

Asset Returns

Sept 30, 2007	YTD	2006	2005	10 Year	20 Year
Domestic stocks					
Large	9.1	15.7	4.8	8.4	11.8
Large Value	5.9	22.0	6.9	11.0	12.8
Large Growth	12.5	8.9	5.1	5.4	10.3
Small	3.2	18.2	4.5	9.4	10.9
Small Value	-2.7	23.2	4.4	13.3	13.5
Small Growth	8.9	13.1	4.0	4.9	7.8
Micro Cap	1.8	16.2	5.7	13.5	13.2
International stocks					
Large	12.8	26.0	13.3	8.1	8.4
Large Value	8.2	30.0	14.4	10.6	11.0
Large Growth	16.4	21.9	13.6	5.3	5.9
Small	11.9	24.9	22.0	8.6	-
Small Value	11.3	28.4	23.2	10.2	-
Emerg. Mkts.	30.7	30.7	32.6	8.5	-
EM Value	41.8	37.3	25.8	10.5	-
EM Small	37.9	28.4	37.3	25.8	-
Sectors					
U.S. REITs	-5.1	35.5	13.1	15.2	11.7
Energy	28.8	18.4	40.2	11.5	12.0
Bonds					
Short Term	3.9	4.8	2.3	4.3	4.6
Five Year	3.9	3.9	1.7	6.2	7.5
Long Bond	3.5	1.7	6.6	7.9	10.3
Total Market	3.7	4.3	2.4	6.2	8.0
Other					
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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Volatility

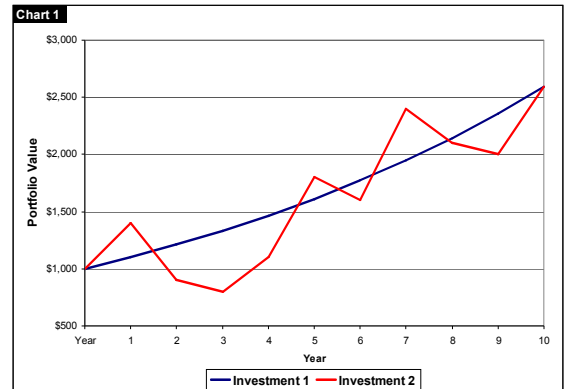
Webster's Dictionary defines volatile as "characterized by or subject to rapid or unexpected change." Ironically, the example in the online dictionary is "a *volatile* market." In real life, volatility can be a slippery concept and can mean something different to each person. Chart 1 is a simple illustration of volatility. The two portfolios have the same 10 year return, but very different levels of volatility. Which portfolio would most investors prefer?

Assuming we want to minimize volatility, how do investors measure it, what impact does it have on returns and what tools can we use to manage investment volatility? Given the movement in the market over the last three months, I thought it would be helpful to take a look at these topics and review how we consider volatility in our investment process at Thornhill Securities.

Definitions

Personal Perspective –

Everyone has a unique tolerance for and perception of volatility. It's usually shaped by past experiences and outlook on the current state of affairs. Additionally, the most intense feelings of volatility are usually associated with downward market moves, not upward moves. If the market drops 300 points in a single day, some people shrug it off, looking at the decline as a buying opportunity. Others have trouble sleeping that night, fearing a collapse the next day or recalling the Great Depression. Neither is right or wrong, the feelings are a real and a personal reaction to volatility. That reaction might be influenced by education and research on market behavior, but the feeling is always very real.



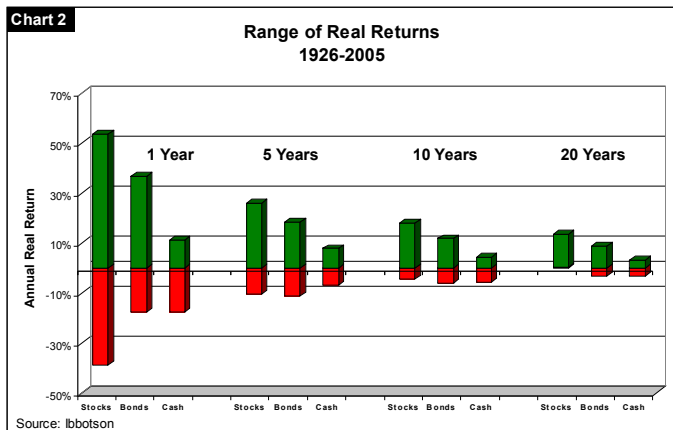
Quantitative Measure –

Standard deviation is the typical measure of volatility used in many different fields. It measures the likely variability of returns around a "mean" return. The smaller the standard deviation, the less volatile the investment. It is useful for comparing different investment options and analyzing portfolio construction. Treasury bill returns have a very low standard deviation (1% since 1970), whereas small growth stock returns have a 23% standard deviation over the same period. Obviously, rational investors would expect a higher return for the added volatility. However, that isn't always the case and we'll review the relationship between risk and return later.

