INVESTMENT LETTER

A PUBLICATION OF CALDWELL TRUST COMPANY

MARKET SNAPSHOT: JUNE 29, 2007 DJIA: 13,408 NASDAQ: 2,603 S&P 500: 1,503 10 YEAR TREASURY NOTE: 5.03%

HEDGING FACTS

The purpose of this month's Letter is to introduce a new, often misunderstood subject: hedging. While many equate the term "hedge fund" with highrisk, new hedging techniques allow Caldwell Trust Company to utilize these methods, if needed, while faithfully fulfilling its fiduciary responsibility.

As generally defined in law, a fiduciary is …
anyone who, serving for compensation under an agreement or contract, consents to act on behalf of another person to manage, possess, or invest assets while holding discretion to do that which is best and unequivocally in the sole interest of that other person's private or financial affairs, or for that person's named beneficiaries.

Hedge funds: background

The term "hedge fund" has been mentioned so often that it is hard to imagine anyone missing it, even the most casual news reader or viewer. Because of the history that only "speculators" buy and sell on margin or use these types of non-traditional market products, the term "hedge" has become almost synonymous with taking higher risks. Obviously, it is very possible to invest in securities to do just that. The role of a fiduciary, however, requires the opposite approach.

Volatility and risk

Hedge funds are like most managed funds run by professionals, but with a significant difference: unlike mutual funds, hedge funds can and do borrow money to invest for their shareholders or partners. They also escape much of the closer regulatory scrutiny that conventional funds endure.

The goal of hedge funds is to produce superior investment returns by trading more actively, taking more risks and leveraging their returns with the additional borrowed monies. Obviously, because of the higher risks they take, returns are volatile—sometimes much higher and sometimes negative—compared with returns earned from more conventional funds or through more traditional investments in publicly traded securities.

Fiduciary responsibility

High risk has long been considered a cardinal sin for trust service providers like Caldwell Trust Company. Most fiduciaries have stayed with the practice of investing client wealth by buying and holding traditional stocks and bonds. In fact, one of the highest goals for a true fiduciary is, and forever has been, to seek to earn the highest investment returns possible for clients by taking the lowest possible risks. In addition, determining a client's risk/reward tolerance and attaining the appropriate level of risk versus reward for that client should remain the first priority for a fiduciary before undertaking to manage his or her portfolio.

New ways to reduce risk

That said, it is necessary to explain, if only briefly, how it is possible today to actually reduce a portfolio's exposure to unforeseen stock price declines by employing "hedging" techniques that were unavailable to most of us until just a year or so ago.

It is understandable that reducing risk while still holding all existing portfolio security positions probably seems odd to clients and fiduciary managers alike—and too good to be true. Nonetheless, this is exactly the case, thanks to new "hedging" investment vehicles never before available to private investors.

Most of these investment securi-

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ties recently introduced into the marketplace are similar to the often-discussed Exchange-Traded Funds. ETFs are like mutual funds except that, until recently, they were unmanaged and simply invested to reflect some particular investment area of interest.

The first ETF started as an "index fund" mimicked the S&P 500 average, a common measure of the broader stock market. That index fund enabled smaller investors to buy one share of a stock that held an interest in all 500 S&P stocks. That gave each investor a widely diversified exposure to the stock market that both reduced risk and eliminated the need to pick individual stocks.

The S&P500 Index ETF (Symbol: SPY) is the largest ETF in existence today because of its popularity and obvious attraction. Further, the fund's expense ratio is so low as to be nearly insignificant.

New hedge fund securities created recently resemble the traditional ETFs but differ in one unique way. Unlike funds that seek to match the moves of the broad market, the new hedge funds are managed so as to have the market price of their fund shares move as closely as possible in the *exact opposite direction* of the broad market itself. In simplest terms, if the S&P market average goes up 2%, the hedged S&P500 ETF (Symbol: SH) fund will fall 2%.

While each new hedge security has its own characteristics, those that most closely match an exact opposite stock market relationship are going to be the easiest to understand and probably will become the most popular with managers, and even fiduciaries, as they begin to be acquired—as they surely will—in conservative client portfolios.

CONCLUSION

Caldwell Trust Company remains optimistic about the prospects for stocks. However, for those investors who wanted to take a little profit or lessen their exposure with these recent market highs, prior to the advent of these new ETFs, the only recourse for the average investor was to sell stocks and pay the capital gains tax. Now that same investor can use the new ETF funds to hedge: he or she simply acquire shares of a fund to "immunize" some portion of the stock portfolio against price declines.

The big question for concerned investors is deciding what percentage of one's stock portfolio to protect. Remember that nothing in the world of investing is a free ride. Roland Caldwell, founder of Caldwell Trust Company, reminds us that "perfection is the enemy of investment success."

When hedging a portfolio, the percentage chosen means that if the market continues to rise, the hedge will produce the exact opposite percentage fall in value so as to immunize against price changes both up and down.

Those who are not concerned about general market volatility as the market reaches its new highs can share Caldwell Trust Company's confidence that stocks are still the investment of choice.

On behalf of the entire Caldwell Trust Company family, we send our heartfelt wishes for a Happy July 4th Holiday and great summer.

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