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## Elimination Newsletter

*"Separating fact from fiction since 1998. The antidote to Wall Street."*

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### **A Look Ahead to 2010 for Pt. Reyes and the Introduction of Pt. Sur**

December 28, 2009

#### **Some history on Pt. Reyes first**

In the fall of 2007 we knew that global equity markets were peaking out and it looked to us like a major correction was at hand. Our decision to take the entire portfolio we manage to cash in November 2007 is a testament to that insight. At the time we did not offer a model that had income as a primary objective, followed by capital preservation as a secondary objective. We felt we needed to offer people a place to hide during what might turn out to be a protracted bear market. That turned out to be a prescient call.

It was probably no coincidence that at about the same time one of our clients came to us with a request for a fixed income model. Their initial account was actually funded in November 2007. We then opened the model to other clients and kicked it off officially January 1, 2008.

We were not strangers to the bond markets as bonds had often played important roles in other models we manage. From 1990-1998 we used bonds as very important parts of portfolios at my practice that preceded 5T Wealth Management, LLC. So making the adaptation to running a portfolio that primarily consisted of bonds was easy.

Here is a brief description of the model:

**"The Point Reyes model is for investors seeking current income, protection of capital and low volatility. The model is primarily focused on taxable fixed income investments including domestic and foreign corporate bonds, U.S. government agency notes and bonds, U.S. treasury notes and bonds, foreign government bonds and money market accounts. The model may also invest in preferred stocks and convertible preferred stocks. Up to 20% of the model may be allocated to common stocks of companies that have historically paid high dividends."**

At December 31, 2009 Pt. Reyes will be two years old. Minimum account size is \$250,000.

The first year results (2008) for Pt. Reyes were actually disappointing. We invested a portion of the assets in preferred bank stocks and they got hammered in value. The model finished 2008 down 6.44%. We sold all the stocks in the model in late 2008 and promised clients that we would not invest in stocks during 2009, no matter what. We wanted to make sure that we avoided the potential volatility that stocks can add and provide a safe haven for investors in 2009. It worked. It now looks like the model will finish 2009 with a total return between 9 and 10%. The return will come in at somewhere between 2.5% and 3.5% for the entire period. That is much better than money market rates over that period of time.

Approximately 98% of the assets in Pt. Reyes are currently invested in corporate bonds that have maturities between one and five years. 1% is invested in the Chinese Yuan and 1% is in cash.

We created a "bond ladder" by staggering the maturities of the bonds from one to five years in fairly equal tranches. This has been very effective in 2009 and we believe it will continue to serve us well in 2010.

### **Let's look forward now to 2010**

Our base case for interest rates in 2010 is that they will rise. Here is a quote from our 2010 forecast:

- Interest rates should start to rise in 2010, but rate increases will be very subdued. The central banks of the USA and Europe are likely to be on hold until at least of the middle of 2010.

Since we wrote that many of the major firms have come out with their forecasts for 2010. One of the most aggressive was issued today by Morgan Stanley. Here is a quote from Bloomberg, dated December 28, 2009.

**"If Morgan Stanley is right, the best sale of U.S. Treasuries for 2010 may be the short sale.**

**Yields on benchmark 10-year notes will climb about 40 percent to 5.5 percent, the biggest annual increase since 1999, according to David Greenlaw, chief fixed-income economist at Morgan Stanley in New York. The surge will push interest rates on 30-year fixed mortgages to 7.5 percent to 8 percent, almost the highest in a decade, Greenlaw said.**

**Investors are demanding higher returns on government debt, boosting rates this month by the most since January, on concern President Barack Obama's attempt to revive economic growth with record spending will keep the deficit at \$1 trillion. Rising borrowing costs risk jeopardizing a recovery from a plunge in the residential mortgage market that led to the worst global recession in six decades.**

**'When you take these kinds of aggressive policy actions to prevent a depression, you have to clean up after yourself,' Greenlaw said in a telephone interview. 'Market signals will ultimately spur some policy action but I'm not naive enough to think it will be a very pleasant environment.'** "

We certainly sympathize with Mr. Greenlaw's point of view and we too expect rates to rise.

