



## Item 8 Methods of Analysis, Investment Strategies and Risk of Loss

### Importance of Risk Management

*"It's not what you make, it's what you keep that counts!"*

Risk management is of great interest to investors, particularly in light of the 2000-2002 and 2008 bear markets and year-by-year stock market gyrations. We employ an ongoing, multiple-element risk management process. We also rely on common sense and the judgment of professionals that is based on decades of market experience. We analyze the amount of risk we are taking on behalf of shareholders, both on an absolute basis and relative to benchmarks. We use this data to help us determine how best to position the portfolios, in light of current/ongoing market conditions and other variables.

WFG model portfolios are managed in such a way that Clients may be able to avoid the devastating impact that can occur with various money management strategies that fail to appreciate the role risk reduction plays in potentially achieving attractive long-term returns. By assessing where opportunities vs. risks are unusually compelling, via our **ConVal<sup>®</sup>** (Contrarian Value) investment approach, we can proactively adjust the funds asset allocation via both the stock/bond mix and individual holdings.



### Impact of Losses on Investor Returns

Numerous studies have demonstrated that:

***Superior long-term compound returns can potentially be achieved by lessening the extent to which an investment portfolio suffers significant negative returns over a given period of time.***

As an example, to make up for a negative return over the prior 12 months of 50%, the investment would need to rise 100% just to get back to break-even. This is not a very likely scenario.

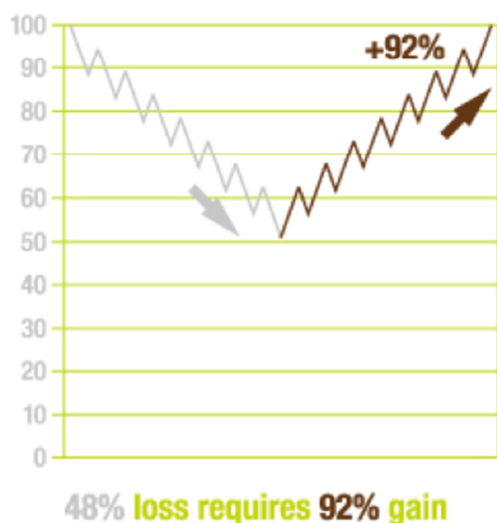
***The steeper the losses, the higher the degree of difficulty of ever catching up.***

During the bear markets of 2000-2002 and the fall of 2008, the S&P 500 index dropped a cumulative total of approximately 48%. In dollars, \$100,000 dropped to \$52,000. Many investors falsely believed that to get back to where they started, they needed to earn 48% to get back the lost \$48,000. While this may seem logical to some, the math doesn't work that way. In order to move from \$52,000 back to \$100,000, the investor would need a return of 92%. That's right 92%! They would need to average 6.76% per year, over ten years, to get back to where they started. The NASDAQ index suffered a devastating 72% loss during the tech bubble bursting between 2000-2002. Here, an investor's \$100,000 dropped to \$28,000. In this case, a 257% return is needed to get back to \$100,000. This investor would need to average 13.58% per year over ten years.

Steep losses in the stock market this decade have impacted millions of pre-retirees and retirees, with many having to delay retirement and/or go back to work. Some will not live long enough to see their wealth recover. Some can now be found in their retirement years as greeters at Wal-Mart or Home Depot, trying to stay afloat after their savings were swept away by the "poor decision making, poor advice" hurricane. Many of these investors' savings were devastated by either poor advice and/or attempting to "self direct" their wealth. Too many investors bought into the belief of the "new economy," and "this time it's a different story."

**The High Degree Of Difficulty Of Rebuilding Wealth After Steep Losses**

The chart below illustrates the concepts we are sharing in our commentary above.

**Hypothetical S&P 500  
Bear Market and Recovery****Hypothetical S&P 500  
Bear Market and Recovery****Severity of Negative Return Wreaks Havoc on True Performance**

Consider the examples in the following table:

Negative Return	Return Required To Make Up Prior Year's Negative Return	Comments
-1%	1.01%	No problem
-10%	11.1%	Still no problem
-25%	33.3%	This can be made up
-40%	66.6%	Holy C###
-50%	100%	Oh S###
-70%	233.3%	Where is Dr. Kerxxxxx?

**The “Volatility Penalty” Hurts Your Bottom Line**

Deep negative returns in any given year penalize the investor, to the point where the investor may not be able to catch up in subsequent years. Why? In these subsequent years, the investor is not starting with their original investment amount – they are starting with the newly shrunken account value. Therefore, positive returns of the subsequent years have to outweigh by far the negative return in order to erase its impact on your balance sheet.

