EQUITY **F**UND **O**UTLOOK

In the following pages you will find a description of the investment approach of **EQUITY FUND OUTLOOK**. In short, it is a "bottom-up" fund selection and upgrading process and does not rely on market timing. Fund ratings are based on mostly on reward potential, exposure to risk, and how the two compare. The measure of reward to risk we call the Investment Skill Quotient, or “ISQ”, and is a key feature in choosing the best managed funds. Another term used to describe the same thing is “efficiency”. The rating model also looks at expenses, the tax effects of distributions, and condition of trend lines. Investors attempt to maximize growth potential while not exceeding their overall risk ceiling through careful fund selection and portfolio building and upgrading as fund ratings change and attractive new funds become available.

Much of the discussion in the GUIDE is intended for investors who want to build and manage their own portfolios and like to understand the theory. But you can profitably use EFO by following the model portfolios, referring to the Wish List, or getting ideas from the commentary and fund tables. So, let the GUIDE help you understand, but don't let it get in the way of a pleasurable and profitable use of the monthly letters!

January 24, 2005

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FUND EVALUATION

Fund Classes

EFO assigns funds into two main categories, diversified and specialty. Both categories are further divided into comparable classes.

DIVERSIFIED FUNDS funds normally have at least thirty issues in a portfolio and attempt to spread the funds over several industries, with no special angle that restricts choice of stocks. They must have reasonably flexible investment policies. We strongly favor such funds and focus our coverage on them. They also are most useful for the investor using a market timing approach as they correlate better with the broad market and are more predictable.

Diversified funds are further divided into three classes according to risk exposure:

1 Higher Risk: Will likely grow substantially faster than the market in rising markets and decline more than the market in falling markets. Usually concentrated, may be leveraged, and usually specialize in small but rapidly growing companies. Average risk exposure rating is 16; the range is from 13 up.

2 Market or Average Risk: "Businessman's risk" type funds that will grow more than the market during rising periods and decline about average for the market during declining periods. Most growth fund investors use primarily these funds. Average risk exposure rating is 10; the range is from 8 to 13.

3 Lower Risk: Have more issues and larger firms in their portfolios than funds in other classes. Quality of holdings and yield is usually considered. They may not grow as much as the market in rising markets, but decline less than the market in declining markets. They are the best candidates for a buy-and-hold strategy. The average risk exposure is 7; the range is from 8 down.

SPECIALTY FUNDS require close consideration by the investor of the potential for that particular area of concentration. These funds are placed in the classes below:

4 Sector: All funds not considered diversified as described above and not falling into the four special categories below. Industry specialization funds are the largest component in this category.

5 Foreign Diversified: Funds investing abroad only, elsewhere called "international funds."

6 Regional: Funds that focus on a particular region or country other than the U.S. Regions followed are emerging markets, Europe, Pacific basin / Asian, Japan only, and Latin America. For Pacific and Asian funds the code xJ after its name means that it does not hold Japan issues.

7 Global: Funds that may invest anywhere in the world; sometimes known as "worldwide funds." This service treats global funds more of as especially flexible domestic diversified funds than as foreign funds.

8 Gold: EFO reports only performance as they are too little correlated to the domestic stock market for EFO ratings and other measurements to be useful.

Fund Coverage

Equity Fund Research follows most no-load and low-load (3% or less) growth funds. Equity Fund Outlook covers about 250 of the better-managed funds. The entire equity fund universe is constantly being watched for addition to the letter, especially new funds. *Suggestions are welcome*. In the commentary comparison is often made to the Wilshire 5000 Index, a very broad index of actively traded stocks on all exchanges. Performance of the index, when mentioned, always includes dividends; that is, the figure is a total return figure. The ticker symbol will be in parentheses after the name. Fund tickers are five characters and end in "X".

New fund announcements

Funds new to EFO or on the Watch List are provided with these items of information in parenthesis:

(telephone number / minimum investment requirement / brokerage availability / website).

Symbols for brokerage: fF Fidelity Brokerage, sS Charles Schwab, wW TDWaterhouse. Upper case means "no trading fee". Telephone numbers for brokers can be found on page 13.

Following this information the abbreviation for the fund and its family as shown in the tables is presented in brackets:

[c GRP Fund name] where c is the class, and GRP is the fund group name. The telephone number and address for groups are in the DIRECTORY.

Fund Ratings

The ratings are based primarily on the growth and risk measures. Other factors can increase or decrease the rating. Most of these factors are shown in the Fund Surveys. Each factor used in the ratings is discussed below and may be the subject of a regular or special report. For diversified funds the rating for a fund is based on its attractiveness to an investor of the corresponding class. That is, there is a slightly different model for each diversified class. Gold and sector funds are rated with the aggressive model. Diversified foreign stock funds are rated with the moderate risk model. All funds are benchmarked to the Vanguard Total Stock Market Index (VTSMX) fund, which reflects the Wilshire 5000 with dividends reinvested less the .20 expense ratio to run the fund. When all trend lines for the Wilshire 5000 Index are rising the rating for this fund is 75.

How to use ratings is discussed in Portfolio Management.

