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PORTFOLIOS FOR INTERESTING TIMES

By: Robert Klosterman, CEO & Chief Investment Officer

Ancient Chinese Curse: "May You Live in Interesting Times"

Few would disagree that we do in fact live in interesting and challenging times for those building and preserving assets for long-term financial security. Current concerns include the slow recovery from the 2008 global financial meltdown, the potential breakup of the European Monetary Union (Euro), the potential of high inflation due to monetary stimulus by the Federal Reserve and of the governments, and high unemployment numbers that show little hope of reducing significantly any time soon. Combined with near non-existent interest rates on fixed income investments, the opportunities to meet short and long-term objectives seem to give investors and savers a steep hill to climb to meet their objectives.

In spite of all these challenges the US stock market has been rolling along much better than most would have expected this year. For investors in diversified portfolios and not invested 100% in the US markets, the question is: "Are we missing out?". Our firm, White Oaks Wealth Advisors, has often used, rightly or wrongly, the S&P 500 as one of the factors in measuring portfolios because clients were familiar with it. There have been times in the past when the S&P 500 outperformed our strategies. One of those times was during the late1990's when Cisco, Oracle and Microsoft's heavy weighting in the S&P gave an unusual strength to that index. More broadly diversified strategies did not look as attractive relative to this one index. It was a new world where valuations and income generation were not important and a time when the rules had changed. Our firm lost a few clients during that time and it was difficult and painful to stick to our core beliefs that valuations matter. We know it is unrealistic to "always" beat a particular asset classes' returns in the short run. What is the short run? White Oaks has always thought of long-term as a three to five year investment cycle so short-term is the one to three year time frame. By way of example, after the 1998 to 2000 time frame the investment structures looked much different and by 2002 several clients returned and are here to this day. Most clients had stayed with us because they shared our long-term views and, by sticking with their strategy, had benefited and enjoyed a much better result than those who had followed the "new way".

It often has been said, "the more things change the more they stay the same". Today a significant portion of the S&P 500's gains are weighted heavily towards Apple's 70%+ year to date returns. Yet, more importantly, it was never our expectation that there would not be times like these where one index *looks really good* relative to the performance of a more diversified strategy over short periods of time as referenced above above. As ***Chart One*** *(at the end of article)* shows, asset classes come in to and out of favor with great regularity. Asset classes thrive and dive consistently and the turns come quickly, and without warning. We can all intellectually acknowledge that fear and greed are the emotions that drive the volatility of the markets, but avoiding getting caught up in the swells of these emotions is difficult to achieve. Yet, this is the formula to getting uncommonly good results compared to the "average" investor. As an example, for many years the Dalbar organization has conducted a study of the average returns of mutual funds versus the returns of investors who invest in those funds. The differences are startling. According to the 2012 study, the average investor earned 3.49% versus a market return of 7.81% of a difference of 4.32% PER YEAR. The difference being timing decisions by investors. The ten year number for the average investor is 2.39%. Contrast that with an Asset Allocation strategy shown in ***Chart Two*** *(at the end of article)* for ten years. As you can see the more balanced asset allocation strategy, ten year return, is markedly higher. I've often made the offer: if you or any one you know can pick the BEST asset class each year I have a REALLY GOOD JOB for you! Its high pay and all you have to do is give me a call in early December and tell me which asset class will win in the following year. That's it; nothing to it! So far no takers. Clearly over time diversified portfolios have won the day through difficult and interesting times and we continue to believe they will.

The choice of measurement against any index is a difficult one with many options. Most do not recognize that there are easily over 20,000 separate index choices. Yes, over 20,000! As mentioned above the S&P 500 was chosen a long time ago as it was recognized by many and easily found in the popular media of the day. The character of the S&P 500 is a US based index and it is the largest 500 companies. It is, in essence, a large cap US market index. It ignores small companies, international, etc. Early in my career, its global importance was quite large, as the US made up over 70% of the value of all stocks in the world. The percentage has dropped to less than 50% and is expected to shrink as the emerging frontier markets continue to grow at a faster pace, along with the US and the rest of the established industrialized nations.

