

Early Summer 2008

NAVIGATOR

The Newsletter for the Clients of TGS Financial Advisors

No Spherical Chickens

by James S. Hemphill, CFP® CLU ChFC CIMA

With the U.S. economy staggering toward recession, the global economy possibly close behind, and the Presidential election turning into a mud-slinging grunge-fest before the primaries are even through, I suspect we could all use a good laugh. So, I'd like to start with a joke about a farmer, though not one with daughters...

A chicken farmer in Blue Bell wants to increase egg production, so he calls the Lancaster County agriculture extension agent. The agent examines the farmer's operation, and advises him to improve the ventilation in the chicken coops and install heaters. Egg production goes up 5%.

The farmer wants more, so he calls in a biologist from Slippery Rock State. The biologist takes blood samples from the chickens and runs a bunch of tests. He calls back a week later and advises the farmer to add soy protein and lecithin to the chicken feed. Egg production goes up an additional 10%.

Encouraged, but not satisfied, the farmer decides he needs more fundamental science. He calls in a chemist from Penn State. The chemist takes feather samples and subjects them to mass spectroscopy. Two weeks later he submits his report, advising the farmer to add selenium and potassium to the chicken feed. Egg production goes up another 20%.

Now the farmer is really pumped and is convinced that science can solve his problems. He calls in a physicist from Cal Tech. The physicist visits the farm, studies the chickens and observes the egg-laying process. He fills a notebook with equations. A month later, he calls the farmer. "I can show you how to increase your egg production by 250%," he tells the farmer.

The farmer is overjoyed. "That is wonderful! How do I do it?"

"It is not easy to explain over the phone. I will come to the farm tomorrow."

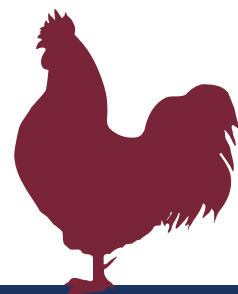
The next day, the physicist arrives in a van. He parks, takes out a large blackboard and sets it up in front of the chicken coop. The physicist starts by drawing a circle on the blackboard, then begins to cover the space beneath with equations. Furiously writing, the physicist ends with a last equation, $\Delta P_e = \uparrow 250\%$. Then he looks up at the farmer, points at the circle, and says, "First, assume a spherical chicken..."

For the last decade or two, financial engineers have been telling their own version of the spherical chicken joke. Instead of assuming perfectly round poultry, hedge fund managers and investment bank honchos assumed they possessed complete data sets on such real-world phenomena as mortgage default rates, the correlations between asset classes, and the economic returns of different investments.

The recent punchline was the near-meltdown of the U.S. financial system.

The current financial turmoil is the result of the failure of one of the fundamental concepts of financial economics, Modern Portfolio Theory, a powerful analysis of portfolio diversification strategy

TGS
FINANCIAL ADVISORS
A Registered Investment Advisor



for which Harry Markowitz, Merton Miller and William Sharpe won the Nobel Prize in Economics in 1990. Modern Portfolio Theory describes how to design an optimally di-

sions and their consequences, is not that predictable. The orbit of a moving object in space can be precisely predicted. The decisions of human beings under the stress of greed or fear cannot be.

“The orbit of a moving object in space can be precisely predicted. The decisions of human beings under the stress of greed or fear cannot be.”

versified portfolio given information about returns, volatility and the correlations between asset classes.

Most investment managers use elements of Modern Portfolio Theory. Exactly how we use these Nobel Prize-winning economic concepts depend on what we believe they are. Are they *insights* (useful but inherently incomplete descriptions of real-world phenomena) or *equations* (accurate mathematical representations with reliable predictive value)?

Much of modern financial engineering rests on the assumption that portfolio theory is both accurate and predictive. Working on that assumption, hedge fund managers added leverage and complex derivative securities to the mix in pursuit of enhanced returns and higher fees. Big banks earned big bucks putting together high-yielding portfolios of low-quality mortgages for institutions eager for high returns in a low-return world, while retaining the really toxic residues in their own portfolios.

Unfortunately, those high-risk portfolios rested on unstable foundations. To imagine that the moving parts of the financial system can be accurately described by looking at limited historical data sets, or precisely plotted on perfect bell curves, is arrogance that has been reliably punished by economic loss, from Long Term Capital Management in 1997 to Bear Stearns Enhanced Strategies Fund in 2007.