Rating Factors

Measurements of GROWTH POTENTIAL, RISK EXPOSURE and INVESTMENT SKILL QUOTIENT are the primary components of fund ratings. The third measure is simply the first divided by the second. Their use in the rating system is described below. The norm for all three measures is 10. Thus, the scores for all three measures for the Vanguard Total Stock Market Index are 10, as that fund is used as a proxy for the Wilshire 5000 Index with dividends.

Growth Potential

The object is this measure is to show how a fund changes compared to the market during rising market periods. ("The market" in this case is the Vanguard Total Stock Market Index fund. It consists of two elements: Relative performance during rising periods only, and relative performance over several fixed periods.

1) Relative performance during rising periods is figured for up to ten rising periods in the last three years. The average weighted relative gain is the primary ingredient of the Growth Potential value. Greater weighting is awarded according to recentness and length of the rising periods. A limit of twice the market is set to avoid misleadingly high relative performance for aggressive new funds in their first few months.

2) In figuring the overall rating for a fund, the above relative growth ratio, which is focused on up-market history, is considered along with relative performance over the last 78 weeks (aprox. one-and-a-half years) and 156 weeks (aprox. three years). For funds with less than 78 weeks of history the sole ingredient in figuring growth potential is average relative performance in rising periods in which the fund existed.

Growth potential values usually range from 6 (very week) to 18 (very strong).

Risk Exposure

Risk Exposure is a composite measure also consisting of three components:

1) An average of declines relative to the Vanguard Total Stock Market Index fund in up to six recent declining periods is computed, in the same way as in the growth measure above.

2) A comparison of the 36-month standard deviation of monthly returns of the fund to that of the S&P 500 index.

3) A comparison of the weighted average price/earnings ration of the fund's stocks to that in the Wilshire 5000 index.

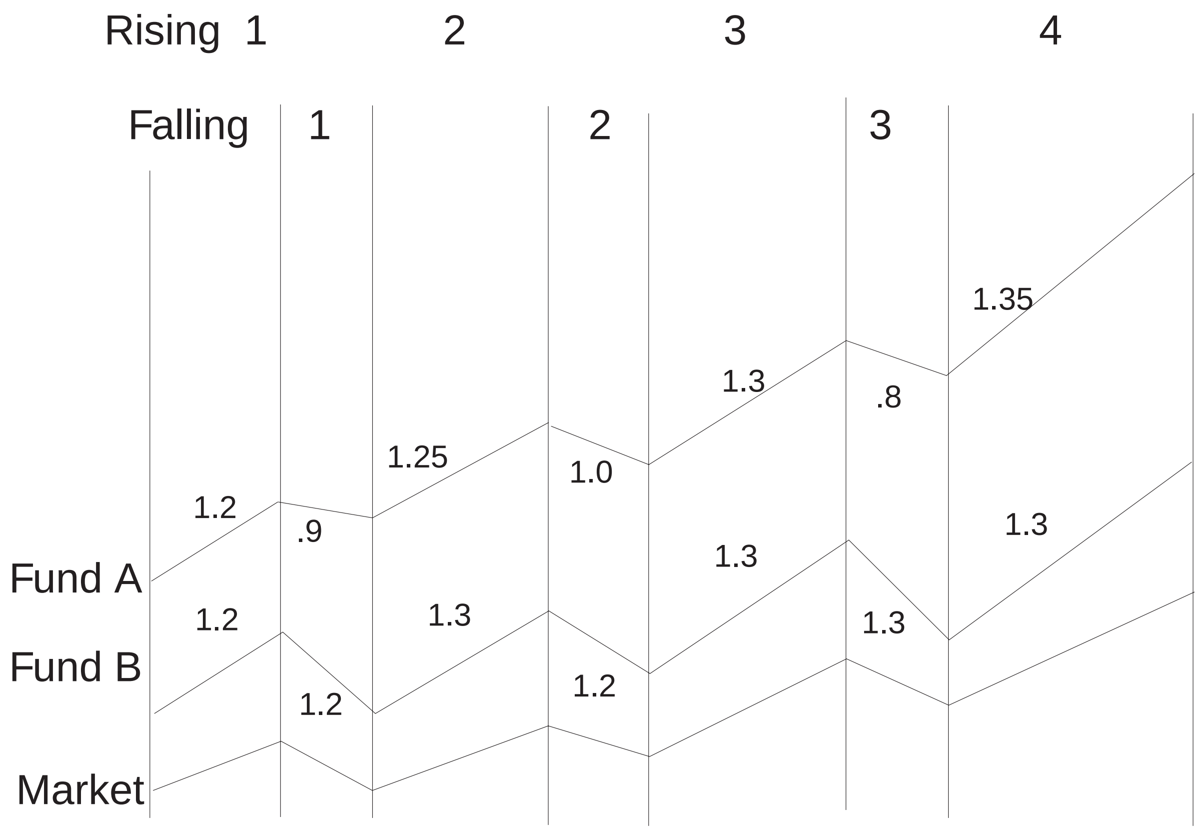
In figuring the overall rating for a fund risk is weighted more for conservative funds than aggressive funds.