But not everyone agrees with his assessment of how much they will rise.

Bloomberg also reports:

**"Ten-year notes will end 2010 at 3.97 percent, according to the average of 60 estimates in a Bloomberg News survey that gives greater weight to the most-recent forecasts."**

The ten-year note rate is at 3.83% on December 28, 2009.

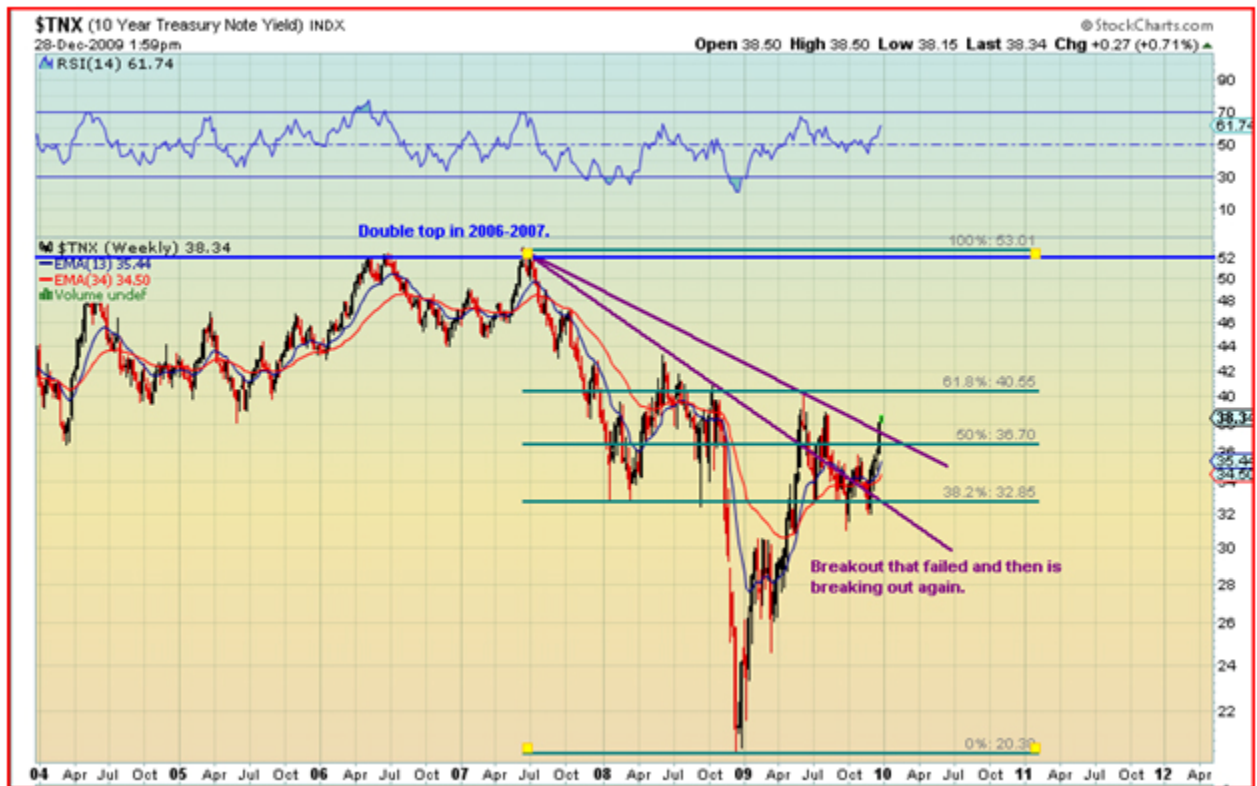
Edward McKelvey, senior economist in New York at Goldman Sachs Group Inc., the top-ranked U.S. economic forecasters in 2009, according to data compiled by Bloomberg, expects yields to drop to 3.25 percent. Goldman Sachs says unemployment will average 10.3 percent in 2010, hindering the recovery.

