

## Asset Returns

February 28, 2007	YTD	2006	2005	10 Year	20 Year
<b>Domestic stocks</b>					
Large	-0.5	15.7	4.8	8.4	11.8
Large Value	-0.3	22.0	6.9	11.0	12.8
Large Growth	0.6	8.9	5.1	5.4	10.3
Small	0.8	18.2	4.5	9.4	10.9
Small Value	0.2	23.2	4.4	13.3	13.5
Small Growth	1.5	13.1	4.0	4.9	7.8
Micro Cap	0.6	16.2	5.7	13.5	13.2
<b>International stocks</b>					
Large	1.5	26.0	13.3	8.1	8.4
Large Value	1.4	30.0	14.4	10.6	11.0
Large Growth	1.4	21.9	13.6	5.3	5.9
Small	4.3	24.9	22.0	8.6	-
Small Value	4.5	28.4	23.2	10.2	-
Emerg. Mkts.	-2.3	30.7	32.6	8.5	-
EM Small	2.8	37.3	25.8	10.5	-
EM Value	2.1	37.9	30.8	13.0	-
<b>Sectors</b>					
U.S. REITs	6.4	35.5	13.1	15.2	11.7
Energy	-3.0	18.4	40.2	11.5	12.0
<b>Bonds</b>					
Short Term	0.9	4.8	2.3	4.3	4.6
Five Year	1.0	3.9	1.7	6.2	7.5
Long Bond	2.1	1.7	6.6	7.9	10.3
Total Market	1.4	4.3	2.4	6.2	8.0
<b>Other</b>					
Inflation	-	3.2	3.4	2.6	3.1
Comm. RE	-	16.6	20.4	12.7	8.4
Residential RE	-	7.7	13.4	7.8	5.1
Hedge Funds	-	13.0	2.7	8.7	-
Commodities	-	-2.9	18.9	3.2	5.2

### SOURCES:

Large Cap data is based on S&P 500 returns.  
 Large Value and Growth returns are based on Russell 1000 Value and Growth data.  
 Small Cap, Small Value & Small Growth are based on Russell 2000, R2000 Value and R2000 Growth data.  
 Micro Cap returns are based on the CRSP 9-10 index of the smallest publicly traded stocks.  
 Int'l Large, Large Value and Large Growth are based on MSCI's EAFE Indexes.  
 International Small & Small Value returns are based on small company data in developed markets from DFA.  
 Emerging Markets data is from MSCI's Emerging Market. Emerging Market Value and Small Cap data is based on Indexes maintained by DFA.  
 REITs are based on the Wilshire REIT index.  
 Energy data is from S&P's energy index.  
 Short term bonds are represented by Lehman's index.  
 Five year bonds are five year treasury returns and long term bonds are 20 year treasuries.  
 Total Bond market is the Lehman Aggregate Index.  
 Other data comes from the Federal Reserve, National Association of Realtors, HFRI & the CRB.

**PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS. INVESTMENT OBJECTIVES, RISKS, CHARGES, EXPENSES AND OTHER IMPORTANT INFORMATION ABOUT A FUND ARE CONTAINED IN THE PROSPECTUS; READ AND CONSIDER IT CAREFULLY BEFORE INVESTING. PROSPECTUSES ARE AVAILABLE ON COMPANY WEBSITES OR FROM TSI.**

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## Uniform Prudent Investor Act

In 2004, Texas adopted its version of the Uniform Prudent Investor Act (UPIA). The law outlines the investment requirements for trustees managing investment portfolios. Although, Thornhill Securities, Inc. (TSI), as an investment advisory firm, is not directly subject to this law (our majority shareholder Austin Trust is governed by the law), the law outlines useful objectives and guidelines for investment management that are consistent with our process. Additionally, the law may ultimately apply to investment fiduciaries outside of trust relationships. In this month's newsletter, I'll discuss the background leading up to the UPIA's implementation, the law's objectives, requirements placed on fiduciaries by the law, and TSI's investment process in the context of the UPIA.

### Background

The UPIA updates the previous "Prudent Man Rule" that outlined a certain level of care and skill that should be applied based on particular circumstances. The trustee was generally expected to act as a "Prudent Man" would manage his own affairs in the same situation. Over time, updates to the law became problematic because some investments were deemed "speculative" and considered imprudent. The investments were evaluated on a stand-alone basis and their impact on the overall portfolio was not considered. However, this approach was inconsistent with "Modern Portfolio Theory," which outlined a framework for investing that considered the risk and return characteristics of an entire portfolio. An asset class that might be considered "speculative" on a stand-alone basis, could positively impact a portfolio's risk/return profile based on its correlation with other assets and its return characteristics. The UPIA mandates an investment process that is consistent with "Modern Portfolio Theory" and considers the entire portfolio instead of any one asset in isolation.

