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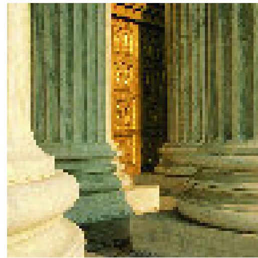
DIALOGUES

FINANCIAL STRATEGIES FOR DISCUSSION SM



Let's face it volatile markets can be difficult to withstand. But during such times, many opportunities can arise, especially if you remain patient and focused on the long term. These principles can lead to a more rewarding investing experience. Let's discuss how.

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Approaching the Unpredictable

If you could predict the future, just think how different your life would be—you'd always know which day to bring an umbrella, you'd never have to grapple with tough choices like whether to accept that new job offer or buy that new house and you'd be hailed as a genius for your uncanny ability to pick the Super Bowl winner each year.

But you can't predict the future, so you do what everyone else does—you try to make the best possible decisions for your situation based on the information that is available. As a prudent investor, this approach should carry over to your investment portfolio, which is why you hear and read so much about the concepts of *asset allocation* and *diversification*.

The whole point of asset allocation (the spreading of funds across different asset categories, such as stocks and bonds) and diversification (the spreading of funds across different investments *within* each asset category) is to help smooth some of the surprising and turbulent price swings that are an inevitable part of life in the financial markets. By spreading out your investments, you also spread out—and possibly reduce—your overall risk. What's more, you may improve your longer-term returns as well, by giving your portfolio the opportunity to spend more time compounding and growing and less time trying to play the market's ups and downs.

A prudent, long-term investment strategy built on the sound principles of asset allocation and diversification may help your investment portfolio be more successful in today's uncertain world. We can review your current strategy and allocation to see if there's an opportunity to make your wealth work harder for you—and to do so with less risk.

And take comfort in knowing that life is much more interesting when it includes the occasional surprise.

Diversification does not ensure against loss.

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The Diversification Advantage

Sharp price swings like the ones seen in the past year are an inevitable part of life in the financial markets. They also serve as an important reminder of how *diversification*—the spreading of funds across different investments *within* asset categories such as stocks and bonds—can reduce the risk of a single catastrophic loss, such as a company bankruptcy or a bond default, wiping out an entire portfolio.

But the potential benefits of this approach actually go much further than that. Diversification may also help you achieve higher returns—at lower risk—than any single asset in your portfolio could by itself. Even assets with relatively low returns may actually boost overall investment performance, if their risk and return characteristics are sufficiently different from the other assets in the portfolio.

It may be hard to understand how investing in an underperforming asset could lead to *better* portfolio performance. But that is precisely what makes diversification such a powerful tool. Just as a high-grade steel alloy can be created by combining other materials, it may be possible to create a stronger portfolio by combining stocks, bonds and other financial assets. Properly done, a sound asset allocation strategy may reduce portfolio volatility and may lead to faster growth over time.

A Theory of Diversification

Prudent diversification isn't just about adding more stocks or bonds to your portfolio. Years of investment practice have given the word a much more specific meaning. Beginning in the 1950s, financial researchers realized that by combining different assets, they could, in theory, create portfolios that would deliver higher returns with less risk than any one asset would by itself. This insight spurred the creation of a disciplined, fact-based approach to diversification, sometimes known as Modern Portfolio Theory (MPT).

One of the keys to MPT is the fact that returns on different assets usually aren't fully *correlated*—meaning they don't always move in the same direction at the same time or by the same amounts. This means that returns on different assets may partially offset each other, reducing overall portfolio volatility. The chart on this page shows the historical correlations between a number of popular asset classes and the Standard & Poor's 500 Index.

Correlation isn't the only factor that needs to be taken into account when building diversified portfolios. The expected risks and returns for each asset also help determine whether including it can produce gains. Other things being equal, the higher the expected return, the more likely it is that adding an asset to a portfolio will improve performance. Likewise, the *lower* the expected volatility, the more likely an asset is to improve performance.

