Five Stars, Shmive Stars:

Recently the mutual fund research giant Morningstar—originator of the ubiquitous "star rating" system for mutual funds—published a study in which it found that low fund expenses were actually a better predictor of future performance than were its own star ratings. Specifically, the study found a much stronger link between funds that had low expense ratios and high future performance than it did between funds with high star ratings and high future performance.

As a client of Rockwood Wealth Management, you already know that there exists no statistical persistence of over-performance. You already know that five star funds do not remain five star funds—we have been beating that drum since day one. What made this "man bites dog" event particularly compelling is that the information came from Morningstar itself, the very firm that has made its living from touting the virtues of its star-rating system. Actually, we think it speaks a great deal about the integrity of the folks at Morningstar for transparently releasing these results.

Not surprisingly, the study garnered a huge amount of attention in the press (perhaps more than for which Morningstar bargained). The notion that Morningstar would assert that low fund fees would trump star ratings as a predictor of future performance is a real eye-opener of sorts.

Yet that's exactly what they said. According to Russel Kinnel of Morningstar, who authored the study, "If there's anything in the whole world of mutual funds that you can take to the bank, it's that expense ratios help you make a better decision. In every single time period and data point tested, low-cost funds beat high-cost funds."

In an effort to protect their brand, Morningstar then went on to assert that high-star funds tend to outperform low-star funds, but admitted the link wasn't nearly as strong as the fee connection.

The implications for those charlatans in the industry who use star ratings to sell past performance to prospective clients are very clear: As far as predicting future performance goes, you are far better off looking for low-fee funds than high-star funds. The very group that compiles the rankings says so themselves.

This conundrum presents a serious problem for all those brokerage firms, banks and insurance companies out there who love to sell the star ratings— because their aggregate fees are often…let us see if we can arrive at the right phrase: unconscionable. Many times these providers' funds have expense ratios well north of 2%, and high turnover ratios that bring total annual fund costs into the 3% to 4% range.

When you have a fund family that consists of dozens or even hundreds of funds (as most of the large financial services firms do) then it's easy to randomly have some funds with high star ratings. So every few months, these providers assemble their top performers and roll out the high-priced marketing machine to glorify the amazing star ratings these funds du jour have received.

If these firms were forced to start advertising their low expense ratios instead, they would have a real problem with their next ad campaign. Clearly, these firms are hoping that the Morningstar study fades quickly from the investing public's memory. Don't let it fade from yours, as it won't be long before the next time someone starts babbling to you about how smart the managers of their five-star funds are.

That Mutual Fund Ad May Be True, But It Is Definitely Disingenuous.

Someone once said that the difference between unethical and ethical advertising is that unethical advertising uses falsehoods to deceive the public, while ethical advertising uses truth to deceive the public. Looking through all the mutual fund ads that run in the consumer press, it appears the investment industry has become expert in the latter.

With 45% of Americans investing in mutual funds, accounting for more than $9.6 trillion dollars, competition is fierce in the industry. Just about any newspaper or magazine will have advertisements like the one pictured below by Putnam Investments.