The Risk Exposure for a portfolio can be figured by multiplying the percent of a holding in a portfolio by its risk rating and adding the results. Cash would be figured at zero risk. Or one could multiply each fund's risk exposure by the dollar value, add the sums, and divide by the total portfolio value, including cash. Weighted average risk for a portfolio provides a convenient way to manage a portfolio that forces out funds that have become too risky for the market environment.

Risk Exposure values usually range from 5 (very low risk) to 18 (very high risk).

Investment Skill Quotient (Reward/Risk Ratio) or ISQ

The chart illustrates EFO growth and risk concepts. The market during a hypothetical three-year period has been divided into segments of four rising and three declining periods. Above it are two funds that may appear at first glance to track each other closely. The average relative performance of the four rising periods is 1.28 for Fund A and Fund B, meaning that both funds have grown 28% more on average than the market in recent rising periods.



But Fund B falls much more during market declines. Its relative risk is 1.23 while that of Fund A is actually less than the market, giving an average relative risk of .9.

The final growth potential and risk exposure readings, of which the relative performance within market segments is a large part, could be utilized to figure a ratio of reward to risk. **The division of Growth Potential by Risk Exposure yields a useful measure of management skill.**

Assume that the other components of Growth Potential and Risk Exposure in this case did not change the figures. Fund B's reward/risk score would be 1.28 divided by 1.23, giving a neutral 1.04. On balance Fund B is not much "smarter" than the market.

But for Fund A the same calculation (1.28 / .9) gives us 1.42, suggesting that Fund A is about 40% more efficient in delivery of reward for its level of risk than the market. The manager is adding value beyond just that from above-market performance in rising markets.

The rational investor would prefer to own funds that, among several choices of equal growth potential in rising markets, would decline the least in falling markets. Or, to put it another way, among the funds that meet his risk tolerance, an investor would prefer those with the most growth potential.

The EFO Investment Skill Quotient (ISQ) is the EFO name for this measure. **ISQ is a key component in fund ratings and unique to EQUITY FUND OUTLOOK. ISQ values usually range from 5 (very inefficient) to 20 (very efficient).**

Load (Sales), Redemption and 12b-1 Charges, Tax Impact

Ratings are not adjusted for load or redemption charges. The investor must consider such charges separately. If a 12b-1 plan is in effect, a fund may charge existing shareholders a percentage of fund assets toward marketing costs EACH YEAR a fund is held. We penalize fund ratings for 12b-1 charges, as these affect all classes of shareholders.

Expense Ratio

This is the percent of total fund expenses to average total assets for the last fiscal year. This value includes the management fee and operational costs. While fund performance figures are net of expenses, an investor will fare better in a market downturn with a lower expense ratio. The rating is reduced directly by the expense ratio. Expense ratios for funds with less than one year's tend be high at first but decline as assets grow. The rating computed thus far is reduced by the expense ratio.

Tax Impact

Tax Impact is a percentage that an investor in the 35% marginal tax bracket would loose to federal taxes on average over the last two years from taxes on distributions. The second rating in the Fund Survey Reports (see below) reflects the tax impact value and is designed for taxable accounts. **When a rating appears in EFO without qualification it is the rating without any tax considerations. Sometimes this is referred to as the Tax-advantaged Rating or T/A Rating.**

Trendline downturns

Points are subtracted when the 13-, 26- or 39-week arithmetic or exponential trendlines turndown. If the fund otherwise has a high rating, initial downturns may not cause a sell rating, but in most cases when all six trendlines are down the rating will fall below 65, which means SELL. This part of the rating system is designed to limit losses. In bear markets all trendlines do turn down for many funds and ratings fall below 65.

(An exponential moving average assigns greater weights to more recent periods, so it changes more quickly than the corresponding arithmetic moving average for the same period.)

REPORTS

Fund Survey Reports

The Fund Survey Reports contain descriptive and analytical material on about 180 diversified funds and 60 specialized funds. All performance figures are true total return figures. That is, they reflect price change and income. We adjust for distributions in the same way that the fund does, using the actual price for reinvestment that the fund uses. Thus performance figures will reflect an investor's exact experience, assuming reinvestment of distributions is elected.

For fail-safe purposes a downturn in both the 39-week AND 13-week exponential and arithmetic moving averages accompanied by the price dropping more than 3% below its 39-week moving average will force a rating below 65 FOR THAT FUND. Some of the fields are explained below.

Class:

1 Higher-risk, 2 Market-risk, 3 Lower-risk, 4 Sector, 5 Foreign: geographically diversified,
6 Foreign: regional or one-country, 7 Global, 8 Precious metals (not always covered)

Fund names are preceded by group code as listed in the DIRECTORY. **A name in bold** indicates the fund is at a new high for the last 200 weeks. A "r" beside the name means the fund is closed to new investors; a "c" means it is closed to all investors.

Load charge**:** A number in this column is the percentage load, rounded to a single number. In some brokerage arrangements this may be waived.

Redemption fee: An **r** means the fund charges a fee on redemptions of shares held less than 90 days and an "R" for a fee on redemptions of shares held for less than a period greater than 90 days. The DIRECTORY shows the exact period.

Brokerage availability: lower case means trading fee is charged, UPPER CASE means no transaction fee. If a load is shown as well as brokerage availability in lower case, most times the load will be charged instead of the trading fee. In a few cases the load in waived but the trading fee is charged. Check with the brokerage before placing a buy.