Since the 1960s, economics has become increasingly math-centered. But all that elegant math depends on complete and reliable data sets, and on consistent and predictable relationships between variables. Life, defined by human deci-

Here at TGS Financial Advisors, we need to be able to make prudent decisions in our clients' interests in a world of imperfect data and uncertain outcomes. Instead of a model that is elegantly and precisely wrong, we have constructed one that is inelegantly and roughly useful. Like all system-builders, we make certain assumptions:

- We know that we can't predict the future.
- We believe that investments represent ownership of real economic assets, not elements of a data set.
- We assume that human beings will act in unpredictable ways, especially at the inflection points (market tops and bottoms) where emotions run rampant. We can't precisely predict those emotions, but we stand ready to take advantage of the results during periods of greed or panic.

These assumptions inform our strategies. We don't leverage. We limit the size of our positions. We diversify because we believe that it will help reduce risks but recognize that we can never precisely predict our downside risks or upside opportunities. We use the mathematics of Modern Portfolio Theory as an aid in our attempt to reduce risk through diversification, not as an engine to take larger risks in pursuit of larger returns.

So far we are happy with the results. We strive to deliver positive returns during bull markets and to avoid crippling losses during market declines. Most importantly, our goal is to fulfill our mandate – to help clients who are saving sufficiently or spending prudently to become, and remain, financially independent for a lifetime.

For the firm,
James S. Hemphill



TGS TRANSITIONS TO THE RAYMOND JAMES INVESTMENT ADVISORS DIVISION

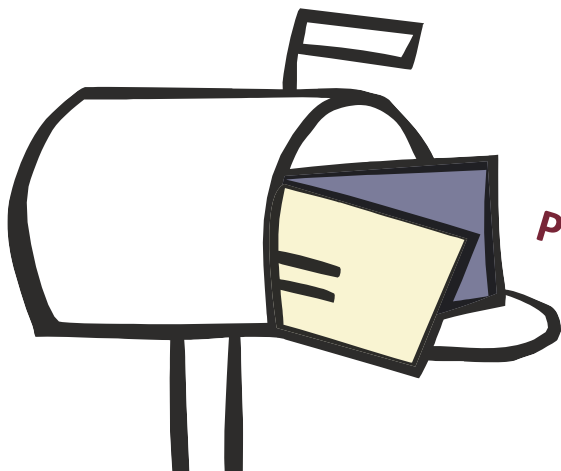
by David A. Burd, CFP®

In last quarter's Navigator we discussed our relationship with Raymond James Financial Services (RJFS) in the article [TGS, You and Our Broker-Dealer, Raymond James](#). We examined RJFS' role as our broker-dealer, why we chose RJFS when founding our firm in 1990, and how our relationship and the industry, has changed over time.

Three years ago, RJFS created an entirely new corporate division called the Investment Advisors Division (IAD). It was designed to provide services to Registered Investment Advisor (RIA) firms who are entirely fee-based.

TGS is now almost entirely fee based and has, for years, accepted the more stringent fiduciary requirements demanded of a RIA. We have decided to transition to this new RJFS division.

Most things will stay the same for you, including: account numbers, titles, beneficiary designations, online access and check writing. A few changes you can expect to see in the future include: the ability to purchase institutional – class mutual funds that have a lower internal cost structure, a Wrap Fee program in which TGS will be able to absorb RJFS transaction charges, and the flexibility to coordinate client billing in which we can deduct our fee as specified by you from one account, rather than incrementally from all accounts.



**Please complete, sign and return
all paperwork as soon as is convenient**

E-mail Address Update

Over the next few months, as we make the move to the Raymond James IAD division, we will transition to our corporate e-mail addresses and our Raymond James e-mail addresses will be phased out.

*Please use our TGS addresses, which are:
firstname.lastname@TGSFinancial.com.*

Team members' e-mail addresses can also be found on the firm's web site at www.TGSFinancial.com

We are not changing our relationship with you. We will keep doing the work we've always done – implementing your long-term investment strategy and coordinating your financial planning.

In order to make this transition to the new Raymond James division you will have to update your account paperwork. We will be mailing packets of updated paperwork to you through early July. Please complete and sign all forms and return them in the provided pre-paid envelope as soon as possible to assist us in a smooth transition to IAD.

If you have any questions regarding the transition to the Investment Advisors Division, please feel free to contact us at (610) 892-9900, (800) 525-4075 or questions@tgsfinancial.com.

