

WEALTHWISE

SUMMER 2006 NEWSLETTER

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Invest in the Global Economy

Insights from Towneley

What do the following have in common: baby formula, Velcro®, wallet phones and translucent concrete? They are all innovative products created by companies based outside the United States.¹ Non-U.S. companies dominate several of the world's major industries from telecommunications to automobiles.² As consumers, we regularly purchase and use both foreign- and domestic-made products here in the U.S. Why then should we limit our investment options to the U.S. financial markets?

We at Towneley believe that there are compelling reasons to include international exposure in most long-term investment portfolios. Including non-U.S. holdings in your portfolio can: **1)** expand your investment opportunities; **2)** boost portfolio performance; and **3)** reduce portfolio risk. Towneley's Director of Marketing, Robert Seaman, recently sat down with Towneley's founder and Chairman, Wesley McCain, to discuss his views on the subject.

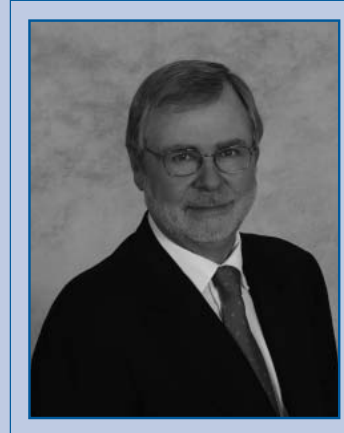
Wes, I know you have studied the global financial markets for quite some time. Why have international equities outperformed U.S. equities over the last couple of years?

I believe the most significant reason dollar-based investors have benefited substantially more from their international investments over the last two or three years is that foreign markets were severely under-valued compared to the U.S. market. In 2005, however, the under-valuation gap between foreign and U.S. markets closed somewhat so that presently we feel both international and U.S. equities are selling at or close to fair value relative to each other. However, we expect further downward adjustment in the U.S. dollar, relative to its trading partners, may help boost international returns for U.S. investors going forward.

Are foreign equities still a good investment given the rising correlation between U.S. and non-U.S. markets?

I am often asked this question. Although correlation among U.S. and non-U.S. markets has been rising over time, there is still a significant amount of non-correlation remaining. Economic policies, growth rates, interest rates, currency values and investor perceptions differ markedly from one country to another. Consequently, market returns,

Continued on page 2



Towneley's own Wesley McCain, Ph.D., CFA

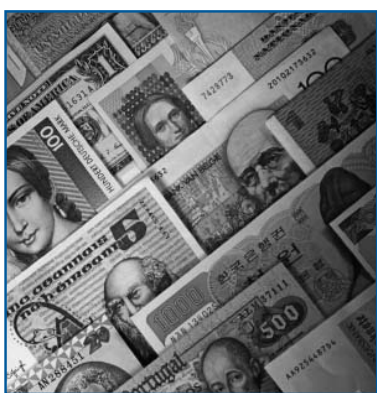
Wesley McCain, Ph.D., CFA is the founder and chairman of Towneley Capital Management, Inc. (TCM) and co-founder of the Libre Hedge Funds. Prior to founding TCM in 1971, he was an assistant professor of finance at Columbia University's Graduate School of Business Administration. He received a BBA from the University of Michigan, an MBA from Columbia University and an MA and Ph.D. from Stanford University. Dr. McCain is a Chartered Financial Analyst and a member of the CFA Institute.

Invest in the Global Economy *(continued)*

which are affected by these factors, vary as well. In addition, foreign equities present risk/return opportunities different from those provided by U.S. equities. For these reasons, any amount of non-correlation between U.S. and foreign equities is an advantage.

What is correlation and why is it important?

Correlation is the statistical measure of the degree to which the movements of two securities are related. If two securities are correlated, their prices move in tandem to some degree, so that when the price of one is up, the price of the other is up as well. The closer the correlation coefficient is to 1, the closer the movement of the two securities. A portfolio that contains only highly correlated securities is more risky than one with less correlated securities. Our goal as investment advisors is to create portfolios that will generate the highest returns with the least amount of risk. To do this, the portfolios must be diversified, which means they must be made up of different asset classes and securities that are not highly correlated. Securities that have low correlation, such as U.S. and foreign equities, or bonds and equities, either do not fluctuate in tandem, or do so only moderately. Generally, the lower the correlation among the various portfolio holdings, the lower the risk to portfolio assets.