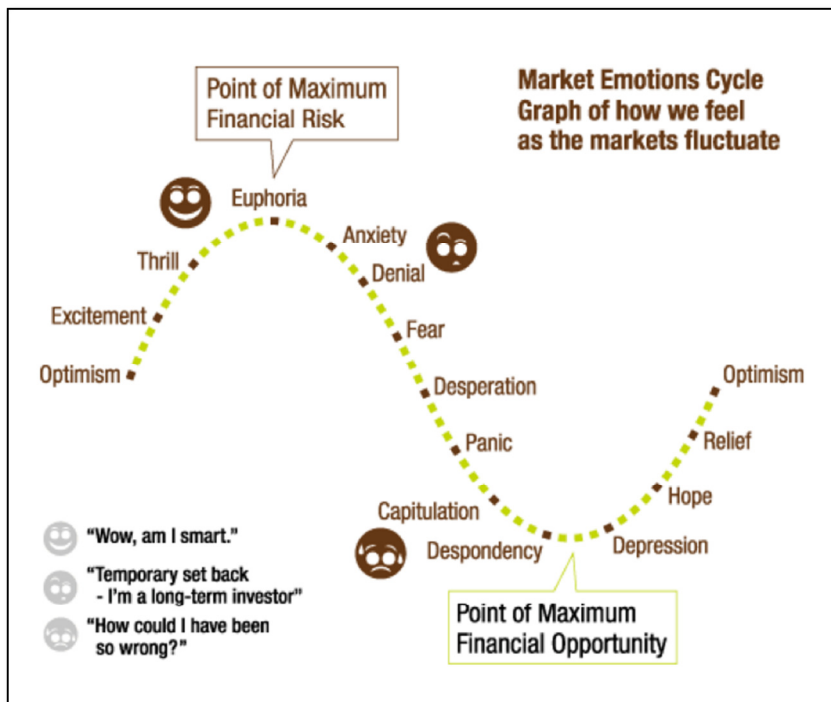
For this reason, considering the average return of the stock market over years can be red herring for investors – even in a decade-long view of your investments, the volatility of return for individual years can have real effects on your overall return on investment.

## Cycle of Investor Emotions

While it should be textbook strategy for investors to be willing to “buy low” and “sell high,” thousands of years of human behavior wiring make this impossible to implement for most investors. Numerous studies of investor behavior indicate that achieving solid long-term investment results are disabled by greed and fear for the majority of investors.

Too many investors prefer to buy when the news is good and sell when the news is bad. WFG Clients delegate the emotional aspect of achieving successful long-term investment results, allowing the Advisor to navigate the choppy waters of market psychology.

### Investor Emotion and the Stock Market



The stock market must work within equilibrium. *For every investment sold, there has to be a buyer.* At times of financial crisis when the stock market is way down, and the news media proclaims the second Great Depression is upon us, a redistribution of wealth takes place:

- 1) Scared, “media-informed,” confused, impatient and panicking sellers greatly outnumber the buyers. It is these limited number of shrewd buyers (like Warren Buffet, WFG) that do the noble thing. They buy, buy, and buy, allowing the sellers to feel better they are doing what their gut is telling them to do.
- 2) Panic-selling is not limited to individuals. Investment committees of pension plans, endowments, etc. are also notorious for “chasing” the stock market, both on the way up and on the way down.

We desire WFG Clients to be on the winning side of the wealth redistribution that often takes place when emotional investors are willing to practically give away investments worth much more than they perceive.



## Industry Studies of Investor Behavior

To further complicate the forces investors are up against, the field of behavioral finance has shown that regardless of how investors fill out various risk questionnaires (results often suggest allocating 75-100% to stocks, based upon a greater than 10-year time horizon), investors are in reality “risk averse” and do not react equally to gains and losses.

It is one thing for investors to attempt to forecast their emotional reaction in advance of a bear market. It is completely another to experience the negative returns and reduction of wealth based upon actually participating in a bear market. In fact, research by Kahneman and Tverski<sup>(1)</sup>, among others, has shown investors feel the pain of negative returns 2-3 times stronger than they feel the joy of positive returns.

- Regardless of the long-term return potential of an investment, many investors simply cannot emotionally tolerate the volatile price swings of portfolios with a high stock allocation (75% or greater).

WFG believes that investors should steer clear of trying to hit home runs with the high incidence of striking out and instead should focus on a more emotionally positive path of building wealth slowly and surely with an eye towards risk management as more important than focusing on “big returns.” Studies by the Bogle Financial Markets Research Center<sup>(2)</sup> on investor behavior also indicate that most investors (self-directed or professionally advised) capture less than 50% of the actual return of the stock mutual funds they are invested in. This is a result of a consistent cycle of buying high and selling low. We call this “shooting yourself in the foot with the same gun repeatedly” behavior. The table below provides a hypothetical example of the devastating results negative investor behavior can play on wealth accumulation:

Comparison	Starting Capital	Average Return	Ending Capital In 10 Years	Income From Ending Capital @5% Withdrawal Rate	Percentage of Potential Income Captured
The Hypothetical Return Offered By The Stock Market Via “XYZ” Equity Mutual Fund	\$100,000	10%	\$259,374	\$12,969	100%
Hypothetical Returns Experienced By Investors Who Buy High and Sell Low In The “XYZ” Equity Mutual Fund	\$100,000	4.5%	\$155,297	\$7,765	60%

WFG can assist investors in removing the emotions of investing typically experienced by investors via our **ConVal**<sup>®</sup> investment approach. WFG’s experienced fund management team “does the driving,” significantly improving the chances of an investor’s hard-earned dollars earning a reasonable, compound rate of return over time. Portfolios are driven by the **ConVal**<sup>®</sup> process that attempts to limit the severity of negative stock market returns when they occur, yet provides for the capture of an important portion of positive stock market returns.

