

## Happy Anniversary to Us!

By Eric G. Hoffman, CPA and Chief Investment Officer

They say that time flies when you're having fun, which means that I must have had a lot of fun over the past five years. It's now been five years since we launched our Quantitative Equity Model (QEM) back on October 1, 2004. Those five years have been pretty event-filled – a war, a recession, a new President, a stock market collapse, a banking collapse – and kept us on our toes.

When we launched the QEM, we had high hopes for it. Although Ken Stern & Associates (KS&A) has been offering direct, personal

asset management since we were founded, this was to be the first time we would have a centralized tracking model for our equity selections. I'm pleased to report that the total return of the model over the period ending September 30, 2009 has been 30.32% versus a return of 5.18% for the Standard & Poor's

500 Total Return Index (S&P 500). For details of this performance, as well as important disclosures, please see the final pages of this report. The QEM strategy is not appropriate for all client portfolios; whether or not it is appropriate for your portfolio depends on your personal circumstances.

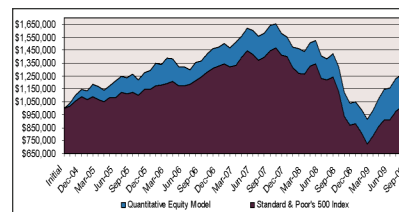
In reviewing all that we've done with the model over the years, as happy as I am with the results, I'm even happier with the process and the way that we've built and refined it. When I first started working with Ken, back in 2003, he talked quite a bit about *kaizen*, the Japanese term for the process of continuous improvement.

This concept is always at the forefront of our minds.

Our goal for the QEM was to create an investment methodology that added "Alpha" – long-term results superior to those of the benchmark S&P 500 Index, while maintaining a comparable level of risk. Based on our

collective experiences, we believed that the first step towards this goal would be to systemize our investment process – not only our stock selection criteria, but when and how we trade, the evaluation process, and our macro-economic outlook. The term "quantitative" refers not only to our methodology for finding suitable stocks, but for the overall systemized structure.

Most of our team members have a "value" bias and weren't in favor of developing a short-term, trading-oriented system. We were also leery of developing a "buy and hold" (or, "buy and hope," as some would say) system that didn't reflect the changing



QEM Growth of \$1 Million Since Inception

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nature of the markets. What we eventually settled on was a system based on value-oriented purchases and sales based upon positions either reaching “fuller” valuations or when we became convinced that our initial purchase logic was flawed.

Based upon these ideas, we developed the following process:

- Start with a macro level overview of the markets and the economy.
- Assess which of the 10 sectors of the S&P 500 we believe should be overweighted and which should be under-weighted, based on our assessment of intermediate-term drivers of out- and under-performance. Look forward, rather than in the “rear-view mirror.”
- Review holdings from the prior month to determine which positions we would like to sell, taking into account valuations and catalysts and assess the impact of those sells on our target weightings.
- Look for potential buys on our screens. These screens are based on a proprietary quantitative system, ranking issues from each of the S&P sectors by a number of pre-determined criteria to develop an optimized subset to select from.
- Trade only on pre-specified days each month in order to minimize the emotional impact of daily news flow.

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## War Stories

In light of the *kaizen* concept, let me share a few of the lessons that we’ve learned since we’ve been running this model:

**1. Keep your eye on the big picture** – Our methodology dictates that outperformance or underperformance is driven in steps. We first strive to add Alpha by being underweight or overweight in the appropriate sectors, THEN we concern ourselves with selecting the positions in each sector. In reviewing performance, individual stocks are more appropriately benchmarked against their sector (or even industry) than they are against the overall market. The overall model is what gets benchmarked against the S&P 500, not the individual holdings. If

Technology is the hottest sector during a given time period, I could potentially have the worst performing Technology stock, but it could still look good against the overall index. The benchmark needs to be relevant – how did my Tech stocks do relative to other Tech stocks? Did our sector overweighting and under-weighting add Alpha or decrease it?