INSIDE THE BLACK BOX ■

Surveying the World Economy (Part 2)

by Marvin L. Barron III, CFP®

Last quarter, I set out on a survey of the world economy as viewed through the U.S. dollar. Mindful of the (alleged) Mark Twain quote - "History does not repeat itself. It rhymes." - I began by looking at the dollar's *relative price*, which demonstrated that, even though the dollar has fallen 50% since 2000, such movement is not unusual. It happened in the 1960's and in the 1980's, and the sun still rose the next day.¹

Now it's time to examine *absolute price*. *Relative price* asked us to judge the present against the past. Mainly, it required data. To study *absolute price*, we must evaluate the present against some ideal standard of value. This requires a theory. Since we are examining the dollar, we require a theory of money. That's no problem, money has been around for a long time.

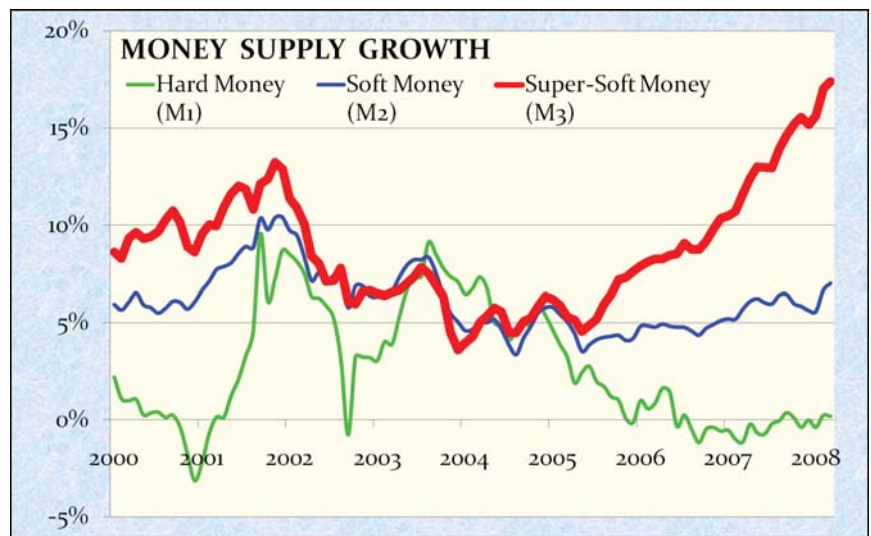
Our Theory of Money starts with a distinction between the money system and the economic system. Before money was invented (~5,000 B.C.), and even in the more recent times of crisis, economies have gotten by with barter. Only now that money is ubiquitous, is it easy to confuse the two systems. One helpful comparison is this: the economy is the engine; money is the oil. Money helps things to hum along and keeps the engine from seizing up. But, absent the engine, a dollar is just a portrait of a dead president.

So, what should a dollar be worth? Nothing. Zip. Nada. Dollars are nice, but you can't eat them. Their value is based solely on the fact that they can be used to buy real goods, if (and only if) those goods are priced in dollars. This is true for all economies, everywhere, always.² In a fundamental

way this mechanism drives the value of money on the international markets (as exchange rates) and in domestic markets (as inflation).

In essence, money is a commodity priced by supply and demand. On this theory we can study the dollar's *absolute price*.

The supply side of that equation is simple. Supply is determined by the Federal Reserve. As this graph shows, supply is growing rapidly (see the graph below).



Source: John Williams. Shadow Gov't Statistics

The demand side of the question is more interesting and will require a few articles to suss out. There are four pillars to the demand for dollars, two of which are unique to America. I term the two general ones *domestic production* and *domestic investment*. The unique ones are *third party transactions* and *the leviathan effect*.

For now, let's start with the effect of *domestic production* on dollar demand. This effect is derived from the basic fact that dollars are required to buy anything made in America. Our *domestic production* creates demand for dollars, which increases the dollar's value on currency markets.

Our trade balance tracks *domestic production*, and thus this pillar of the demand for dollars. If we export more and

¹As an aside and tie in to Jim's article, isn't it astonishing how often "one in a lifetime" events seem to happen in financial markets? Perhaps it's a matter of perspective. After all, many blood-sucking insects only live for a week or two.

²Unless you really value small, mass-produced portraits of dead presidents.

The Innocents

Since January we have travelled mostly in Asia. The countries are very different from each other. India is very different from Vietnam, which is in turn very different from Malaysia, and so on. There are different ethnicities, language groups, religions, cultures and cuisines. Some of these countries like Cambodia are desperately poor, while a few like Singapore are genuinely rich, firmly First World in wealth and infrastructure. Some are free and democratic, others autocratic and repressive.



We were in China shortly before the Olympics, in the wake of a major disaster, and at a time when Chinese nationalism was surging. It was a bumpy ride.

