Financial Common Sense

ROCKBRIDGE INVESTMENT MANAGEMENT, LLC

January 2011

Craig A. Buckhout
CFA

Anthony R. Farella
CFP®, AIF®

Rockbridge Investment Management is a group of like-minded professionals working with a select group of clients with whom we can have a significant impact. Everything we do is focused on building and preserving wealth for our clients. We help remove complexity so clients can focus on the simple but difficult process of successful investing.

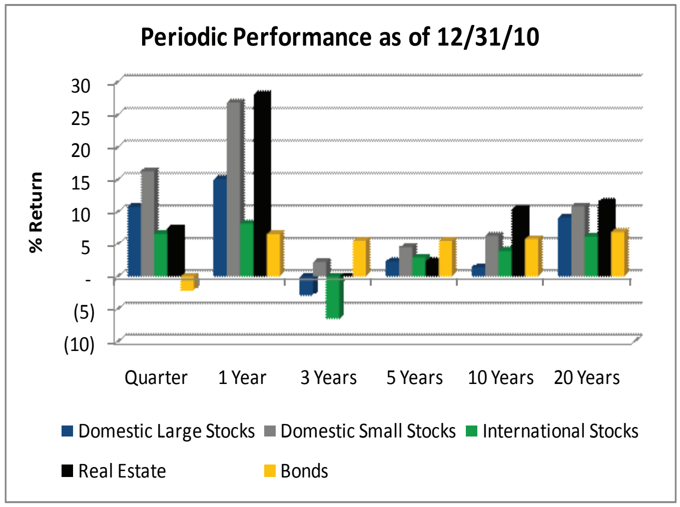
Rockbridge Investment Management, LLC

101 South Salina Street
Suite 400
Syracuse, NY 13202

Phone: 315-671-0588
1-888-689-2351
Fax: 315-671-0589

Market Commentary by Craig Buckhout

Capital Market Recap
Equity markets finished the year with a flourish. In the fourth quarter the S&P 500 was up 10.8%, small stocks (Russell 2000) were even stronger with 16.3% returns, while the international markets (EAFE up 6.7%) were held back by sovereign debt worries and uneven economic growth.



For the year, the story was similar. All markets had strong positive results, led by small company stocks, real estate, and emerging markets, with returns in the 20-30% range. Only developed international markets were at or below long-term expected returns.

Notably, intermediate term bonds lost money in the quarter as interest rates rose, but bonds did well over the year, with returns of 6.6%. A drop in interest rates increased the value of bonds during the first three quarters of the year, adding significantly to interest

(Continued on page 2)

Top 4 Investment Resolutions for the New Year by Anthony Farella

At the start of each new year, many of us make resolutions to improve our lifestyles. It's a natural time to take stock of the past year and look to make some beneficial changes for the future. Tops on most lists are shedding pounds, getting fit, quitting bad habits, or learning something new.

In this spirit I've come up with my top 4 investment resolutions for 2011.

1) Ignore economic forecasts
We are constantly bombarded with contradictory economic predictions. Markets are forward looking and incorporate all known information into a security's price. Generally good economic news, such as we see now, has already been incorporated into prices. Therefore, only surprises matter to the markets. Good surprises and bad surprises are the biggest drivers of security prices. The surprising information is instantly reflected in the next day's prices. By definition, surprises cannot be forecasted, making it impossible to make bets that pay off ahead of time.

(Continued on page 4)

Market Commentary (cont.)

payments (yield). Falling rates have left the intermediate bond index with a yield of 3% or less, meaning rates will need to fall further for bond returns to exceed that level in the short term.

Three Reasons to Ignore Performance When Making Asset Allocation Decisions
Portfolio risk is determined by asset allocation, primarily the basic split between fixed income (cash and bonds) versus equities (small, large, and international stocks). Risk is inextricably linked to return, but performance data can blur our rational analysis of risk. Here are three reasons we should try to ignore performance data when determining our asset allocation.