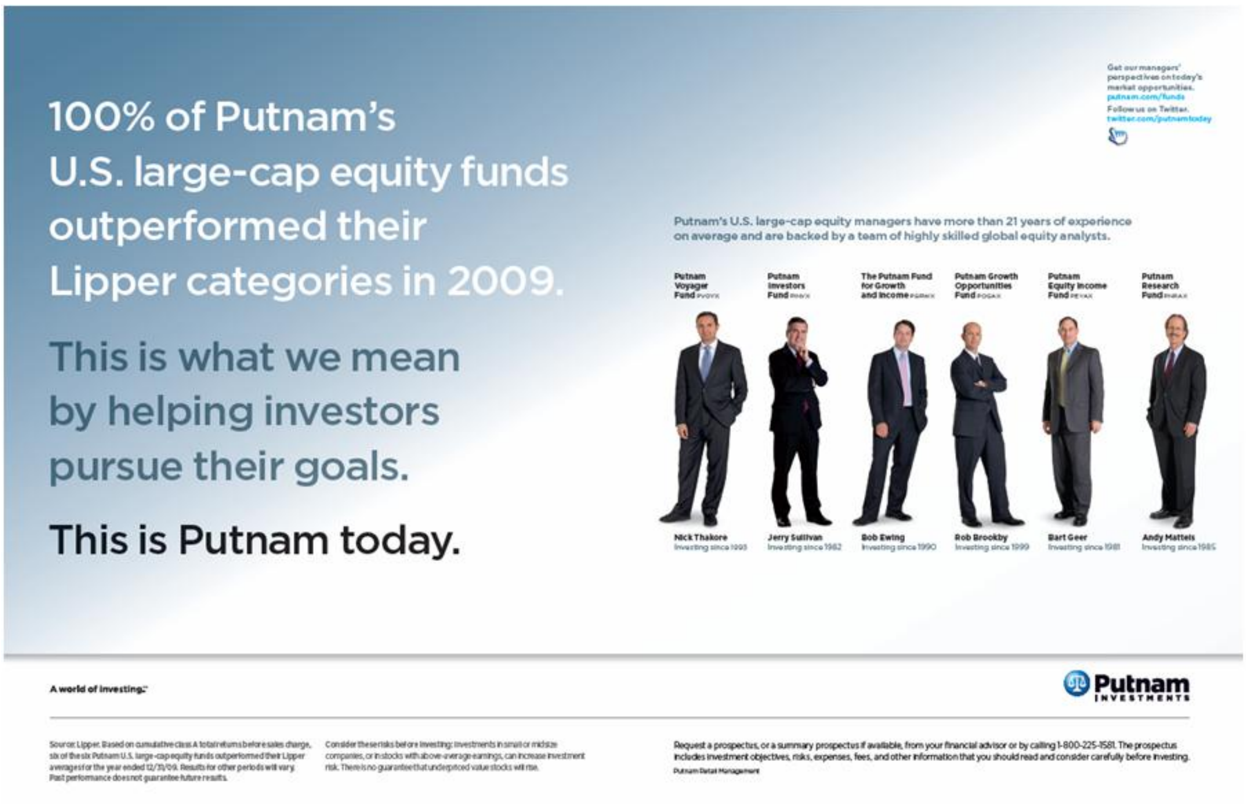
Covering two full pages in Investment News magazine, it was impossible for the reader to miss this ad and its clear message: Our managers are talented and experienced, and our funds have delivered exceptional performance.

While the ad is truthful, there is a larger truth that isn't being communicated: For most of these funds, all this talent and experience has not translated into added value for the funds' shareholders when measured against a passive benchmark.

performance, cannot be extrapolated into the future, and leading investors to believe it can is disingenuous.

So what happens when Putnam's Large Cap funds are properly benchmarked against passive indices over an extended time? The table on the following page shows how the funds in the ad stacked up over the past 10 years to an appropriate market benchmark.

On both a nominal-return and risk-adjusted basis as measured by the Sharpe Ratio (return per unit of risk assumed), only two of the six funds (33%) added any value at all. And the two funds that did add value barely did so



The ad leans heavily on the managers' outperformance against Lipper Categories. The catch of course, that Lipper Categories are not the same as a passive benchmark. Lipper Categories are simply group comparisons, comprising data gathered from other actively managed funds; given that over any measured period it is common to see 60% to 80% of actively managed funds fail to beat their passive benchmark, using Lipper tells me the Putnam funds beat a bunch of other actively managed funds which on average fail to beat their passive benchmark. Essentially, by using a Lipper average, Putnam has lowered the bar.

Second, the advertisement touts a single year's performance (2009). Measuring performance over a single year tells investors absolutely nothing other than it would have been nice to have held those funds for that year. Past performance, especially only a single year's

once the amount of risk they assumed was factored in. So while it is certainly true that 100% of the Putnam U.S. large-cap funds beat their Lipper Average in 2009, considerably less have beaten their passive benchmark on a nominal or risk-adjusted basis over a meaningful period of time.

We are not picking on Putnam. This is very similar to what the broad-based data confirms and what we see on a daily basis: the majority of actively managed funds can't beat their passive benchmark. Delivering market-beating returns is a difficult thing to accomplish for mutual funds, so most fund ads seek to change the yardstick by which they are being measured to avoid this unpleasant truth. It's analogous to a baseball pitcher who convinces the umpires to increase the size of the strike zone since he knows he has a problem throwing strikes.

Fund Name	Asset Class	Total Return Annualized 10 Year	Standard Deviation (Volatility) 10 Year	Sharpe Ratio 10 Year	Added Value
Putnam Investors	Large Blend	-3.75	17.7	-0.28	No
Putnam Research	Large Blend	-1.53	17.51	-0.15	No
Index: Russell 1000		0.16	16.22	-0.07	
Putnam Voyager	Large Growth	-1.93	18.65	-0.15	Yes
Putnam Growth Opportunities	Large Growth	-6.51	19.79	-0.37	No
Index: Russell 1000 Growth		-3.63	18.85	-0.24	
Putnam Fund for Growth & Income	Large Value	1.3	15.86	-0.01	No
Putnam Equity Income	Large Value	5.28	14.05	0.25	Yes
Index: Russell 1000 Value		3.84	15.72	0.13	