During the nearly four decades I have been in this business there have been "many a sirens beautiful song" trying to gain our attention and virtually all have their brief time in the sun and then fade off for a time. Successful investing is capitalizing on the ebb and flow of various opportunities. That is not to say there are not unique opportunities to benefit from. We do recognize that the challenges of increasing volatility, due to High Frequency Trading and ETF's, combined with enough 100 year events to make us all feel like we are 1,000 years old, is not lost on us and we are bringing in special opportunities to mitigate and gain benefit from.

We believe that the best thinking in portfolio design is dominated currently by Generation 3 principles. As a quick update for those who have not had the opportunity to see either of those sessions yet (we highly recommend you view the recording if you haven't already) Generation 1 Portfolio Design is based on a base of splitting between 60% Domestic Equity and 40% Domestic Bonds. It was and continues to be a fairly narrow view of the investment universe. With interest rates at generational low levels, its myopic view can leave an investor extremely exposed to the risks of rising interest rates causing drops in value.

In the early 1950's Professor Harry Markowitz presented a paper that ushered in a new generation of portfolio design thinking. Generation 2 Design introduced the notion that most of the combination of a portfolio came from its allocation to certain types of assets (asset classes) and that other asset classes, because of their reacting differently to economic events, one could reduce risk and improve returns.

Generation 2 thinking was an advancement and did offer considerable value, but its impact has been diminishing lately. One of the sources of the contrasting market movements and excess returns was the lesser levels of liquidity in certain asset classes. At one point International stocks were considered to be less liquid than US stocks. With the increasing globalization of our world this is less true than before and markets tend to move together rather than independently. The Economic and Market Update has a slide that shows the dramatic shift that has occurred over the past few years.

This leads us to the Generation 3 portfolio design. Keep in mind the principles of Generation 2: diversification benefits portfolios, but the nature of the asset classes often used has changed, and those traditional asset classes will most likely have less impact in the future when trying to adequately diversify and insulate a portfolio against risk. Generation 3 adds a broader look at asset types/classes that will provide more consistent returns over time than liquid markets with their increased volatility. In my thirty years plus of experience I've never met an investor that minded

minded upside volatility. I have met many that get concerned with downside volatility. This is why Generation 3 thinking is so important for individuals who are looking to their portfolios for long-term security and providing more consistent returns over time.

The entrance of High Frequency Trading (HFT) and Exchange Traded Funds (ETF's) have added to the volatility of the market. When combined with the number of significant events (see table below) the nature of the distribution of market returns, and we as investors, have experienced sharper and more pronounced extremes in the traditional liquid markets. This is troublesome for those counting on their portfolios for long-term financial security.

Returns Non-Normally Distributed

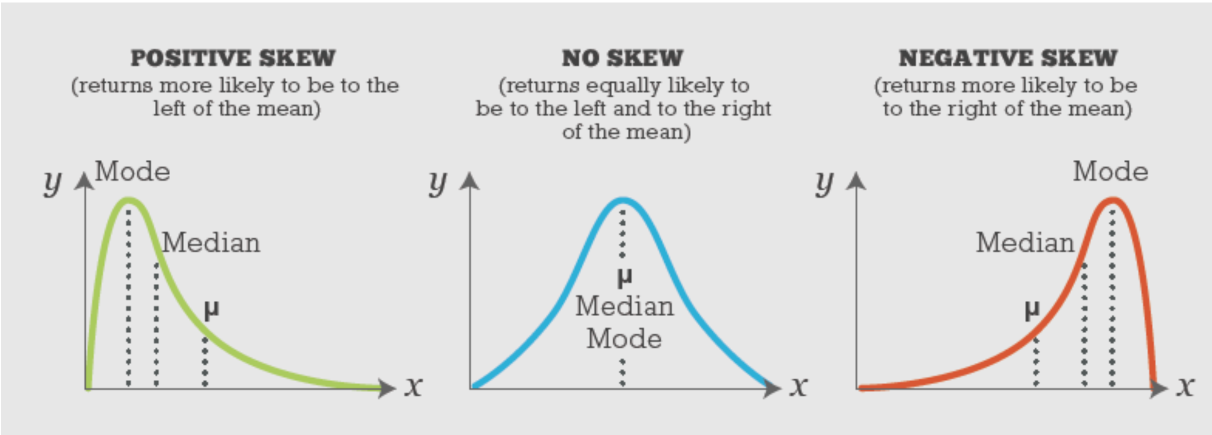
How frequent are "once in a lifetime" events?

