

Sunrise Advisors Investment Philosophy For Equity & Balanced Accounts

Modern Portfolio Theory, Hedge Fund Principles, and Absolute Returns

How important is your asset manager's investment philosophy?

In the May 2003 edition of *Bloomberg Wealth Manager*, a lead article was entitled "Moonstruck—Disenchanted with traditional portfolio strategies, advisors are quietly gravitating to core-and-satellite approach." Many advisors, including some of the largest and most sophisticated in the country, changed how they manage money simply because they lost 25-50% of client assets in the 2000-2002 bear market.

Sunrise Advisors is steadfastly committed to the philosophy that we have developed over our 30-plus years of professional investment management. We have successfully employed it for decades, in both up and down markets, for the benefit of our clients. And it is very similar to this 'new' core and satellite strategy.

In our core investment portfolio, we use a standard approach. According to *Bloomberg*, these core investments should be a significant portion of the portfolio. They should be efficiently invested in a traditionally diversified group of benchmark holdings. We do that. However, we tweak the portfolio to maximize returns based on the economic environment.

Like many advisors, we use the Nobel Prize-winning Modern Portfolio Theory which relies upon proper diversification to reduce investment risk and improve returns. This proven strategy involves the use of negatively correlated investments to offset large swings in the overall portfolio value. That is where the 'satellite' comes into play. We differentiate ourselves at Sunrise by how we manage the satellite portion of our portfolios. While our investment philosophy does not include the use of hedge funds, in certain markets we may use some of the same principles exercised by hedge fund managers.

So how can Modern Portfolio Theory and hedge fund concepts benefit investors? Like Grandma's best recipe—a pinch of this and a little of that can conjure up sweet success. (Any recipe for proper investing, however, must change as the economy changes.)

First some history, so you will understand our theory. Hedge fund investing goes back to Alfred Winslow Jones, Columbia University, in 1949. After interviewing the best minds on the Street, he concluded that no one could predict or should try to predict the direction of the markets overall. He created a strategy that would make the overall direction of the market less relevant to investor returns.

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To do this he took \$100,000 and went to a brokerage firm/bank and said, "I would like to buy \$100,000 of ABC stock." Then he told the broker, "I'd like to sell short \$100,000 of XYZ stock, and using the borrowing power of the ABC position, I would like \$50,000 more to buy IBM on margin." In this way, with \$100,000 worth of capital, he had \$250,000 worth of market investments with a \$50,000 net market exposure (netting out his one position positively-correlated and one position negatively-correlated to the market). Viola, he had created the 'hedge fund' concept. It supposedly disassociated portfolio returns from the broad market movements, and it used two speculative techniques (short selling and leverage) to actually lower market risk.

Today, many professionals still consider the Jones-model to be the best risk-reward profile for hedge funds. In this portfolio, the amount of risk and potential for reward are determined by the temperament and skill of the manager choosing the investments.

Another concept of hedge fund investing revolves around the idea of 'absolute return'. Absolute return is not an investment style. Instead, it refers to the pursuit of consistently positive returns every year, no matter what happens in the marketplace. It also refers to the preservation of capital and avoidance of significant loss. This can only be done if an investment manager has the ability to take advantage of the 'other side' of the market. That is, we must be in a position to profit from such events as an overpriced stock market, a declining US dollar, or rising interest rates. 'Absolute return' tries to find a way to profit, or at least protect, no matter what other markets or managers are doing.

Oversimplifying, we use two parts Modern Portfolio Theory with one part the Jones-model hedge fund with the objective of achieving 'absolute returns'. (We believe a recipe using two parts hedge fund would be too caloric for our conservative style.)

In Bull Markets, we use Modern Portfolio Theory to balance the overall core and satellite holdings to achieve a participatory return. The reason people invest in the stock market is for the potentially large returns. So when the market goes up, we want to be in there to get our share. In this case, the satellite and the core holdings are diversified and mostly correlated to the advancing broad markets. In the satellite portion, we want to be in those sectors that are most likely to show the greatest returns.

In Bear Markets, our quest for absolute returns, or positive returns each year, becomes more difficult. Difficult, yes, but possible. As the downturn unfolds, we generally reduce core portfolio assets, while adding to those in the satellite. In the satellite, we buy some assets that are negatively correlated to the overall market, and we also look for areas of opportunity that may or may not be related to the overall market trend, like a hedge fund manager. To a degree, then, the core portfolio holdings are hedged by the satellite holdings.

You must realize that we are not market-timers, and we are not interested in speculation. That is why our recipe calls for only one part hedge fund theory per two parts Modern Portfolio Theory. So in keeping with the absolute return principle of preserving capital, during very severe downturns we might do well by incurring slight losses or staying even.

There are, of course, periods where the markets have no direction, periods where the markets implode or bubble, and periods where negatively correlated assets will move in the same direction. Anomalies and divergences happen. These are the times that we can be most helpful to our clients by giving a clear perspective of the financial landscape or by anticipating economic changes.