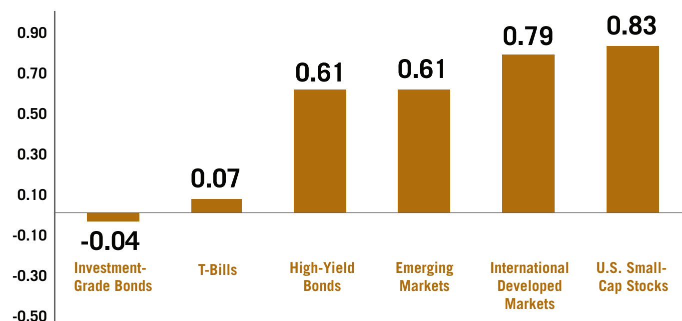
A Question of Correlation

Correlation is measured on a scale of -1 to +1. If the correlation between the returns on two different assets is +1, they are said to be *perfectly correlated*. Their returns always move in the same direction at the same time and by the same amounts.

If correlation is less than +1 but more than zero, assets are said to be *positively correlated*. Returns move in the same direction more often than not. If correlation is less than zero, assets are said to be *negatively correlated*. Their returns tend to move in opposite directions, by opposite amounts.

Positive correlation reduces but doesn't eliminate the benefits of diversification. As long as the correlation between two assets is less than +1 (less than perfect) it may be possible to improve performance by including them in your portfolio.

Correlation with the S&P 500: 1990 through 2007



Source: Citi Global Investment Committee

Correlation, return and volatility—all three need to be taken into account when designing diversified portfolios. This process is called *portfolio optimization*. It's a complex procedure, in which mathematical formulas are used to compare the returns, volatility and correlation of each asset class.

Risk and Return

The chart to the right is a simple example of how diversification can influence performance. It displays risk-and-return results for different portfolios consisting of large-cap U.S. stocks and long-term government bonds. The portfolio at bottom left is 100% bonds; the next one is 90% bonds and 10% stocks; the next is 80% stocks and 20% bonds; and so on until you reach the portfolio at upper right, which is 100% stocks.

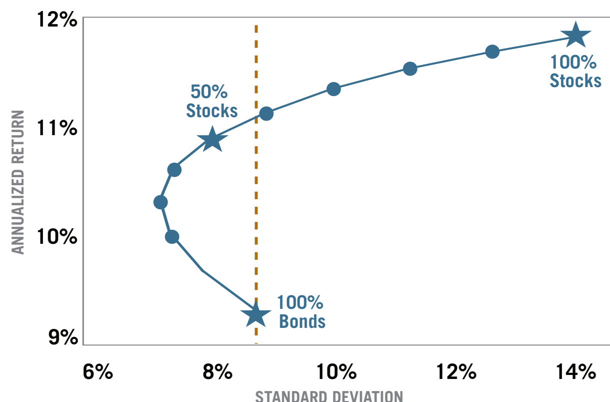
Notice the line connecting the portfolios isn't straight, but rather curves up and to the left before swinging around toward the all-stock portfolio. This is the diversification dividend in action.

Historically, equity returns have tended to be more volatile than bond returns. Yet, because bonds and stocks are not perfectly correlated, adding stocks to an all-bond portfolio historically has *reduced* volatility—at least, up to a point. Lower volatility has also improved returns, pushing the line up and to the left.

Over the period shown, the portfolios to the left of the dotted line on the chart delivered *better* performance than the all-bond portfolio, even though they contain increasing amounts of stocks, a riskier asset. Eventually, though, the higher volatility associated with stocks overwhelmed the diversification effect, pushing the line back toward the right-hand side of the chart.

The bottom line: Over the period shown, a blend of 50% bonds and 50% stocks was less risky than an all-bond portfolio, but produced more than two percentage points of extra return.

Risk and Return Results for Stock and Bond Blends: Twenty Years Ending December 2007



Source: Smith Barney

Over a 20- or 30-year period, this can add up to a big increase in the value of a portfolio.

This same basic logic still applies when other asset classes—such as small-cap stocks, international equities or even alternative asset classes such as hedge funds or real estate—are added to the portfolio. But the process of deciding what share, or "weight," in the portfolio should be given to each asset class does become more complex.