**2. Sometimes the best trade is no trade** – First, let me say that the QEM is an “investment” model, not a “trading” model. I differentiate those two by the intended duration of holding – short-term holds are trades, long-term holds are investments. Trades are often based upon price action, while investments typically are based upon longer-term valuation parameters. That being said, there are times when our indicators point towards a frothy market or

when we just can’t seem to find positions on our screens that we find to be attractive. When that happens, it’s important to remember that you don’t NEED to always be fully invested. Sometimes it’s okay to sit on the sidelines and wait for better opportunities. Feeling like you need to be fully invested can lead to unwise or poorly researched purchases.

**3. Have reasonable expectations of volatility** – A few years back, we purchased a position in a steel company, only to sell it a month later at a loss. It went down too quickly and, rather than assessing whether the fundamentals that prompted the purchase were still the same, we decided that we’d rather take a loss than have it potentially go down further. Well, anyone who has ever purchased a steel stock should be able to tell you that they are VOLATILE. For us to have gone

into the position without having had realistic expectations was our mistake. The volatility that scared us off ended up being a double-edged sword – as you may have guessed, the stock moved higher after we sold.

**4. Learn from the past** – I don't say this solely in regards to making the same mistakes twice (although that is a good thing to avoid!), but in regards to keeping an eye on positions that you may have traded in the past. Once you've made an investment, you should have a reasonable idea of what the "drivers" are for price appreciation for that holding – the macro trends, the economic contributors, the industry-specific parameters. It only makes sense to re-use that information as conditions change. In our current model, we hold three of the "original" model positions, as well as two more that were part of the original model, were sold and later re-purchased. Another original position has been purchased and sold twice. Three other positions that we currently hold were purchased after inception, sold, and then repurchased. This lesson applies to industries as well as to individual stocks. If you know how to assess one bank, you have a frame of reference for applying that knowledge to another.

**5. I much prefer turning investments into trades than vice versa** – Back when I used to be a floor trader, we used to joke about the trades that went against us immediately that we decided to hold on to as a longer-

term "investment." They certainly weren't intended to be investments and we often held on to them much longer than expected to salvage our pride on the loss. As someone making investments now, sometimes it makes sense to turn that investment into a trade – if your investment shoots up right after you buy it, consider closing the position and taking the gain, rather than getting greedy and risking your profits. I can remember a couple of times when we did exactly that. We had a position in a GPS map-maker a while back that moved up much more quickly than we had originally anticipated. We had actually already decided to sell it and take the profit when they announced that they were to be acquired and we were able to capture a bit more premium. Recently, although we really wanted to keep a higher weighting in Financials, we thought it made much more sense to take a short-term profit in one of our positions than to risk losing our gain.

**6. It's better to be happy than right** – I first heard this phrase from a friend who had learned it from a therapist who was helping to keep the peace in his marriage. The gist of it is there are times when you are right and you know you're right, but the "cost" of vindicating yourself is much worse than just dropping the subject and moving on. In retrospect, I would have reduced our weighting in Financials during the crisis of the last year much more quickly than we did. We

simply believed that the crisis was being driven more by psychology and fear than by new knowledge of problems. As it turns out, it doesn't matter what pushes a stock down – a psychologically driven decline looks exactly the same on your statement as a fundamentally driven one.

**7. Value is always the same** – No matter what's going on in the market and the world (deficits, terrorism, interest rates, climate change, etc.), some asset will always be cheap relative to others, and some asset will always be expensive. Good deals, by definition, are RELATIVE to other assets. Additionally, whether a stock is a good value or not, depends not only on the investor's outlook, but upon how the future eventually plays out. It's natural to assume, whether things are good or bad, that the status quo will continue. Peak earnings will never go down or trough earnings will never get better. Those that think apart from the herd realize that the economy cycles – when it's good, it eventually won't be as good, and, when it's bad, it eventually gets better. Basing your assessment of value on this knowledge takes a contrarian mindset but can add significant Alpha.