- (1) Daniel Kahneman is a psychologist and Nobel laureate. He is notable for his work on the psychology of judgment and decision-making, behavioral economics and hedonic psychology.
- (2) Bogle Financial Markets Research Center was started by Jack Bogle, founder of Vanguard Mutual Funds, one of the two largest mutual fund groups in the world.



## Methods of Analysis

**ConVal® (Contrarian Value) investment process:** Results in a preference to invest in securities that are out of favor with and/or go unnoticed by most investors, and are therefore, potentially undervalued. The **ConVal® process** plays a major role in the selection of other investment companies and in the top-down approach regarding tactical decisions WFG can make in regards to over- or under-weighting a given asset class and the equity/fixed income mix as a whole. WFG looks to take advantage of investor dissatisfaction and resulting price devaluation to buy low, then wait for sentiment to change, and prices to rise, over time.

**Fundamental Analysis:** We measure the intrinsic value of a security to determine if the company is underpriced (indicating it may be a good time to buy) or overpriced (indicating it may be time to sell). The price of a security can move up or down along with the overall market regardless of economic and financial factors.

**Technical Analysis:** We analyze past market movements and apply that analysis to the present in an attempt to recognize recurring patterns of investor behavior and potentially predict future price movement. Technical analysis does not consider the underlying financial condition of a company. This presents a risk in that a poorly-managed or financially unsound company may underperform regardless of market movement.

**Asset Allocation:** Suitable to the Client's investment goals and risk tolerance we attempt to identify an appropriate ratio of securities across multiple asset classes, such as stocks, bonds, hybrids, managed futures, commodities, large companies, small companies, and cash. A risk of asset allocation is that the ratio of securities, fixed income, and cash will change over time due to stock and market movements and, if not corrected, will no longer be appropriate for the Client's goals.

**Risks for all forms of analysis:** Our securities analysis methods rely on the assumption that the companies whose securities we purchase and sell, the rating agencies that review these securities, and other publicly-available sources of information about these securities, are providing accurate and unbiased data. While we are alert to indications that data may be incorrect, there is always a risk that our analysis may be compromised by inaccurate or misleading information.





## Investment Strategies

We may use the following strategy(ies) in managing Client accounts, provided that such strategy(ies) are appropriate to the needs of the Client and consistent with the Client's investment objectives, risk tolerance, and time horizons, among other considerations:

**Long-term purchases.** We may purchase securities with the idea of holding them in the Client's account for a year or longer. Typically we employ this strategy when we believe the securities to be currently undervalued, and/or we desire exposure to a particular asset class over time.

The risk in holding the security for this length of time in a long-term purchase strategy is that we may not take advantage of short-term gains that could be profitable to a Client. Moreover, if predictions are incorrect, a security may decline sharply in value before sold.

**Short-term purchases.** When utilizing this strategy we may purchase securities with the idea of selling them within a relatively short time (typically a year or less). We do this in an attempt to take advantage of conditions that we believe will soon result in a price swing in the securities we purchase.



**Option writing.** We may use options as an investment strategy. An option is a contract that gives the buyer the right, but not the obligation, to buy or sell an asset (such as a share of stock) at a specific price on or before a certain date. An option, just like a stock or bond, is a security. An option is also a derivative, because it derives its value from an underlying asset. The two types of options are calls and puts:

A call provides us the right to buy an asset at a certain price within a specific period of time. We will buy a call if we have determined that the stock will increase substantially before the option expires.

A put provides us as the holder the right to sell an asset at a certain price within a specific period of time. We will buy a put if we have determined that the price of the stock will fall before the option expires.

We may use "covered calls", in which we sell an option on security you own. In this strategy, you receive a fee for making the option available, and the person purchasing the option has the right to buy the security from you at an agreed-upon price.

We may use options to speculate on the possibility of a sharp price swing. We may also use options to "hedge" a purchase of the underlying security; in other words, we may use an option purchase to limit the potential upside and downside of a security we have purchased for your portfolio.

We may use a "spreading strategy," in which we purchase two or more option contracts (for example, a call option that you buy and a call option that you sell) for the same underlying security. This effectively positions you on both sides of the market, but with the ability to vary price, time, and other factors.