



1720 E Calle Santa Cruz
Phoenix Arizona 85022

HUTCHISON INVESTMENT ADVISORS
Registered Investment Advisor
Founded on a CPA Firm Background

E-mail:dave@davecfp.com
602-955-7500
Fax 602-955-1458

2011 Informational Series of Common Client Questions and Investor Education

The Bad Math of Investment Losses

The Importance of Our Participate yet Protect Strategy – Measured Risk Analysis

We offer to share our ideas with you at no cost or obligation

Average returns over a number of years do not count in investment math. Portfolios with the same average annual return can have very different ending values.

Making money is more dependent on not losing money by seeking the lowest risk consistent with return expectations. We measure and analyze historical risk of portfolio recommendations using Modern Portfolio theory (Beta/Alpha). We also recommend alternatives without equity or bond market risks.

A higher percentage gain is necessary to recover from a certain percentage loss. There is a reciprocal relationship between losses and gains. The relationship is nonlinear - as the loss gets bigger, the gain needed to recover increases at a growing rate.

If you have doubled your money by a 6% annual return for 12 years, but then have a 50% loss, your entire 100% 12 year gain is lost – you are back to your original investment amount.

In the “financial crisis” decline of 2007-2009 the S&P 500¹ lost 57%. In the “tech bubble” decline of 2000-2002 the S&P 500 lost 49% and the Nasdaq 100 index¹ lost 83%.

Return Needed to Restore Loss & Probability of Recovery Based on S&P 500 data 1970-2009

| Portfolio loss | Needed cumulative gain to restore loss | Percentage chance* of recovery from loss within... | | | | | |
|----------------|--|--|---------|---------|---------|---------|----------|
| | | 1 Year | 2 Years | 3 Years | 4 Years | 5 Years | 10 Years |
| -10% | 11.1% | 52.5% | 74.4% | 81.6% | 78.4% | 77.8% | 93.5% |
| -20% | 25% | 25.0% | 48.7% | 68.4% | 67.6% | 72.2% | 93.5% |
| -35% | 54% | 0.0% | 17.9% | 34.2% | 56.8% | 61.1% | 93.5% |
| -50% | 100% | 0.0% | 0.0% | 7.9% | 13.5% | 36.1% | 80.6% |
| -65% | 186% | 0.0% | 0.0% | 0.0% | 2.7% | 5.6% | 61.3% |

*Probabilities calculated from historical returns of the S&P Index over the past 40 years
Source: Craig Israelsen, Ph.D.

This assumes no money is withdrawn that “locks in losses.”

The S&P 500 Index generated a single-year gain of 11% or more in 21 years between 1970 and 2009. Therefore, based on historical return patterns, there is a greater than 50% chance that the S&P 500 could recover from a 10% loss within one year. As always, past performance is not a guarantee of future results

While the current equity outlook appears quite favorable vs. bonds having high risk, there is always risk in the equities (stocks). As there are always market risks, I recommend “participate yet protect” as much as possible strategies depending on individual investor objectives, investment time frame and risk tolerance.

Tidbits - The terms "bear" (first known use of term in 1892) and "bull" are thought to derive from the way in which each animal attacks its opponents. That is, a bull will thrust its horns up into the air, while a bear will swipe down. These actions were then related metaphorically to the movement of a market: if the trend was up, it was considered a bull market; if the trend was down, it was a bear market. A 20% loss over at least a 2-month period is usually referred to as a “bear” market.

¹Investors cannot directly invest in indices. Past performance does not guarantee future results.

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