Let me interpret all that for you. We have two heavy weights in Morgan Stanley and Goldman Sachs who are currently in total disagreement on the direction of long term rates in 2010. We have a consensus of forecasts that there will be an upward bias on rates in 2010, but that they will not be moving much.

**All of this provides us with significant comfort that our relatively short term ladder of 1 to 5 years is just the right place to start 2010.**

If rates do rise in 2010 we will get a chance to buy bonds offering those higher yields as bonds that are currently in the portfolio mature and need to be replaced.

If rates are rising in 2010 that should be a sign that the economy is experiencing a sustainable recovery and therefore rates should likely be higher as we move into 2011, at which time we will be replacing more bonds at higher rates. The upshot is that we would be able to raise the overall yield of the portfolio without significant risk to principal value, given the short maturities held in Pt. Reyes.



Here is a somewhat complicated chart of the \$TNX which represents the 10 Year Treasury Note Index. You can see that the recent top for this yield was a "double top" in 2006 and 2007 at around \$52. (this represents 5.2% yield). If Morgan Stanley's forecast is correct those double tops will be breached. If Goldman Sachs is right we are headed back to the 38.2% Fibonacci retracement at about 32.85 (green line), which equals 3.28%

If the "consensus forecast" is right we are headed to just under the 61.8% retracement at 40.55 (green line), which equates to just about 4.00%

We honestly feel we have no edge on this trade. We are sympathetic to the Morgan Stanley forecast. Frankly the amount of debt the U.S. government is issuing leads us to believe that rates MUST rise just to attract buyers to soak up all the new bond supply. But we remind you that we warned in our 2010 forecast:

**"If the dramatic 'reflation trade' they have on, through the use of so much deficit spending, doesn't work we are eventually in for one heck of a depression."**

That is the base case for rates declining next year. The 'reflation' trade simply doesn't work, deflation sets in, and rates continue to come down. While we don't think that this is the likely case one only has to look to Japan to understand that such a set of circumstances could evolve. Their 10 year Treasury rate is 1.31% and has been extremely low for nearly two decades now. They are experiencing real deflation in their economy despite years and years of central bank stimulus. It is possible that could happen here, and that is what Goldman Sachs seems worried about.

Therefore we will be sticking to our plan for Pt. Reyes in 2010. We will be limiting new purchases of bonds to those that have shorter term maturities until we get a better feel for where rates are going. This will provide us with future flexibility, give us the ability to provide competitive yield, while concentrating on maintaining the value of the portfolio.

We have concentrated exclusively on shorter term U.S. corporate bonds so far, but we are open to buying U.S. treasuries, agencies, or foreign bonds that will benefit the portfolio.

The plan is simple, keep the portfolio stable and provide a competitive rate of return. That will be the goal for 2010.

If yields actually fall in 2010 we would expect the bond prices in the portfolio to rise. Gains would be muted if rates merely fall back to 3.25% on the 10-year treasury-but a muted gain is better than none!

We recommend this model for any investor who remains totally skeptical of the twin recoveries that we have experienced so far in 2009, related to the economy and the stock market; and who is seeking current income and capital preservation.

If you want to sit out 2010 watching and waiting before you make your judgment about taking more risk with your money, Pt. Reyes seems to us to be a good place to do it.

## **Pt. Sur in 2010**

Pt. Sur is our newest model. Like most new models at 5T Wealth it grew out of a request from a client. This particular client is currently heavily invested in Pt. Reyes, is quite risk adverse. He relies on the interest from Pt. Reyes for part of his retirement income.

