

Key West and Cape Lookout in 2010

December 30, 2009

Key West will be three years old on December 31, 2009. This model got its start because we were frustrated with our inability to achieve performance for some of our smaller client's accounts that was equivalent to the performance levels for larger client accounts. We were noticing that trading costs were having a bigger impact on performance in the small accounts than they were in the large accounts. We decided to experiment with the idea that if we traded only ETF's in these accounts, rather than individual equities, that we could cut trading costs and improve performance.

An ETF is an investment product, similar to a mutual fund, which represents a basket of securities such as an index. It is designed to replicate the returns of that index or a specific market (such as the technology market) or a commodity such as oil, gold or silver.

Let me offer you an example. Let's say we want to accumulate a significant allocation in health care and pharmaceuticals for a model. In the Hatteras model, account sizes average over \$2.5 million. In order to get our allocation we decide to buy 5 stocks. Let's pick Amgen (AMGN), Medtronic (MDT), Pfizer (PFE), Merck (MRK) and Gilead (GILD). It would cost a total of \$40 to buy the stocks. That is 5 trades at \$8 each. \$40 is barely significant to a \$2.5million account. On the other hand the same \$40 can be quite significant to an account valued at only \$100,000; particularly if you are trading often.

We can buy the **Health Care Select Sector SPDR (XLV)** and find all five stocks in its top 10 holdings. By doing so we haven't exactly duplicated the trade that we might have made for Hatteras, but we have come darned close. Certainly if the sector moves up both Hatteras and Key West are going to benefit, and Key West bought its position for 1/5th the cost of the similar position in Hatteras.

That is the "method behind the madness" for Key West. We are actually trying to provide very similar performance to Mendocino or Hatteras for smaller accounts that we manage, by using primarily ETF's.

ETF's offer other advantages as well, particularly over mutual funds:

- Lower costs - ETFs generally have lower costs than other investment products because most ETFs are not actively managed and because ETFs are insulated from the costs of having to buy and sell securities to accommodate shareholder purchases and redemptions.
- Buying and selling flexibility - ETFs can be bought and sold at current market prices at any time during the trading day, unlike mutual funds and unit investment trusts, which can only be traded at the end of the trading day.
- Tax efficiency - ETFs generally generate relatively low capital gains, because they typically have low turnover of their portfolio securities.
- Market exposure and diversification - ETFs provide an economical way to rebalance portfolio allocations and to "equitize" cash by investing it quickly. An index ETF inherently provides diversification across an entire index. ETFs offer exposure to a diverse variety of markets,

including broad-based indexes, broad-based international and country-specific indexes, industry sector-specific indexes, bond indexes, and commodities.

- Transparency - ETFs, whether index funds or actively managed, have transparent portfolios and are priced at frequent intervals throughout the trading day.

The ETF market is maturing rapidly but it still does not cover the entire spectrum of assets that are used in other models managed by 5T Wealth. Therefore we do find ourselves occasionally finding it better to use a closed end fund or a mutual fund to fill out certain asset classes or sectors within the model.

Key West has inspired us to rethink some of the things we do in all our models. For example, we have made it clear in our 2010 Forecast that we favor the BRIC countries growth prospects in 2010 over the USA. The BRIC's are Brazil, Russia, India and China. To capture much of the prospective move from their stock markets an investor could buy four ETF's that represent those markets including MSCI Brazil Index Fund (EWZ), Market Vector Russia ETF Trust (RSX), Powershares India Portfolio (PIN), and FTSE/Xinhua China 25 Index Fund (FXI). That involves four trades. Or, you could buy the Goldman Sachs BRIC Fund (GBRIX), a mutual fund, that invests in all these markets-one trade! We have purchased GBRIX for Key West.

Key West also owns Goldman Sachs Absolute Return Tracker Fund (GJRTX). This fund attempts to replicate performance of a universe of hedge funds. It is a unique asset that is presently held only in our Key West and Cape Lookout models. We are considering adding it to all the models.