And sometimes our best advice involves maintaining discipline and encouraging clients to just be patient. After all, finding a well-conceived plan, then staying with it through difficult times, is half the battle.

You should know how your investment advisor thinks. The clarity with which you understand your advisor's investment philosophy will determine if the plan is compatible with your personal dreams and goals. And that will ultimately determine your success.

Sunrise Advisors Mission Statement

To produce successful, long-term investment results
by using proven asset-management techniques and
by providing the most appropriate, highest quality,
lowest cost investments for our clients.

To communicate clearly in our advisory role,
enabling us to better serve each client
in a relationship of understanding and trust.

To set up a portfolio review with Sunrise Advisors, contact us at (913) 681-0215
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Core Portfolio with NEGATIVELY Correlated Satellite
Client Asset Allocation – February 2000

When we believe the market is overvalued and headed for a downturn, the Satellite portion of our portfolio is configured with securities that are negatively correlated (move in the opposite direction) to the market and the Core portion of our portfolio. This enables us to benefit from a declining market and/or protect the value of the assets in the portfolio.

**This was our actual asset allocation for our mutual fund portfolio during February of 2000. Sunrise Advisors uses individual securities (equities and/or bonds), mutual funds, and/or exchange-traded funds in our managed portfolios.

SUNRISE ADVISORS						
Asset Allocation Portfolios						
<u>CORE (+)</u>		<u>ST/MMKT</u>	<u>LOW</u>	<u>BALANCED</u>	<u>MEDIUM</u>	<u>HIGH</u>
Near Cash	Money Market	75%	32%	18.5%	18%	4%
	Strong Short-Term Bond	25	12	7.5	8	4
Bonds	Strong Advantage	0	13	20	8	3
Growth Stock	Schwab S&P 500	0	6	8	8	10
	Selected American	0	3	4	5	7
Growth & Income	American Century G&I	0	4	5	7	9
	Excelsior Value & Restr.	0	4	5	7	9
Small-Med Cap Growth	Third Avenue Value	0	3	4	5	8
	Weitz Value	0	3	4	5	8
<u>SATELLITE (-)</u> Market Diversifiers	Invesco Energy	0	5	8	7	9
	American Century Gold	0	4	4	5	6
	Rydex Ursa	0	8	8	12	16
	Cohen & Steer Realty	0	3	4	5	7
	% Near Cash	100	44	26	26	8
	% Bonds	0	13	20	8	3
	% Equities	0	43	54	66	89
		100%	100%	100%	100%	100%
Asset Allocation (February 2000)		ST/MMKT	LOW	BALANCED	MEDIUM	HIGH

To contact us: call (913) 681-0215 or visit our website, www.SunriseAdvisors.com

Core Portfolio with POSITIVELY Correlated Satellite
Client Asset Allocation – February 2003

When we believe the market is undervalued and has potential for gains, the Satellite portion of our portfolio is configured with securities that are positively correlated (move in the same direction) to the market and the Core portion of our portfolio. This enables us to get generate quality returns during times of opportunity.

**This was our actual asset allocation for our mutual fund portfolio during February of 2003. Sunrise Advisors uses individual securities (equities and/or bonds), mutual funds, and/or exchange-traded funds in our managed portfolios.

SUNRISE ADVISORS Asset Allocation Portfolios						
<u>CORE (+)</u>		<u>ST/MMKT</u>	<u>LOW</u>	<u>BALANCED</u>	<u>MEDIUM</u>	<u>HIGH</u>
Near Cash	Money Market	75%	28%	14%	14%	2%
	Turner Ultra Short (1yr)	25	12	14	8	0
Bonds	Dreyfus Short Term (3yr)	0	13	18	8	3
Growth Stock	Oakmark	0	10	10	12	16
	Selected American	0	8	6	12	14
	Schwab S&P 500	0	4	4	5	6
Growth & Income	Excelsior Value & Restr.	0	4	6	7	9
	Am. Centruy Equity Inc.	0	3	4	5	8
Small-Med Cap Growth	FBR Small Cap Financial	0	3	6	7	9
	Oakmark Inertnational	0	3	4	5	8
<u>SATELLITE (+)</u>	Excelsior Energy	0	5	6	7	9
Market Diversifiers	American Century Gold	0	0	0	0	0
	Rydex Ursa	0	0	0	0	0
	PIMCO Global Health	0	3	4	5	8
	Rydex OTC (Nasdaq 100)	0	3	4	5	8
	% Near Cash	100	40	28	26	2
	% Bonds	0	13	18	8	3
	% Equities	0	47	54	66	95
		100%	100%	100%	100%	100%
Asset Allocation (February 2003)		ST/MMKT	LOW	BALANCED	MEDIUM	HIGH

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