Major Financial Crises since 1980

1982 → Mexican default
1987 → Black Monday (Dow fell 22.6%)
1989-1991 → U.S. S&L crisis
1989-1991 → Latin Amer. debt crisis
1992-1993 → European Monetary System crisis
1994-1995 → Mexican peso crisis
1997-1998 → Asian Financial crisis
1998 → Russian default & LTCM
2001-2002 → Argentine default & dot-com bubble bust
2007-2009 → Financial market meltdown
2010-2012 → Greece/EU crisis

These events have produced more and more extremes in the markets. Notice in ***Chart Three*** *(at the end of article)* how the number of experiences on each end of the distribution curve have increased significantly. These are known as "Fat Tail" events in "Investment Geek Speak". Of course, we love the right side of the chart that shows more extreme "positive" events. It's a lot less fun when we ultimately experience the "Left Fat Tail" event that will naturally occur when investing in investment strategies, focused on market events that can be driven by non fundamental events, such as HFT and speculation using ETF's.

The essence of Generation 3 design is to add additional strategies to the portfolio that either capitalize on the volatility or have high probability of generating equity type consistent returns without the "Left Fat Tail" volatility of traditional long-only stock portfolios. Most holders of wealth would most desire the shape of the distributions, of returns, in their portfolio to be most like the chart on the left below. More positive and less negative results. To do that requires different pieces in the allocation of the portfolio rather than the traditional, long only, equity and fixed income pieces that dominated Generation One and Generation Two portfolio design.



Examples in your strategy include using managers that:

- Trade Stocks; not only long but can short them as well
- Mortgage Back Securities providing high yields
- Commodity Investments to off set inflation
- Non Traded REITs
- Traded REITs
- Trading Strategies that capitalize on extreme price movements

More detail on these strategies are in your Strategy recording which we strongly suggest you review this quarter. This quarter's session will spend a little less time on Macro Economic and Market events since the change from last quarter is little, if any, and spend more time on the strategy and what is contributing, as well as, its impact on the strategy's returns.

We have added a number of additional indexes for comparison this quarter. The S&P 500 is on asset class that measures the performance of the 500 largest public companies in the US. As you can see from the first chart in this paper, all asset classes have their day, and diversified portfolios never hit the top of the chart, (as shown in Chart 2) but win the day over the long-term. We are under the belief that winning the long-term contest is what you, as our client, want us to do. To that end, we are designing and evolving your strategy to meet those objectives.

Please do listen to the Quarterly Strategy Update, as referenced above, and give us a call for more information. We are very excited about the long-term prospects for this strategy and want you to be fully informed.

Summary

Todays' environment, due to increased volatility and the nature of more traditional investments, presents interesting alternatives that will improve the probability of success in the long-term. These strategies should always be measured by taking a long-term view to obtain the, better than average, result desired. The Generation 3 Portfolio design should result in a less volatile, more consistent yielding type of portfolio.

