Fourth Quarter Newsletter 2004

VIGIL Strategies

Taking you where you want to be

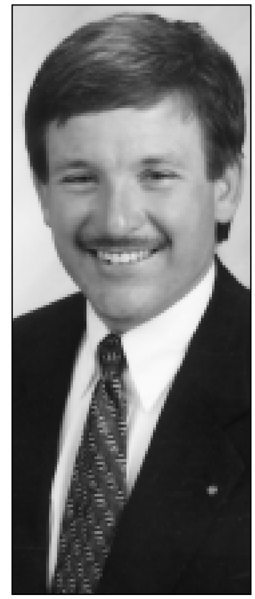
When things aren't what they seem

As we are in the season for giving gifts, what I want to discuss here reminds me of a gift of old that I learned about back in school. An army would fill a Trojan horse with its soldiers and give the horse as a gift. As soon as the horse was wheeled inside the castle, the door would open and the invaders would be released to capture the castle. An attacking force made to look like something it is not.

Over the past decade, the "financial advocacy" model for delivering financial advice and services has taken root. The notion that you can pay a professional fee to obtain financial advice, much as you would pay a professional fee to obtain medical or legal advice, and that the advisor doesn't receive other financial benefits from the recommendations made is exactly what most investors want if they know the service exists and understand the difference between it and the normal financial services delivery models. This is why there is an increasing and growing demand for fee only financial services providers.

Brokerage firms, recognizing the true threat and superiority of the financial advocacy model, have responded with so-called "fee based" services. Fee-based services are the "Trojan horses" of financial services. They are designed to look like something they are not. Although they are similar in the sense that there is a fee charged for the service, that is where the similarity ends.

Recently an unnamed brokerage firm attempted to persuade a client that the fees the brokerage charges for their "fee based" services were the same as the fees financial advocates like Vigil charge for fee-only services. However, unlike the fee-only financial advocacy model where there is no other compensation of any kind derived from recommendations made, brokerage firms stand to profit in many ways in addition to their fee-based fee from the recommendations they make. If you need a bond, they'll sell one to you – out of their inventory, at a price and profit they determine, rather than scouring the universe of bond options for the best deal for you. If you need a mutual fund, they'll recommend one to you. Unfortunately, it is likely to be a fund that pays the brokerage firm disclosed or undisclosed fees to "encourage" the firm's brokers to recommend that fund over other funds, or even over other classes of that exact same fund, that would provide better performance for the investor. If you need a stock, they'll sell you one. However, oftentimes these are also stocks



that the brokerage firm owns, either because they have bought them from some other investor or because they have bought them from the company itself, raising questions as to the fairness of the price you are charged as well as to whether that stock is truly better for you than some other stocks that the brokerage firm may not have in inventory. They may recommend an annuity for you. But if the annuity has penalties for getting out of it before a certain time passes, that penalty arises from the fact that the brokerage firm has been paid a commission to recommend that annuity to you. There are more than likely other annuities out there for you that don't have penalties because there are no commissions paid that would ultimately perform better for you.

When I raised these other avenues of compensation with the client to demonstrate that "fee-based" is not fee-only, it must have struck a chord with the brokerage firm; I got a nasty letter from their legal department. I guess the truth hurts. Despite their protestations, the broker's "advisors" providing these fee-based services all have brokerage licenses. Why do they have brokerage

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licenses? Because they need them in order to be able to legally take the kinds of additional compensation from their fee-based services discussed above. If their services were truly equivalent to fee only services, there would be no need for brokerage licenses because there wouldn't be any of that compensation to capture.

The holiday season is full of myths we'd love to believe. St. Nick. Santa Claus. Brokerage firms would love to have you continue to believe in the myth that "fee based" services are the same as fee only. But just as we all eventually "wise up" as to the myths of the holiday season, so too a small but growing number of investors are "wising up" to the myths promoted by the huge advertising budgets of large brokerage firms and turning to truly objective, fee only financial advocates for professional financial guidance. If you don't have the time, energy, desire or aptitude to diligently examine the recommendations of a fee-based broker/advisor to make sure they are truly the best and in your best interest, our gift to you this holiday season is to warn you that a brokerage's "Trojan horse" gift of fee-based services actually contains an invading army of hidden additional compensation for the broker that reduces your return! Resolve in 2005 to make sure your financial house is in order and stays that way by seeking out the professional guidance of a fee only financial advocate.

Happy Holidays and Best Wishes for the New Year!

Tom Batterman
President
Vigil Trust & Financial Advocacy

Answering Your Investment Questions

Each quarter we attempt to provide you with valuable information about investments, estate planning, and wealth building strategies. Many of you then contact us with specific questions about the market and our thinking. Your questions often inspire our next newsletter's articles. This quarter we have prepared a Q&A to cover questions we've been recently asked by clients and others.

Are there any new areas that Vigil Trust and Financial Advocacy is researching? On the asset-class side we have been doing work on commodities. This is a new area for us, one that we first began looking at in early 2003. Recent academic research suggests that using a commodity-futures-based index portfolio (such as PIMCO Commodity Real Return, a mutual fund) would have historically delivered long-term returns in line with stocks (though not on an after-tax basis) and, because commodities are negatively correlated with the stock market, they also serve as a powerful diversifier. We are continuing to actively research this asset class.

