds favor higher rates and a lower dollar over our five-year tactical time horizon. *This is a key reason for our large tactical position in absolute-return-oriented and unconstrained bond funds and our underweighting to IGB.* These funds have flexible mandates that, among other things, can enable them to minimize losses or generate gains from rising interest rates or a falling dollar. These funds also may invest heavily in non-core fixed-income sectors, such as high-yield bonds, foreign and emerging-markets bonds, and foreign currencies. Because of our confidence in the managers of the funds we own, given this added flexibility we believe they will add value versus IGB over the longer term.

Emerging-Markets Local-Currency Bonds (ELB): We expect emerging-markets local-currency bonds to generate mid- to upper-single-digit returns over our five-year investment horizon. Because ELB invest exclusively in non-dollar emerging-markets debt, it is an obvious beneficiary from depreciation in the dollar versus emerging-market currencies.

Arbitrage Strategies: These strategies have relatively low downside risk and moderate expected returns across most scenarios. This is a tactical position in which we have given up the potential for equity-like (double-digit) returns in a best-case scenario in exchange for the risk-management benefits of lower but more certain returns across all the scenarios.

Equities: As has been the case for a while now, our analysis indicates the stock market (*you do not own the stock market, we are currently utilizing actively managed mutual funds for our equity exposure*) is likely to generate unsatisfactory returns in most scenarios over our five-year horizon. In conjunction with our conviction that our

active equity fund managers will outperform the broad market indexes, this explains why our equity underweight is not even larger. If we see risk increase but stocks do not yet reflect it, we could further reduce equities. We also expect that periods of fear will give us the chance to buy stocks at attractive prices. In the meantime, we are alertly watching this complex environment and are prepared to act quickly when and if it makes sense to do so.

WHAT WOULD LEAD US TO BECOME MORE OPTIMISTIC?

We are occasionally asked what would lead us to increase our equity exposure or become more optimistic about the macro environment. In terms of increasing our equity exposure, first and foremost would be an improvement in market valuations, which would raise our return expectations for stocks over our five-year analysis horizon. All else equal, a drop in stock prices improves the expected future return.

Alternatively, if our assessment of the economic fundamentals and, in turn, corporate earnings growth materially improves while stock prices remain flat, that could also lead us to increase our exposure to equities based on higher expected returns. This happens naturally (and gradually) over time as we roll forward our five-year earnings-growth estimates in our various scenarios. We also continue to reassess the positive impact on our earnings-growth estimates from the growing share of U.S. corporate profits coming from emerging-markets demand. Credible and concrete policy actions to control the United States' long-term structural budget deficit and evidence of successful deleveraging among the public and private sectors would be additional fundamental factors that could lead us to shift our scenario assessment to a more positive range of outcomes for riskier assets.

CONCLUDING THOUGHTS

As we've written in our past commentaries, if there is one thing we can be almost certain of, it is that there will be market shocks over the next few years and they will create investment opportunities for us to take advantage of. There may also be events that magnify risks

that we will want to further protect against. In either case, we will continue to invest based on where our research and analysis leads us, not based on what the investment herds are doing. In the long run, investing based on our research conviction has paid off for our clients, and we are confident it will continue to do so.

We appreciate your continued confidence. If you have any questions, please don't hesitate to contact me.

Gregory L. Kozerski, CPA, CFP®, AIFA®
President

OUR MISSION

Waterford Advisors exists to provide comprehensive financial planning services. We will accomplish this mission with excellence in everything we do.

We will provide independent, objective, and unbiased financial planning advice. Our only allegiance will be to our clients. We will have an unyielding commitment to the achievement of our clients' financial goals and objectives. To that end, we are committed to continually improve our people, processes, services, and facilities.

We will never lose sight of the basic premise that an uncompromising commitment to service and above all unquestionable ethics is the only true path to success.

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TAX CORNER: TAX AUDITS—UNCLE SAM WANTS YOU!

The government is pumping billions of dollars into tax collection in an effort to collect every penny it can.



OBAMA ADMINISTRATION INCREASING IRS AUDITS

Worried about a tax audit? Maybe you should be. The government is pumping billions of dollars into tax collection in an effort to collect every penny it can. More than 1.5 million Americans were audited last year, an increase of about 11% from 2009 to 2010. Even more audits are expected as the Obama administration plans to spend \$8.2 billion in tax enforcement initiatives in 2011, a nearly 10% increase over last year.

HEED THE RED FLAGS

Being meticulous with your tax return may seem obvious, but many people aren't careful enough.

