

**Welsh Money  
Management LLC**

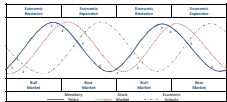
# Welsh Money Management LLC

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## Program Explanation

August 2007

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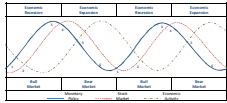
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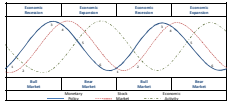


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## Program Explanation

# The Concept of “False” Diversification

Smart investors attempt to lower the risk of their investment portfolio by diversifying among different asset classes. Typically, an investment professional will help an investor, by recommending an allocation based on their goals, risk tolerance, age, and other factors. For example, a normal allocation could be 60% stocks, 30% bonds, 5% real estate, 5% cash (money market). Within each of these asset classes, an additional layer of diversification can be provided by investing in different sectors. The 30% allocated to bonds can be invested in a mix of Treasury bonds and corporate bonds with varying maturities. The 60% allocated to stocks can be well diversified by adopting the allocation shown in Table 1 (on the next page), which would give them exposure to a wide variety of asset classes and management strategies:



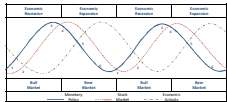
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# The Concept of “False” Diversification

**Table 1**

<b>Investor Growth Allocation</b>	
Large Cap Index Fund	14%
Balanced Fund	14%
Large Cap Growth Fund	10%
Value Stock Growth Fund	15%
Growth Stock Fund	14%
Mid Cap Growth Fund	5%
Small Cap Growth Fund	5%
Technology Fund	5%
International Growth Stock Fund	5%
International Value Stock Fund	5%
Emerging Markets Growth Fund	3%
<u>European Stock Fund</u>	<u>5%</u>
<b>Total</b>	<b>100%</b>

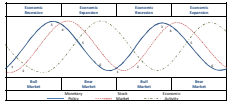


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## Program Explanation

# The Concept of “False” Diversification

Once established, the allocation is usually maintained for twelve months. Armed with a diversified portfolio, the investor naturally feels they have done everything ‘right’, and should be protected from incurring significant losses in their portfolio. Unfortunately, in a global economy, worldwide financials markets have become more linked. This means stock markets around the world are more correlated than in the past, moving up and down together. During 2001 and 2002, well diversified investors learned a painful lesson. A diversified portfolio merely diversified their losses. Below are the bear market returns with dividends reinvested for actual investments (either mutual funds or ETFs) that fit the investment allocation profile above. Mutual funds with a good performance record vs. their peers were used in order not to skew the results in a negative fashion. The investments below are listed in the same order as in Table 1 above, and reflect the period from August 31, 2000 through October 7, 2002.

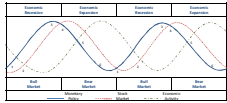


## The Concept of “False” Diversification

**Table 2**

Allocation's Bear Market Returns		
S&P 500 Index ETF	SPY	-46.01%
Fidelity Balanced	FBALX	-16.14%
Fidelity Large Cap Stock	FLCSX	-51.95%
Putnam New Value	PANVX	-18.86%
ING Growth	AEGRX	-61.77%
Janus	JAENX	-75.35%
Fidelity Adv Small Cap	FSCIX	-45.25%
NASDAQ 100 ETF	QQQQ	-79.61%
T. Rowe Price European Stock	PRESX	-44.84%
MFS International Value	MGIAX	-31.38%
Templeton Developing Markets	TEDMX	-28.74%
<u>AIM European Growth</u>	<u>AEDAX</u>	<u>-44.69%</u>
<b>Average Weighted Return</b>		<b>-42.49%</b>

**The 60% allocated to stocks would have caused this investor’s portfolio to lose -25.49% of its total value between August 30, 2000 and October 7, 2002.**



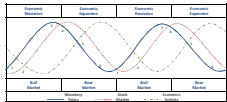
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# The Concept of Diversification of Investment Style

The primary reason this well diversified portfolio performed so poorly is that every investment manager was using the same investment style. Every money manager was buying good quality companies that fit the respective investment criteria of their fund, and holding the stocks of those companies for a period of 3 to 5 years, irrespective of how the markets were performing. Most money managers will remain 90% to 98% invested all the time.

Welsh Money Management has developed a Dynamic Asset Allocation process that is driven by market activity, much like a driver steers a car. As car drivers, we don't predict when the road will curve. Instead, we watch the road and make adjustments as the road curves to the right or left. As the stock market swings up and down, the Dynamic Asset Allocation process moves your money into the market to take advantage of a rally. More importantly, if the trend turns down, your money will be moved out to preserve your capital. And, if specific conditions are met during a decline, the process will establish short positions, to profit from the decline.

