

HEADWATER INVESTMENT CONSULTING, INC.

Registered Investment Advisor

INVESTING WITH DISCIPLINE

JUNE 30, 2010

Part 1 of 3 in a Special Article Series: Managing Risk

WIT & WISDOM

"If you know the enemy and know yourself, you need not fear the results of a hundred battles."

Sun Tzu, an ancient Chinese military general, strategist and philosopher, translated from his military treatise, *The Art of War*.

THE ART OF RISK

By Brian Lawrence, CFA

The above quote from the ancient writings of Sun Tzu is more than a timeless piece of guidance for generals. The book offers valuable insight into life and business that we are able to apply today as investment advisors, particularly in how we take risk on a client's behalf.

Determining how much risk to take with your investments is a difficult task. Yet this decision is perhaps the most important step down the path to a successful investing experience. Emotion and a lack of knowledge often complicates the process. Fortunately, there are ways to understand and address these challenges and answer the question, "What is my real risk tolerance?"

Know yourself

As Sun Tzu pointed out, knowledge of yourself and of your obstacles is very powerful. Regarding investments, this knowledge should start with an understanding of what you want to accomplish. What are your goals? "I want to make a lot of money" does not count. Retirement, college education, income generation, keep pace with inflation. These are examples of goals that allow for proper planning.

Once various goals are identified, a time horizon can be attached to them. The amount of time you have to invest, or time horizon, is crucial. Typically, the longer you have, the more risk you can take. If you are young and planning for retirement, loading up on risky

INDEX SCORE-CARD

QUARTERLY RETURNS

	1 st	2 nd
US Large Cap:	5.4%	-11.4%
US Small Cap:	8.8%	-9.9%
International Stocks:	0.9%	-14.0%
Emerging Markets:	2.1%	-9.1%
US Bonds:	1.8%	3.5%
Foreign Bonds:	-0.9%	-0.28%
REITs:	10.0%	-4.1%
Commodities:	-5.0%	-4.8%
TIPS:	-0.02%	3.8%
Treasury Bills:	0.03%	0.04%

1st Quarter for the period ending
3/31/2010

2nd Quarter for the period ending
6/30/2010

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THE ART OF RISK (CONTINUED)

investments is fine. If something goes wrong, you have time to make up losses as the market goes through its cycles. However, if you are in retirement and dependent on your investments for income, your situation is quite different and your portfolio should reflect a less risky mix of investments.

Understanding your goals and time horizons will get you a long way towards understanding the logical amount of risk to take. Most investors want to take reasonable risk for reasonable return to achieve their goals. Therein lies the art of risk. What is reasonable?

Our level of understanding impacts how we view the relative riskiness of an activity or investment. Some people like to rock climb, some people think it's crazy. The same holds true for investment risk. What is reasonable to one person may seem ridiculous to another based on differing perceptions and innate risk tolerances. With practice, a rock climber understands how the rope, harness, and other equipment work as a system to keep him safe. Such an understanding sets him free to literally scale mountains. Likewise, working with a trusted advisor and knowing your investment goals are keys to understanding your risk tolerance.



final chapters to the crisis have yet to be written, but the experiences of the last two years reinforce historical evidence regarding how dangerous it can be to make emotional decisions. March of 2009 was a bleak time for the economy. Little if any hope existed...and that is right when the stock market began a stunning rally.

Formulating a plan and writing it down is a straightforward way to counteract emotional decision-making. We call this plan an Investment Policy Statement (IPS). An IPS outlines your risk tolerance, investment goals and timeline for your investments. Also, it sets targets for how much you should hold in stocks, bonds, and other assets. The written plan provides you with a document that can be reviewed in times of stress, or adapted when life changes occur. An IPS provides a rational framework for decision-making.

Risk is very personal. You must be completely honest with yourself and your advisor about what kind of risk-taker you are at heart, and know that as you progress through life, your risk tolerance will change. Risk is tough to

define, yet accurately determining your risk tolerance is necessary to reach your investment objectives. Understanding your goals, time horizons, and innate riskiness helps you and your advisor reach your investment objectives.

Know the Enemy

One of the greatest enemies, or obstacles, to an investor is emotion. During the recent financial crisis, it was very easy to lose sight of investment goals; it was tempting to abandon rational investments. The

The Special Article Series: Managing Risk.

Part 1: The Art of Risk

Part 2: The Stock-Bond Decision

Part 3: Rebalancing Act

INDEX LIST

US Large Cap: S&P 500.

US Small Cap: Russell 2000.

International Stock: MSCI EAFE.

Emerging Markets: MSCI Emerging Markets Index.

US Bonds: Barclays Capital Aggregate Bond Index.

Foreign Bonds: Barclays Capital Global Aggregate Bond Index.

REITs: FTSE NAREIT Composite Index.

Commodities: Dow Jones UBS Commodity Index.

TIPS: Barclays Capital US Treasury Inflation Protected Securities Index.

Treasury Bills: Short-term government issued securities with maturities less than 90 days.

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