Here is a report regarding the fund that comes from SeekingAlpha.com:

"Goldman Sachs has become the first bank to create a hedge fund replication tool in a move that could lead to a shake-up of the \$1,300bn hedge fund industry.

The platform will greatly undercut the notoriously high fees of the hedge fund sector. Those investing through a fund of funds can end up paying annual charges of 4-7 per cent, with up to 50 per cent of their returns eaten up by fees. Goldman will charge a flat 1 per cent.

Goldman's Absolute Return Tracker index (Art), is set to be among the first of a flood of hedge fund cloning products likely to be launched in a revolution being compared with the arrival of index-trackers in the mutual fund world a generation ago. 'There is a lot of dead wood in the industry - people who should not be running hedge funds,' said Harry Kat, professor of risk management at London's Cass Business School, who has just launched his own hedge fund replication tool.

'A lot of them will leave the business, because people are smartening up. Index replication is going to become as important as it is in traditional long-only investment, with 30-40 per cent of the market.'

Replication strategies are based on academic research that suggests hedge fund performance is largely driven by movements in underlying markets, such as equity, bond and commodity prices, rather than the intrinsic skill of managers.

Goldman has spent two years developing the algorithm that underpins its platform. The performance characteristics of thousands of hedge funds will be fed into the system monthly and Art is designed to decompose these data and calculate the aggregate position of the hedge fund

universe. This position can then be replicated, potentially allowing Goldman to generate hedge fund performance at a fraction of the cost.

Clones such as Art avoid the negative selection bias that bedevils existing investible hedge fund indices and funds of funds, due to the fact that few of the better hedge funds are open to new investment.

It will be far more liquid, with trading available on a daily basis.

'This may be ideal for any large institution that has been looking at hedge funds but doesn't like the fact that it takes six months to put money in and to take it out again,' said Edgar Senior, executive director in Goldman's fund derivatives structuring team."

Key West has been the incubator for several good ideas that now appear in other models. We have also brought key ideas from other models to Key West.

For example, we used individual bonds in the Key West accounts when we decided to build out a significant allocation to bonds in late 2007. At the time there was no ETF available that invested in the short term corporate bonds that we liked so we simply bought individual bonds just like we did for all the other models.

Here are the allocations for Key West as we head into the New Year:

Asset	% Allocation
Equities	24
Gold	3
Money Market	14
Hedge Fund Tracker	5
Bond ETF's	26
Individual Corporate Bonds	28
	100

We have a smaller equity allocation and larger bond allocation in this model than many of the others. We will be looking to add to equities after January 1 by spending down the portion in Money Market.

We are quite pleased with the way Key West works for most of our clients who use it. Our only problem with the model is that there are accounts in the group that are simply too small. We are no longer accepting accounts under \$150,000 into the model.

During 2009 we have been running an alternative model for accounts under \$150,000. It is called **Cape Lookout** and it is very likely to be our last new model. With the addition of **Cape Lookout** and **Pt. Sur** in 2009 we have rounded out our offerings with nine distinct models.

Cape Lookout

Cape Lookout is for our smallest client accounts, those under \$150,000, but it has no maximum investment. Many clients who own accounts in the Cape Lookout model also have larger accounts in one or more of the other models.

Cape Lookout is invested entirely in mutual funds. All the funds are "no load" and most are institutional class shares, which have significantly reduced internal fees. We are constantly screening the universe of mutual funds for what we consider to be "best of breed". We favor Morningstar's rankings and reporting, as well as Smart Money's fund selector tools.

Cape Lookout is our only "buy and hold" model. Mutual funds can't be actively traded like stocks, etf's and individual bonds, so we simply don't trade them. We buy funds with the intent that we will hold them for a minimum of six months. That is not to say that if something drastic were to occur with a fund that we would simply sit and watch. We wouldn't. But each time we buy a fund for the model it is our intent to hold it for a significant period of time.

