

12/31/2007 Quarterly Newsletter

Discipline is the key to success

With every approach to the stock market, bear in mind that there will always be periods of over-performance and periods of under-performance. Here at Disciplined Wealth Management (DWM), our goal is to concentrate your portfolio in the leading asset classes while avoiding the performance-sapping lagging asset classes; over the long term, our approach strives to provide you with better performance compared to the overall stock market average (the S&P 500) and with less risk. In summary – stay disciplined during times of under-performance; don't become emotional and abandon a proven long-term strategy during a usually short period of under-performance, but stick with it and let the strategy work for you. If someone says they are never wrong, they have just proven themselves otherwise.

General commentary –

"Buy and Hope"

Today's most widely recommended investment strategy is known as "buy and hold," but I call it "buy and hope." It's a passive strategy where investors own a basket of stocks or mutual funds and then just sit back, and let it ride. Wouldn't it be great if it was that easy!? Unfortunately, the exaggerated potential of buy-and-hold investing is more myth than reality.

The more you study the history of the stock market, the more you begin to understand the real dangers of buy-and-hold investing. A single bear market can destroy a large portion of your accumulated assets. Unfortunately, many mutual fund companies, the popular financial press, and even some professional investment advisors have convinced the majority of investors to accept the "let it ride" philosophy. Do they need to be reminded that, on average, bear markets come along every four or five years?

Nobel Laureate Paul A. Samuelson states, "The longer you own stocks, the greater the risk of a devastating loss." Passive investors will try to forget about the last big decline, but forgetting about history is not a good idea. Bear markets slash portfolio values an average of -32.7%. However, there have been declines of 86%, 54%, and 48% this century (1). In terms of real dollars, had you invested \$100,000 in the stock market in January of 1973, your investment would have shrunk to \$51,800 in just 21 months - a loss of 48.2%.

Assuming you were able to continue your buy-and-hold strategy, you would have waited another seven and a half years just to break even! Sick over their losses, most buy-and-hold investors eventually give up and bail out. And who can blame them.

Successful investing in the stock market takes more than a single decision to buy a mutual fund or a stock. It requires many important adjustments as market conditions change. Optimistic predictions from the so-called experts of Wall Street make interesting commentary, but do little to protect your assets when the stock market falls.

We do not pretend to know the future. But we know that buy-and-hold investing will not preserve your assets in the next market decline. The Disciplined Wealth Management approach provides investment strategies that seek to preserve and grow assets in both bull and bear markets.

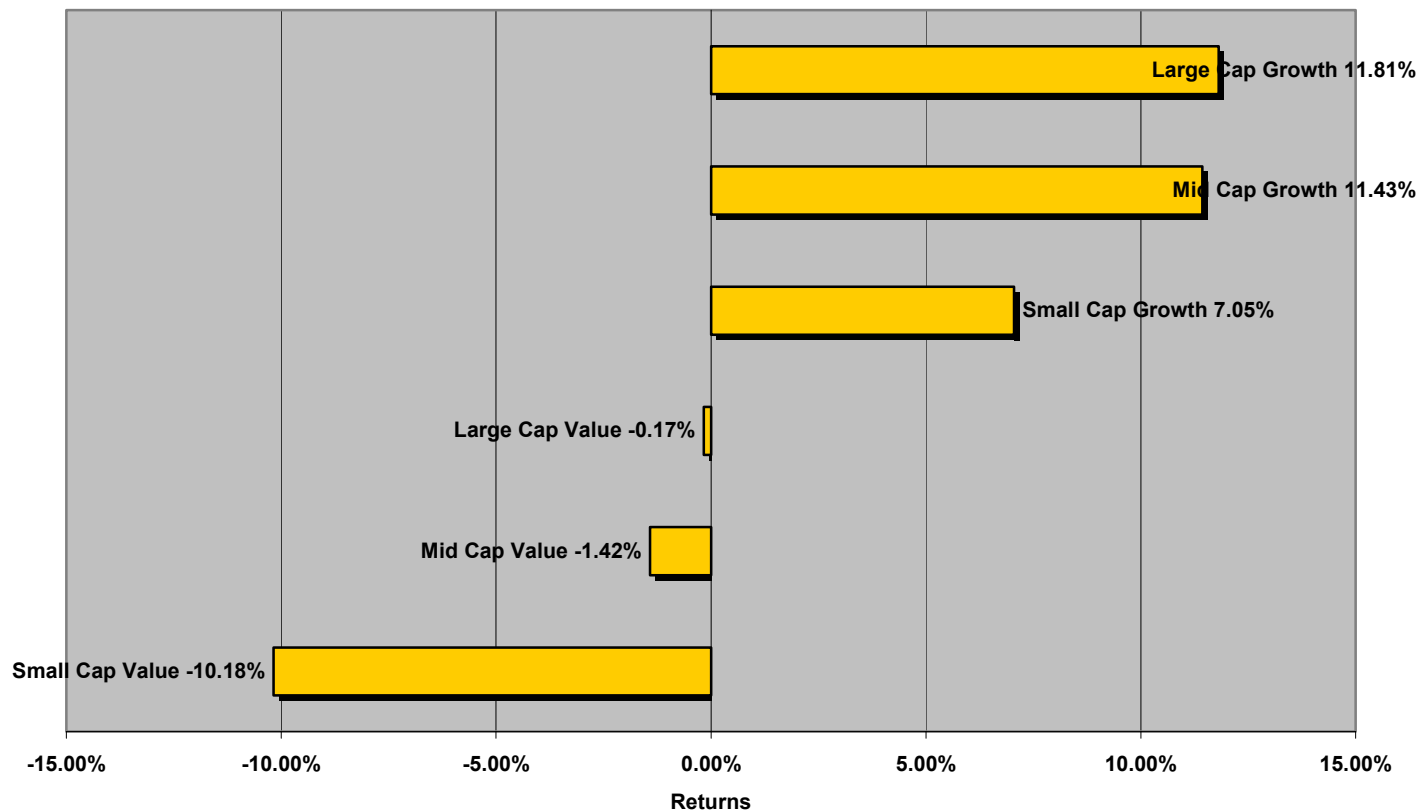
As we go to press, the overall market environment indicator remains Bearish. We will continue to monitor this indicator and make the necessary adjustments.