We're also focusing attention on foreign stock valuations. We believe foreign stocks are somewhat undervalued. We are looking for other data and information sources that can help us with our analysis. Our near-term objective is to determine whether foreign stocks may be at fat-pitch valuation levels relative to U.S. stocks (the answer is probably no). Our more important long-term objective is to come up with some combination of better data, metrics and information sources to improve our ability to assess foreign valuations with a high degree of confidence.

We have also done quite a bit of work on hedge funds (see the next question) over the past year but this is not an area we are focusing much time on currently. Not long ago we looked at TIPS (Treasury Inflation Protected Securities), but we don't feel their valuations are particularly attractive right now, and the hedge against unexpected inflation they provide increases our exposure to other risks that we think are equally as dangerous.

On the fund manager due diligence side we have been very active. We have been looking at a number of domestic and international equity funds including Excelsior Value and Restructuring, Cambiar, Baron Fifth Avenue Growth, Smith Barney Large Cap Growth, Legg Mason Growth, Matrix Value, Osterweis, Third Avenue International Value, Marsico International, Scudder International Select (formerly Deutsche) and Harbor International, among others. Each of these is a full blown due diligence project. A number of these are still in progress, while some have been completed (some made the cut and others didn't).

On an ongoing basis we are always maintaining our research on each asset class and the funds we own and recommended.

Does Vigil Trust and Financial Advocacy view hedge funds as an opportunity? Over the last couple of years we have done extensive research on

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hedge funds as an investment, including work on specific funds and funds-of-funds. We have also looked at most of the hedge-funds like mutual funds.

Our findings have been disappointing. Hedge funds have onerous price structures, very high minimums (most of the good ones are around $1 million) and are tax inefficient. Typically it makes sense to diversify exposure across several hedge funds which, because of the individual fund minimums, requires a very large investment portfolio to facilitate owning positions in multiple funds. Funds of hedge funds are an alternative but these add another layer of fees resulting in total charges of 4% or more, even on products whose return potential we believe is mediocre. We looked at quite a few of them including some with lower minimums but in most cases could not get past what we viewed as onerous fees. We also looked at the few mutual funds that have hedge-fund-like characteristics and with a few exceptions we were underwhelmed. Finally and importantly, because hedge funds are so hot these days, we believe that the volume of money flowing into hedge funds may result in reduced returns in some hedge fund strategies. So we wouldn't be surprised if performance in coming years is lower than what we've observed over the past decade.

Despite the fact that hedge funds are very popular these days, and there are some very skilled hedge fund managers, in most cases they only make sense for very large, tax-exempt portfolios.

Everyone knows interest rates are going to rise—why aren't you holding more cash or shorter-term maturities? We think interest rates are likely to move higher over the next year or two. But we don't know that they will move higher. "Everyone" thought rates would move higher this year, and though the Fed has raised rates, this directly impacts only short maturities. As of the end of September interest rates on 10-year Treasuries were actually slightly lower than they were at the end of last year so that the intermediate-term bond funds we hold have outperformed cash and even the S&P 500 in 2004. Also, rate rises are not always as detrimental as some people seem to make them out to be. In a rising-rate environment, declining bond prices are offset by higher reinvestment rates for the coupon income, and in most scenarios involving intermediate-term bonds it doesn't take very long before initial losses are more than recouped. So the magnitude of the risk posed by rising rates isn't that great when compared to some of the other potential risks that exist. In assessing these risks, we must always deal with incomplete information, so there is a certain amount of weighing the odds. There are scenarios that would be very negative for stocks that would be less negative or even positive (recession/deflation) for bonds. We hold bonds as a hedge against these scenarios. Cash or shorter-maturity bonds would perform okay in these scenarios but not as well as bonds. We've compromised, holding some of both.

We are also often asked the opposite question, about why we hold cash. The answer is similar. There are various possible scenarios so from a risk-management standpoint we are

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Financial Advocates Willing To Speak To Your Group

Vigil Trust & Financial Advocacy professionals are available to participate in your program, at no cost, and discuss financial management issues of interest to you.

We routinely speak to medical practices, bar associations, civic groups, trade associations, university groups, and other professional groups that are interested in learning more about financial topics from a fee-only perspective.

With the calendar year coming to an end, now is the perfect time to invite a financial advocate to speak to your group about retirement plan options. The key to a successful retirement plan is managing the plan with success. This takes experience, expertise, and a solid record of performance. At Vigil, we excel in each of these areas. As a fee-only advisor, Vigil is uniquely positioned to help your professional group create a plan that is flexible, efficient, and boasts no-load investments.

Contact Anza D'Antonio or Tom Batterman at 715-848-8110/800-950-8110 to schedule a speaking engagement.

Taking you where you want to be

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tempering the interest-rate sensitivity of our defensive positions (fixed income) by holding some cash or some funds that have shorter maturities.

With all the uncertainty in the world, is this a time to be very conservative? That is a question that should be answered first by examining each client's ability to take on risk and their need for return. Right now, the S&P 500 looks to be in a fair-value range, and may even be slightly undervalued, suggesting that returns in a base-case scenario could be in the high single digits, and possible even a little bit higher. So while the market may not be fully pricing in all of the risks out there, the valuation picture is sufficiently benign that a large underweighting to equities probably doesn't make sense from an investment standpoint. Again, each client, in conjunction with their financial advocate, should assess the risk exposure they are comfortable with and ensure that their portfolio reflects their objectives.

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