You do not have to grapple with the complexities of diversification or portfolio optimization on your own. Speak with us for more information about these processes and how you might be able to get more out of your portfolio over time—with less risk.

[1] *Investments: Analysis and Management*, Sixth Edition, by Charles P. Jones, Wiley & Sons, 1998; *Modern Investment Management: An Equilibrium Approach*, by Bob Litterman, Wiley Finance, 2003, and the Private Bank Brochure *Whole Net Worth Asset Allocation,* Citigroup, 2003.

Diversification does not ensure against loss.

The S&P 500 Index is an unmanaged, market-value-weighted index of 500 stocks generally representative of the broad stock market. An investment cannot be made directly in a market index.

Bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating, or creditworthiness, causes a bond's price to decline. High-yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues. Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made.

As further described in the offering documents, an investment in alternative investments can be highly illiquid, is speculative and not suitable for all investors. Investing in alternative investments is only intended for experienced and sophisticated investors who are willing to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks may include: loss of all or a substantial portion of the investment due to leveraging, short selling, or other speculative practices; lack of liquidity in that there may be no secondary market for the fund and none is expected to develop; volatility of returns; restrictions on transferring interests in the fund; potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized; absence of information regarding valuations and pricing; complex tax structures and delays in tax reporting; less regulation and higher fees than mutual funds; and advisor risk. Individual funds will have specific risks related to their investment programs that will vary from fund to fund. Actual results may vary and past performance is no guarantee of future results. Past performance is no guarantee of future results. These strategies do not guarantee a profit or protect against a loss and may not be suitable for all investors. Each customer's specific situation, goals, and results may differ. This data is being presented for illustrative purposes only. Historical returns do not necessarily account for fees or transaction costs, which may be charged when investing in an actual portfolio of securities.

Coping With Volatile Markets

What Long-Term Investors Need to Know

Periodically, investors are given a sharp reminder that stock prices can go down as well as up—and can do both very quickly and with relatively little warning. These sudden market movements can raise doubts about the wisdom of a long-term commitment to equity investing.

Investors are often tempted to overreact in such situations. Their first instinct may be to sell holdings, particularly stocks that are highly susceptible to market moves. Or, they may try to "time" the market—liquidating positions in hopes of buying them back at cheaper prices when the worst is over. This is usually a mistake: Even professional money managers can't often guess the market's next move.

When markets turn volatile, it's more important than ever for investors to keep a clear head and a cool hand. The middle of a sudden correction—or an upswing—isn't the right time to be making impulsive emotional decisions about your portfolio. As the saying goes: Act in haste, repent at leisure.

Risk and Reward

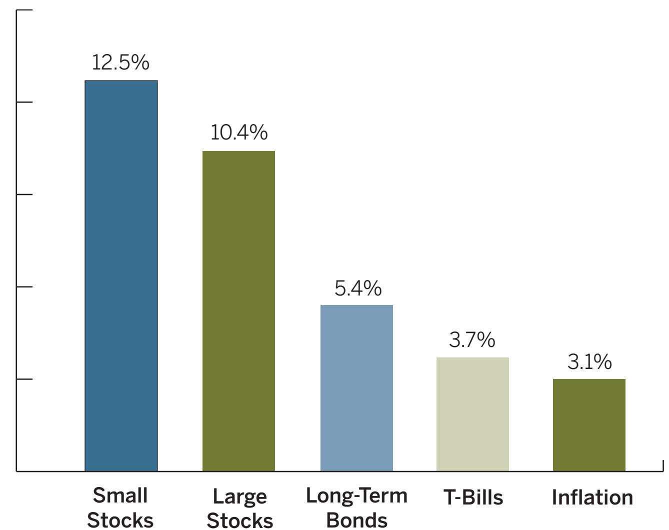
Short-term volatility is a fact of life in the stock market, a risk equity investors have to be prepared to accept. While diversification and prudent portfolio management may reduce this risk, it cannot be eliminated entirely. However, a review of more than eight decades of market history suggests long-term investors in U.S. stocks typically have been well rewarded for the risks they have taken—particularly when compared to supposedly "safe" investments such as government bonds and money market instruments. How well? Consider this:

- **A dollar invested in large-cap U.S. stocks** at the beginning of 1926 could have grown to almost $3,250 by the end of 2007, according to Ibbotson Associates.
- **By comparison, that same dollar invested in long-term Treasury bonds would have grown to only $77,** while $1 invested in short-term Treasury bills would have been worth just $20, according to Morningstar, a financial research firm.
- **The annualized return on large-cap stocks over the past 82 years has been just under 10.4%—**almost twice the average return on long-term U.S. government bonds, according to Ibbotson. T-bills, meanwhile, have barely kept ahead of inflation over that same period.

Equities have not only outperformed over the long run, they've done better over most shorter-run periods as well.

Large-cap U.S. stocks (as represented by the S&P 500 Index) have delivered higher returns than either T-bills or Treasury bonds in 36 of the past 62 years—or about 58% of the time, according to data from Ibbotson and Smith Barney. The same data shows that since 1945, stocks have outperformed bills and bonds in 43 out of 58 rolling five-year periods (or more than 74% of the time) in 44 out of 53 rolling ten-year periods (more than 83% of the time) and in every 20-year rolling period.

Annualized Returns: 1925 through 2007



Past performance is not a guarantee of future results.

Source: Citi Smith Barney, Ibbotson Associates/Morningstar. Please see important disclaimers at the end of this report.

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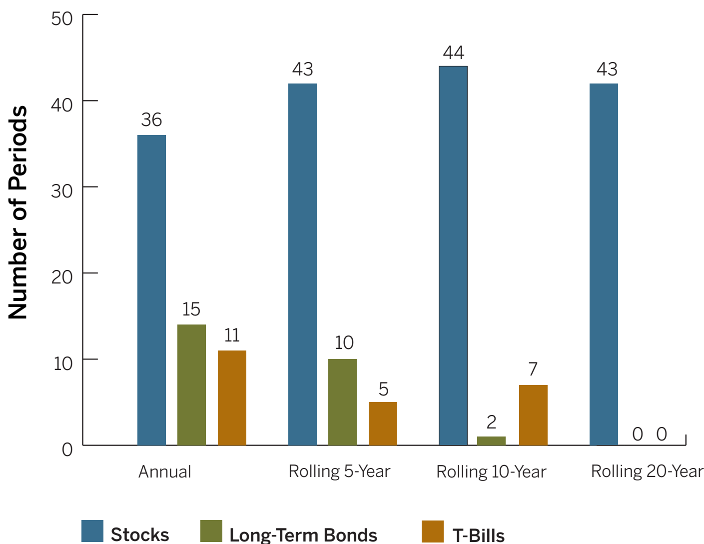
The Odds Favor the Long-Term Investor

On a monthly or quarterly basis, stocks historically have been more volatile than bonds, T-bills and most other fixed-income assets. The market has also experienced deep and prolonged downturns, such as the 49% decline seen during the 2000 – 2002 bear market. However, these events have been less common than many investors might think:

- Returns on the S&P 500 have been positive in 59 of the past 82 years—or almost 72% of the time.
- During that same period, there have been only ten years in which the market lost more than 10%, and only five years in which it lost more than 20%.
- On the other hand, returns have been greater than 10% in 47 of the past 82 years, and greater than 20% in 31 of those years—or almost two years in every five.