F Fidelity Brokerage S Charles Schwab W TD Waterhouse

or **Purchase restrictions:** If a fund is closed to all purchases "**hard**" or "**soft**" will appear instead of load and brokerage items. Hard means the fund is closed to both new and additional investments; soft means that existing shareholders may add to their accounts but no new accounts will be set up. "**drct**" means that a fund that formerly could be bought at a brokerage must now be purchased directly. "**advs**" means this fund can be bought at fund supermarkets brokerages for clients of advisors but is not available retail or, if it is, not without a load or very high minimum.

Same Manager Since/Distribution Pattern Year current manager took over. A # means a distribution is probable before the end of this or the next month.

Distribution frequency:

Y yearly **M** monthly
S semi-annual **Q** quarterly

Tax impact: the percent of an investment lost to federal income taxes from distributions on an average annual basis in the last two years. Funds are required to pass their tax liabilities to shareholders. This means net income and capital gains must be distributed at least annually and are taxable. The calculation assumes a 35% marginal tax rate and a 15% long-term capital gain rate. The value in the Survey report is 10 times the percentage to show more precision in a tight space. This 1.5(%) shows as 15. (In issues before February 2005 it would have shown as 2 after rounding and values below 0.5 were not shown at all.)

For taxable accounts the lower the better. No flag means the fund in the last two years has paid no or very little distributions in the last two years. Newer funds with no distribution history will have no flag, so a blank tax-impact does not mean that fund might not someday prove to be tax inefficient. For taxable accounts, values of 10 or more suggest looking for choice. Since there is no way to predict the next capital gain distribution, Tax Impact can abruptly increase when a substantial distribution occurs at end of a good year before which there was a period of little or no distributions in a sustained poor market.

Expense ratio: Most recent annual expenses as a percentage of average total net assets for the past fiscal year.

Portfolio turnover rate: Annual, as a percentage of average total fund assets during the past fiscal year.

Performance and trend: Percentage change in value (total return) for the indicated period. Performance figures in bold are higher than for the Wilshire 5000 Index (with dividends) for the same period.

Performance figures are followed by moving average trendline indicators. The arrow ↑ shows the direction of the arithmetic moving average trend. If the exponential moving average trend is also in the same direction the arrow **↑** is shown in bold.

Portfolio Characteristics: Seven codes describe fund style and portfolio condition.

Capitalization of most firms in fund: L larger large, l smaller large, M larger mid, m smaller mid, S larger small, s smaller small, or A all-sizes

Stock Selection Style: How the manager picks stocks.

G earnings growth momentum, V value, B growth at a reasonable price (blend of G and V), I index based

Diversification: how many securities in the portfolio, as of last report.

a under 30 issues, b 30-49, c 50 - 79, d 80 - 119, e 120 or more issues

Concentration: Pct of assets in top ten holdings; larger percentages can help a good stock picker outperform the market.

a over 50 pct, b 40-49 pct, c 30-39 pct, d 20-29 pct, e under 20 pct

Cash position: A high cash position can be a drag on performance in rising markets. The flags are as of last financial report.

no flag: 5% or less in cash, ¢ 6 to 15% in cash, $ over 15% in cash, \ leveraged (portfolio is borrowing money to invest)

Market correlation: Two columns, each a measure of how closely a fund tracks within the last twelve month to 1) the NYSE Composite Index, and 2) the NASDAQ OTC Composite. A "-" means a negative correlation; positive correlation from 0 to 9 where 0 is nil and 9 is very close.

Total net assets: Generally, the larger a fund the harder is to manage, especially for small-cap funds.

A -TNA under $100 million; B -$100 to $249 million C -$250 to $499 million; D -$500 to $999 million; E -over $1 billion. If no information is available a space will appear.

Three Sector Weightings: A measure of the portion of the portfolio that is in financial services, healthcare + biotech, and technology: from 0 for nil or very low to 9 for very high. (In issues prior to January, 2004 only the technology weighting is shown.)

Growth potential, **Risk Exposure, and Investment Skill Quotient (ISQ)**:

The norms for these measures are 10.

The higher the Growth Potential, the more a fund has risen relative to the market in rising periods. If Growth Potential has grown by more than 10% since the last issue, an up arrow will show after the current value. Likewise, a down arrow will show if it has fallen by more than 10%.

The lower the Risk Exposure, the less the fund has fallen relative to the market in declining periods. If risk exposure has fallen by more than 10% since the last issue, an up arrow will show after the current value. Likewise, a down arrow will show if risk exposure has grown by more than 10%.

Relative P/E is the fund price/earnings ratio compared with that of the Vanguard Total Market Fund, a proxy for the Wilshire 5000 comprehensive index of the market. The norm is also 10. Values higher than that show that the fund's holdings are comparatively pricey and suggest greater risk in a market decline. This measure is especially useful for newer funds where history of declines to measure are limited. "Price" is the stock price; "earnings" is earnings per share for the last twelve months.

ISQ is a measure of reward / risk and management skill computed by dividing Growth Potential by Risk Exposure, then multiplying the result by 10. Measures above 10 indicate a better than average relationship of relative rises in up-markets to relative declines in down markets.