Downside Analysis –

Looking at the downside risk in your investments or the risk of failing to achieve a specific goal is another way to define volatility. If an investor is saving for retirement, how likely are they to meet their savings

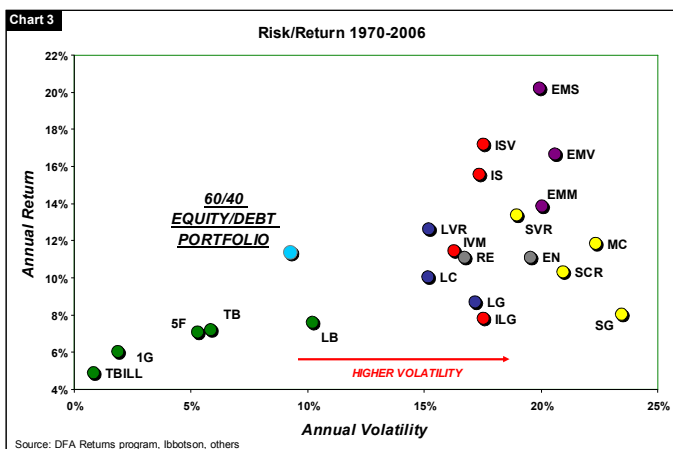
goal by age 65? Given a particular strategy, what was its return in past market meltdowns?



Time Frame – Your perception of volatility is heavily influenced by the time frame you use for viewing market action. On any one day, the market is only slightly more likely to be up than down. That means you’ve got almost a 50% chance of seeing declines if you check the market every day. If you had only checked the market on January 1 each year, there was only a 33% chance of negative returns since 1926. Over the same period, there is no 20 year window with negative stock returns and only a 13% chance of negative returns over a 10 year time frame. Chart 2 shows the range of returns for different investments and holding periods since 1926.

Implications

Risk/Return Relationship – Chart 3 shows the historic return and volatility for the asset classes we track in this newsletter. The implication that risk and return are related is clearly demonstrated in this chart. Investors who want higher return will need to take on higher volatility. If you graphed the downside scenarios for these investments, the story would be much the same. Despite what I hear on the radio from people selling “risk free” investment schemes, there is no free lunch as far as risk and return are concerned.

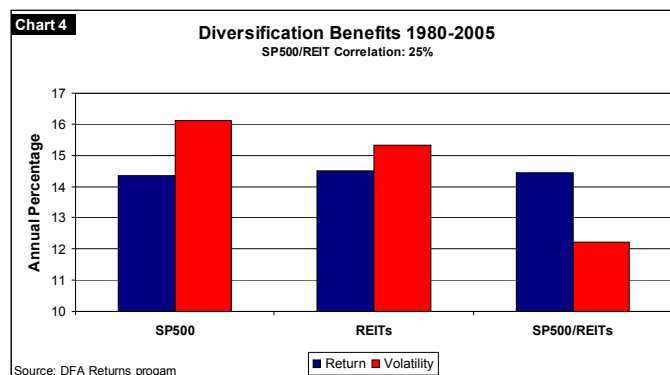


Behavioral Issues – Volatility can cause investors to make decisions counter to their long term goals and risk tolerances. It can happen on the upside as well as the

downside. How many people piled into risky technology issues in 1999 and early 2000, afraid they would miss the huge upside promised by analysts and Wall Street? Similarly, many people bail out of the market when things seem the worst, only to see the market rebound sharply right after a protracted correction. Since 1970, the biggest single month in the S&P 500 was in October 1974 (up 17%), immediately after the worst 12 months in the market (down 39%).

Application

Transparency – At TSI, we research the markets and quantify the various volatility measures for individual asset classes and portfolios. Standard deviation, historic downside and Monte Carlo analysis are all useful in understanding the potential volatility in different investment portfolios. It’s our philosophy that transparency is always the best policy. If a particular portfolio would have dropped 40% back in 1973, we should know and so should the client.



Diversification – A central tenant of Modern Portfolio Theory is that diversification reduces non-systematic risk (one aspect of volatility). Consequently, investment strategies should diversify broadly within an asset class and across different asset classes. Chart 4 demonstrates the impact of splitting a portfolio between the S&P 500 and REITs. Compared to either asset individually, the combined portfolio had similar returns with lower volatility.

Optimize Portfolios – Chart 3 demonstrates the relationship between risk and return. However, it also shows that not all asset classes are created equal. For a given level of historic return, different asset classes have dramatically different volatility characteristics. Additionally, assets can be combined to reduce volatility with similar levels of return. The theoretical 60/40 portfolio had lower volatility than some bonds, but returns similar to the S&P 500.

In conclusion, volatility is a complicated concept but important to understand and quantify. Our approach to managing portfolios includes a detailed examination of volatility and its implications for each client portfolio.