What we learned from running this QEM model could fill a book. It wouldn't surprise me if Ken were to do that some day in his next writing venture. Regardless, running this model has provided a great growth opportunity for all of us involved. We'd like to thank our clients for entrusting their savings to KS&A and for giving us this opportunity. We remain committed to continuing to strive to add Alpha to your portfolios and to your lives!

## END-OF-THE-YEAR IDEAS, TIPS AND STRATEGIES

By Ken Stern, Managing Director

Tax, estate, and investment planning are paramount at this time of year. This type of planning is essential year-round, but particularly now, as the year winds down. Luckily, you still have a few months left in 2009 to take advantage of these planning opportunities. Here are some strategies you may wish to consider:

**1. Harvest gains to offset losses.** Many investors sold stocks this year or last year and have losses or have a loss carry-forward. You might consider selling your holdings that have a gain in order to offset against these losses. This can help to take advantage of your carry-forward capital losses, but also possibly lower tax rates. Many experts expect the Federal Government to increase the capital gains tax rate next year, which means taking a gain now could save you some money. Talk to a tax professional about restrictions, holding periods or other implications.

**2. Estate tax uncertainty.** In 2010, the Federal estate tax rate will be zero. Unless Congress makes changes, the exemption limits for 2011 drop to less than one-third of what they are for 2009 and the rate increases to 55% from the current 45%. Strategies can be enacted **DURING YOUR LIFETIME** to take advantage of current

exemption limits. If estate tax avoidance is a concern, you may wish to consider advanced planning strategies to reduce the taxable size of your estate. Talk to your Family Wealth Advisor and your legal counsel about gifting strategies and other advanced techniques.

**3. Study the Roth Conversion allowances that go into effect in 2010.** The possibility of converting a traditional tax-deferred IRA or 401(k) to a tax-free Roth and having two years to pay the tax on the amount converted is potentially lucrative and merits research! This appeal is enhanced by the fact that many of us have lower taxes this year, as well as lower IRA/401(k) values.

**4. Consider some of the "standard" year-end strategies.** These include ideas such as maximizing 401(k) plans, creating defined benefit pension plans, prepaying certain expenses or structuring income to delay realization of certain income until 2010.

**5. Use the end of the year to get organized and assess what you have.** This includes reviewing your estate plan. Pay special attention to who your beneficiaries and trustees are. Have you talked to them? Do they understand what is required of them? Do they understand

what needs to happen if you get sick or die? Are they capable of executing the job? Will they be influenced by their spouses or family members? These are all important questions to discuss and now is a great time to do it.

**6. Review your insurance policies.** Do you have the proper deductibles? Where are the gaps in coverage – particularly for your health care? Have you written out caregiver instructions? Include the names of medicines that you are taking, along with dosages, and contact information for your physicians. These lists can truly be lifesavers!

**7. Simplify your financial life.** Why deal with it if you don't have to? If you have credit cards you don't need or investment or bank accounts that are inactive, consolidate them. Life is too short to spend so much time trying to keep track of assets that are spread all over – make it easy on yourself and simplify where you can. Contact your advisor to understand the implications, but simple is often better.

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Get **ALPHATIZED!**

Contact Ken Stern & Associates to  
obtain your complimentary  
**ALPHA ANALYSIS** today!