(1) "Bull and Bear Markets, Past and Present" By Dr. Bryan Taylor, Global Financial Data, Inc.

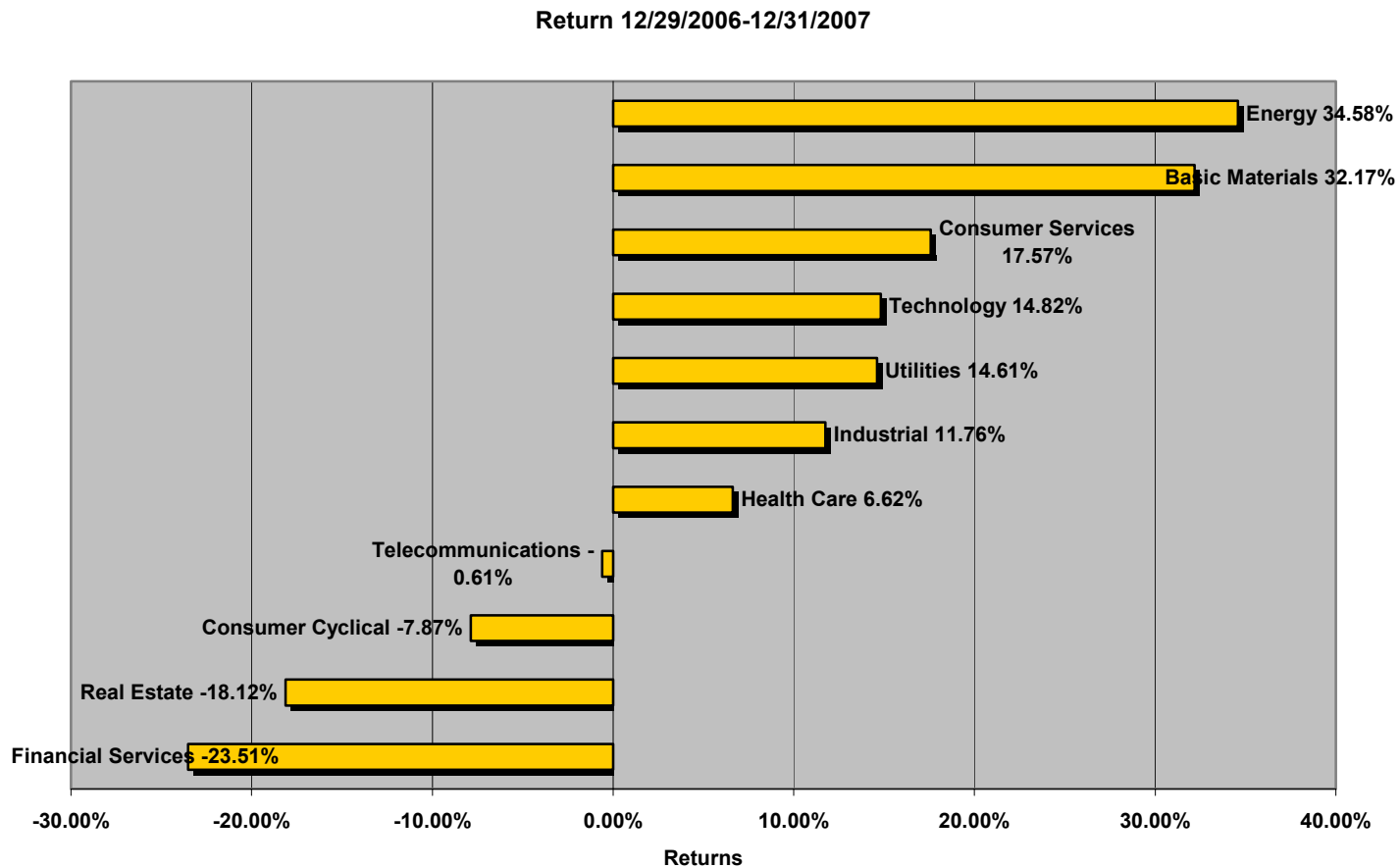
Please note that, in the following pages, the charts showing the performance of certain asset classes are for illustrative purposes only and they do not reflect the ranking system utilized by DWM.