Ratings: The first rating (T-A) is for Tax-advantaged accounts such as IRAs. The second rating (TAX, to the right of the /) is for taxable accounts and reflects the Tax Impact from distributions in the last two years. **If there were no distributions the ratings are the same**. Based on 75 as a norm, ratings are calculated for each fund based on its class. Values below 65 are SELL / AVOID signals; investor in TAX-ADVANTAGED portfolios should consider upgrading when a holding falls to below 70. A rating of at least 75 should be expected for new or additional buying, but 85 or higher is better.

Funds by Rating within Class Report

This report is found on the last pages and lists all funds in order of their current rating within class. Growth potential, risk exposure and Investment Skill Quotient are shown, with 10 as a norm. Also, a performance figure for a period not elsewhere shown.

The symbols below may appear between the class and fund family code:

^ Sales charge applies **$** Requires $10,000 or more as initial investment
a Asset allocation fund
b Balanced fund (bond and stocks) or stock fund that may use bonds as a defensive measure
d Must be purchased Directly from the fund; still listed with brokerages
h Closed to all new or additional investments ("'hard" close)
k Restricted to retirement plan accounts (IRA/Keogh)
R Redemption fee on shares held for some period over 90 days; **r** the period is 90 days or less.
s Closed to new investors; current shareholders may add $ ("soft" close)

After the fund name are capitalization and stock selection style codes:
L/l Large-cap **M/m** Mid-cap **S/s** Small-cap **A** All sizes companies considered

Small cap means assets under $2.0 billion; large cap means assets over $5 billion. If the cap code is in lower case the fund lies in the smaller half of its range.

G Earnings growth **B** Growth-at-a-reasonable price (blend) **V** Value **I** Index

Fund Charts

The fund charts in EFO are designed to make each chart as easily comparable to another as possible.

Descriptive material

The dollar value on the chart by the telephone number is the **minimum initial investment requirement**.

Telephone numbers: The national toll-free number (if any) and the local number are shown with the state postal code next to the local number. If a fund has an intrastate toll-free number it will be shown instead of the local number. Also, the **EFO class** is shown on this line.

Alpha and Beta: Alpha is a measure of how much better or worse a fund would do than the market when the market has a zero return. Funds with a positive alpha tend to have an efficiency ratio above 10. Beta is a ratio of performance relative to the market over the last four years. Thus a beta of 2.0 means that the fund would be expected to gain twice as much as the market when it rises and fall twice as much as the market when it declines. **R-squared** is a measure of how tight the fit is between the fund and the market. Values over .85 mean the alpha and beta are more useful. *If "alpha-adj" is shown, the alpha has been divided by the beta to show a sort of 3-year efficiency ratio*.

Chart components

On the left scale is the percent change from the first value on the chart. If a fund existed for 200 weeks, the effective annual compound growth rate over this period is shown on the right scale.

Funds are plotted with all distributions reinvested. The **fund price line** is indexed to start on the same base line for each chart. This series is then plotted on a log scale. This way *each vertical distance reflects that same percentage change* Dates are shown on the bottom scale at 40-week intervals. The **39-week moving average** is plotted as a solid line. The **13-week moving average** is shown as a dashed line. Charts cover 200 weeks or about three years and ten months.

One way to check a fund for better-than-market performance is to compare change in the fund versus change in the market over the last 13 and 39 weeks. If it has started to underperform the market for some while it may be a sign that the fund is changing its colors for the worse. The **Relative-Strength Line** (RSL) starts with figuring the relative strength for a fund expressed as an average of the ratios of value now over that of 13 and 39 weeks ago. The same ratio is made for the Wilshire 5000 Index (with dividends) for each of the 200 weeks on the chart. To get the RSL all 200 weeks of fund average 13- and 39-week relatives are divided by the same ratios for the market for each week.

Interpretation

Generally, an investor will want to buy funds only if its 39-week moving average (39WMAV) trend is rising and consider rotating to some better rate fund if the trendline showing this average turns down. Actual EFO fund buy/sell decisions are more complicated than that, but simple trend line analysis can tell the investor a good deal.

A **downturn in the 39-week moving average** could mean both it and its 39-week exponential moving average trend have turned down. Check the Fund Survey Listing for two down arrows by the 39-week percentage change where the second flag is the exponential moving average.

Smoothness of the trend line: A fund that is consistent and less volatile week-to-week is going to have a smooth trend line for most of its rising phase.

Proximity to 39-week trend line at end of corrections: Secondary corrections in bull markets tend to bring funds back down to their 39-week trend lines. Most aggressive funds will experience a drop a few percentage points below this trend line; moderate risk funds will meet the trend line and conservative funds will meet or stop just short of the trend line. During "tertiary" corrections funds will retreat to their 13-week moving averages in the same fashion according to type. Thus if a correction stalls at the 13-week area, it will likely not continue into a full secondary correction. If it moves decisively through the 13-week line, it likely will complete the corrective process and shake hands with its 39-week trendline not far in the future.