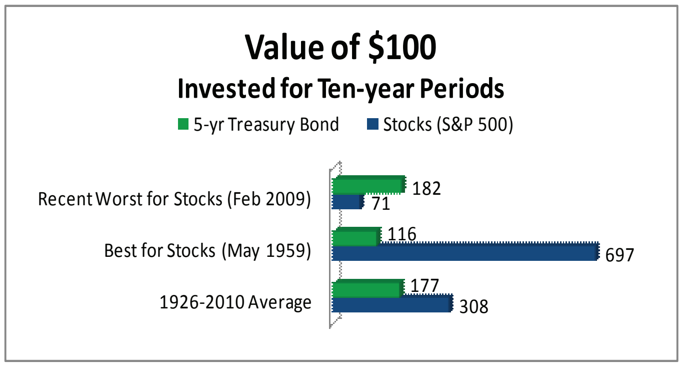
1) Recency bias – Studies have shown that we tend to give disproportionate prominence to recent observations. In the early 1990's we were busy telling people they should be willing to take stock market risk and get over the fact that bonds had outperformed stocks for much of the 70's and 80's. By 2000 everyone wanted to own technology stocks and we were busy telling people they should include bonds in every portfolio. In 2009 we were back to talking about maintaining a commitment to stocks.

Mark Twain said that history does not repeat itself, but it does rhyme. We need to be prepared for the rhyme and not base decisions on our recent experience that "feels" like a long-term trend.

> ***"History doesn't repeat itself, but it does rhyme."***
> *– Mark Twain*

2) The long-term can be very long – Bonds have outperformed stocks over the past ten years. This is contrary to long-term expectations. It is unusual but not unprecedented. In other periods of similarly dismal stock performance, the same thing happened. Bonds (5-year US bonds) outperformed stocks (S&P 500) for ten-year periods ending 1938-41, again in 1974-83, and now 2008 to the present.

I can't remember what I had for breakfast, say nothing of how my portfolio was behaving ten years ago. For most of us, ten years is a very long time, and yet market performance can be very far afield of our expectations over any ten-year period. On average since 1926, stocks have provided an annual return of 11.9% ($100 grew to $308) and bonds have returned 5.9% ($100 grew to $177). However, the ten-year period ending May 1959 was the best for stocks, when $100 grew to $697 (compared to $116 for bonds). These results are in contrast to the period ending February 2009 when $100 invested in stocks ten years earlier was worth only $71 while $100 in bonds grew to $182. The chart below shows how much these returns can vary for a particular ten-year period.



3) It is difficult to make money predicting how the market will react to current conditions – One year ago it seemed inevitable that interest rates would rise and destroy bond values. It may still happen at some point in the future but the opposite occurred in 2010 – a costly error for anyone acting on that prediction last year. Similar examples are easy to find.

Conclusion – Ignore performance to make better decisions. Think of the asset allocation decision in terms of managing risk, and do not let your return expectations (long-term future expectations) be influenced by recency bias, a misperception of what is long term, or the tempting notion that someone can predict how markets will react to our current situation.◆

Patrick E. Rohe
CRPC®

The Results Are In - Active vs. Passive
by Patrick Rohe

Most investors track the direction of the financial market by checking where the S&P 500 or Dow Jones Industrial Average finishes on a daily basis in their local paper. Some days they were pleased with what they saw and others not, but as a whole 2010 left most investors optimistic about the direction of their retirement portfolios. However, most people forget to check how their portfolio returns did relative to these numbers, and if they had, might think of changing advisors as a New Year's resolution as well.

In 2010, a mere 25% of active managers beat their respective benchmarks, with many active managers calling it the "toughest year on record." High correlations between stocks, low spreads on returns, and tough economic times were their reasons for underperformance. Nowhere did they mention that either high costs or lack of ability could have played into their lacking returns. Better yet, only two-thirds of active managers plan to beat the S&P 500 next year, which leaves me wondering what the other third plan on getting paid for while going to work each day?

Upton Sinclair once said that "it's amazing how difficult it is for a man to understand something if he's paid a small fortune not to understand it," and this seems to be the case with active management as well. The latest data from Standard and Poor's shows that active managers continue to underperform and at a rate that is far worse than chance.

This underperformance by active managers is not unique to 2010, yet instead, it only gets worse when you look at it over the long run. For the five years ending September 2010, only 4.1% of large-cap funds, 3.8% of mid-cap funds, and 4.6% of small-cap funds maintained a top-half ranking over five consecutive 12-month periods. Statistically, 6.25% of funds would fit this criteria, assuming a 50% chance of falling into the top half each year.

This shows that not only have active managers underperformed their respective benchmarks in 2010, but that you have a better chance of picking which one will outperform its peers over a five-year period by blindly drawing a name from a hat!