Let's talk about the risks associated with international investing. Aren't international investments much riskier for U.S. investors than domestic investments?

Not in the right proportions in a well-diversified portfolio. In fact, our research and experience have shown that over time, the greatest portfolio return per unit of risk occurs when 10% to 30% of total equity exposure is invested in foreign equity funds. Some international equity exposure is desirable in a portfolio because its historically low correlation to U.S. equities helps reduce risk and boost returns.

What are the primary risks associated with international investments and what steps does Towneley take to minimize those risks for its clients?

For U.S. investors, some of the risks of international investing are

similar to those associated with domestic investments, such as market risk and liquidity risk, while others, such as currency exchange risk, exclusively pertain to investments in non-U.S. markets. Historically, the benefits of including some international holdings in a U.S. investor's portfolio have far outweighed the risks. Towneley mitigates most of these risks to a large extent by investing in diversified international mutual funds, as opposed to directly purchasing foreign stocks and bonds. In addition, to reduce currency risk we may include in the international portion of our clients' portfolios one or more funds that hedge the dollar. Illiquidity is usually not a problem since we do not invest directly in emerging markets or small countries, and we generally limit the amount of emerging markets exposure we provide our clients to no more than 15% of total international holdings.

How do currency fluctuations, particularly the changing value of the U.S. dollar, affect international investment returns?

When a U.S. investor purchases a foreign security, U.S. dollars are converted to the local currency to make the purchase. Then, when the foreign security is sold or dividends are paid, the proceeds are converted from the local currency back into U.S. dollars at the current exchange rate. The gain or loss in dollar value resulting from the exchange

of currency is added to--or subtracted from--market returns to determine the total return to the U.S. investor. Currency risk, the possibility that currency fluctuations will impact returns, is an investment risk inherent in international and other currency-sensitive investments.

Let me give you an example. Suppose a U.S. investor purchases \$100 of a euro-based security, which, due to current exchange rates, is valued at €82 (euros). Assume for simplicity, that the investment does not generate any returns. Assume also that by the time the U.S. investor sells his stake in the euro-based security, the U.S. dollar has lost 25% of its former value relative to the euro, so that now \$100 is worth only €62. When he converts his capital back into dollars, the U.S. investor receives \$125; a 25% return on his investment due solely to the effects of currency fluctuations and exchange rates. In this example, because the dollar lost value relative to the euro, the U.S. investor benefited. When the dollar gains value relative to foreign currencies, however,

U.S. investors suffer when their foreign investment returns are converted back into dollars.

How much international exposure is appropriate for an individual U.S. investor?

Based on our analysis of historical returns, risk correlations and risk patterns, we recommend most people limit their international exposure to 10-30% of the equity portion of their portfolio. The optimal percentage is a function of what else is in their portfolio. For example, if 60% of your portfolio was allocated to equities, the most international exposure you should have would be about 18% of your total portfolio; leaving 42% of your portfolio invested in domestic equities.

For institutions that seek perpetual existence, would the allocation be the same, or different?

It depends whether they have any international obligations, or exclusively domestic obligations. If an institution has only dollar-based obligations, then no less than 10% and no more than 30% of their equities should be foreign. If they're truly a global organization, with half their membership, obligations, and expenses in non-dollar countries and currencies, then they might want to invest as much as 40% or 50% of their equity exposure in foreign issues, but that would be a rare situation.

How much emerging market equity exposure should a U.S. investor have?

That's a tough question. Emerging market equities, from countries such as China, India, and Brazil, can potentially yield high returns, but at a high level of risk. Therefore, somewhere between 2 and 8% of total equity exposure in emerging markets is best for most investors. For example, a portfolio with 20% of the equity portion in international might

have 15% of that in emerging markets, which constitutes 3% of total equity. It's a pretty small slice of the pie for the average investor, but our experience has shown that on a risk-adjusted return basis, emerging markets outperform developed markets enough of the time to justify including some emerging markets exposure in your portfolio.