The chances of you being audited or otherwise hearing from the IRS can increase depending upon various factors, including whether you omitted income, the types of deductions or losses claimed, certain credits taken, foreign asset holdings and math errors. Although there's no sure way to avoid an IRS audit, you should be aware of red flags that could increase your chances. Here are the 12 most important ones:

FAILURE TO REPORT ALL TAXABLE INCOME

The IRS receives copies of all 1099s and W-2s that you receive during a year, so make sure that you report all required income on your tax return. The IRS computers are pretty good at matching these forms received with the income shown on your return. A mismatch sends up a red flag and causes IRS computers to spit out a bill. If you receive a 1099 for income that isn't yours or the income listed is incorrect, get the issuer to file a corrected form with the IRS.

CLAIMING THE HOME-BUYER CREDIT

First-time homebuyers and longtime homeowners who claimed the homebuyer credit should be prepared for IRS scrutiny. Make sure you submit proper documentation when taking this credit. First-time homebuyers have to attach a copy of their settlement statement to the return, and longtime homeowners should

also attach documents showing prior ownership of a home, including records of property tax and insurance coverage. All claims for this credit are being screened. As of May 2010, more than 260,000 returns had been selected for correspondence audits (examinations done by mail rather than face-to-face) because filers did not attach the necessary documents to their tax returns. And those numbers will continue to grow.

Also, the IRS has ways of policing the recapture of the homebuyer credit. Generally, the credit is required to be recaptured if the home is sold within three years for homes brought in 2009 or 2010 and within 15 years for homes bought before 2009. The IRS is checking public real estate databases for sales of homes for which the credit was taken.

CLAIMING LARGE CHARITABLE DEDUCTIONS

This comes up again and again because the IRS has found abuse on audit, especially with those taking larger deductions. We all know that charitable contributions are a great write-off and help you to feel all warm and fuzzy inside. However, if your charitable deductions are disproportionately large compared to your income, it raises a red flag. That's because the IRS can tell what the average charitable donation is for a person in your tax bracket. Also, if you don't get an appraisal for donations of valuable property or if you fail to file Form 8283 for donations over \$500, the chances of audit increase. Be sure you keep all your supporting documents, including receipts for cash and property contributions made during the year, and abide by the documentation rules. Also attach Form 8283, if required.

HOME OFFICE DEDUCTION

The IRS is always very interested in this deduction, primarily because it has a pretty high adjustment rate on audit. This is because history has shown that many people who claim a home office don't meet all the requirements for properly taking the deduction and others may overstate the benefit. If you qualify, you can deduct a percentage of your rent, real estate

taxes, utilities, insurance, and other costs that are properly allocated to the home office. That's a great deal. However, in order to take this write-off, the space must be used exclusively and on a regular basis as your principal place of business. That makes it difficult to claim a guest bedroom or children's playroom as a home office, even if you also use the space to conduct your work. Exclusive use means a specific area of the home is used only for trade or business, not also where the family watches TV at night. Don't be afraid to take the home-office deduction if you're otherwise entitled to it. Risk of audit should not keep you from taking legitimate deductions. If you have it and can prove it, then use it.

BUSINESS MEALS, TRAVEL & ENTERTAINMENT

Schedule C is a treasure trove of tax deductions for self-employed. But it's also a gold mine for IRS agents, who know from past experience that self-employed tend to claim excessive deductions. Most under-reporting of income and overstating of deductions are done by those who are self-employed. And the IRS looks at both higher-grossing sole proprietorships as well as smaller ones.

Big deductions for meals, travel and entertainment are always ripe for audit. A large write-off here will set off alarm bells, especially if the amount seems too large for the business. Agents know that many filers slip in personal meals here or fail to satisfy the strict substantiation rules for these expenses. To qualify for meals or entertainment deductions, you must keep detailed records generally documenting the following for each expense: amount, place, persons attending, business purpose and nature of discussion or meeting. Also, receipts are required for expenditures for lodging while traveling away from home. Without proper documentation, your deduction is toast.

CLAIMING 100% BUSINESS USE OF VEHICLE

Another area that is ripe for IRS review is use of a business vehicle. When you depreciate a car, you have to list on Form 4562 what percentage of its use during the year was for business.