CHART ONE

Annual Returns for Key Indices (1992–2011) Ranked in Order of Performance

1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Russell 2000 Value 29.14%	MSCI Emerging Markets 74.84%	MSCI EAFE 7.78%	S&P/Citi 500 Growth 38.13%	S&P/Citi 500 Growth 23.97%	S&P/Citi 500 Growth 36.52%	S&P/Citi 500 Growth 42.16%	MSCI Emerging Markets 66.42%	Russell 2000 Value 22.83%	Russell 2000 Value 14.02%
Russell 2000 18.41%	MSCI EAFE 32.57%	S&P/Citi 500 Growth 3.13%	S&P 500 37.58%	S&P 500 22.96%	S&P 500 33.36%	S&P 500 28.58%	Russell 2000 Growth 43.09%	BC Agg 11.63%	BC Agg 8.43%
MSCI Emerging Markets 11.40%	Russell 2000 Value 23.77%	S&P 500 1.32%	S&P/Citi 500 Value 36.99%	S&P/Citi 500 Value 22.00%	Russell 2000 Value 31.78%	MSCI EAFE 20.00%	S&P/Citi 500 Growth 28.24%	S&P/Citi 500 Value 6.08%	Russell 2000 2.49%
S&P/Citi 500 Value 10.52%	Russell 2000 18.88%	S&P/Citi 500 Value -0.64%	Russell 2000 Growth 31.04%	Russell 2000 Value 21.37%	S&P/Citi 500 Value 29.98%	S&P/Citi 500 Value 14.69%	MSCI EAFE 26.96%	Russell 2000 -3.02%	MSCI Emerging Markets -2.37%
Russell 2000 Growth 7.77%	S&P/Citi 500 Value 18.61%	Russell 2000 Value -1.54%	Russell 2000 28.45%	Russell 2000 16.49%	Russell 2000 22.36%	BC Agg 8.70%	Russell 2000 21.26%	S&P 500 -9.11%	Russell 2000 Growth -9.23%
S&P 500 7.62%	Russell 2000 Growth 13.37%	Russell 2000 -1.82%	Russell 2000 Value 25.75%	Russell 2000 Growth 11.26%	Russell 2000 Growth 12.95%	Russell 2000 Growth 1.23%	S&P 500 21.04%	MSCI EAFE -14.17%	S&P/Citi 500 Value -11.71%
BC Agg 7.40%	S&P 500 10.08%	Russell 2000 Growth -2.43%	BC Agg 18.46%	MSCI EAFE 6.05%	BC Agg 9.64%	Russell 2000 -2.55%	S&P/Citi 500 Value 12.73%	S&P/Citi 500 Growth -22.08%	S&P 500 -11.89%
S&P/Citi 500 Growth 5.06%	BC Agg 9.75%	BC Agg -2.92%	MSCI EAFE 11.21%	MSCI Emerging Markets 6.03%	MSCI EAFE 1.78%	Russell 2000 Value -6.45%	BC Agg -0.82%	Russell 2000 Growth -22.43%	S&P/Citi 500 Growth -12.73%
MSCI EAFE -12.18%	S&P/Citi 500 Growth 1.68%	MSCI Emerging Markets -7.32%	MSCI Emerging Markets -5.21%	BC Agg 3.64%	MSCI Emerging Markets -11.59%	MSCI Emerging Markets -25.34%	Russell 2000 Value -1.49%	MSCI Emerging Markets -30.61%	MSCI EAFE -21.44%