Top-Performing Asset Class 12/31/45 through 12/31/07



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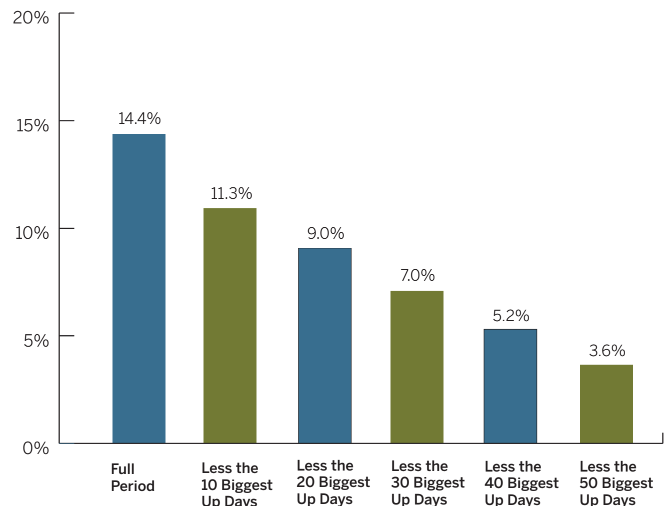
Source: Citi Smith Barney, Ibbotson Associates/Morningstar. Please see important disclaimers at the end of this report.

Annualized Increase in the S&P 500: 1980 through 2007 Net of Dividends



Past performance is not a guarantee of future results.

Source: Citi Smith Barney

Many studies have suggested equity returns are actually higher than what the market's historical volatility otherwise would suggest. In other words, investors are demanding—and, on average, getting—unusually high returns to accept the risks associated with owning stocks. This extra return (sometimes known as the equity risk premium) is one of the reasons the stock market has proven so attractive for long-term capital accumulation.

The Risks of Market Timing

In theory, investors could boost returns even more by avoiding—or successfully timing—market volatility. However, as mentioned earlier, this is extraordinarily difficult. And the costs of being out of the market at the wrong time can be enormous.

From 1980 through December 2007—a period containing more than 7,000 trading days—an investor who missed the 50 biggest up days would also have sacrificed more than 75% of the increase in stock prices during that period—converting a 14.4% annualized rise into a gain of only 3.6%.

Of course, if an investor could figure out how to catch the biggest up days in the market, while missing the biggest down days, he or she could add, not subtract, from long-term performance. The problem is that the biggest up days often come immediately after the big down days. Jump out of the market after a big decline, and there's a good chance you'll miss at least part of the rebound.

> **The costs to long-term investors of putting money to work in the market at the wrong time—i.e. right before a market top—have been relatively small, at least over the long run.**

On the other hand, the costs to long-term investors of putting money to work in the market at the wrong time—i.e., right before a market top—have been relatively small, at least over the long run. An investor who put $10,000 in large U.S. stocks at the tops of the last eight major bull markets could have had a portfolio worth more than $2.7 million by the end of 2007. By comparison, the same amounts invested in T-bills at the same times could have grown to roughly $503,000 over that same period.

Conclusions

Taking a long-term perspective on market volatility isn't always easy. However, overreacting to the latest market events can easily compound the damage, by forcing investors to sell at the bottom or miss all or part of a subsequent recovery. It can also lead them to forget the powerful long-term case for equity investing.

Investors can best protect themselves from short-term volatility by developing prudent, diversified investment strategies—ones that reflect their long-term goals and tolerance for risk. They can and should review these strategies periodically to see if they still match their financial needs. However, changes shouldn't be based on the latest dip or surge in the market—or fear of where the next one might lead. Because the most critical danger most investors face isn't the risk of short-term volatility, it's the risk of making decisions they will regret later.

Built to Last:

Generating Income in the New Retirement

Just as more sophisticated asset allocation strategies and approaches helped you grow your retirement savings, new thinking on asset allocation is now emerging as you prepare to start drawing down and spending these funds. Successful investing now refers to sufficient retirement cash flow. Risk is no longer defined solely by volatility; it is also defined by income shortages. In sum, you need a cash-flow plan that will help sustain your lifestyle in retirement while being flexible enough to absorb unforeseen expenses.

New Retirement, New Needs

When figuring out your annual retirement cash-flow need, there are certain factors—beyond basic living expenses and the occasional indulgence—you should account for. Longevity is one. The Society of Actuaries, in their Annuity 2000 Mortality Table, suggests that for couples age 65 today, odds are that (assuming good health) at least one spouse will live to age 92, hence a need for longer-lasting savings. Health care is another factor. Assuming Medicare benefits remain at current levels, couples will need approximately $300,000 to cover health expenses in retirement if living to average life expectancy—and as much as $550,000 if living to age 95, according to the 2007 Retirement Confidence Survey of the Benefit Research Institute®.

