



Address Label

The investor of today does not profit from yesterday's growth—Warren Buffett

“SOMEONE IS SITTING IN THE SHADE TODAY BECAUSE SOMEONE PLANTED A TREE A LONG TIME AGO.”

“If the Fed Chairman whispered to me what his monetary policy was going to be over the next two years, it wouldn't change one thing I do.”

“Invest within your circle of competence. It's not how big the circle is that counts, it's how well you define the parameters.”

“OUR FAVORITE HOLDING PERIOD IS FOREVER.”

“We don't believe in the Noah's Ark principle of investing, winding up with two of everything. Then you have a zoo.”

—Excerpts from “Thoughts of Chairman [Warren] Buffett”- compiled by Simon Reynolds

### Stock Spotlight — Texas Instruments (TXN—\$32.50)

Texas Instruments has been included in all three model portfolios over the past few quarters, and warrants the spotlight due to having been added to client accounts over the past two years.

The company engages in the design, manufacture, marketing, and sale of high-technology components in the United States and internationally. It operates in two segments, Semiconductor and Education Technology. The Semiconductor segment offers analog semiconductors and digital signal processors, which are used in applications that serve the communications, computer, consumer electronics, automotive, and industrial markets. The Education Technology Segment supplies graphing handheld calculators; business and scientific calculators; and classroom tools and professional development resources to help students and teachers interactively explore math and science.

TXN's Notable Statistics	
Market Capitalization	\$ 42.6 Bil.
5 Yr. Annual Growth Projection	16 %
SFM's Price / Earnings Ratio	13.5
SFM's Calculated 'Payback Ratio'	9 %
Net Profit Margin	19 %
Dividend Yield	1.2 %
3 year average Return on Equity	28.4 %
Debt / Assets	0.20



### Funds, Funds, and More Funds—Part III (a.k.a. What are ETFs, anyway?) By Adam Sommers

This is the third article in my series explaining well-known mutual funds, actively managed closed-end funds, and the hot new investment vehicle—exchange-traded funds (ETFs).

My April article focused on the distinct advantages of closed-end funds. If you aren't confused already, you need to know that **officially, closed-end funds are exchange-traded funds (ETFs)** — meaning they trade on the stock exchange in the 'secondary' market—but are separate and different from index-ETFs. Closed-end funds and index-ETFs are both under the same 'ETF' umbrella. Since closed-end funds have been around for decades, the recent buzz around ETFs is usually directed at the newest and most exciting of the bunch—index-ETFs.

**Index-ETFs operate much the same way as index mutual funds:** ETFs offer low costs, the opportunity to track an index, relative diversification, the potential for tax-efficiency, and a consistent management strategy.

You can invest in no-load index mutual funds, so why would you choose to purchase index-ETFs with a commission involved (see the January 2008 article for fee details)? First of all, I believe that when you invest at least \$3,000 in a fund, a \$10 commission is not material.

But there are advantages to choosing an ETF over a no-load index fund. One of the advantages of closed-end funds applies here: trading is more efficient, as you can use stop and limit orders, margin buying, short selling, as well as trade options on ETFs—any time during market hours. From Vanguard: **“ETFs offer the advantages of traditional index funds with the trading flexibility of individual stocks.”**

But **the single biggest advantage of ETFs is their tax efficiency.** Did you know that you often (in a taxable account) pay income taxes on mutual funds even when you “lose money” (your statement shows a decline in value) on a mutual fund in a given year? So how do ETFs remedy this situation? From Vanguard again: ‘Unlike mutual funds, ETFs do not generally experience cash flows into or out of the fund. Only

certain sophisticated institutional investors are authorized to purchase or redeem shares directly, and they do so almost exclusively with securities.’ The ETF manager can even choose to trade-away to these ‘authorized participants’ the lowest cost holdings first, thereby reducing the future taxable gains on the remaining holdings in the ETF portfolio. These ‘in-kind’ transactions benefit the ETF in three ways: **The ETF does not incur transaction costs or realize capital gains, while also reducing the ETF's future tax liability.**

“Institutional investors sell their ETF shares to individual investors on the open market, who may then sell their shares to other investors for cash. These market trades have no effect on the ETF itself: no cash flows into or out of the ETF that would require it to purchase or liquidate holdings, incur trading costs, or realize capital gains [much like a closed-end fund]. As a result, **the ETF is largely able to hold down its operating costs and limit the distribution of taxable gains to shareholders.**”

After this six-month diatribe as to the benefits and disadvantages of each of the different fund structures, how do I decide what to place into client portfolios? **I admit that it is still an art—but one which I am attempting to build into a science.**