To help smooth the volatility we have used "market neutral" funds and we have the model well diversified.

There are currently seven funds in the model. The asset allocation is similar to many of the other models in that we are tending to favor the following asset classes:

- Higher yield stocks
- Foreign and emerging market stocks, with emphasis on the BRIC countries
- Shorter term bonds
- Energy
- Gold

So, while the tools may be different we are emphasizing many of the same themes that run through other models.

Cape Lookout has had a good year in 2009. We are now one trading day from wrapping up the year and we will look forward to another solid year for the model in 2010.

Happy New Year,



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5T WEALTH MANAGEMENT manages accounts with various histories and investment objectives. Various accounts may be managed differently from time to time.

Krsek makes frequent reference to the model portfolios called Hatteras, Mendocino, Halifax, Bonavista, Fresnel and The New World. During 2005 Paul Krsek was appointed Chief Investment Officer of 5T WEALTH MANAGEMENT, and as such is responsible to make all trading and management decisions for all client accounts which are being managed according to a specific portfolio model. A description of each of our models can be found on our website at <http://www.kaassets.com/choices.htm>.

Not all accounts managed by 5T WEALTH MANAGEMENT are "modeled" accounts. We strongly urge our clients to understand which model, if any, are being used to manage their accounts.

As of July 3, 2007 Lee O'Dwyer joined 5T WEALTH MANAGEMENT as a portfolio manager. Paul Krsek and Lee O'Dwyer frequently discuss investment ideas, model portfolio strategies and the investment policies of 5T WEALTH MANAGEMENT. But when it comes to the implementation of those policies Krsek is primarily responsible to manage the accounts that fit into each model portfolio description. He generally makes all final investment and trading decisions relative to those accounts that are considered to be "modeled." However, in Krsek's absence O'Dwyer does have the authority to trade all client accounts. He has been actively trading accounts in the various models since joining 5T WEALTH MANAGEMENT.

From time to time 5T WEALTH MANAGEMENT receives requests from clients to purchase securities that are not included in the model portfolio to which they are assigned. Effective May 24, 2006, 5T WEALTH MANAGEMENT has encouraged clients to hold such securities in a separate account for the client. Because 5T WEALTH MANAGEMENT is a "fee only" registered investment advisor" it charges its normal management fee for monitoring such securities in the separate accounts in which they are held.

5T WEALTH MANAGEMENT makes every effort to exclude securities that are 'requested by the client' from the modeled portfolio accounts.

The investment objectives of various accounts and models may be substantially different from one another. Therefore topics or investments mentioned in E-ELLUMINATION may or may not apply to specific managed accounts and/or models.

Trades or adjustments to accounts mentioned in ELLUMINATION may or may not happen in every account managed by portfolio managers at 5T WEALTH MANAGEMENT.

If you are not satisfied with the investment results in your account it is your responsibility to inform Krsek or O'Dwyer and to discuss possible changes that can be made to the account to accommodate and satisfy your needs.

The assets held in managed accounts at 5T WEALTH MANAGEMENT may include stocks, bonds, cash, commodities, foreign exchange or mutual funds or exchange traded funds (ETF's), money market accounts or limited partnerships that represent the same. They are subject to market fluctuation and the potential for losses. The assets are not insured. The value and income produced by these investment products may fluctuate, so that an investor may get back less than they initially invested.

The portfolio managers at 5T WEALTH MANAGEMENT do not guarantee results.

Past performance should not be considered an indicator of potential future performance. If you do not consider yourself suitable, either emotionally or financially, to experience volatility and/or losses in financial markets, you should not invest.

From time to time Krsek lists the simple annual returns of the six model accounts in this newsletter. These accounts are "models" and do not represent the actual results accruing to individual accounts. Simple annual return does not represent "time weighted return" as reported individually to clients in their quarterly reports prepared using Centerpiece.

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