FOUNDATION SERVICES LLC

PASSIVE PORTFOLIO MANAGEMENT SERVICES

NEED

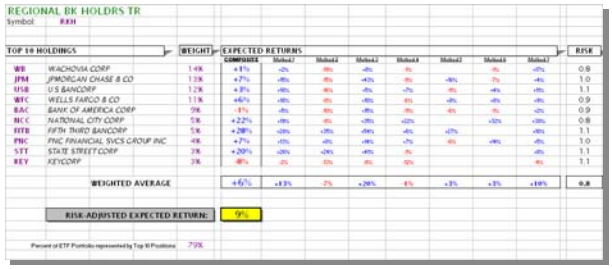
Most investors recognize the need for asset class diversification, ensuring that their portfolios consistently have exposure to fixed income and equity markets. Hopefully, these portfolios also have some relatively constant exposure to hard asset classes as well (gold & other commodities, real estate, collectibles, etc). Studies have shown - including one done by Roger Ibbotson of Ibbotson Associates – that as much as 90% of the variability of a portfolio's return over time is due to asset allocation. We have come to believe that creating a core portfolio of broadly diversified asset classes, with only passive management oversight, makes a good deal of sense for investors with substantial portfolios.

GOAL

Since the whole premise is to maintain a constant exposure to various asset classes, the portfolio can be relatively stable; shifting in and out of classes according to market perceptions can be left to the active managers. However, since the equity portion of the portfolio is often the largest part of the portfolio as well as the portion subjected to the greatest degree of internal variability, a passive approach is often enhanced by a limited amount of risk management. Through a general valuation method employed by active managers, combined with a risk evaluation, a passive approach can estimate which areas of the equity market have exceeded an acceptable degree of risk. A small rebalancing can then occur, whereby funds are shifted from overvalued and riskier areas of the market to areas that are relatively more undervalued with less inherent risk. Though funds would never be fully removed from any asset class or sector, there could be a small adjusting procedure that helps to reduce some of the perceived risk that is inevitable in the equity markets.

The overall outcome, therefore, is the establishment of a solid core of broadly diversified assets that are maintained through periodic rebalancing efforts.

Sample Risk-Adjusted Evaluation



REGIONAL BK HOLDRS TR

Symbol: RKH

TOP 10 HOLDINGS		WEIGHT	EXPECTED RETURNS								RISK
			COMPOSITE	Method1	Method2	Method3	Method4	Method5	Method6	Method7	
WB	WACHOVIA CORP	14%	+1%	-2%	-8%	-4%	-1%		-1%	-17%	0.8
JPM	JPMORGAN CHASE & CO	12%	+7%	+8%	-8%	+10%	-1%	-18%	1%	-4%	1.0
USB	U S BANCORP	12%	+3%	+8%	-8%	-5%	-7%	-1%	+4%	-8%	1.1
WFC	WELLS FARGO & CO	11%	+6%	+8%	-8%	+8%	-1%	-8%	+8%	-8%	0.9
BAC	BANK OF AMERICA CORP	9%	-1%	-8%	-8%	+8%	-8%	-1%	-1%	-2%	0.9
NCC	NATIONAL CITY CORP	5%	+22%	+8%	-1%	+38%	+22%		+32%	+38%	0.8
FITB	FIFTH THIRD BANCORP	5%	+28%	+28%	+28%	+44%	-8%	+27%		-8%	1.1
PNC	PNC FINANCIAL SVCS GROUP INC	4%	+7%	+1%	-8%	+8%	-7%	-1%	+4%	-8%	1.0
STT	STATE STREET CORP	3%	+20%	+28%	+28%	+4%	-1%			-8%	1.1
KEY	KEYCORP	3%	-8%	-2%	-1%	-8%	-12%			-1%	1.1
	WEIGHTED AVERAGE		+6%	+13%	-2%	+28%	-1%	+3%	+3%	+10%	0.8
	RISK-ADJUSTED EXPECTED RETURN:		9%								
	Percent of ETF Portfolio represented by Top 10 Positions	79%									

BENEFITS

Ensures Exposure

A core portfolio should be one that is not subjected to a great deal of variation or attempts at timing. This base portfolio, once established with a desired allocation goal in mind, should never find itself with zero exposure to an important asset class. An actively managed account can be subjected to the current outlook of a manager who may want to eliminate exposure to an asset class based on his firm's reigning perceptions of future performance. If the manager and/or his firm are mistaken, the portfolio could be subjected to needless underperformance if the wrong asset classes are removed. A strictly maintained core portfolio would ensure that some degree of exposure stays in place regardless of market analysts' current consensus thinking. In addition, this blending of asset classes will help ensure a greater degree of stability in the overall portfolio.

Reduced Fee Structure

Many investors rely on their active managers to maintain a de facto core on their behalf. Thus they instruct these professionals to "always maintain at least a 30% exposure to bonds" or "make sure you have at least 5% in cash". However, this means that the investor is paying a full actively managed fee for what is, in essence, merely a passive allocation approach. If a bond is redeemed, the manager finds a similar bond to replace it, but many times that is the extent of the process. By recognizing that the investor desires to maintain a core, with broadly diversified assets by sector and by class, a portfolio can be established that meets those requirements, without being subjected to the higher fee levels imposed by active managers.

Better Active Management

If the investor's core portfolio is established and in place, it means that the active managers can focus on their strengths as managers. Active advisors need not concern themselves with the requirements of a de facto core, and are better able to seek out the very best investment opportunities according to their strengths. They can find the best equity selections, the best currency plays, they best alternative investments or the best market timing opportunities, without having to be limited by the basic foundation of the investor's portfolio.

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