Style boxes – There were no changes in my relative strength rankings from last quarter’s newsletter. However, things have changed if one was to look at where the strength was to start 2007 versus where the strength is starting 2008. 2007 started the year favoring Value over Growth, and it’s amazing how things have changed. As we start 2008, Growth is dominating Value in my ranks. However, the short-term picture is not as clear as the intermediate term picture pertaining to what is leading or what is lagging. Value is performing as well as Growth over the short-term, but remains a big laggard over the intermediate and long term. The picture remains consistent with Large vs. Small as Large continues to outperform Small, which matches the intermediate term reading. Do we see a change where Value is coming back as a new leader? No one knows for sure which is why we will continue to rely on our time-tested relative-strength analysis to guide our investments surrounding style boxes.

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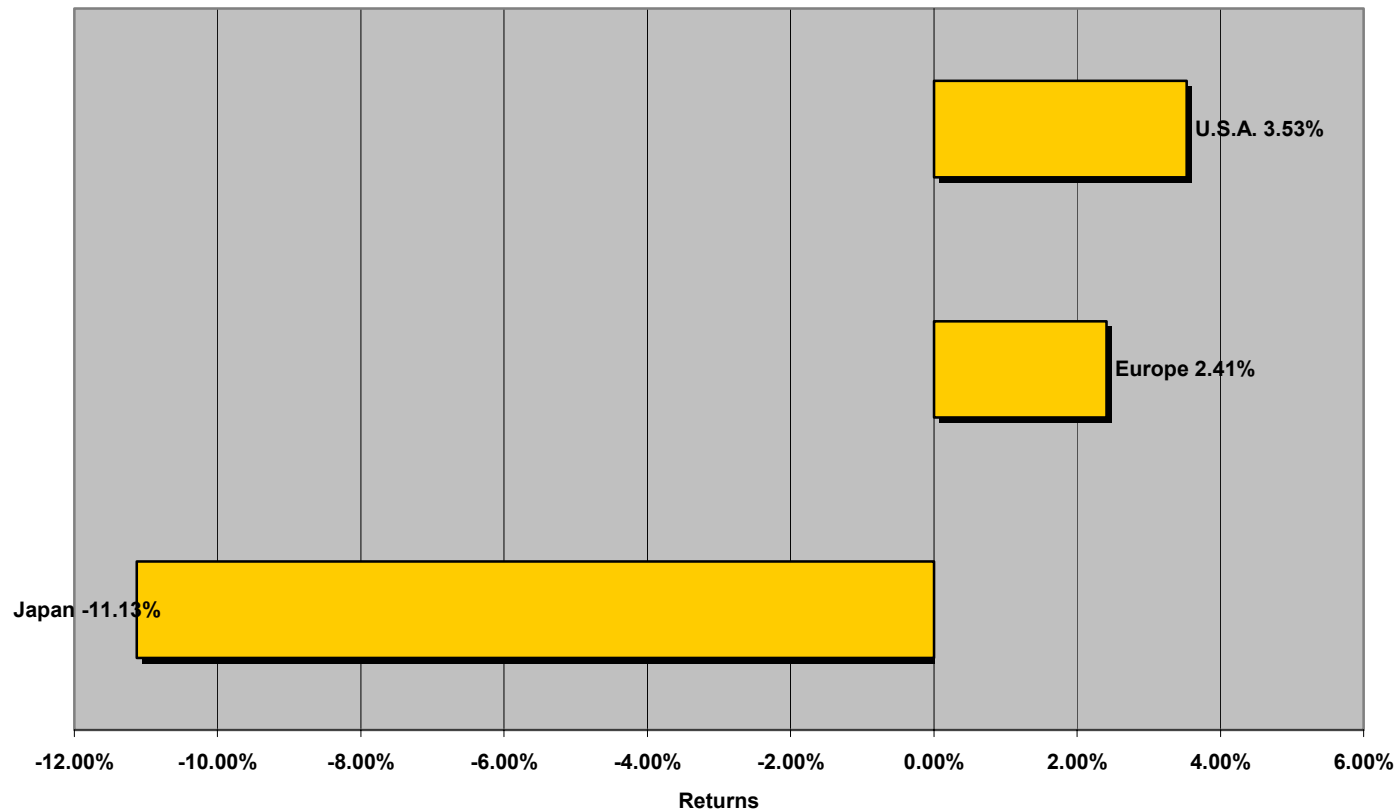