#### Five Year Average Annual Returns

- Dow Jones Industrial 30 Average : 5.3 %
- Standard & Poor's 500 Index: 6.3 %
- NASDAQ Composite Index: 8.3 %
- Russell 2000 Small Company Index: 10.8 %
- SFM's MODEL 25 PORTFOLIO: 15.9 %  
(see inside the newsletter for updates to the Model Portfolio)

**Sommers Financial Management's  
AGGRESSIVE Stock Portfolio**

Company Name	Risk Grade	P/E Ratio	Growth Rate	Payback Yield
Actions Semiconductor	D	9.3	25%	148%
American Eagle Outfitters	C	7.7	13%	17%
Asta Funding	F	11.8	9%	10%
Franklin Resources	B	11.2	11%	12%
Biovail	D	7.5	6%	21%
Cherokee	D	9.1	2%	9%
Coach	C	11.6	18%	11%
Syneron Medical	C	10.9	14%	12%
<b>Federated Investors</b>	B	11.4	12%	9%
Forest Laboratories	B	9.2	11%	13%
J2 Global	D	12.4	17%	11%
Lam Research	C	14.4	14%	16%
<b>Microsoft</b>	A+	13.0	11%	9%
<b>Nokia</b>	A-	8.5	13%	11%
New Frontier Media	D	7.3	15%	15%
Nutrisystem	F	5.0	17%	25%
OptionsExpress	C	10.8	19%	11%
Occidental Petroleum	B	8.5	19%	11%
<b>Pfizer</b>	B	8.6	4%	12%
<b>Texas Instruments</b>	A-	12.0	16%	11%
Virpharma	D	20.1	16%	27%
MEMC Electronics	C	15.2	26%	12%
World Acceptance	D	7.7	15%	9%
<b>Exxon Mobil</b>	A+	8.0	11%	10%
Zenith Insurance	C	7.2	18%	14%
<b>Averages:</b>		<b>10.3</b>	<b>14%</b>	<b>19%</b>

**Sommers Financial Management's  
Conservative INCOME Stock Portfolio**

Company Name	Risk Grade	P/E Ratio	Div. Yield	Ret. on Equity
Accenture	A+	12.3	1.0%	60%
Allied Irish Banks	C	4.8	9.6%	20%
Colgate-Palmolive	A+	15.6	2.3%	76%
ConocoPhillips	A-	6.9	2.0%	14%
Chevron-Texaco	A-	8.1	2.6%	24%
<b>Federated Investors</b>	B	11.4	2.7%	36%
IBM	A-	12.0	1.7%	33%
Intel	A-	14.0	2.6%	17%
Johnson & Johnson	A+	13.2	2.9%	25%
Kellogg's	A-	13.2	2.6%	46%
Eli Lilly	B	11.4	4.1%	24%
McGraw-Hill Publishing	B	10.8	2.2%	46%
3M	B	10.9	2.9%	30%
<b>Microsoft</b>	A+	13.0	1.6%	35%
<b>Nokia</b>	A-	8.5	3.2%	39%
Novartis	A-	15.5	2.7%	18%
Southern Copper	B	10.2	6.3%	51%
Pepsi	A-	20.6	3.3%	27%
<b>Pfizer</b>	B	8.6	7.3%	11%
Proctor & Gamble	A-	14.3	2.6%	16%
Qualcomm	A-	21.5	1.4%	20%
<b>Texas Instruments</b>	A-	12.0	1.4%	28%
US Tobacco	A-	12.5	4.6%	199%
<b>Exxon Mobil</b>	A+	8.0	1.8%	33%
Yum Brands	A-	16.4	2.1%	151%
<b>Averages:</b>		<b>12.2</b>	<b>3.1%</b>	<b>43%</b>

**Sommers Financial Management's  
ORIGINAL "Model 25" Stock Portfolio**

Company Name	Value Grade	Cash Flow	Risk Grade	Market Cap
Accenture	C	B-	A+	Large
Actions Semiconductor	A	A+	D	Micro
American Eagle Outfitters	A	B	C	Small
Allied Irish Banks	A+	A	C	Mid
Boeing	A-	C	B	Large
Franklin Resources	C	B+	B	Mid
Biovail	A	A-	D	Small
Colgate-Palmolive	C	B	A+	Large
ConocoPhillips	A	D	A-	Mega
Chevron-Texaco	A-	C	A-	Mega
Syneron Medical	B-	A+	C	Micro
<b>Federated Investors</b>	B	A	B	Small
Graco	C	A-	B	Small
Intel	C	B	A-	Large
Johnson & Johnson	C	C	A+	Mega
McGraw-Hill Publishing	C	B	B	Mid
3M	B	C	B	Large
<b>Microsoft</b>	C	A-	A+	Mega
<b>Nokia</b>	A	C	A-	Mega
Occidental Petroleum	B	B	B	Large
<b>Pfizer</b>	B+	C	B	Mega
<b>Texas Instruments</b>	B	B+	A-	Large
US Tobacco	D	A	A-	Mid
<b>Exxon Mobil</b>	A-	C	A+	Mega
Zenith Insurance	A	B-	C	Small