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
BC Agg 10.26%	MSCI Emerging Markets 56.28%	MSCI Emerging Markets 25.95%	MSCI Emerging Markets 34.54%	MSCI Emerging Markets 32.59%	MSCI Emerging Markets 39.78%	BC Agg 5.24%	MSCI Emerging Markets 79.02%	Russell 2000 Growth 29.09%	BC Agg 7.84%
MSCI Emerging Markets -6.00%	Russell 2000 Growth 48.54%	Russell 2000 Value 22.25%	MSCI EAFE 13.54%	MSCI EAFE 26.34%	MSCI EAFE 11.17%	Russell 2000 Value -28.92%	Russell 2000 Growth 34.47%	Russell 2000 26.85%	S&P/Citi 500 Growth 4.65%
Russell 2000 Value -11.43%	Russell 2000 47.25%	MSCI EAFE 20.25%	S&P/Citi 500 Value 5.82%	Russell 2000 Value 23.48%	S&P/Citi 500 Growth 9.13%	Russell 2000 -33.79%	MSCI EAFE 31.78%	Russell 2000 Value 24.50%	S&P 500 2.11%
MSCI EAFE -15.94%	Russell 2000 Value 46.03%	Russell 2000 18.33%	S&P 500 4.91%	S&P/Citi 500 Value 20.81%	Russell 2000 Growth 7.05%	S&P/Citi 500 Growth -34.92%	S&P/Citi 500 Growth 31.57%	MSCI Emerging Markets 19.20%	S&P/Citi 500 Value -0.48%
Russell 2000 -20.48%	MSCI EAFE 38.59%	S&P/Citi 500 Value 15.71%	Russell 2000 Value 4.71%	Russell 2000 18.37%	BC Agg 6.97%	S&P 500 -37.00%	Russell 2000 27.17%	S&P/Citi 500 Value 15.10%	Russell 2000 Growth -2.91%
S&P/Citi 500 Value -20.85%	S&P/Citi 500 Value 31.79%	Russell 2000 Growth 14.31%	Russell 2000 4.55%	S&P 500 15.79%	S&P 500 5.49%	Russell 2000 Growth -38.54%	S&P 500 26.47%	S&P 500 15.06%	Russell 2000 -4.18%
S&P 500 -22.10%	S&P 500 28.68%	S&P 500 10.88%	Russell 2000 Growth 4.15%	Russell 2000 Growth 13.35%	S&P/Citi 500 Value 1.99%	S&P/Citi 500 Value -39.22%	S&P/Citi 500 Value 21.17%	S&P/Citi 500 Growth 15.05%	Russell 2000 Value -5.50%
S&P/Citi 500 Growth -23.59%	S&P/Citi 500 Growth 25.66%	S&P/Citi 500 Growth 6.13%	S&P/Citi 500 Growth 4.00%	S&P/Citi 500 Growth 11.01%	Russell 2000 -1.57%	MSCI EAFE -43.38%	Russell 2000 Value 20.58%	MSCI EAFE 7.75%	MSCI EAFE -12.14%
Russell 2000 Growth -30.26%	BC Agg 4.10%	BC Agg 4.34%	BC Agg 2.43%	BC Agg 4.33%	Russell 2000 Value -9.78%	MSCI Emerging Markets -53.18%	BC Agg 5.93%	BC Agg 6.54%	MSCI Emerging Markets -18.17%