Source: Morningstar

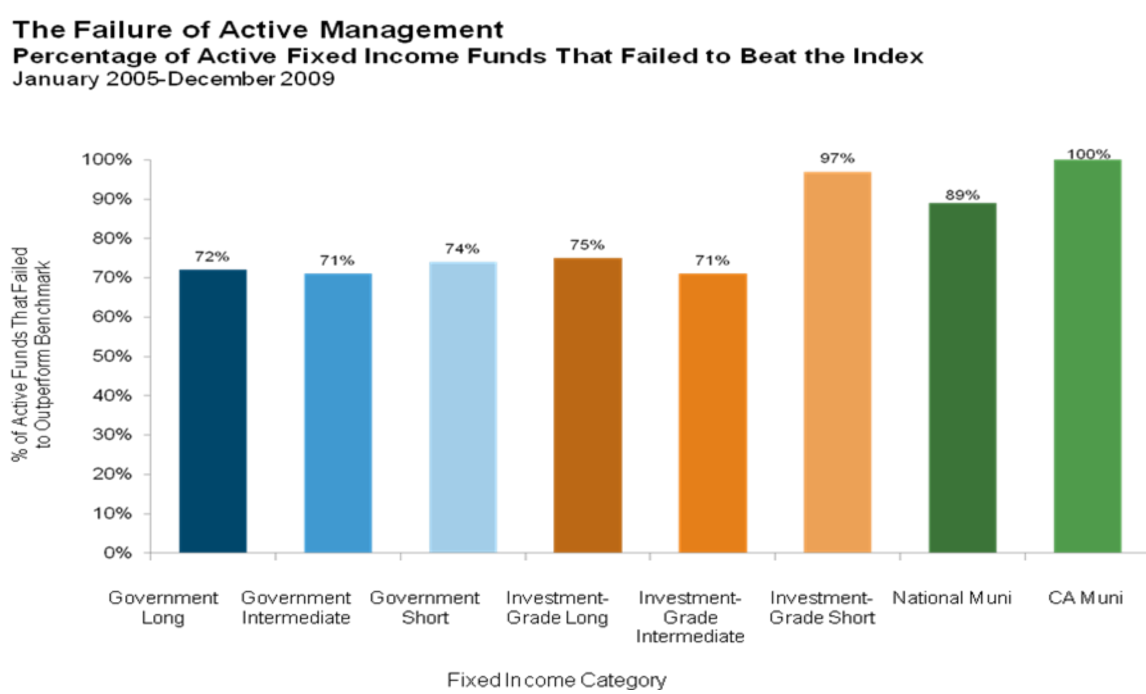
Fixed Income Risk in Your Portfolio

With interest rates near historical lows, some investors may be anxious about a possible rate climb and its potential impact on their fixed income investments. Rising interest rates typically cause existing bonds to lose value. Of course, rate movements in either direction affect portfolio returns. This is true in any market environment, regardless of the current rate level. The larger question is how to manage the risk. We thought we might spend some time writing about how we evaluate your current fixed income exposure, and the core principles of fixed income investing:

Interest rate movements are unpredictable.
Academic research offers strong evidence that the bond market is efficient, and that bond prices and interest rates are not predictable over the short term. This uncertainty is reflected in the often-contradictory interest rate forecasts offered by economists, analysts, and other market watchers.

Today's bond prices already reflect expectations for tomorrow's business conditions and inflation, and these expectations can change quickly in response to new information. This new information is fundamentally unknowable in advance. Investors who accept market efficiency should not be surprised when the credit markets foil the experts. If prices were easy to forecast, you should find a host of fixed income managers with market-beating returns. But most of them underperform their respective benchmarks over longer time periods as seen below.

Since no one has a reliable method for determining whether interest rates will rise or fall in the near future, we do not make fixed income decisions based on a forecast, media coverage, or own hunches.



Pursuing higher returns requires more risk taking.
The strong link between risk and return appears in all properly functioning capital markets. When investing in stocks, bonds, or other assets, investors must accept more risk to pursue a higher potential return.

In the fixed income markets, earning a return above short-term government instruments is usually a function of assuming more term and credit risk. Term risk refers to a bond's maturity, and credit risk refers to the creditworthiness or default potential of the borrower. Bonds with longer maturities and lower credit quality are usually considered riskier and have offered higher yields and returns to compensate investors for higher risk.

