



AMERICAN FINANCIAL ADVISORS, LLC

1st Quarter 2007

Market Perspective and Risk Tolerance

Every individual investor's perspective on the market – or any issue – will differ. The only way to discover true risk tolerance or aversion to risk is to see how you react when there's a quick or unexpected market decline like we had the last week of February.

Such was the case on Tuesday, February 27 with a 400 -500 point drop in the Dow during the course of the trading day. At the end of the week the major averages for 2007 were all in negative territory – except the International EAFE index – which was up ½%. European markets also dropped 3%.

For that week last month, the averages were down: DJIA -4.2%, S&P 500 -4.4%, NASDAQ -5.8%, Russell 2000 -6.2%, and the International MSCI EAFE -4.4%. Year-to-Date (YTD) in 2007 those same averages had yielded the following returns: DJIA --2.8%, S&P 500 --2.2%, NASDAQ --1.9%, Russell 2000 --1.6%, and the International MSCI EAFE +.05.

The drop on February 27th was fueled when investors awoke to discover the markets in China has lost 9% of their value overnight while we were sleeping. What the news reports didn't convey to investors was the markets in China gained 130% in the previous 12 months in 2006 and had gained an additional 13% during the first eight weeks of the New Year.

Adding fuel to the fire was former Fed Chairman Greenspan – who spoke at a business conference in Hong Kong on February 26 – the day before the meltdown. Greenspan mentioned a recession in 2007 was possible, but added a caveat that most forecasters were not anticipating a recession in 2007 and were indeed looking forward to 2008. Apparently the news media forgot to convey the 2nd half of his statement.

If you combine the above issues with a technical computer glitch, you have the makings of a panicked sell-off versus the underlying fundamentals that remain mostly positive. The computers that handle trades weren't keeping pace. This led to a sudden drop of 200 points between 2:55 and 3:05 – a ten minute window – as the computer systems caught back up with the volume. This also triggered computerized program selling.

How does last week's decline effect our perspective towards risk management and our client's portfolios?

At AFA we made a conscious and definitive choice to start using DFA funds in clients' portfolios back in 2001 as part of our equity strategy. We are now in our sixth year of the relationship with Dimensional. DFA assets have grown from \$60 billion to over \$123 billion in the past five years. This is due to entrusted entities like AFA, Boeing, Bellsouth, Kellogg's, Citigroup, Pepsi, and Pfizer - university

endowments including Stanford, Cornell, and Cal Tech – and states like Maryland, California, Utah, Oregon, Illinois, and Nebraska who feel comfortable and trust the professionals at Dimensional to manage their pension dollars.

During the past 5 years, well-diversified Dimensional Funds (DFA) have produced annual rates of return that range anywhere from 14-23%. Combining these DFA funds with other investment vehicles in your portfolios have provided our clients with a positive investment experience and helped us control overall risk inside the total portfolio mix.

Following is an excerpt from a 2006 Morningstar¹ report on index funds that speaks volumes:

*“Consider the success **Dimensional Fund Advisors (DFA)** has had in offering its funds through advisors who undergo training on the merits of passive investing and in portfolio construction theory. Consider that over the past decade the dollar weighted return of all index funds was just 79% of the time weighted return investors could have gotten with those funds. Yet, the figures for DFA are much better. In fact, the dollar-weighted returns of DFA funds over the past 10 years are actually higher than their time-weighted returns – suggesting advisors who use DFA encourage very smart behavior among their clients, buying more out of favor segments of the market and riding them up, rather than buying at the peak and riding the trend down, which is usually the case with fund investors.*”

Dollar versus Time Weighted Returns

	<u>10-year DWR%</u>	<u>10-year TWR%</u>
Dimensional Funds (DFA)	12.81%	12.37%
ALL Index Funds	7.06%	8.94%

You can control risk in a reasonable manner by staying well-diversified with a combination of stocks, bonds, REITs, cash, and other instruments inside your portfolio. Including the Dimensional Funds (DFA) as part of our overall strategy is giving our clients good returns with reasonable risk management – and lower fees. We feel this approach addresses many concerns investors face during their lifetime.

Tax Reports

In preparation for your 2006 tax returns, you will also find enclosed the applicable reports needed when completing your taxes. The original cost basis of your holdings may reflect the date and price of when your accounts came under management at American Financial Advisors, LLC. Please check your original trades to compare accurate gains and losses. These reports will help you with your tax planning. Please forward this information to your tax advisor to prepare your final returns for the year.