With only one month left in our trip, we are thinking about our return. Our older kids have spots reserved on their soccer teams. We've paid our first installments of school tuitions. My office has scheduled some important moves forward in which I will be an active participant.



It has been a wonderful year, and at the same time I can't wait to get back.

Until we meet again,

James S. Hemphill

import less, the trade balance becomes more positive and the dollar strengthens. Unfortunately, the trade balance has trended downward since the 1970's. *Domestic production* can only reflate the dollar if the U.S. is able to rebuild its export infrastructure and imports fewer foreign-made goods. This process will take years and we are just getting started.

However, don't think me a complete pessimist on the dollar. *Domestic production* is just one of the four pillars of dollar demand. As noted above, that pillar is growing stronger, slowly. In this space next quarter, I'll examine the other three pillars of dollar demand (*domestic investment, third-party transactions, and the leviathan effect*). We'll find in these pillars that a few pleasant surprises wait in store.

A RECORDING OF THE PRESENTATION
THE WIZARD OF OZ AND THE WORLD TODAY
IS AVAILABLE BY REQUEST. PLEASE CONTACT
SHAUNA PELKEY AT (610) 892-9900 OR
(800) 525-4075 TO RESERVE A RECORDING.

7TH ANNUAL Wealth Management Conference

AT APPLEFORD ESTATES

Clients, and friends of the firm joined us on April 29, 2008 at Appleford Estates in Villanova, Pennsylvania for our 7th Annual Wealth Management Conference. Attendees enjoyed cocktails and hors d'oeuvres outside in the picturesque gardens, followed by dinner and a presentation titled *The Wizard of Oz and the World Today*, given by the firm's Research Director, Marvin L. Barron III.



Visit the Hemphills' travel blog at

www.travelpod.com/members/oneyearaway



CLIENT SPOTLIGHT

Judy & Bob Katten

Judy and Bob Katten have been keeping busy in their home state of Florida. Judy won the 2008 Senior Tournament at the Boca West Country Club in Boca Raton, Florida, where she is a member. She began playing golf with her parents at the age of seven.

Bob recently completed the Space Coast Century, a 100-mile bike ride, which began in Cocoa Beach, Florida. He has been biking for four years.

TGS WELCOMES SVETLANA KOVACEVIC



Svetlana Kovacevic joined TGS in March of 2008 as the firm's Operations Associate. She graduated Cum Laude from Gwynedd-Mercy College with a Bachelors of Science in Business Administration.

Svetlana has been working in the industry for six years with Citizens Bank. As an Assistant Branch Manager at Citizens Bank, she managed the branch staff and operations while successfully assisting in their growth.

Svetlana and her husband, Denis, live in Philadelphia with their daughter, Alexandra.

OFFICE NEWS

Vincent R. Barbera

IN THE PRESS

Our Financial Planning Director, Vincent Barbera, has been getting a lot of press lately. In April and May he was quoted in the following articles:

Dow Jones Newswire

- *Getting Personal: How to Save on Health Care*

Journal of Financial Planning

- *Self-Improvement Solutions: The Benefit of a Study Group*

Smart Money

- *Advisors are Moving Back into the U.S. Funds*
- *Only Two Microcap Funds Make Our Cut*

TheStreet.com

- *Why Tapping your 401(k) Early Can Sting*
- *Eight Strategies to Save on a New Car*
- *Five Tips for 20-Somethings to Save for Retirement*

The Wall Street Journal

- *Repositioning for a Rebound*

David Burd and Shauna Pelkey Present at RJFS National Conference

David Burd and Shauna Pelkey presented at the Raymond James *National Conference for Professional Development* in Orlando, Florida on March 10, 2008. The pair spoke on best practices that TGS Financial Advisors has successfully implemented.

From March 9th through the 12th, almost 800 financial advisors from across the nation attended educational sessions about retirement planning strategies, wealth management, performance reporting and asset allocation concepts. The four-day event concluded with keynote speaker Steve Forbes, Chairman and CEO of Forbes, Inc.

CLIENT Q & A

Q: What is umbrella liability insurance? Should I have it?

A: Umbrella liability is a type of insurance that protects you against claims that exceed coverage by your policy. It kicks in once you reach the limit on the underlying liability coverage for your homeowners, renters, condo or auto policy.

This coverage may come into play if:

- You are sued under your auto insurance policy after an accident.
- Your neighbor slips and falls on your property and you're sued under your homeowners' insurance.
- A storm causes a tree on your property to damage someone else's property. (This usually falls under the "I thought that was covered by my homeowners policy" category).