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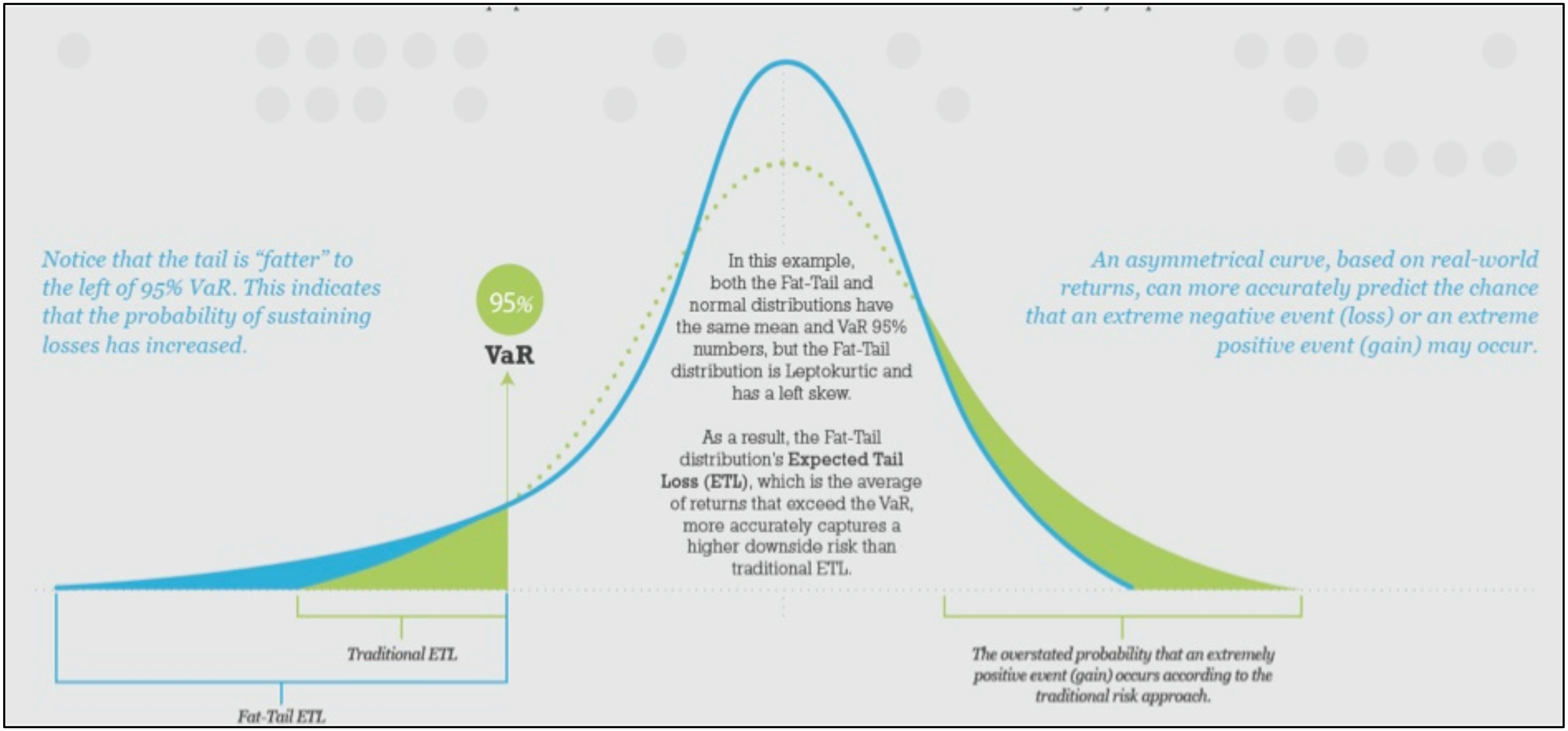
CHART TWO