Claiming 100% business use for an automobile on Schedule C is red meat for IRS agents. They know that it's extremely rare that an individual actually uses a vehicle 100% of the time for business, especially if no other vehicle is available for personal use. IRS agents are trained to focus on this issue and will closely scrutinize your records. Make sure you keep very detailed mileage logs and precise calendar entries for the purpose of every road trip. Sloppy recordkeeping makes it easy for the revenue agent to disallow your deduction. As a reminder, even if you use the IRS' standard mileage rate to deduct your business vehicle costs, ensure that you are not also claiming actual expenses for maintenance, insurance and other out-of-pocket costs. The IRS has found filer noncompliance in this area as well and will look for this.

CLAIMING A LOSS FOR A HOBBY ACTIVITY

Your chances of "winning" the audit lottery increase if you have wage income and file a Schedule C with large losses. And, if your Schedule C loss-generating activity sounds like a hobby—horse breeding, car racing, and such—the IRS pays even more attention. It's issued guidelines to its agents on how to sniff out those who improperly deduct hobby losses. Large Schedule C losses are audit bait, but reporting losses from activities in which it looks like you might be having a good time is just asking for IRS scrutiny.

Tax laws don't allow you to deduct hobby losses on Schedule C; however, you do have to report any income earned from your hobbies. In order to claim a hobby loss, your activity must be entered into and conducted with the reasonable expectation of making a profit. If your activity generates profit three out of every five years (or two out of seven years for horse breeding), the law presumes you're in business to make a profit, unless the IRS establishes to the contrary. If audited, the IRS is going to make you prove you have a legitimate business and not a hobby. So, make sure you run your activity in a business-like manner and can provide supporting documents for all expenses.

CASH BUSINESSES

Small business owners, especially those in cash-intensive businesses—taxi drivers, car washes, bars, hair salons, restaurants and the like—are

an easy target for IRS auditors. The agency is well aware that those who primarily receive cash in their business are less likely to accurately report all of their taxable income. The IRS wants to narrow the tax gap, and history has shown that cash-based businesses are a good source of audit adjustments. It has a new guide for agents to use when auditing cash intensive businesses, telling how to interview owners and noting various indicators of unreported income.

FAILURE TO REPORT A FOREIGN BANK ACCOUNT

The IRS is intensely interested in people with offshore accounts, especially those in tax havens. U.S. tax authorities have had some recent success in trying to get foreign banks (such as UBS in Switzerland) to disclose information on U.S. account holders. Also, the IRS had a voluntary compliance program where people came in and reported their foreign bank accounts and foreign assets in exchange for lesser penalties than they would have otherwise been subject to. The IRS has learned a lot from these probes.

Failure to report a foreign bank account can lead to severe penalties, and the IRS has made this issue a top priority. Make sure that if you have any such accounts, you properly report them when you file your return. Keep in mind, though, that if you have never previously reported the foreign bank account on your return, and you decide to do so for the first time in 2010, that might also look suspicious to the IRS.

ENGAGING IN CURRENCY TRANSACTIONS

The IRS gets many reports of cash transactions in excess of \$10,000 involving banks, casinos, car dealers and other businesses, plus suspicious

activity reports from banks and disclosures of foreign accounts. A recent report by Treasury inspectors concluded that these currency transaction reports are a valuable source of audit leads for sniffing out unreported income. The IRS agrees and it will make greater use of these forms in its audit process. So if you are a person who makes large cash purchases or deposits, be prepared for IRS scrutiny. Also, beware that banks and other institutions file reports on suspicious activities that appear to avoid the currency transaction rules (such as persons depositing \$9,500 cash one day and an additional \$9,500 cash two days later).

MATH ERRORS

One of the biggest reasons that people receive a letter from the IRS is because of mathematical mistakes they make on their tax returns. If you make an error in your favor, you are going to hear from the tax man, and there is a greater risk of the IRS pulling the whole return for audit. So take time to ensure all your calculations are correct. Even though math errors may not lead to a full-blown audit, it's always best to remain under the radar of IRS computers.

TAKING HIGHER-THAN-AVERAGE DEDUCTIONS

If deductions on your return are disproportionately large compared to your income, the IRS audit formulas take this into account when selecting returns for examination. Screeners then pull the most questionable returns for review. But if you've got the proper documentation for your deduction, don't be scared to claim it. There's no reason to ever pay the IRS more tax than you actually owe.

HALF OF ALL AMERICAN HOUSEHOLDS PAY NO FEDERAL INCOME TAX

Fifty-one percent of households owed no federal income tax for 2009, according to a study by the nonpartisan Joint Tax Committee. In fact, about 30% of all households got back a check for their full income tax bill due to refundable tax credits. The largest credits utilized being the earned income credit, home buyer credit and the making work pay credit.