In the face of longer lives and rising medical costs, if the fixed income component of your portfolio is too heavy, you could be increasing your risk of outliving your assets. An effective retirement portfolio certainly should generate an investment return that is high enough to meet after-tax expenses and outpace inflation while providing as much protection as possible. A periodic analysis of your asset allocation is important, especially once you begin tapping your accounts.

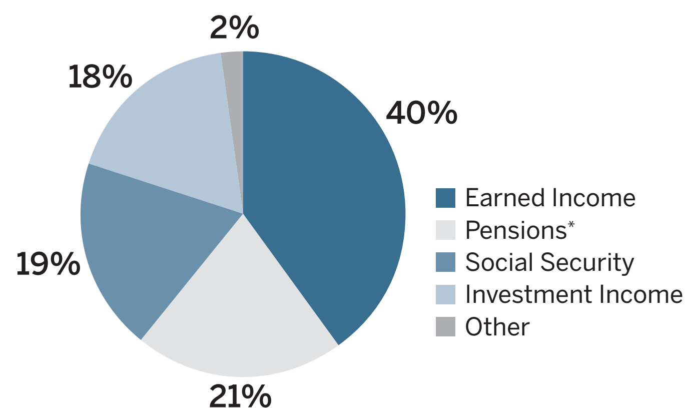
In the same way that members of the previous generation relied on pensions and Social Security to account for a large part of their retirement cash flow, today's boomers have an emotional yearning for a guaranteed source of income.

Certainly, assets in taxable investment accounts and 401(k) plans, IRAs and other tax-deferred accounts will comprise the bulk of retirement income for many people. But since investment returns are not guaranteed, income from these sources will vary with market performance. So, even though investments and other wealth may negate the need for Social Security, they can't provide the same peace of mind.

It's no secret that the worst possible time to experience a market downturn is when you have the greatest amount of money at stake, which is typically right before and right after retirement. Retiring, coupled with a sudden market downturn, can result in a serious shortfall in retirement income that usually can't be overcome using conventional investments and asset allocation strategies. Allocating a portion of your portfolio to guaranteed income sources can be helpful in mitigating that risk.

When it comes to your vision of retirement and the shift in needs that may accompany it, we can work with you to create a plan and build a portfolio that is designed to sustain you for the long haul.

Where Will Retirement Cash Flow Come From?



Data Source: Morningstar as of March 1, 2007.
*Includes all defined benefit and defined contribution plans.

Smart Strategies for Investing in Any Market

Be Better Prepared to Preserve and Protect Your Portfolio

Headline news frequently highlights how quickly the financial markets can change. For some investors, this news precipitates a degree of uncertainty about the future, and possibly prompts them to look for a more conservative approach to help them preserve and protect their investments.

Investors are least likely to be permanently affected by current volatility if they keep their wits about them, as past experience has shown. Also, by adhering to a long-term investment strategy, they could be in a better position to benefit when the market recovers.

Meanwhile, here are some investment strategies that—when carefully applied—could help better prepare investors to respond to any major economic and investment trends that may affect portfolio performance.

- Periodically fine-tune the portfolio's asset allocation.
- Review equity positions.
- Take advantage of convertible securities.
- Consider the guaranteed income, tax benefits and death benefit guarantees of variable annuities.
- Rebalance the portfolio with fixed-income opportunities.
- Consider alternatives to cash.
- Set investment horizons globally.
- Establish a regular investment program, such as dollar cost averaging.

Some Helpful Reminders

- Now is not the time to ignore or abandon investment portfolios.
- The longer the time horizon, the less investors should be concerned about short-term market fluctuations.
- A diversified portfolio held for longer-time increments may help reduce the risk of losing money.

These strategies can work smartly to help cautious investors potentially take advantage of the changing financial marketplace.

Past performance is not a guarantee of future results. Diversification does not ensure against loss.

Dollar cost averaging does not guarantee a profit or protect against loss. Investors should consider their ability to sustain investments during periods of market downturns.

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