How will the economic emergence of China and India affect global markets and investing?

This seems to be a hot topic right now. The biggest thing that China and India have to offer is a very intelligent, educated, motivated work force at relatively low wages. But wage rates are only part of the total equation. Anyone who looks at business realizes that it's the total cost of production, which is the mix of capital, labor and productivity, that matters. China and India are going to have to invest capital in research, equipment, education and training to make their workers more productive. Higher productivity will result in higher wages. Continued improvement in the quality and production

of goods from these countries should have a deflationary effect on the price of those goods, boosting exports and, theoretically attracting additional investment dollars.

When do international bonds (developed and emerging) have a place in investor portfolios?

I would recommend them for investors who are non-dollar-based. For example, if they spend half their time in Europe and half their time in the U.S., they would have expenditures in non-dollar assets, specifically euros. So euro-bond exposure, an example of developed market bonds, would be just fine for those investors. Also, an institutional investor, or an individual investor that has a very long time horizon, might have international bond exposure as well. For shorter time hori-



At Towneley, we take a global approach to portfolio composition and investing. We believe that most investors with long time horizons will benefit from some degree of international exposure in their investment portfolios.

zons, international bond funds that hedge, or protect against currency fluctuations, may be used. Emerging market bonds are highly speculative and are not appropriate for most investors.

We've used the terms international and global investing interchangeably throughout this interview. Is there a difference?

Yes. In terms of mutual fund classifications there is a distinction. International mutual funds invest all or most of their assets in non-U.S. securities. Global funds invest in both U.S. and non-U.S. securities. As we move toward a truly global economy, however, the lines between these classifications are blurring. We are finding many domestic equity funds, and some domestic bond funds, with international holdings in their portfolios. It doesn't necessarily make these funds global funds, because the foreign percentages are too low, but I think it evidences the desirability of including foreign investments in a diversified portfolio.

Many of the world's largest companies are now multinational, with business operations in several different countries, not just their home country. Companies like Toyota, Sony and Nokia may have their home offices outside the U.S., but they have significant business presence within the U.S. They employ thousands of Americans, operate plants and own property in this country, borrow dollars and contribute to our GDP and our tax base. Yet their names are commonly among the ten largest holdings of large cap international equity funds. It's pretty clear that domestic and foreign businesses are becoming difficult to disentangle. When you put together a portfolio that includes U.S. equities, foreign equities, and domestic and foreign bonds, you really are creating a global portfolio, so I think it's most appropriate to refer to the practice of including non-U.S. holdings in U.S. based investor portfolios as global investing.



Wes, what is Towneley's overall approach to global investing?

At Towneley, we take a global approach to portfolio composition and investing. We believe that most investors with long time horizons will benefit from some degree of international exposure in their investment portfolios. Through our cornerstone investment strategy, the Multiple Mutual Fund Program (MMFP), we offer diversified portfolios of no-load, low expense ratio mutual funds that are appropriate for all types of investors and accounts. Our MMFP portfolios are designed to generate superior long-term returns with minimal risk, based on each client's risk tolerance, time horizon and needs. We also offer three investment strategies utilizing exchange traded funds: a global balanced strategy, a developed markets strategy and an emerging markets strategy. ■

To learn more about Towneley's global investing strategies, contact Robert Seaman at Towneley Capital Management, Inc. at 800-545-4442 or rseaman@towneley.com.

Footnotes:

1) Henri Nestle first developed baby formula in 1867 in Switzerland. Another Swiss creation, Velcro was developed by George de Mestral in 1948. The first wallet phone using





















Sony's FeliCa smart chip was recently launched by NTT DoCoMo, Inc. in Japan, and is currently being tested for distribution in Europe and the U.S. Developed for architectural use by Hungarian architect Aron Losonczy in 2001, translucent concrete or liquid stone is being readied for market by LiTraCon. A successful exhibition featuring the new material recently concluded at the National Building Museum in Washington D.C.