A few points to note on the data: they didn't take payroll taxes into account, so some of these households did have an overall tax bill. The recession hit in 2009, this boosted the numbers of low-incomers and two stimulus-related tax breaks the home buyer credit and the making work pay credit are no longer in effect.



UNDERSTANDING SEQUENCE OF RETURNS RISK

Most individuals are not aware of the significant differences in managing portfolios during the accumulation and distribution phases.

Sequence of returns risk involves the order in which investment returns occur after the accumulation phase ends and the distribution phase begins, and the impact of those returns on people who are transitioning into retirement, or recently retired. In a nutshell, it's the risk that you'll experience negative returns during the years shortly before or after retirement, lock in losses by making withdrawals, and dangerously shorten the life span of your savings.

Sequence of returns risk is an investment risk that only affects investors who are actively drawing income from their investment portfolios, such as retirees who rely on their investments to maintain their standard of living. *Sequence of returns has no impact during the accumulation phase, where no withdrawals are being made, but it can have disastrous results in the distribution phase.* Downside protection of one's financial assets is critical and can help mitigate sequence of returns risk.

WHY HAVEN'T YOU HEARD OR READ MUCH ABOUT SEQUENCE OF RETURNS RISK?

Simply, most individuals and sadly the majority of financial advisors are not aware

of the significant differences in managing portfolios during the accumulation phase and the distribution phase of one's life.

IT'S THE SEQUENCE OF RETURNS THAT'S IMPORTANT—AVERAGE ANNUAL RETURN IS IRRELEVANT

Consider this: over the 17-year period from 1987-2003 the S&P 500's average return was 13.47%. It doesn't make any difference if we look at the returns from 1987 to 2003, or from 2003 to 1987, the average return is still the same. But when taking withdrawals, the sequence of returns makes all the difference to the year end portfolio values. The same initial capital, the same withdrawal amount, the same returns—but a different sequence produces dramatically different results.

For a hypothetical \$100,000 portfolio taking \$10,000 a year withdrawal adjusted for 4% inflation over those 17 years, the difference is a remaining balance of \$76,629, after 17 years versus a portfolio being completely exhausted after only 10 years. The tables below illustrate the dramatic difference in portfolio values that occurs by inverting the rates and putting 2003's

performance first and 1987's last.

Note that three years of negative returns at the beginning of the withdrawal sequence completely negate the positive returns of the best bull market anyone in retirement is likely to experience. Performance for 1995-1999 was +37.6%, +23.0%, +33.4%, +28.6% and +21.0% respectively. It is unlikely that we will see that kind of winning streak again for quite some time. Regardless of those five consecutive years of great returns, the portfolio drops to \$4,348 after the tenth year's withdrawal—the point of ruin.

HOW DO WE MINIMIZE THIS RISK?

Sequence of returns risk never completely disappears, but there are a number of techniques Waterford Advisors uses to significantly minimize our clients exposure to this risk. The use of Product Allocation Strategies (as discussed in some detail in our spring newsletter) such as Variable Annuities with Living Benefits, Immediate Fixed Annuities and Maturity Matched Portfolios (MMP) are some of the techniques we employ to guard against this risk.

Year	Portfolio Value: Beginning of Year	Value After \$10,000 Inflation-Adjusted Withdrawal	Rate of Return	Portfolio Value: Year End
1987	100,000	90,000	5.25%	94,725
1988	94,725	84,325	16.61%	98,331
1989	98,331	87,515	31.69%	115,249
1990	115,249	104,000	-3.11%	100,766
1991	100,766	89,067	30.47%	116,206
1992	116,206	104,040	7.62%	111,967
1993	111,967	99,314	10.08%	109,325
1994	109,325	96,166	1.32%	97,435
1995	97,435	83,750	37.58%	115,223
1996	115,223	100,990	22.96%	124,177
1997	124,177	109,374	33.36%	145,862
1998	145,862	130,467	28.58%	167,754
1999	167,754	151,744	21.04%	183,671
2000	183,671	167,020	-9.11%	151,805
2001	151,805	134,488	-11.89%	118,497
2002	118,497	100,488	-22.10%	78,280
2003	78,280	59,550	28.68%	76,629