So as you look back over 2010 and plan for another year, do yourself a favor and review your retirement portfolio. It's more important than you might think and can make a drastic impact on the way you spend your retirement years. No individual wants to pay a premium for the likelihood of underperforming market returns, yet a majority of the populations does.

Take a moment this New Year and make sure you are not just following the crowd. Though, for current Rockbridge clients, you can cross this one off and move to the next thing on your list of resolutions! ◆

> ***"It's amazing how difficult it is for a man to understand something if he's paid a small fortune not to understand it . . ."***
> *– Upton Sinclair, Pulitzer Prize-winning American author who wrote over 90 books, most notably the 1906 novel "The Jungle"*

Top 4 Investment Resolutions for the New Year (cont.)

2) Keep bonds in your portfolio
I've recently fielded many calls from clients who are worried about predictions that bonds are poised for collapse. Bonds have outperformed stocks over the past ten years, which is unusual but not unprecedented. As interest rates rise, the value of your bond holdings will go down. However, over the long run, bond returns are predominantly determined by the interest payments generated from holding the bond. Additionally, the primary reason to hold bonds is to reduce risk in the overall portfolio that includes much riskier stocks.

3) Revisit your asset allocation
The new year is also a good time to review your investment plan. Ask yourself a few important questions: Have my long-term financial goals changed? Is my time horizon different? Has my ability, willingness or need to take risk changed? If you answered yes to one of these questions, then it may be appropriate to revisit your current asset allocation. Making changes to a portfolio based on short-term market disruption is almost always a bad idea. However, reallocating your portfolio based on rational changes to your situation should be done at any time the need arises.

4) Control the controllable, ignore the rest
It's easy to say, but hard to do. The highest probability of investment success comes from 3 important factors:

- Understand Risk: Determining asset allocation based exclusively on your need, willingness and ability to take risk.
- Control Costs: The use of low-cost passively managed mutual funds that match the return of the various markets will result in more money in your pocket at the end of the day.
- Diversify: Incorporating various asset classes into an investment plan reduces overall portfolio risk for a given level of expected return.

The value of an investment advisor is to help you understand these factors for investment success and provide the discipline to carry out the plan, often in opposition to conventional wisdom.◆

Returns from Various Markets

The following table shows the returns from various markets over periods ending December 31, 2010:

Market/Asset Class	Quarter	1 Year	3 Years	5 Years	10 Years	20 Years
Money market	0.0%	0.1%	0.8%	2.4%	2.4%	3.7%
Bond market	-2.2%	6.6%	5.6%	5.6%	5.8%	6.9%
Large-cap stock market	10.8%	15.1%	-2.9%	2.3%	1.4%	9.1%
Small-cap stock market	16.3%	26.9%	2.2%	4.5%	6.3%	10.8%
International equity market	6.7%	8.2%	-6.5%	2.9%	3.9%	6.2%
Inflation	0.2%	1.1%	1.3%	2.1%	2.3%	2.5%

Market Benchmark Portfolios

The following table shows returns from our market benchmarks over periods ending December 31, 2010:

Benchmark	Quarter	1 Year	3 Years	5 Years	10 Years	20 Years
Capital preservation	-0.1%	4.8%	2.8%	4.0%	4.0%	5.5%
Conservative	2.0%	8.1%	2.7%	4.4%	4.5%	7.1%
Moderate	4.1%	11.2%	2.1%	4.6%	4.8%	8.2%
Aggressive	6.6%	12.8%	0.3%	4.0%	4.2%	8.5%
All equity	10.1%	14.4%	-2.7%	2.8%	3.4%	8.7%

Note: These results were developed by simulating past returns in the various markets included in each benchmark, assuming the reinvestment of dividends and other earnings and deductions of costs totaling 0.20%. The money market is represented by 90-Day Treasury Bills; the bond market by the Barclays Capital Government/Credit Bond Index; the domestic large cap market by the S&P 500; the domestic small cap market by the Russell 2000 Index; and the international equity market by the EAFE Index. This data is presented to show the long-term relationship between returns at various levels of investment risk. It is not intended to present performance results experienced by clients of Rockbridge Investment Management, but is intended to provide a benchmark against which actual performance might be judged. Also, readers should recognize that future investments would be made under different economic conditions. It should not be assumed that future investors would experience returns, if any, comparable to those shown above. The information given is historic and should not be taken as any indication of future investment results.