

## Horizon Notes

**Website Update**—We have recently finished a complete revision of our website. Our web address remains the same at [www.horizon-advisors.com](http://www.horizon-advisors.com). We are currently in the process of creating a website presence for Maddox, Thomson & Associates and the two sites will be linked to one another, so that visitors can navigate easily between the two sites. We expect to complete the Maddox, Thomson website by the end of May. The web address will be [www.maddoxthomson.com](http://www.maddoxthomson.com). The new websites are state-of-the-art, with simpler navigation. They each include descriptions of our processes and services, biographical information on our advisors, and our contact information. If you have a chance to visit the sites, we'd love to hear any comments or suggestions you may have.

**Technology Update**—We have completed the conversion and migration of our information technology to an off-site secure location. The result of this change is that we now have secure, 24x7 web access to our information systems. This is a big step forward in our business continuity plan and will ensure that there is no disruption to our ability to take care of our clients. If there is some sort of interruption to our business, we want to be sure that our data is secure and accessible, so that we can continue to run our business and serve our clients during any recovery period.

**Newsletter Schedule**—Those of you who are clients of the firm recently received your quarterly performance reports. In order to expedite our quarterly reporting and deliver our clients' portfolio reports as quickly as possible, we have decided to issue our newsletter independently of these quarterly reports. In the future, On the Horizon will be delivered in the month following the end of the each quarter.

## COLLECTED THOUGHTS

*"All my life I wanted to be somebody. Now I see I should have been more specific." - Lilly Tomlin*

## Impediments to Good Investment Behavior

As investment advisors and stewards for our clients, part of our job is to continually study investment research, not just research about particular types of investments or investment managers, but the investment management process itself. One of the most interesting areas of study in the field of investment process is known as Behavioral Finance. Behavioral finance is the science of how investor behavior affects the investment process. Researchers have identified a number of behavioral tendencies which work, individually or in combination, to undermine the ideal investment process.

Don Philips, the president of Morningstar, recently spoke at an industry conference, which we attended. Morningstar is one of the largest suppliers of mutual fund information and performance history. Phillips highlighted recent studies which showed significant differences between the total returns which were earned by individual mutual funds and the collective returns of individual investors in these same mutual funds. The studies show that individual investors' returns are significantly less than the returns of the funds themselves.

The returns for the mutual fund were calculated on a "buy and hold" basis – that is, the return was calculated as though there were no additions or withdrawals from the fund during the applicable period. The investor returns were calculated on an asset weighted basis, simulating additional moneys flowing into and out of the fund during the time period. For example, a particular fund might have a total annual return of 10%, with most of the return occurring during the first half of the year. However, if investors added substantial sums of money to the fund during the latter part of the year when the returns were less robust, their asset weighted returns would be lower than the fund's total return of 10%.

The comparative returns showcase investors' dismal ability to "time the market." The investors' asset weighted returns were influenced by two behavioral biases, namely: (1) **greed** (purchasing additional shares of the funds after a period of strong performance by the fund)

and (2) **fear** (selling shares of the fund during periods of bad performance by the fund or the market in general.)

This sort of “performance” by investors highlights two of the overriding behavioral issues that successful investors must overcome, namely **overconfidence** and **panic or capitulation**. Research shows that we investors are behaviorally inclined to be overconfident that recent performance will continue, leading us to buy when the market is rising and to panic and sell when the market is falling (or has fallen so much that we just can’t stand the pain of loss any more!)

The root cause of this problem can be summed up by saying that “Investors have long-term expectations of returns, but a very short-term market perspective.” We have all heard the old saw of “buy low, sell high” or that one should buy stocks like they buy socks, i.e., wait until they are on sale! But, while investors understand the logic and rationale of these strategies, our built-in behavioral biases are able to overwhelm our best long-term investment intentions.

The behavioral biases of fear and greed are constantly amplified by short-term-oriented financial news. One commentator calls this short-term fixation “performance myopia” and it drives investors to make decisions which are not in their best long-term interests. So, instead of following Warren Buffet’s advice to “Be fearful when others are greedy and greedy when others are fearful,” investors tend to react to greed by buying at any price and to fear by selling at any price. It is evident that when our investment decisions and returns rely on human instinct and behavior, rather than a disciplined investment process, investors are at a real disadvantage.

