

Perspectives

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Understanding Independence

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As the memories of our 4th of July celebrations begin to fade, we as Americans do not let fade the true meaning of the day— independence.

Independence and the right to freedom of choice are critical to all aspects of our lives, including the business we conduct. At this time we should reflect on the importance of the independent nature of the businesses and advisors with whom we choose to engage.

Imagine a scenario in which you are working with an inexperienced, below-average, entry-level salesperson who was pressured to sell you products that would generate the most money for his firm regardless of whether or not it was necessarily in your best interest. Also imagine that this salesperson emerged from a sales training program and was expected to reach sales quotas and sell lucrative and high-commission proprietary products. If I asked you to guess this salesperson's profession, what would be your first guess? Car salesman? Telemarketer? Are these typically the people you seek out for advice or purchases? As you know, unfortunately there are salesmen in the financial services industry who meet this description, and independence is not part of their value propositions.

However, in cities and towns all across America, you will find independent financial advisors ready to deliver on what matters most: **trust**.

The concept of "trust" in delivering financial advice represents three very important ideas:

- Independent, objective and comprehensive advice;
- Solution independence; and
- Compensation transparency.

Independent, Objective and Comprehensive Advice

The majority of independent advisors (independent of proprietary products) offer truly comprehensive planning that goes beyond the normal focus of investments and highly commissioned solutions. Often, independent advisors are experienced tax or law professionals and can plan holistically, taking into consideration taxes, estate and retirement income planning, and many other strategies that are vital to maintaining financial health. In addition, they also have a number of outside independent resources they can access for specific areas of expertise.

Solution Independence

Independent advisors are not captive employees and therefore have the ability to offer investments from a wide range of providers. They have the freedom to choose solutions from the universe of companies that are designed to best meet their clients' needs and are not beholden to any proprietary products. Furthermore, the independence afforded in the selection of the appropriate solutions allows for the possible use of alternative investments that may further help diversify and mitigate volatility in their clients' portfolios.

Compensation Transparency

As self-employed small-business owners, independent advisors have the freedom to offer a variety of solutions and compensation models. This affords compensation transparency to find an agreeable pricing model that fits the needs of their clients.

It is an advisor's choice to become independent and the belief in this model flows through to the benefit of their clients.

Your local independent advisor, like the firm that gave you this copy of *Perspectives*, may not have the budget to advertise during the Super Bowl. He or she may not have the budget to remodel the office with the finest of furnishings or a luxurious upscale address, but in a time when honesty and transparency are lacking, isn't it refreshing to know someone is actually on your side? Isn't it refreshing to know that your advisor is as independent as you are?



Demystifying Hedge Funds

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What are hedge funds?

Hedge funds. Those two words have recently invoked an uneasy feeling in many investors. It seems that most investors feel that hedge funds are investments that should be left to those who can afford to lose all of their money in the market! Seemingly everyone wraps all alternative investments into this “black box” known as hedge funds. A hedge fund is an investment in various stocks and/or bonds that utilize different trading strategies that do not resemble those found in traditional stock and bond investments.

As the name implies, the basis of hedge funds are to hedge against some event. Only recently have certain hedge funds been used in a manner to try to increase risk, specifically through the use of leverage in efforts to enhance return. 1st Global’s stance on hedge funds falls in line with the traditional definition of hedge funds: Hedge funds serve a very important function. If chosen wisely and used appropriately, these instruments may help reduce the volatility of a portfolio while helping to compound portfolio returns over time.

What is a hedge fund of funds?

Simply put, a hedge fund of funds is a single fund that invests in multiple hedge funds. So what makes a fund of funds appealing? By purchasing a fund of funds, you are able to invest in a single instrument that provides access to a variety of hedge fund managers that normally manage money for only ultra-high-net-worth investors. Fund of funds also give you the ability to access several different hedge fund managers and strategies. This helps eliminate single manager risk as well as strategy risk.

What role do hedge funds play in a portfolio?

The primary role that hedge funds play in your portfolio is to mitigate risk. In traditional stock and bond investments, as the market moves up and down, so goes your portfolio value. This is because traditional investments only make money when prices go up. However, one of the strategies that hedge funds provide is the opportunity to “short” the market and remain “long” in stocks and/or bonds concurrently. This enables hedge funds to capitalize on both up and down markets, giving hedge funds a possible advantage because their returns are less dependent on market movement. By introducing hedge funds into your portfolio, you can mitigate some of the stock and bond volatility risk that your traditional stock and/or bond investments will experience. Hedge funds accomplish this through a set of trading strategies that behave differently from the traditional stock and/or bond investment trading strategies.

How do hedge funds benefit a portfolio?

As mentioned earlier, the primary benefit of hedge funds is risk mitigation; however, another possible benefit of including hedge funds in a portfolio is an increased compounding effect. By lowering the volatility of an investment, the effects of compounding may be

greater. Less volatility means a smoother return stream over time, allowing a portfolio to grow at a steady pace. By reducing volatility, a portfolio may recoup a downward movement in the market faster than one with higher volatility with respect to returns.

For example, let’s look at the HFRX Global Hedge Fund Index versus the S&P 500 returns for 2008 and 2009:

	2008 Return	2009 Return	2008-2009 Cumulative Return
HFRX GHFI	-23.25%	13.40%	-12.97%
S&P 500	-37.00%	26.46%	-20.33%

*For illustrative purposes only.

Regarding the illustration above, hedge funds are not guaranteed to have positive returns. They are designed to limit downside losses; however, they are not impervious to losses. By limiting the downside, there simply is less ground to make up when the markets rebound. While most investors focus on the upside potential of an investment, this chart shows the cumulative benefits of giving up some of the upside potential in exchange for greater downside protection and for better compounding of returns over time.

For more information about hedge funds, contact your independent financial advisor today.



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Investment advisory services offered through 1st Global Advisors, Inc.

Indices are unmanaged and cannot be purchased directly by investors. Past performance is not an indicator of future results.

Hedge funds are speculative investments and are not suitable for all investors, nor do they represent a complete investment program. The funds are only open to qualified investors who are comfortable with the substantial risks associated with investing in hedge funds. The funds investment program is speculative and entails substantial risks. Specific risks associated with underlying securities that populate the hedge funds in which the fund invest include: 1) Risks inherent in a investment in securities: loss of money, illiquidity, volatility; 2) Specific risks associated with limited liquidity: underlying securities may not be available to sell for long periods of time thus limiting exit strategies and redemptions; 3) The use of leverage: leverage compounds returns by adding exposure which can enhance performance but also exacerbate losses; 4) Short Sales: risks are illiquidity, use of leverage and unlimited loss potential; 5) Options and Futures: risks are volatility, illiquidity and substantial loss of money beyond initial investment; 6) Derivative Instruments: risks are volatility, illiquidity and substantial loss of money beyond initial investment; 7) Investments in non-U.S. securities: risks are illiquidity, currency fluctuations, lack of transparent management and geopolitical; 8) “Junk” bonds and illiquid investments: loss of money, inability to sell securities, legal issues, corporate malfeasance, bankruptcy proceedings and volatility otherwise not associated with bonds.

Investors should recognize that they will bear asset-based fees and expenses at the fund level and, indirectly, fees, expenses and performance-based compensation of the investment funds in which these funds invest. In addition, the overall performance of a fund of funds is dependent not only on the investment performance of individual managers, but also on the ability of the fund’s advisor to allocate the fund’s assets among such managers on an ongoing basis. Investors should understand that they will likely be required to obtain extensions of the filing date for their income tax return due to possible K-1 delays. Investors could lose some or all of their investment.