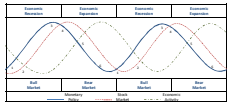


## The Concept of Diversification of Investment Style

Here is an example of how the Dynamic Asset Allocation process would have performed from 2001 through 2006. The comparison below is between a Traditional allocation of 60% stocks (S&P 500 index), 30% bonds( Lehman Bond Index), and 10% cash( money market fund), and the Dynamic Asset Allocation process. The figures for the process are based on back testing by Larmee Associates, an independent third party provider of custom programming services since 1986 that has no relationship with Welsh Money Management.

	2001	2002	2003	2004	2005	2006
<u>Traditional</u>	-4.24%	-10.06%	18.49%	7.90%	3.93%	11.21%
\$100,000	\$95,760	\$86,126	\$102,051	\$110,113	\$114,441	\$127,270
<u>Dynamic</u>	73.55%	3.98%	48.22%	43.96%	9.57%	40.73%
\$100,000	\$173,550	\$180,407	\$267,474	\$385,055	\$421,905	\$593,747

Rather than relying solely on the ‘buy and hold’ investment style to protect their portfolios from significant market declines, investors can more meaningfully diversify their investment portfolio, and potentially lower their investment risk in the process, by incorporating a different investment style into their allocation method.



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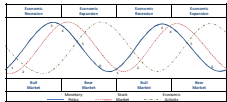
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# How Does the Dynamic Asset Allocation Process Work?

There are two tools currently that drive the Dynamic Asset Allocation process (DAA), with plans to add a third component before year end. The first tool is focused on Sector Exchange Traded Funds (ETFs), which are very similar to sector mutual funds. Both are based on a portfolio of stocks representing a specific sector, like health care, technology, or utilities. The primary difference is that sector mutual funds are usually bought and sold at the end of the day from a mutual fund company like Fidelity. Sector ETFs are bought and sold on an exchange, like the New York Stock Exchange, hence the name exchange traded funds.

If our Dynamic Asset Allocation process had been in effect in May 2002, the back testing shows the long only Sector ETF component would have sold the four positions it was holding between May 21 and May 29. These were the Russell 2000 Value fund, the S&P Small Cap 600 fund, the Dow Jones U.S. Real Estate fund, and the S&P Midcap fund. These funds were sold at an average price of 1078.80 on the S&P 500. On July 23, 2002, just two months later, the S&P 500 closed at 797.70. By moving out of these funds in late May, the Sector ETF model avoided a decline of -26.1% in the S&P 500.

Just after the market bottomed in March 2003, our back testing shows the Sector ETF component would have purchased four funds on March 17. These purchases were the Cohen & Steers real estate fund, the Russell 2000 Value fund, the S&P 500 Small Cap 600 fund, and the Dow Jones U.S. Real Estate fund. These funds were sold between January 16, 2004 and April 8, 2004 for an average gain of 44.35%.



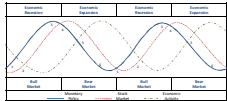
## How Does the Dynamic Asset Allocation Process Work?

The second component of the Dynamic Asset Allocation process is based on the S&P 500. This component invests in the exchange traded fund that follows the S&P 500 as it moves up and down during the trading day, and the S&P 500 futures, which also closely tracks the S&P 500. The S&P ETF is commonly called the S&P Spiders. Since the S&P component can trade at any time during the trading day, it was back tested to 1987 by Larmee Associates using 30 minute data.

When the S&P component turns positive, a position is taken in the S&P futures, or the S&P Spiders ETF, and is liquidated when the S&P component turns negative. When the level of market volatility is adequate, the S&P component will also establish short positions in the S&P 500 futures and the S&P 500 Spiders ETF, in an attempt to profit from a market decline.

During the third quarter in 1998, the S&P 500 fell -10.3%, as hedge fund Long Term Capital Management imploded and Russia defaulted on its debt. If our Dynamic Asset Allocation process had been in effect in 1998, the back testing shows the S&P component gained 29.9% during the quarter, primarily from short trades.

The Dynamic Asset Allocation process allocates 20% of a client's account to the S&P component, and the balance to the Sector ETF component.



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## Contact Information

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### **Welsh Money Management LLC**

3578 Camino Arena

Carlsbad, CA 92009

(760) 436-3574 phone

(760) 436-6574 fax

[www.welshmoneymanagement.com](http://www.welshmoneymanagement.com)

**E. James Welsh**

[jwelsh@welshmoneymanagement.com](mailto:jwelsh@welshmoneymanagement.com)