2) Derived from "The Forbes Global 2000," 4/18/2005, retrieved 4/6/2006 (http://www.forbes.com/free_forbes/2005/0418/066.html). Six or more of the largest 10 companies in each of these industries are based outside the U.S.: Automobiles (8 of 10), Construction (8 of 10), Telecommunications (7 of 10), and Transportation (6 of 10).

Top Performing Markets in the World

International exposure is important because, more likely than not, equity markets in one or more foreign countries will outperform the U.S. stock market each year. Over the last 10 years, the U.S. market was never the best performing devel-

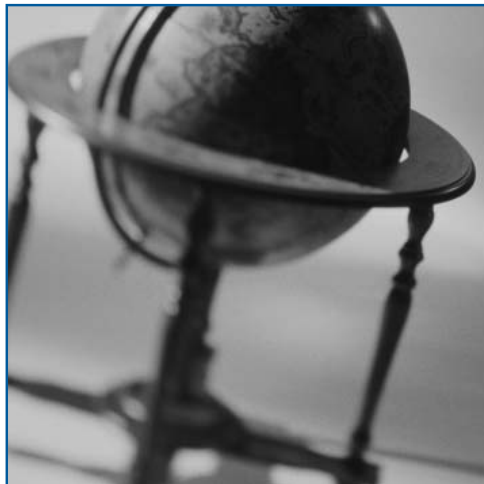
oped market in the world, although we finished second in 1995. The following table illustrates historical U.S. market performance relative to that of the developed markets that comprise the MSCI EAFE Index:

Year	Best Performing Market	Worst Performing Market	U.S. Rank out of 24 Developed Markets
2005	 Denmark	 U.S.	24
2004	 Austria	 Finland	23
2003	 Greece	 Finland	23
2002	 New Zealand	 Germany	18
2001	 New Zealand	 Finland	8
2000	 Switzerland	 Greece	12
1999	 Spain	 Ireland	11
1998	 Finland	 Norway	8
1997	 Portugal	 Singapore	6
1996	 Spain	 Japan	11

This table also illustrates the importance of diversifying among foreign markets. No one knows which country's stock market will be the best performer in a given year; different countries or regions outperform at different times. Towneley designs its diversified global portfolios to include investments in many different foreign markets, which positions our clients to take advantage of upswings in the various markets as they occur, and also helps hedge exposure to underperforming markets. ■

Towneley's Global Investment Strategies

As a global asset allocation specialist, Towneley Capital Management, Inc. offers several different investment strategies, each designed to provide clients with diversified exposure to financial markets around the world. In addition to our **Multiple Mutual Fund Program**, which utilizes mutual funds to create an integrated, broadly diversified portfolio, Towneley offers three more narrowly focused global investment strategies utilizing exchange traded funds (ETFs). We use ETFs for our Global Balanced, Developed Markets and Emerging Markets strategies because they provide a low cost, highly liquid means of tracking country specific, and broad market, indexes.



Our **Developed Markets Strategy** focuses on equity opportunities in developed European, Asian and North American countries such as Austria, Australia, Belgium, Canada, France, Germany, Hong Kong, Italy, Japan, Netherlands, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

Our **Emerging Markets Strategy** focuses on equity opportunities in dynamic, developing economies such as fast-growing, populous China and India, technologically advanced Israel, Korea and Taiwan, new European Union members the Czech Republic, Hungary, Poland

and Turkey, and resource-rich South Africa, Russia and Brazil. ■

Towneley research analysts designed our **Global Balanced Strategy** for investors seeking to participate in the capital appreciation potential of major equity and bond markets around the world. The objective of this strategy is to target high total real return with moderate risk over the long term. Assets are allocated between U.S. and foreign equity, fixed income and hard assets, and rebalanced periodically.

Please contact Robert Seaman at 800-545-4442 or rseaman@towneley.com for more information.

Minimum investment of \$150,000 per account, minimum net worth of \$1,000,000, and determination of suitability required for participation in the Global Balanced, Developed Markets and Emerging Markets strategies.

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