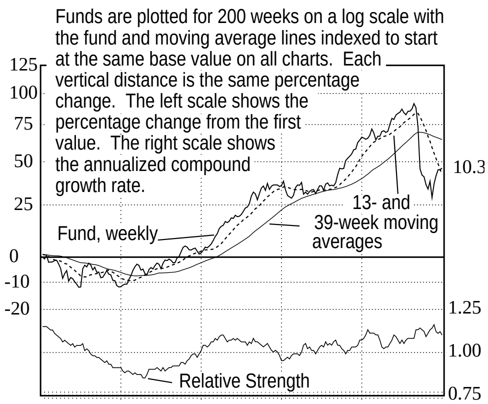
How a fund bottoms in corrections with respect to its trendlines is useful in classifying it according to risk and in predicting levels at which a fund can be expected to bottom during a correction already underway. And the more a fund tracks above its trend line during corrections the more efficient it generally is. That is the greater reward/risk ratio it offers, whatever its risk.

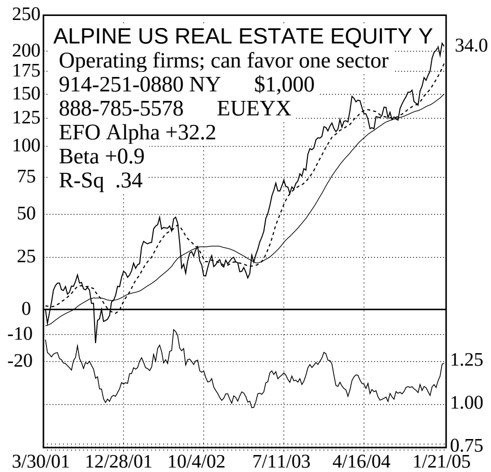
RSL patterns are useful as hints of meaningful changes. A fall below 1.0 is a signal to watch for possible trouble. An upward reversal may be a signal that a recovery is underway. Also watch for:

<u>High market correlation</u>: Lines that are parallel to the 1.0 base line most of the time move closely with the market even if they perform better or worse over a market cycle.

<u>Low market correlation:</u> Lines that extend widely in both directions from the baseline. High values can occur when a fund holds up well during a market correction or simply beats a rising market. Low values will be seen when a fund corrects more than the market or fails to rise as high as the market.

<u>Amount of time above 1.0</u>. The more time a fund's RSL is above 1.0 the better it is doing over 39 and 13 weeks. Look especially for breakouts above 1.0 after a long spell under it, and for fall-troughs after a period of higher-than-average performance. When a better performing fund's RSL falls below 1.0, it is a warning to watch ratings for a sell signal.





PORTFOLIO MANAGEMENT

SELF-DIRECTED PORTFOLIOS

Creating a Portfolio

The best portfolios are diversified as to market capitalization and stock selection style. A third each in large-, small- and mid-cap and growth, blend and value would be a base from which to start. Sometimes there are not enough highly rated funds to fill all slots, so overweighting of the winning cap/style funds may occur. (This service does not see geography is an essential part of the diversification picture.) No portfolio should exceed the investors risk ceiling. Depending on your investment horizon and temperament most investors could be described as aggressive, moderate (market risk) or conservative. The corresponding Risk Exposure ceilings would be 12.5, 10.0, and 7.5, more or less.

While building, or when reviewing your existing portfolio have an idea of its growth potential and risk exposure. For example, here is how to figure the weighted average risk exposure for the portfolio below.

SAMPLE PORTFOLIO

	SHARES HELD	DATE PURCH	CURRENT VALUE	PCT PORT	TOTAL RETURN	GRWTH	RISK	ISQ	T-A RAT
Money market fund	9,058.960	$9,059		13%					
Quest Discovery	491.932	5/26/94	$8,417	12%	+58.5%	11	11	11	90
General Mid Cap Stock	694.820	10/27/94	$9,866	14%	+38.0%	12	8	15	89
Atlantic Micro Cap	3,707.048	10/2/95	$10,676	15%	+7.1%	15	11	13	91
Pilgrim Blue Chip	555.447	12/4/95	$8,926	13%	+6.6%	10	7	16	88
Olympus Small/Mid Cap	561.315	12/18/95	$9,868	14%	+8.6%	12	8	14	87
Premier New Horizons	340.467	1/31/96	$7,177	10%	+2.5%	14	14	10	93
Avant Guard Index Value	405.186	2/6/96	$6,284	9%	+0.7%	10	6	17	84
PORTFOLIO VALUE			$70,273						

Wtd Avg Grwth Pot. 10.4 Risk Exposure 8.1 ISQ 12.8
Pct large cap 22 Pct mid cap 28 Pct small Cap 25
Pct growth style 37 Pct value style 23

1. The value of each position is multiplied by its risk rating. Those products are added up and divided by the total portfolio value, any cash included. Below is the workout for **weighted average risk exposure**.

	Value	Risk	value-wtd risk
Money market fund	9,059		
Quest Discovery	8,417	11	92,587
General Mid Cap Stock	9,866	8	78,928
Atlantic Micro Cap	10,676	11	117,436
Pilgrim Blue Chip	8,926	7	62,482
Olympus Small/Mid Cap	9,868	8	78,944
Premier New Horizons	7,177	14	100,478
Avant Guard Index Value	6,284	6	37,704
Sums	70,273		568,559

2. The sum of (value *x* risk) products; 568,559; is divided by the portfolio value; 70,273; to give the weighted average risk of 8.1. Risk for a money market fund is zero.