We began this discussion by explaining that part of our job is to study investment research, such as behavioral finance. Another (maybe more important) part of our job is to make sure that we apply the lessons learned in this research to the everyday care and maintenance of our clients’ investment portfolios. By following a well-defined, disciplined investment process, we provide a long-term perspective on investment management and returns. This helps to protect against bad short-term decisions, based on fear and greed.

## Market Review

The following table shows market index returns for the 1st quarter, trailing 12-months, and past 3 years.

Index	1st Qtr	1-Year	3-Year
S&P 500 (Large Stocks)	0.18%	9.73%	26.16%
Russell 2000 (Small Stocks)	1.66%	4.65%	35.64%
EAFE (International Stocks)	3.52%	17.50%	60.61%
Lehman Bond Aggregate	1.71%	6.64%	8.66%

The first quarter of 2007 gave investors a bumpy ride and tested the nerves of those who were anxious about the extended run the market has enjoyed since last summer. January began the year on a positive note with the S&P 500 rising 1.4%. Then February rattled the market with a late month drop that temporarily pulled most market indexes into negative territory for the year. The pullback began with a single-day decline in the Chinese stock market that was in excess of 8%. This steep and unexpected slump spooked markets worldwide causing a brief panic among those who were already thinking the market was due for a retreat. However, a rally in March brought most of the indexes back into positive territory and allowed the S&P to end the quarter up 0.2%.

Global expansion and a weakening dollar have fueled impressive returns in international equities for the past four years. As a result, American investment dollars have been flooding into international funds. This trend continued in the first quarter and will likely persist until the superior returns come to an end. Even with U.S. investors chasing returns in international markets, many institutional asset managers feel that Americans are biased toward U.S. equities and would benefit from more international exposure. We are not bothered by the increased interest in international funds and continue to believe that foreign investments are an important part of a well diversified portfolio.

The Federal Reserve remained quiet in the first quarter and kept the Fed Funds rate unchanged at 5.25%. Inflation fears seem to have calmed with the core CPI coming in at 2.7%, but a tight labor market could again spark concerns. There have been persistent, albeit minor, indicators of inflation, which have made the Fed reluctant to cut

rates. With the unemployment rate at 4.5%, which is well below the long-term average of 5.7%, employers may be forced to pay more to attract qualified workers which could lead to higher inflation. Fed Chairman Ben Bernanke has indicated repeatedly that he will raise the Fed Funds rate if it is necessary to keep inflation close to the target level of 1-2%.

Overall the economy has remained robust, but investors are beginning to become concerned that trouble in the housing market could cool consumer spending. Without question, consumer spending plays an important role in the U.S. economy, but corporate earnings continue to be very strong and capital spending has picked up as employment has increased. The anxiety about the economy comes primarily from the uncertainty of how increasingly restrictive lending practices for sub-prime loans will impact the spending habits of U.S. consumers.

With the record breaking rise in the market since July, security prices do not look as cheap as they did a year ago. Even at this newsletter's writing, the upward momentum has continued in earnest. However, valuation multiples remain reasonable and are near their long-term averages. We believe that the recent climb has helped the market return to a more normal state and does not necessarily mean that we are at risk for a major decline. We are cautiously optimistic about the rest of the year, but we expect additional volatility and are wary that an interest rate hike by the Federal Reserve could cool investor optimism.

Thank you very much for your continued confidence in our service and advice. If you have any questions, comments, or would like to schedule some time to come by and review your goals and objectives, or to just visit, please call.

#### COLLECTED THOUGHTS

*"When someone with experience proposes a deal to someone with money, too often, the fellow with money ends up with the experience and the fellow with experience ends up with the money." - Anonymous*

#### Manager Spotlight— Mainstay ICAP Select Equity

At Horizon Advisors, we feel that the best way to reduce the risk in our clients' portfolios is to not only diversify the types of investments our clients own, but also the styles of the different managers we use. Institutional Capital, LLC, better known as ICAP, has a unique style for managing their Select Equity Fund. We recently conducted our annual due diligence review of this fund and thought we would take this opportunity to highlight their process.