One year ago he wanted absolutely nothing to do with the stock market. By this fall he was encouraged by the gains he was seeing in the stock market. He was seeking investments that pay yields that are competitive with the bonds held in Pt. Reyes, but that also held out the possibility of capital appreciation. Yet he wanted to limit his exposure to the volatility common in the general stock market.

Our work with the other models has led us to favor stocks that pay substantial dividends and we had already assembled quite a list within our various models. We consolidated those names into a single portfolio, did some extensive back testing on it, and proposed making it a new model.

Pt. Sur is currently comprised of 39 stocks that make up 98% of the portfolio. 2% remains in cash. The dividend yield of the overall portfolio is 5.22% (as of December 28, 2009).

The portfolio's price movement has a 96% correlation to the S&P 500 (SPX) and a 95% correlation to the Dow Jones Industrial Average (INDU). That means that Pt. Reyes is slightly less volatile than those two U.S. equities indexes.

Bloomberg currently estimates the 2010 yield on the SPX will be 2.02% and the yield on the INDU will be 2.7%.

It is probably fair to assume that Pt. Sur, as currently constructed, will give you 96% of the price movement of the S&P (UP OR DOWN) while paying you a current yield estimated to be 2.52% greater than that of the INDU and 3.2% greater than the SPX.

Therefore if you are bullish on stocks Pt. Sur might be an ideal place to put some of your money in 2010. Assuming the stock market rises you are likely to capture most of the upside while being paid handsomely along the way.

### **Stop Loss Policy Relaxed on Pt. Sur Model**

We have relaxed our usual 9% stop loss policy on the Pt. Sur model. The policy is a guideline in other models that is used more often than not. In this model we have already let individual stocks drift significantly below the normal stop loss at 9%. We are doing that because this is a model that is targeting income as its first goal, capital preservation as its secondary goal, and capital appreciation as its third goal. If we stop out stocks because they are declining in value we automatically lose the dividend income.

One stock in the model was recently down over 12% from purchase price. It has since recovered to being down 8%. The overall portfolio is up 7.81% since inception on October 26, 2009, through the close of the market on December 28, 2009. That includes reinvestment of all dividends received year-to-date.

In this model we are more interested in continuously monitoring the safety of the dividend income than we are concerned about price movement of the individual stocks. We are more likely to remove a stock from the portfolio because the dividend is threatened than we are because of price movements.

We are assuming that owners of this model are "big boys and girls" who understand the potential trade off they are making relative to stability of principal in order to achieve substantially higher income.

### **Potential for Rising Income**

The 39 companies that are currently featured in the model have all survived the past two years with their dividend yields intact. That alone is a very significant achievement, since many companies have slashed dividend payouts during the recession. We have seen some of the Pt. Sur holdings actually raising dividends during 2009.

We are hopeful that the dividend income from the model can continue to rise in future years as companies continue to announce dividend increases.

### **A combination of Pt. Reyes and Pt. Sur might be the ticket for some**

If you are currently a client of 5T and have all your money in Pt. Reyes, you might want to think about diversifying your funds into a combination of Pt. Reyes and Pt. Sur for 2010. In order to do so you would have to be bullish, or at least neutral on the stock market. If you are fearful that stocks will retreat significantly in 2010, then stay in Pt. Reyes.

If you are a prospective client, seeking current income, either model might suit your needs, depending on your risk profile. Please contact us and we will be happy to discuss suitability with you.

Minimum account size for both models is \$250,000.

### **Contact Us**

If you are a current client and have specific questions about your Pt. Reyes or Pt. Sur account, please feel free to call either Lee (707-603-2673) or Paul (707-603-2672). Or, send us an email at [lee@5twealth.com](mailto:lee@5twealth.com) or [paul@5twealth.com](mailto:paul@5twealth.com).

If you are a prospective client and would like more detailed information about either model please call or write. We are happy to answer your questions.

All the very best and Happy Holidays,



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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-LLUMINATION 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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