Sectors – The bloodletting continued in the financial services sector as more firms reported substantial losses in mortgage-related securities and derivatives. Moves by the Federal Reserve to cut interest rates do not appear to be very helpful. The problem is banks are holding large quantities of paper that cannot be valued. No one knows what it is worth. This creates a fear of the unknown that may be unfounded, but for the moment it is reality. So it comes as no surprise that Financial Services sits at the bottom of our relative strength rankings. Energy and Basic Materials continue their strong hold at the top of my relative strength ranks. Utilities experienced the largest move jumping five spots to claim the third position in my relative strength work. As usual, we will continue to rely on our time-tested relative-strength analysis to guide our investments surrounding sectors.

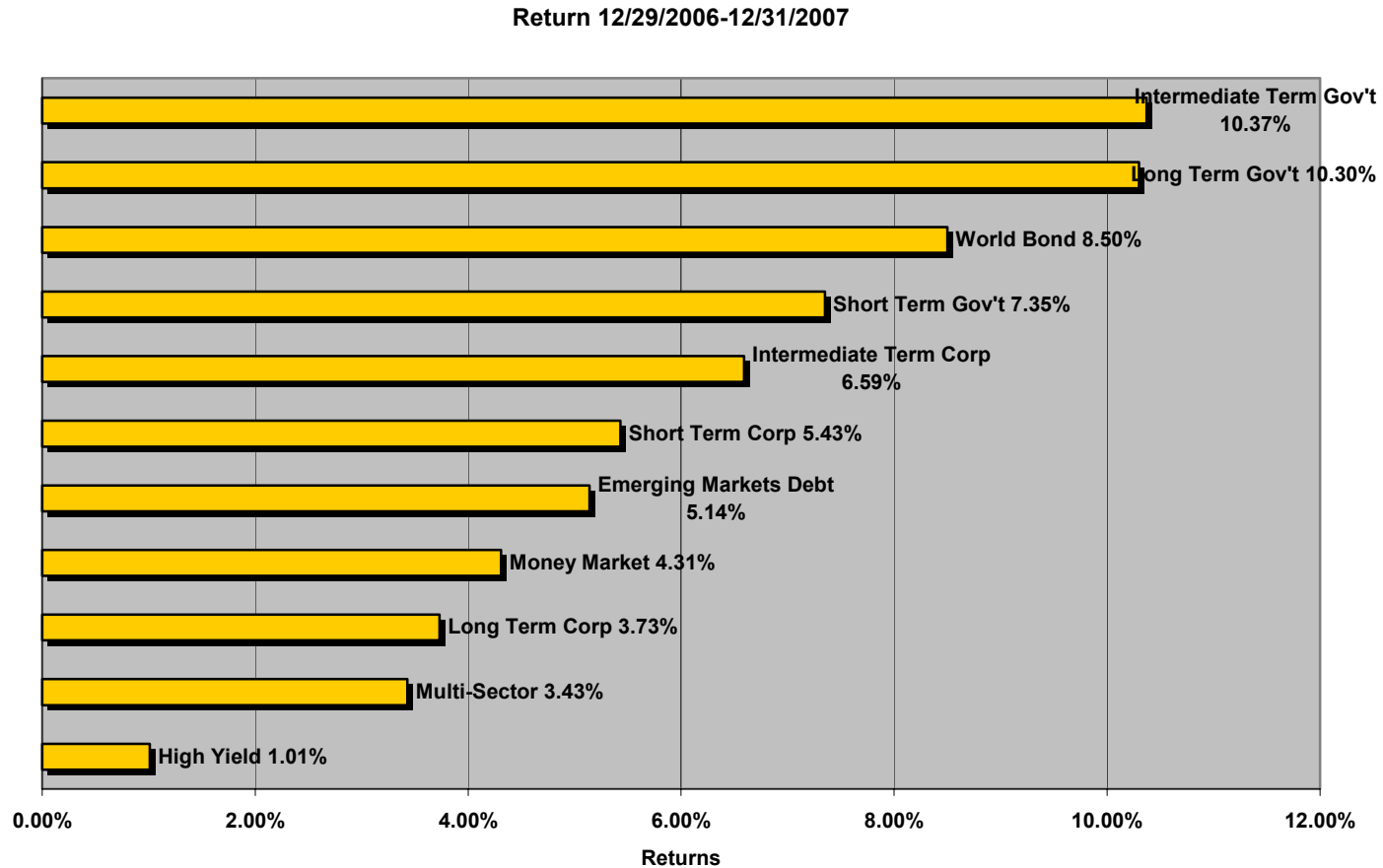


Internationals – The third quarter trend continued as European stocks fared much better than Japanese stocks in the fourth quarter. European stocks as measured by the EuroTop 100 Index were down 2.5% while Japanese stocks as measured by the Tokyo Nikkei Index were down over 8.8%. My relative strength work continues to favor Europe over Japan and will continue to overweight Europe until my analysis suggests otherwise. As usual, we will continue to rely on our time-tested relative-strength analysis to guide our investments surrounding internationals.

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Bonds – World Bonds dominance of being consistently ranked as one of the best places to be came to an end as it experienced the largest move in my ranks, dropping seven spots from the #1 to the #8 position. Falling short-term interest rates in the U.S. proved beneficial for long-term government bonds. I-shares Long-Term Gov't Bond ETF (TLT) gained +6.6% last quarter. This action is counter-intuitive given the significant inflation fears, but the reason might become apparent later. Regardless, we will follow our relative strength analysis and favor Long, Intermediate and Short Term Gov't Bonds. As usual, we will continue to rely on our time-tested relative-strength analysis to guide our investments surrounding bonds.



Forward-looking statement –

Where does it go from here?