The core philosophy for all of the funds managed at ICAP is the belief in investing in large companies that are under priced. This is known as a large cap value strategy. The unique aspect of their approach is that each of their investments must have a clear catalyst for significant price appreciation within a reasonable time horizon. The catalysts they look for include management changes, the introduction of new products, financial restructuring, problem resolution, or exceptional pricing power.

Once they have identified possible investment targets, their research analysts conduct a thorough review of the company's fundamentals and qualitative attributes. The fund's portfolio managers Rob Lyon and Jerrold Senser then review the analysts recommendations and select only the most attractive investment opportunities for the Select Equity Fund.

Rob Lyon joined ICAP in 1976 as an analyst before moving to a competing firm in 1981. He returned to ICAP in 1988 to serve as the Director of Research and eventually became President and Chief Investment Officer. He has a bachelor's in economics from Northwestern and an MBA from Wharton. Jerrold Senser joined ICAP in 1986 and is the Executive Vice President and Co-Chief Investment Officer. Mr. Senser earned a bachelor's in economics from the University of Michigan and an MBA from the University of Chicago.

After remaining independent for more than 35 years, Institutional Capital, LLC was acquired by New York Life Investment Management (NYLIM) in 2006 and now operates as an independent subsidiary.

We have selected the Mainstay ICAP Select Equity Fund for our clients because of their solid investment philoso-

phy, skilled portfolio managers, and long track record of superior returns. As with all of our recommended investment managers, we will continue to monitor the performance and process of this fund to assure it delivers the quality and performance we expect for our clients.

*Disclaimer: This manager (Mainstay ICAP Select Equity Fund) is responsible for managing one or more investments recommended in the past by Horizon Advisors. A complete list of all investment recommendations Horizon Advisors has made in the past 12 months is available upon request.*

## Making Cents

### Proactive Income Tax Planning

As we go to press with this issue of our newsletter, our readers have recently filed their 2006 income tax returns, or in many cases, have requested an extension of time to file. While many of us feel a relief at finishing off last year's filing, it's not too early to begin planning for your 2007 income taxes. In fact, the sooner you begin thinking about this year's filing, the better. If you only think about taxes just before the end of the year you may be missing opportunities. It really makes sense to work on your planning all year long. Following are some general suggestions:

Those of us with tax advantaged employee benefits, such as 401K plans, medical savings accounts or flexible spending arrangements should make sure to take full advantage of these saving vehicles. It is also quite simple to arrange for some or all of your self-employment earnings to be saved in a tax advantaged fashion, but you may

have to plan ahead of time to take advantage of this benefit.

If you plan on making any sizable charitable contributions you may have limits on the amount you can deduct in any particular year, depending on your income. You might also want to consider making contributions with appreciated securities from your portfolio. You will probably get a deduction for the fair value of the stock as well as avoid paying capital gains taxes on the appreciation.

There continues to be a renewed interest in the Alternative Minimum Tax ("AMT"), as it seems to affect more and more taxpayers. While it may be difficult to escape the AMT altogether, there are steps you can take to minimize its impact. For example, you may reduce your exposure to AMT by paying state and local income taxes in one year rather than the next. Further, many investors are not aware that some municipal bonds, called private activity bonds, are subject to AMT. Incentive stock options are not so common any more, but people who own them need to be sure to consider the AMT when they make the decision to exercise them.

We, along with our fellow professionals at Maddox, Thomson & Associates will be happy to review your particular circumstances and help you decide which planning techniques might be appropriate in your particular circumstances. If we haven't already discussed tax planning with you, please give us a call.

Estate Planning

Tax Planning Services

Investment Management

Private Foundation Administration



**HORIZON**  
A D V I S O R S

5851 San Felipe  
Suite 700

Houston, Texas 77057  
713.748.7000

[www.horizon-advisors.com](http://www.horizon-advisors.com)

Financial Planning

Retirement Planning

Tax Compliance Services

Personal Financial Administration