



Dunn Warren Investment Advisors, LLC

The Portfolio Reporter

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Risk is Always Part of Investing

Over the past year, the S&P 500 seems to have moved almost straight up. The S&P 500 is a stock market index maintained by Standard and Poor's. It is an unmanaged list of common stocks frequently used as a general benchmark of market performance. You cannot make an investment directly into an index, but it provides a useful way to talk about market performance. In a little over twelve months, since bottoming in March 2009, the index has gained more than 75%. Looking at the stock market with a slightly longer term perspective, we see that despite this spectacular gain, the S&P 500 is still 25% below the peak it reached in the fall of 2007. Stocks are still more than 10% below the peak value they reached in 2000, more than 10 years ago. The buy-and-hold investor enjoyed incredible gains over the past year, but is still a long way from recovering their bear market losses.

A little more than a year and a half ago, even after the market peaked, optimism was everywhere. Home prices had actually already reached their own all-time highs, several months before the stock market did, but few recognized the dangers lurking in residential mortgages. It is unlikely that anyone could have predicted that Wall Street powerhouses Lehman Brothers and Bear Stearns would both fail, and the financial system would come perilously close to collapsing.

It was barely eighteen months ago that Nobel Prize winning economist Paul Krugman asked "Will the U.S. financial system collapse today, or maybe over the next few days? I don't think so — but I'm nowhere near certain." He wrote this in the New York Times on September 18, 2008, only days before Lehman collapsed and the worst actually lay ahead of us. Unrecognized risks that were present in the summer of 2007 were responsible for trillions of dollars of lost investment capital over the next year.

In barely more than two years, we have gone from an attitude of euphoria to fearful panic and now back to what feels like euphoria again. In the first months of 2009, everyone seemed focused solely on risk and protecting capital. The reality is that risk was present at the market top in 2007, it existed at the bottom in 2009, and is still in the markets today.

Academic and institutional investors generally define risk as the standard deviations of returns. In this sense, there is no doubt that a standard deviation can always be calculated and therefore from an academic perspective, risk is always present. At Dunn Warren, we understand this concept and employ it in our quantitative approach to investing. But, we also define risk as a potential loss of investment dollars and we do all we can to protect against this very real risk.

Over the past year, even as the stock market marched higher and higher, we kept that second definition of risk in mind. It was the central idea that allowed us to do relatively well in the bear market that preceded that bottom. Unfortunately, it also leads to a more protective investment portfolio at market bottoms. This led to painful market-lagging performance over the past twelve months.

In addition to studying risk, we also study the history of the market. The basic cycle of overvaluation to undervaluation plays out time and time again in the markets, and we look to the past as a general guide to the future. There is little precedent in market history for a move like we've seen over the past year. That means that either this time is different or risk is still present in the markets. Another year of gains like we just saw is statistically unlikely.

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Statistical modeling of stock market prices is exhaustively documented by experts like Dr. Jeremy Siegel, a University of Pennsylvania finance professor. In the Concise Encyclopedia of Economics, he writes that over the long-term, stocks average gains of 6-7% a year after inflation. He notes that "Stock prices are quite variable in the short run. The annual standard deviation of after-inflation returns has averaged about 18 percent, which means that about two-thirds of the time, stock returns will be in a range from -12 percent to +24 percent over a twelve-month period." Statistically, based upon the normal distribution, a year like we just saw would be expected to occur 0.15% of the time. You can read the entire article by Dr. Siegel at www.econlib.org/library/Enc/StockMarket.html.

Since it seems improbable that an event like that will occur two times in a row, we will continue to respect risk and acknowledge its presence in the markets. This means we will continue to protect your investment capital, and our own, as much as possible.

Please feel free to pass "The Portfolio Reporter" to interested friends and family members. For more information about your investments, please contact your financial professional.

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MONTHLY CONFERENCE CALL

Our next monthly conference call will occur Thursday, April 15th at 11 a.m. Mountain Time (1 p.m. EST).

Phone Number: 866-740-1260

Access Code: 4682824

To view slides on the internet during the call, go to www.readytalk.com and enter 4682824 under "Join a Meeting".

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