Myths that surround umbrella liability coverage, include:

- It is difficult to coordinate with other insurance.
- The premiums are very expensive.

In reality, umbrella liability can easily be coordinated with your existing insurance. Simply contact your homeowners insurance provider, and ask about umbrella liability insurance. It is affordable, and premiums range from \$200-\$300 annually for \$1 million of coverage.

The actual cost is determined by the amount of coverage, the issuing insurance company, and your own "risk factors" (such as recent traffic tickets or your credit report).

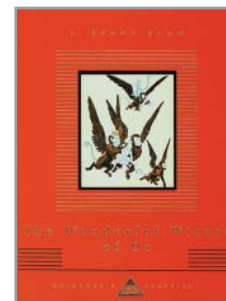
Given the American love affair with lawsuits, umbrella liability insurance may be something to seriously consider.

Susan Mattero
Insurance Coordinator

Book Recommendation

Reviewed by Marvin L. Barron III, CFP®

This quarter we are recommending two books in one binding. The first is a classic children's tale about witches, wizards, and a little girl from Kansas. The second is a scathing satire of 19th-century monetary economics. Both are titled The Wizard of Oz.



In April, at our Wealth Management Conference, I discussed the history behind The Wizard of Oz's and the role it played in the economic debates of its age. Surprisingly, this 108 year-old "children's story" has lessons for the world economy today. It also remains a wonderful fairy tale.

If you've never had a chance to read the book, consider this a nudge in that direction. It won't take you long. After all the characters are familiar, even if the economic debate was left out of the movie (Dorothy's slippers were not always ruby; they were originally silver). If you weren't able to join us at our Wealth Management Conference at Appleford Estates, we do have a recording of the presentation available. Otherwise, enjoy your own summertime trip down the yellow brick road.

The Wizard of Oz
by L. Frank Baum

Quote OF THE QUARTER

"I certainly wouldn't advocate investing in hedge funds. I see no reason to believe they are outperforming the markets."

Dean P. Foster
Professor of Statistics
Wharton School of Business

The Markets at a Glance *(ending March 31, 2008)*

INDEX	VALUE	ANNUALIZED RETURN		
		One Year	Five Year	Ten Year
Dow Jones Industrial Average	12,262.89	1.6%	11.5%	5.5%
Standard & Poor's 500 Stock Index	1,322.70	-5.1%	11.3%	3.5%
Morgan Stanley Europe, Australasia, and Far East Index	2,038.62	-2.7%	21.4%	6.2%
Lehman Brothers U.S. Aggregate Bond	--	7.7%	4.6%	6.0%
Lehman Brothers Municipal Bond Index	--	1.9%	3.9%	5.0%
Six Month Certificates of Deposit	--	4.6%	3.5%	3.9%
Inflation (Consumer Price Index)	--	4.0%	3.0%	2.8%

Inclusion of these indices is for illustrative purposes only. Keep in mind that individuals cannot invest in any index, and index performance does not include transaction costs or other fees, which will effect actual investment performance. Individual investors' results may vary. Past performance does not guarantee future results.

MARKET COMMENTARY

by Marvin L. Barron III, CFP®

The storm is here, but as one of our clients, you have a great advantage over other investors – you have resources at the ready. You will be able to participate fully when markets look cheap. As we discussed at our 7th Annual Wealth Management Conference, we view the economy's problems as a mostly monetary phenomenon.

International developed-market stocks outperformed U.S. stocks for the fifth straight year in 2007 and had slightly smaller losses in the first few months of 2008. We remain advocates of a significant allocation to foreign securities.

We maintain a serious long-term commitment to small/mid-sized value-oriented companies. Though we have reduced our allocation to Real Estate Investment Trusts (REIT's), we keep some exposure to Operating Real Estate as a hedge against volatility and inflation.

“We see neither amazing bargains nor grotesque overpricing.”

We are somewhat concerned about inflation and nominal interest rates over the medium/short term. The markets give short term rallies around each and every interest rate cut. However, the Federal Reserve has to print money each time it cuts interest rates, which eventually leads to inflation. We have a substantial position in inflation-indexed bonds and other assets with high inflation correlations.

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Commodities may be subject to greater volatility than investments in traditional securities. Investments in commodities may be affected by overall market movements, changes in interest rates, and other factors such as weather, disease, embargoes and international economic and political developments. Please note that international investing involves special risks, including currency fluctuations, differing financial account standards, and possible political and economic volatility.