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012YTD	2Q12	Cum.	Ann.
DJ UBS Cmdty 23.9%	MSCI EME 56.3%	REITs 31.6%	MSCI EME 34.5%	REITs 35.1%	MSCI EME 39.8%	Barclays Agg 5.2%	MSCI EME 79.0%	REITs 28.0%	REITs 8.3%	REITs 14.9%	REITs 4.0%	MSCI EME 277.2%	MSCI EME 14.2%
Barclays Agg 10.3%	Russell 2000 47.3%	MSCI EME 26.0%	DJ UBS Cmdty 17.6%	MSCI EME 32.6%	MSCI EAFE 11.6%	Market Neutral 1.1%*	MSCI EAFE 32.5%	Russell 2000 26.9%	Barclays Agg 7.8%	S&P 500 9.5%	Barclays Agg 2.1%	REITs 164.2%	REITs 10.2%
Market Neutral 7.4%	MSCI EAFE 39.2%	MSCI EAFE 20.7%	MSCI EAFE 14.0%	MSCI EAFE 26.9%	DJ UBS Cmdty 11.1%	Asset Alloc. -23.8%	REITs 28.0%	MSCI EME 19.2%	Market Neutral 4.5%	Russell 2000 8.5%	Asset Alloc. -2.1%	Asset Alloc. 86.3%	Asset Alloc. 6.4%
REITs 3.8%	REITs 37.1%	Russell 2000 18.3%	REITs 12.2%	Russell 2000 18.4%	Market Neutral 9.3%	Russell 2000 -33.8%	Russell 2000 27.2%	DJ UBS Cmdty 16.7%	S&P 500 2.1%	Asset Alloc. 5.1%	S&P 500 -2.8%	Barclays Agg 75.4%	Barclays Agg 5.8%
Asset Alloc. -5.4%	S&P 500 28.7%	Asset Alloc. 12.5%	Asset Alloc. 8.0%	S&P 500 15.8%	Asset Alloc. 7.3%	DJ UBS Cmdty -36.6%	S&P 500 26.5%	S&P 500 15.1%	Asset Alloc. -0.2%	MSCI EME 4.1%	Russell 2000 -3.5%	Russell 2000 72.8%	Russell 2000 5.6%
MSCI EME -6.0%	Asset Alloc. 25.2%	S&P 500 10.9%	Market Neutral 6.1%	Asset Alloc. 14.9%	Barclays Agg 7.0%	S&P 500 -37.0%	Asset Alloc. 22.5%	Asset Alloc. 12.7%	Russell 2000 -4.2%	MSCI EAFE 3.4%	Market Neutral -3.6%	Market Neutral 72.1%	Market Neutral 5.6%
MSCI EAFE -15.7%	DJ UBS Cmdty 22.7%	DJ UBS Cmdty 7.6%	S&P 500 4.9%	Market Neutral 11.2%	S&P 500 5.5%	REITs -37.7%	DJ UBS Cmdty 18.7%	MSCI EAFE 8.2%	MSCI EAFE -11.7%	Barclays Agg 2.4%	DJ UBS Cmdty -4.6%	MSCI EAFE 64.8%	MSCI EAFE 5.1%
Russell 2000 -20.5%	Market Neutral 7.1%	Market Neutral 6.5%	Russell 2000 4.6%	Barclays Agg 4.3%	Russell 2000 -1.6%	MSCI EAFE -43.1%	Barclays Agg 5.9%	Barclays Agg 6.5%	DJ UBS Cmdty -13.4%	Market Neutral -2.3%	MSCI EAFE -6.9%	DJ UBS Cmdty 58.0%	DJ UBS Cmdty 4.7%
S&P 500 -22.1%	Barclays Agg 4.1%	Barclays Agg 4.3%	Barclays Agg 2.4%	DJ UBS Cmdty -2.7%	REITs -15.7%	MSCI EME -53.2%	Market Neutral 4.1%	Market Neutral -2.5%	MSCI EME -18.2%	DJ UBS Cmdty -3.7%	MSCI EME -8.8%	S&P 500 33.4%	S&P 500 2.9%

Source: Russell, MSCI, Dow Jones, Standard & Poor's, Credit Suisse, Barclays Capital, NAREIT, FactSet, J.P. Morgan Asset Management.
The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EMI, 30% in the Barclays Capital Aggregate, 5% in the CS/Tremont Equity Market Neutral Index, 5% in the DJ UBS Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. All data except commodities represent total return for stated period. Past performance is not indicative of future returns. Data are as of 6/30/12, except for the CS/Tremont Equity Market Neutral Index, which reflects data through 2/29/12. "10-yrs" returns represent annualized total return. These returns reflect the period from 1/1/02 – 12/31/11.
Please see disclosure page at end for index definitions. *Market Neutral returns include estimates found in disclosures.
Data are as of 6/30/12.

J.P.Morgan
Asset Management

CHART THREE


Notice that the tail is "fatter" to the left of 95% VaR. This indicates that the probability of sustaining losses has increased.
95%
VaR
In this example, both the Fat-Tail and normal distributions have the same mean and VaR 95% numbers, but the Fat-Tail distribution is Leptokurtic and has a left skew.
As a result, the Fat-Tail distribution's Expected Tail Loss (ETL), which is the average of returns that exceed the VaR, more accurately captures a higher downside risk than traditional ETL.
An asymmetrical curve, based on real-world returns, can more accurately predict the chance that an extreme negative event (loss) or an extreme positive event (gain) may occur.
Traditional ETL
Fat-Tail ETL
The overstated probability that an extremely positive event (gain) occurs according to the traditional risk approach.