The current market's gyrations have been unsettling to many, while others asked, "what took so long?" The fact is, periods of market volatility are inevitable. It just hadn't happened for an unusually long time. Until recently, the Volatility Index (VIX), a commonly used measure of stock market volatility, had been fairly low and steady since its last spike in 2003.

Just how inevitable are market declines? Based on the performance of the Dow since 1900, various degrees of volatility have happened on a regular basis. "Routine" declines—losses of at least 5%—have historically occurred more than three times a year. Nearly a third of the time, these declines graduated to a *correction* (losses of 10% or more from a peak), *severe correction* (losses of 15%+) or *bear market* (losses of 20%+) (2). Interestingly, the more severe a market decline is, the more likely it will intensify. Historically, 54% of severe corrections become bear markets. This also demonstrates how unusual the markets have behaved in recent years. While corrections have, on average, occurred annually, the last such occurrence was in November 2002.

The same holds true for the broader S&P 500 Index. Since 1928, there have been 87 stock market corrections, an average of more than one a year. In contrast, however, the S&P 500 Index is closing in on its fifth year without experiencing such a decline. Given these historical trends, it's easy to see why recent market volatility has felt so unsettling.

From the peak on 10/09/2007 to the low on 11/26/2007 the S&P 500 dropped just slightly under 10%. So the question remains where does it go from here?

Will the five-year bull market continue or will the recent decline graduate into a correction, severe correction or bear market? No one knows for sure and only time will tell. DWM will continue to rely on its tactical tools to keep us in line with what the market is actually doing. Always remember: the key to investment success is to stay disciplined and flexible in an ever-changing market environment. The moment you start to second-guess your decisions is usually the time you shouldn't.

(2) Source Ned Davis Research

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Sources:

- Style box data = Russell Indexes. Source www.russell.com and Investors FastTrack.
- Sector data = DJ US Sector Indexes with the exception of Basic Materials and Real Estate utilizing I-Shares. Source Investors FastTrack.
- International data = EuroTop 100 Index for Europe, Tokyo Nikkei Index for Japan, S&P 500 Index for U.S.A. Source Investors FastTrack.
- Bond data = various bond mutual funds and exchange traded funds (ETF). Source Investors FastTrack.