**Commentary and Ramblings  
By Adam Sommers**

As of June 30, 2008 the Original Model Portfolio has experienced its first drop in value over a 12-month period since its inception in June of 2003. While disappointed, I must admit I'm extremely pleased (Mike Tyson would say 'ecstatic') with the Portfolio's five year track record, averaging nearly 19% annual growth, having grown from \$200,000 to more than \$390,000 today. This brings me to an important point: **If you look at the return on any investment over a short period of time, you may not get an accurate representation of the potential return of holding that asset for a longer period of time.**

"Recency" and "backward thinking" are two terms I've read about recently that describe some of the challenges investment advisors like me face every day. Recency comes from an investor's feeling that because a stock has fallen over the past year, it will likely continue to fall, and vice versa. Backward thinking comes into play because investors inevitably like stocks most after periods of strong performance—precisely when valuations are likely bloated—and they like stocks least after periods of declining markets. Studies from the academic field of behavioral finance have shown that these biases lead to decision errors.

Fortunately, investment advisors are hired by investors to help them through these emotional whipsaws and avoid the age-old problem of buying high and selling low—precisely the opposite of what we all aim to do when we invest our hard-earned (and weakening globally) dollars. We as investors should look to take advantage of the bargains available at times like these, while stock prices are down. If you read last quarter's feature article, you'll recall that I relish buying things on sale.

The best and most successful method used to combat these emotional whipsaws is to create—and then stick with—an investment strategy based on your goals, no matter what "noise" the market makes. Warren Buffett might be right in predicting a recession in 2008. But does that mean you should reduce your exposure to stocks, or has the market already priced in that scenario? Ideally, we make investment decisions recognizing that market events may play out differently than anyone could have predicted.

Also key in investing is looking at the fundamentals. There are macro issues that fundamentally affect the markets, such as tax rates, politics, gas prices, etcetera. But many of these things constantly change, and reacting to short term changes or speculation is the result of backward thinking. I feel that micro-fundamentals are much easier to monitor, predict, and use as a basis for decision making.

Those micro-fundamentals are what helps to drive the grading system and the make-up of the Model Portfolio. The Portfolio is always fully invested, and does not "raise cash" in reaction to macro-economic changes or backward thinking. I raise this issue because **since June 1st of 2003—even with a war, an election, a hurricane, and the doubling of oil & gas prices—the Model Portfolio experienced a nearly 19% annual return.** So...what kind of emotional reaction does 19% per year create?

**SFM AGGRESSIVE Stock Portfolio vs.**

**Relevant Benchmarks**

	SFM Aggressive	Russell 2000 Index	Nasdaq Index
3 Month Return:	- 0.6 %	0.0 %	0.6 %
12 Month Return:	- 20.0 %	- 17.3 %	- 11.9 %
3 Year Average Annual:	N/A	2.6 %	3.8 %
5 Year Average Annual:	N/A	10.8 %	8.3 %
ROR Since 4/1/2007:	- 10.2 %	- 11.1 %	- 4.2 %

**SFM Conservative INCOME Stock Portfolio vs.**

**A Relevant Benchmark**

	SFM Income	Dow Jones Industrial Avg.
3 Month Return:	- 3.4 %	- 7.4 %
12 Month Return:	- 11.6 %	- 15.4 %
3 Year Average Annual:	N/A	3.5 %
5 Year Average Annual:	N/A	5.3 %
ROR Since 4/1/2007:	- 4.9 %	- 6.5 %

**SFM ORIGINAL Model "25" Portfolio vs.**

**A Relevant Benchmark**

	SFM Model 25	S&P 500 Index
3 Month Return:	- 5.3 %	- 3.2 %
12 Month Return:	- 13.0 %	- 14.9 %
3 Year Average Annual:	5.6 %	2.5 %
5 Year Average Annual:	15.9 %	6.3 %
ROR Since 6/1/2003:	18.6 %	6.4 %