Average Annual Return: 13.47%

Year	Portfolio Value: Beginning of Year	Value After \$10,000 Inflation-Adjusted Withdrawal	Rate of Return	Portfolio Value: Year End
2003	100,000	90,000	28.68%	115,812
2002	115,812	105,412	-22.10%	82,116
2001	82,116	71,300	-11.89%	62,822
2000	62,822	51,574	-9.11%	46,875
1999	46,875	35,177	21.04%	42,578
1998	42,578	30,411	28.58%	39,103
1997	39,103	26,450	33.36%	35,274
1996	35,274	22,114	22.96%	27,192
1995	27,192	13,506	37.58%	18,581
1994	18,581	4,348	1.32%	4,406
1993	4,406	(10,397)	10.08%	(11,445)
1992	(11,445)	(26,839)	7.62%	(28,884)
1991	(28,884)	(44,895)	30.47%	(58,574)
1990	(58,574)	(75,225)	-3.11%	(72,885)
1989	(72,885)	(90,202)	31.69%	(118,787)
1988	(118,787)	(136,797)	16.61%	(159,518)
1987	(159,518)	(178,248)	5.25%	(187,606)

Average Annual Return: 13.47%

INVESTMENT SELECTION: ACTIVELY MANAGED VS. INDEX/PASSIVE MUTUAL FUNDS



Christina M. Michalczak, CFP®

Academics and investment experts have debated the merits of active and passive investment management for decades. Similar to opposing political parties, the two investment camps see the world in very different ways.

Passive managers contend that they deliver the greatest return over the long term by owning the market. Active managers assert that their stock picking can beat the market.

WHAT IS AN ACTIVELY MANAGED FUND?

As the name implies, these funds invest in equity or fixed-income securities based on the recommendations of a single manager or management team. The aim of active fund management is to outperform the index for a particular fund (not to mention other fund managers they may be competing against). Prevailing market trends, the economy, political and other current events, and company-specific factors (such as earnings growth) all affect an active manager's decisions.

WHAT IS AN INDEX/PASSIVE FUND?

Index funds invest in equity or fixed-income securities specifically to replicate indexes such as the Standard & Poor's 500 or Lehman Brothers U.S. Aggregate. Indexing is an investment management approach based on purchasing exactly the same stocks and bonds, in the same proportions, as an index. This management style is considered passive because portfolio managers don't make decisions about which components to buy and sell; they simply copy the index.

Examples: When you look at mutual funds, an actively managed large cap blend mutual fund manager will try to pick the best 20 – 30 stocks listed in the S&P 500 Index. A passive fund, or index fund, would just own all 500 stocks that are listed in the S&P 500 Index.

WHICH IS BEST, ACTIVELY MANAGED FUNDS OR INDEX/PASSIVE FUNDS?

We believe that both approaches have their merits. While it has become general consensus that active management underperforms passive

management (indexing), this is not the case for every circumstance. There are a number of characteristics to look for in assessing whether an active manager or management team will be able to continue the success of beating their respective index benchmark into the future. First, a disciplined, research-oriented and clearly articulated investment process is crucial. This limits decision errors and helps ensure that things don't fall through the cracks. Second, low expenses not only decrease the obstacle that an active manager must overcome in order to best an index, but they also reflect a commitment to performance and to the shareholder. Finally, it is important to identify an edge, something unique to the approach or process that improves their odds for success versus their competitors.

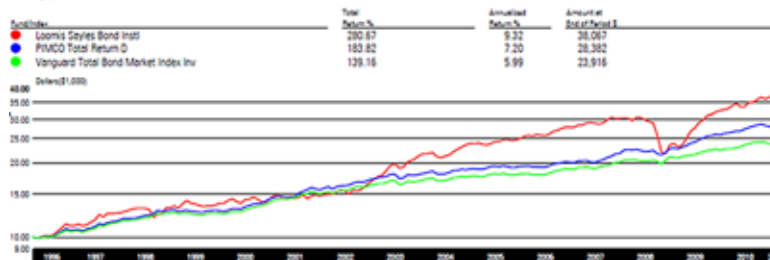
We admit there are some very good arguments in favor of indexing. We employ indexing in a number of circumstances such as:

- if we cannot find a manager that will confidently beat an index over the long-term, or
- when taking on certain tactical positions in our portfolios, or
- when we feel we are in a long term secular bull market

Fixed Income Funds: Loomis Sayles Bond (LSBDX) & Pimco Total Return (PTTDX) vs. Vanguard Total Bond Market Index (VBMFX)

Growth of \$10,000:

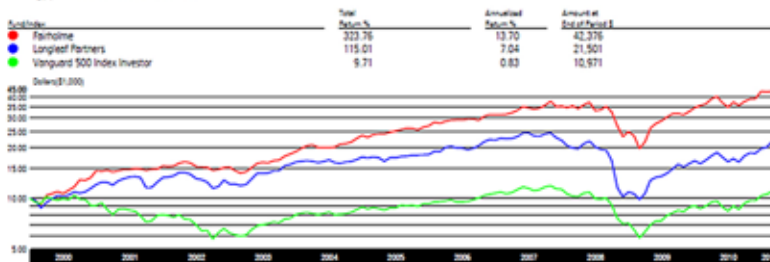
Holding(s) from 04-01-1996 to 03-31-2011



Large Cap Funds: Fairholme Fund (FAIRX) & Longleaf Partners (LLPFX) vs. Vanguard 500 Index (VFINX)

Growth of \$10,000:

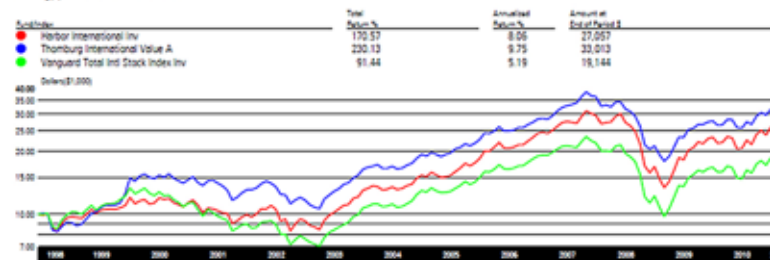
Holding(s) from 01-01-2000 to 03-31-2011



International Funds: Thornburg International (TGVAX) & Harbor International (HIINX) vs. Vanguard Total International Stock Index (VTGSX)

Growth of \$10,000:

Holding(s) from 06-01-1998 to 03-31-2011



Past performance does not guarantee future results.

We believe in using active managers only when our research leads us to a high degree of confidence that we understand why and how a manager has outperformed, and that the right pieces are in place for the outperformance to be sustained in the future. We feel there are a select group of funds that can and have outperformed their indexes (benchmarks). The graphs above show a number of funds, currently held in your portfolios, which have outperformed their indexes over the last decade.

If you have any questions regarding Active vs. Passive investing styles or would like to discuss when or why we use either, please contact our office.

THE NEW COST-BASIS REPORTING REQUIREMENTS

Starting this year, custodians like Schwab and FTJ will begin reporting cost basis information and gain/loss information directly to the IRS and will be required to send cost basis data when transferring assets to other custodians. The original cost basis of a security is generally the purchase price of the security plus commissions and other fees (it is different for property acquired as a gift and for inherited property). Cost basis is used to determine capital gains and losses of an investment for income tax purposes.

The Emergency Economic Stabilization Act of 2008 with final regulations in October 2010 included requirements for financial intermediaries (brokers, banks, transfer agents, and other custodians) to report adjusted cost basis beginning January 1, 2011 for all taxable accounts. The new regulations apply to what the IRS calls

“covered securities” and implementation will be phased in over a three-year period. The phase-in will start with stocks acquired on or after January 1, 2011, then mutual funds acquired on or after January 1, 2012, and finally fixed income securities acquired on or after January 1, 2013. (Covered Securities refer to securities acquired on or after the effective dates in the legislation)

Custodians will begin reporting transactions to the IRS, which will then be matched with investor’s tax returns. The new Form 1099-B, “Proceeds From Broker and Barter Exchange Transactions” will include the gross proceeds of the sale, the adjusted cost basis, and will show whether there is a long or short term gain or loss.

These new regulations also require a “method of accounting” to be chosen for the cost basis used on each sale transaction. Waterford uses

the FIFO (First-in, First-out) method for most accounts. Under this method the first securities lot purchased is assumed to be the first lot sold. The process is repeated sequentially until all sold shares are accounted for. Again the IRS reporting is for positions acquired from 2011 going forward.

Waterford has coordinated our cost basis information with that of the custodians for our clients accounts to ensure our cost basis information agrees to what is being reported by the custodian to the IRS. As such, there is no action required on the part of our clients. However, please feel free to contact our office to discuss these regulations in more detail or to review any questions you may have.



An SEC Registered Investment Advisor • Certified Financial Planner™

Visit us online at www.waterfordadv.com

Phone: 716-580-3906 • Toll-free: 877-512-4924

6225 Sheridan Drive, Suite 214
Williamsville, NY 14221