On the term side, investors who commit their capital for longer periods of time are exposed to the amplified effects of changing interest rates. Bond prices and interest rates move in the opposite direction: When rates rise, the value of an existing bond declines; when rates fall, bond values rise. The market adjusts the price to match the yield available on a new instrument. The longer the bond's maturity, the greater the price adjustment for a particular interest rate change. A long-term bond is more exposed to rate changes than a short-term instrument, and usually (but not always) offers a higher yield to compensate investors for the extra risk. Also, lower-coupon bonds are more affected by interest rate changes than higher-coupon bonds. For example, if rates move 1%, a bond that pays 3% will experience a greater gain or loss than one paying 5%.

On the credit risk side, the government is considered the strongest borrower in the market, so it has a lower cost of capital relative to other issuers. The most creditworthy companies are considered relatively safe, but they must still offer a higher rate than the government to compensate investors for taking more default risk. The weaker a corporate borrower's financial condition, the more it must pay in yield to attract investors. Investors seeking higher returns on the credit spectrum must bear a higher risk of default.

Aggregate strategy drives fixed income decisions.
Investors may hold fixed income securities for a variety of reasons—for example, to reduce portfolio volatility, maintain liquidity, or meet a future funding obligation. Each objective may involve a different portfolio approach, or a combination of strategies to manage tradeoffs. For example, investors who want to maximize current income may not be strongly concerned with the effects of short-term price volatility. They may extend maturity or accept slightly lower credit quality when the market offers a yield premium for doing so. On the other hand, investors seeking long-term wealth appreciation may commit most of their portfolio to equities and keep their fixed income investments short term and high quality to buffer the volatility of stocks.

Regardless of the approach, a professional knows the difference between controlling risk and avoiding it. We cannot eliminate risk, but you can manage your exposure by diversifying across maturities, industries, countries, and currencies to reduce the impact of rates, inflation, currency fluctuations, and other risks. Our decision to take more term and credit depends on the current state of the yield curve and credit spreads.

Many factors influence the direction of interest rates and performance in the bond markets, and these are too multifaceted for anyone to reliably predict. Rather than placing faith in the experts or reacting to economic news, we manage your fixed income component from a portfolio perspective. Your strategy reflects your overall investment goals, risk tolerance, and other personal financial considerations. This approach is prudent for managing your portfolio in an uncertain interest rate market.

Firm update:

Rockwood Wealth Management is proud to introduce two new members of our team.

William (Bill) Aquila, Senior Associate, joined us after working with two nationally recognized brokerage firms. His experiences with his legacy firms led to the development of a belief that financial advice should be rendered free of the conflicts of interest that are inherent in broker-dealer firms. Bill's philosophy and ethic are a tremendously good fit for the clients of Rockwood Wealth Management.

A graduate of The University of Virginia, Bill is currently working on obtaining his Certificate of Financial Planning from Florida State University. With previous experience managing a small business, he can appreciate the unique issues that small business owners face. He is also a member of the Bucks County Estate Planning Council.

Currently Bill resides in Hilltown, Pennsylvania with his wife Kate, and their son and daughter. Besides spending time with his growing family, he has a passion for sailing, playing the piano, fine woodworking and cabinetry, and soccer.

Chris Haave is a senior consultant at Rockwood Wealth Management, assisting affluent families and fiduciaries in the Washington, D.C. area in establishing financial goals and in structuring and implementing prudent investment plans. Prior to joining Rockwood, Chris was Vice President - Business Strategy of The Investment Counsel Company of Nevada, one of the oldest and largest independent investment management consulting firms in Nevada.

Chris served previously as career officer in the U.S. Air Force as an A-10 fighter pilot, foreign policy practitioner and organizational business leader. His final active-duty position was at the White House as the Special Advisor for Europe and Eurasia on Vice President Dick Cheney's national security staff. His flying career included command combat experience in Kosovo and in Operations Enduring Freedom and Iraqi Freedom. His foreign policy experience included serving as a Visiting Fellow at the Council on Foreign Relations in New York and in two North Atlantic Treaty Organization posts. Among his academic credentials are diplomas from the U.S. Air Force Academy, New Mexico State University, the Institute of Political Studies, Lyon, France, and the Harvard Kennedy School, Harvard University.

Chris is a Member of the Council on Foreign Relations, New York, New York and serves on its Term Member Selection Committee. He also serves on the Board of Directors of the World Affairs Council of Las Vegas. A marathon runner, in his spare time he plays tennis with his wife Rhea and his son.

Rockwood Wealth Management
(267) 983.6400
www.RockwoodWealth.com

362 W. Bridge Street
New Hope, PA 18938

200 Harry S. Truman Parkway, Suite 300
Annapolis, MD 21401

Principals:

Brian Booth, CFP®
bbooth@rockwoodwealth.com

Ted Toal, CFP®
ted@rockwoodwealth.com

John Augenblick, MBA, CFP®
john@rockwoodwealth.com