The same process can be used to compute **weighted average growth potential** by substituting the relative growth figures. For cash you could figure the growth potential by dividing the current yield from your money fund by 10, the annual long-term market return. But assigning zero to a temporary cash holding is normal shortcut.

The **Investment-skill Quotient** for the portfolio is computed by dividing the portfolio weighted average growth by the weighted average risk and multiplying the result by 10. *In doing the multiplications, one shortcut is to round values down to hundreds: that is 9,866 becomes 99 and the portfolio value becomes 703.*

Also shown are the percentages in each type of fund by stock selection style and mean market capitalization of stocks in the portfolio. A fund that invests in all sizes of companies is assumed to be equally invested in large-, mid- and small-cap stocks.

Action is implicitly suggested when the risk of your portfolio falls outside the low or high limits in the recommended risk exposure box. Ratings of funds and their growth potential and risk exposure measures can aid in selecting the course of action to upgrade your portfolio to get the maximum growth without exceeding your risk level. In making adjustments to a portfolio, the need for diversification and variety of styles should be considered in selecting new funds.

Action may be appropriate if a holding has done so well as to become more than 30% of a portfolio. Some profits should be taken and put into a highly-rated new fund or current holding that will support or improve on your intended allocation among capitalization and stock selection styles. Taxable accounts might have to wait until a big gain can be offset with some loss.

If you are uninvested, what to do is clear: choose your risk category and tentatively select the highest-rated funds in each class that will give you the best growth potential without exceeding your risk exposure maximum by 20%. The **WISH LIST** may help; it is a summary of the best choices as of publication date and is designed to help do-it-yourselfers get started. It is NOT a portfolio to be followed, but just a snapshot in time with no memory of past recommendations. If ratings permit improve your initial selections to avoid severe overweighting in growth, blend and value styles or large, mid and small-cap stock selection preference. All- or any-cap funds are considered by EFO as evenly divided among the three.

Adjusting a Portfolio

In each issue there will be a **Funds by Rating within Class** Report. This is a listing of all funds we track, except gold, in order of the primary rating, that is the rating for the same class of investor as the fund. Also shown is the risk rating for each fund so that one's portfolio **Weighted Average Risk** can be figured and adjustments made to align it with your risk preference.

If you have growth funds already you may or may not have to take any action. Compare the ratings of the best EFO funds and ratings of funds you own. The greater the spread the more likely you will want to upgrade your portfolio. If the risk of your portfolio is more than the maximum recommendation for your temperament, adjust your holdings to lower the risk level. If the WAR is under the lowest suggested level for your risk ceiling consider adding a fund with more growth potential to your holdings.

-Check Fund Ratings

If suggested allocation is close, check the rating of each fund you hold. Consider rotation to highly rated funds if any of your funds have ratings below 75 and definitely do rotate if any funds you own have ratings below 65. Tax-advantaged investors should be more fussy and sell if a rating falls below 70.

-Make your sells and buys.

If the transfer agent will wire redemption proceeds to your bank, ask them to do this in your letter. You can set up a money fund at a fund group in advance to hold redemption proceeds if you want to redeem in a hurry by phone. Then write a check for any new purchase. Always take advantage of any expedited redemption features on the application. Otherwise, if the fund requires written redemptions, keep several previously signed and signature-guaranteed letters on hand with the date and name of the fund left blank.

MODEL PORTFOLIOS

You may wish to follow a model portfolio instead. As with the do-it-yourself approach, build your version over a period of about two months, so as not to buy everything at a temporary high, and also to allow for changes in recommendations. Ideally, one would buy parts of each targeted acquisition each time, but buying the whole position in a different fund each time is doubtless more convenient and makes figuring cost basis easier for taxable accounts. **Getting to where your experience matches a model exactly can take up to year due to things such as redemption fees or early-sale fees on sells you make to get into sync.**

One disadvantage of following a model portfolio has to do with funds that close. Our policy is to replace immediately funds that are closed to new investors with the best available alternative. A reader owning the fund may have a good reason not to sell, so a disconnect can develop between the EFO and reader portfolio.

We recommend that readers wishing to follow model portfolios exactly use Schwab for the tax-advantaged accounts and both Schwab and TDWaterhouse for taxable accounts. TDW is a "90-day" shop, so if a fund is available in both houses, use TDW instead of Schwab to minimize the chance of being charged an exit fee to sell a no-trading-fee (NTF) fund held more than 90 but less than 180 days. Since Schwab is a more technically sophisticated and dependable environment and offers more load and boutique funds on a noload basis, we forgo the 90-day trading flexibility on the Tax-Advantaged account to keep assets at one custodian.