### Objectives

The Prefatory Note to the Texas UPIA includes the following description:

**Objectives of the Act.** UPIA makes five fundamental alterations in the former criteria for prudent investing. All are to be found in the Restatement of Trusts 3d: Prudent Investor Rule.

1. The standard of prudence is applied to any investment as part of the total portfolio rather than to individual investments.
2. The tradeoff in all investing between risk and return is identified as the fiduciary's central consideration.
3. All categoric restrictions on types of investments have been abrogated; the trustee can invest in anything that play an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing.
4. The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing.
5. The much criticized former rule of trust law forbidding the trustee to delegate the investment management functions has been reversed. Delegation is now permitted, subject to safeguards.

### **Consider entire portfolio not one investment**

The requirement for prudence is applied to the entire investment portfolio instead of any one investment. An individual investment that appears speculative, could actually balance the risk and return characteristics of a portfolio.

### **Risk and return are primary consideration**

The act recognizes the inherent link between risk and return. The fiduciary's primary responsibility is determining the proper risk/return trade-offs for each situation. A retired widow with limited means has a very different profile than a young trust beneficiary with relatively stable income. Additionally, the risk of inflation and preservation of purchasing power (not just principle) should be considered when establishing long term strategies.

### **No categorical restrictions on assets**

Instead of prohibiting certain investments, the act proscribes a process and framework for undertaking the role of fiduciary. Beneficiaries should benefit from a focus on process, because the trustee's responsibilities are more demanding under the UPIA than the "Prudent Man" rules.

### **Diversification is mandated**

The benefits of diversification have long been understood in the context of risk reduction and portfolio optimization. The UPIA mandates diversification within asset classes and across multiple asset classes. In the past, diversification within an asset class might have been enough. The requirement for diversification is mandated unless the trustee determines the purpose of the trust is better met by not diversifying.

### **Delegation permitted**

This recognizes that prudent investing might require a trustee to use outside managers to achieve the objectives of the trust. In the past, delegation was generally prohibited.

### **Factors to Consider**

The UPIA describes specific circumstances trustees should consider when managing assets for beneficiaries. The law states:

*Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:*

- 1. general economic conditions;*
- 2. the possible effect of inflation or deflation;*
- 3. the expected tax consequences of investment decisions or strategies;*
- 4. the role that each investment or course of action play within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;*
- 5. the expected total return from income and appreciation of capital;*
- 6. other resource of the beneficiaries;*
- 7. needs for liquidity, regularity of income, preservation or appreciation of capital; and*
- 8. an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.*

This section is really the heart of the law and includes very broad factors for the fiduciary to consider when managing investments. Additionally, it puts a requirement on the trustee to verify the facts that are relevant to the management of the assets.

### **TSI Investment Process**

Although TSI is not directly subject to the UPIA, our investment process and solutions are consistent with its tenants. We built our process to be consistent with UPIA for several reasons. First, we are an affiliate of Austin Trust Company and share similar investment philosophies. Additionally, the UPIA may ultimately extend to other fiduciaries, including investment advisors. Finally, it makes good business sense. A transparent investment process and philosophy is better for us and our clients.

### **Discovery**

The initial step in our process is one of discovery. We need to understand our clients and our clients need to understand our investment philosophy. Some of the facts we consider in our client's situation include, income, savings, future savings, age, estate planning, tax implications, investment experience and the profile of outside investment accounts. This list provides a foundation for working with our clients. Additionally, we expect situations will change over time; consequently, the discovery process should be an ongoing dialogue.

As important as our understanding of our clients is their understanding of our philosophy and process. We encourage our clients to spend time with us discussing our experience in the markets and the foundations for our investment strategies. Moreover, we provide our clients with outside research and information resources that are relevant to our process.

### **Asset Allocation & Portfolio Construction**

Ultimately, risk and return are related. Our asset allocation decisions attempt to build an allocation that generates a level of risk and return consistent with our clients' goals. When constructing asset allocations for our clients, we apply historical research on 20-30 different asset classes, reviewing their return, volatility and correlations. Based on the level of assets and the client's individual situation, we implement allocations with stocks, bonds, mutual funds and exchange traded funds.

### **Portfolio Management & Review**

Once a target allocation has been implemented, TSI maintains asset allocations within certain limits through periodic rebalancing. The rebalancing has the effect of "buying low and selling high" since we regularly prune high return assets and add to assets with relatively lower returns. Furthermore, we meet with clients on a regular basis to review performance and update our understanding of their goals. Over time, we expect client situations to change, and we make adjustments to our recommendations based on those changes. At the same time, we are continually reviewing asset management research and new products to determine if there are better solutions for our clients.

*Gabe Thornhill*