

ANDRESEN AND ASSOCIATES

FEE ONLY INVESTMENT ADVISOR

P.O. Box 1434 Salinas, CA 93902
(831) 758-1575 or 1-800-345-9644
www.andresenassoc.com

RISK PART I

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Take a look at the graphs on the following page. What they have to say about your portfolio is very important. On these graphs, each dot represents a mutual fund which commonly occurs in our portfolios. The bottom horizontal axis is risk, represented by standard deviation. This is a measure of raw volatility, not correlated risk. In other words, by this measure, an investment may go up and down, but it may do so in concert with others or alone. The more an investment is located to the right, the more risk it has had in past years.

The vertical axis represents reward. The higher an investment is located on the graph, the greater its rewards have been during the past. Obviously the perfect investment would be in the upper left corner of the graph. A bad investment would be depicted on the lower right.

On these graphs you can see the core of our strategy in the past decade, and what has happened to that strategy in the past three years. They also give you some insight into what will happen next.

Bonds are represented by Pimco Low Duration. During both time periods studied, bonds have had low risk...and low returns. We've mostly avoided these very safe investments simply because returns have been so low. We've employed them only as parachutes for lower-risk portfolios, not to make money. In fact, if you look at the ten year plot, you can see that even including one of the nastiest stock market declines in the modern era, the stock market, as represented by the S&P 500, was still able to outperform short-term bonds.

Our primary venue to access the stability of bonds without reducing returns has been to use balanced funds. Balanced funds are mutual funds which combine a portfolio of both bonds and stocks. As you can see on both plots, our selection of balanced funds from Vanguard Wellesley to FPA Crescent has delivered dramatically increased returns compared to pure bond portfolios. They have done this with less risk than the S&P 500. Our choice to invest substantially has been appropriate. However, as the S&P 500 has recovered from the 2000-2003 decline, their relative advantage has diminished.



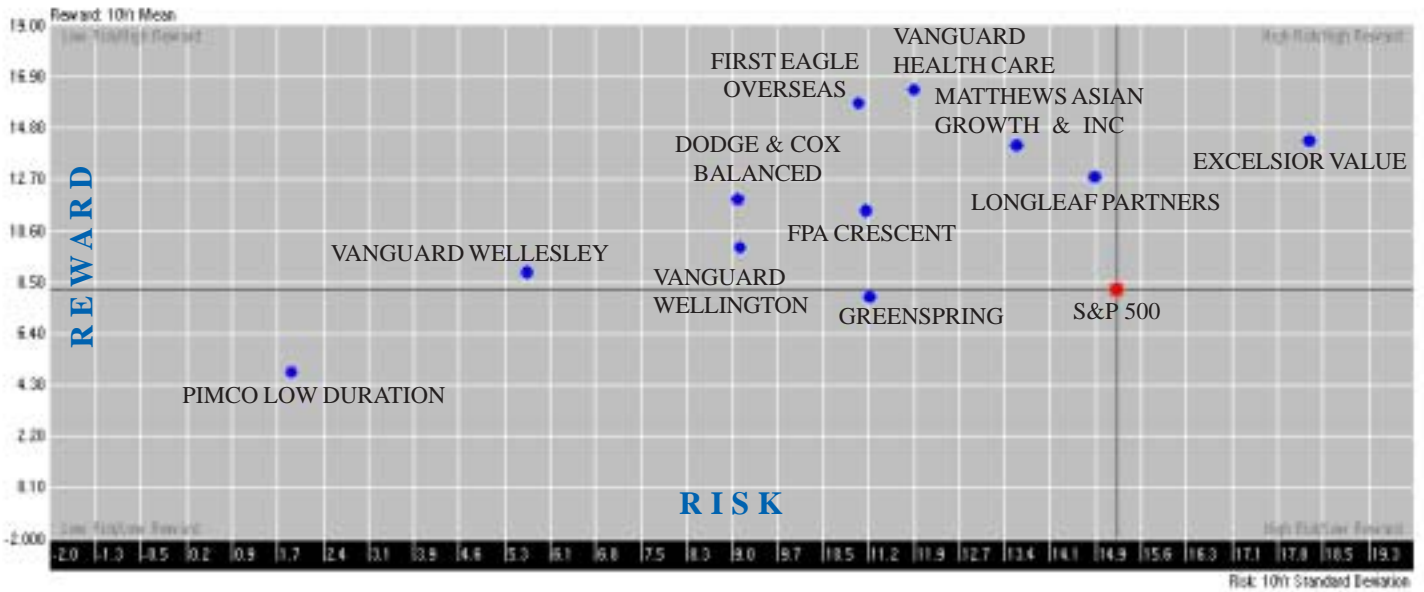
Another venue we've explored to keep risks low and returns relatively high has been health care. Vanguard Health Care has provided higher returns than the S&P 500 with equal or lower risk. Since the fund closed years ago, virtually all our clients who are in this fund have enjoyed these above-market returns.

To beat the S&P 500, we've also focused on small-cap and mid-cap stocks in value funds. As investor interest has come to focus on mid-caps and value stocks, our fund picks have continued to outperform, but with increasing risk relative to the S&P 500. You can see that Longleaf Partners, which utterly rocked during the downturn between 2000 and 2003, is still beating the S&P 500. Fairholme and Excelsior Value & Restructuring are both beating the S&P 500 as well, but with greater risk than the index. The bottom line is this: we've beaten the S&P 500 with these funds, and then partially diversified their risk away through the use of a wide spectrum of other uniquely placed mutual funds.

Nowhere is this specialized risk selection more obvious than in our choices of international funds. As you can see with the First Eagle Overseas fund, currency volatility has given funds like this unique risk characteristics, in addition to returns which substantially beat the S&P 500. While there are no signs of this currency imbalance ending, history tells us that eventually it will end and even reverse, and we will want to alter our portfolios at that time.

We will write more on this subject next month. It is important to understand why risk parameters are changing, what is happening to our value funds to make them now more risky than the S&P 500, and why this matters to you. 🍷

10 YEAR RISK/REWARD SCATTERPLOT



Why these graphs matter to you:

1. Even including one of the worst downturns in US stock market history, stocks still beat short-term bonds over the past ten years.
2. Most of our mutual fund picks outperformed the S&P 500 with less risk in the past ten years.
3. In the past three years, our holdings have gotten riskier relative to the S&P 500.
4. This means that our portfolios are facing genuinely changing market conditions.

3 YEAR RISK/REWARD SCATTERPLOT