FUND MARKETPLACE BROKERS

Accutrade	800-882-4887	www.accutrade.com
Ameritrade	800-454-9272	www.ameritrade.com
Brown & Co.	800-822-2021	www.brownco.com
Charles Schwab	800-266-5623	www.schwab.com
E*Trade	800-786-2575	www.etrade.com
Fidelity	800-343-3548	www.fidelity.com
Scottrade	800-619-7283	www.scottrade.com
MSiebert	800-872-0711	www.msiebert.com
TDWaterhouse	800-233-3411	www.tdwaterhouse.com

For the Taxable Model Portfolio funds may be recommended that are in one of these firms but not the other. Therefore the best strategy is to have an account at both TDW and Schwab to fully follow this portfolio and take advantage of Wish List recommendations.

Other brokerages might work depending on the recommendations. But each have issues. Fidelity Brokerage is a 180-day shop and has additional trading restrictions based on number made in a span of time. And Fidelity doesn't have as many "boutique" and NTF load funds. Scottrade and Brown & Co. are cheap, but primitive in mechanics and reports. Scottrade also requires proceeds of a fund sale to "settle" before being available for buying. This could mean a delay of up to three market days. Brown charges only $5 per trade but may end your trading privileges if you sell NTF funds before 90 days.

The **TAX-ADVANTAGED PORTFOLIO** may experience a larger portfolio turnover than the Taxable Portfolio and it will be geared for investors mid-way between aggressive and market-risk. A Tax-Advantaged Model Portfolio recommendation will always be available at Schwab.

The **TAXABLE PORTFOLIO** is geared for market risk investors and will favor funds that will easier to hold for a longer period and have higher tax-efficiency. To get started, buy the funds not having imminent distributions, check for absence of a # flag in the Fund Survey, meaning a distribution in this or the next month was made in previous years. To be sure, call the fund to check for distribution plans. In three months you should be fully invested.

On rare occasions in the Taxable portfolio we might buy a fund that is not available at Schwab or TD Waterhouse. In this case a direct investment is assumed even if it is available at other brokerages. In this case the dates suggested for buys are based on the assumption that any telephone redemption privilege with wire or electronic funds transfer offered by the fund being sold was adopted by the investor. In such cases the delay between a sell and a buy will usually be one week. If a direct-buy fund is being sold that does not offer such a service, the delay between a sell and a buy will be assumed to be two weeks.

MODEL PORTFOLIO Statements: In the page 5 portfolio listings, Total Return is the total return of that fund since the initial purchase date.

ONLINE UPDATES: Subscribers HOTLINES by email which will contain a link to the website's download page from which the Interim Report (with HOTLINE) or the current or many past issues may be downloaded. Subscribers without email must call the HOTLINE to be aware of trades between issues or remember to check the website each week.

MARKET ANALYSIS

EFO is not a market timing service, but some thought as to what is going in the market is provided in "Market Indicators" box on page one. Your results will not suffer if you ignore this discussion entirely!

Market Risk Measures

Market Risk Measures are based on The **EFO Market Index:** A weighted average of the NYSE, AMEX and NASDAQ OTC composite indices designed to show broad market activity. The weightings are: NYSE 5/8, AMEX 1/8 AND OTC 1/4. This construct more closely parallels typical growth funds than any of the popular indices. Subsequent references to the "Index" mean the EFO Market Index.

- **Variance From Trend (VFT):** The percentage difference between the Index and its 39-week moving average. The higher the value when a correction starts, the more substantial the correction required to bring the market back to its 39-week trend line. Values over +16% can be points from which corrective activity can take place. In a rebound off a bear market, a bullish signal is confirmed when the VFT surpasses +4 and all three trendlines earlier had turned back up.
- **Near-term Risk (NTR):** An average of the sum of percent changes in the Index over the last 39 weeks (an "oscillator") and the VFT. The weights used in the average are 60% for the 39-week oscillator and 40% for the VFT. Readings over +20 suggest caution.
- **Long-Term Risk (LTR)**: (May not be shown) This is mostly a price change oscillator of 260 weeks (260WO) augmented by oscillator and variance measurements over 39 and 78 weeks. Thus Long-Term Risk incorporates four risk measures, the shortest of which is nine months and the longest of which is five years, the latter being the most important. Readings above +90 suggest a major top is near; readings below -20 suggest a major bottom is near.

Trend Indicators

- **13-week Moving Average** (13WMA): shows more recent trends.
- **39-week Moving Average** (39WMA): A simple arithmetic average of the Index for the last 39 weeks; usually changes direction once in a market cycle, but can sometimes give false sell signals when used alone.
- **39-week Exponential Moving Average** (39WXMA): Similar to above, but changes more smoothly and gives emphasis to more recent values; used as a confirmation of the 39WMA.

Other Indicators

- **Ratio of the S&P 500 to its dividends** or Price/Dividend Ratio (PDR). This is the inverse of the yield of the S&P 500, a value found in *Barron's* each week. Values higher than 35 used to suggest us that the market may be overvalued. Values below 10 have always marked bargain territory and alert us that market risk is low. This measure has not been very useful in recent years as high levels were ignored by a booming market and dividends are no longer as common.
- **Price / Earnings Ratio**: The P/E ratio is the S&P 500 Index divided by the weighted average earnings per share of the companies in the index. Measures above 30 suggest an overvalued market.
- **Percent of diversified funds with rising 39-week exponential trendlines**: Obviously the larger the better. There is no rule to call a bottom or top by this measure but it does give a picture of current direction.