# KS&A QEM PERFORMANCE

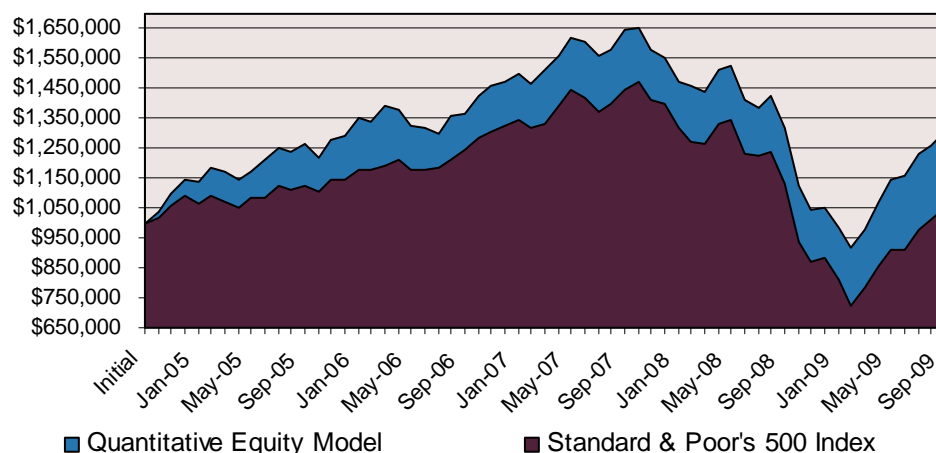
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Results are for the period from October 2004 through September 2009

See the final page of this document for important disclosures.

## Cumulative Return

Growth of \$1 Million



QEM S&P

## Trailing Period Returns

|                     |        |         |
|---------------------|--------|---------|
| Previous Month(Sep) | 3.31%  | 3.73%   |
| Trailing 3 Months   | 12.72% | 15.61%  |
| Trailing 6 Months   | 32.86% | 34.02%  |
| Trailing 12 Months  | -1.42% | -13.38% |
| Since Inception     | 30.32% | 5.18%   |

## Description of the Fund

### Quantitative Equity Model ("QEM")

The stocks that make it into our hypothetical model are selected using a number of screening criteria and a proprietary ranking system, which takes into account a spectrum of ratios and parameters. These factors, coupled with a defined trading discipline, were developed with the single goal of outperforming our benchmark, the Standard & Poor's 500 Index.

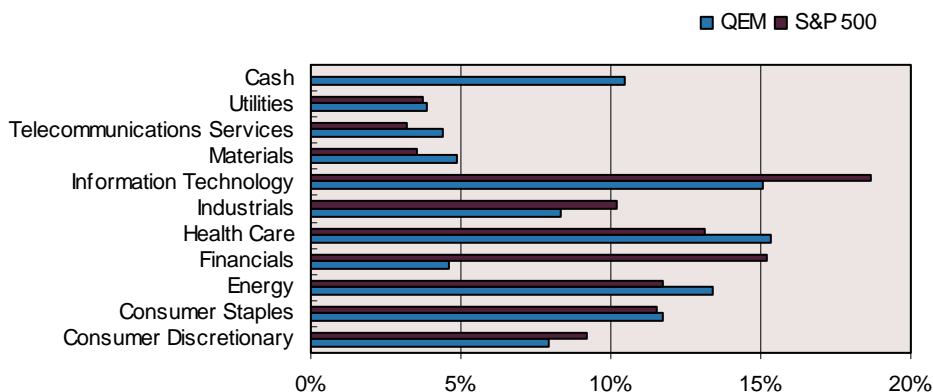
## Monthly Performance

| Year | Jan    | Feb    | Mar    | Apr    | May    | Jun    | Jul    | Aug    | Sep    | Oct     | Nov    | Dec    | QEM     | S&P 500 |
|------|--------|--------|--------|--------|--------|--------|--------|--------|--------|---------|--------|--------|---------|---------|
| 2004 |        |        |        |        |        |        |        |        |        | 3.74%   | 5.92%  | 4.21%  | 14.51%  | 9.23%   |
| 2005 | -0.65% | 4.16%  | -1.23% | -2.40% | 2.65%  | 3.52%  | 2.90%  | -0.93% | 2.04%  | -3.35%  | 4.67%  | 1.14%  | 12.83%  | 4.89%   |
| 2006 | 4.68%  | -0.87% | 7.62%  | -0.08% | -4.71% | 0.06%  | 0.73%  | 4.54%  | 0.36%  | 4.41%   | 2.51%  | 0.98%  | 14.22%  | 15.80%  |
| 2007 | 1.64%  | -2.11% | 3.24%  | 3.01%  | 3.86%  | -0.96% | -2.88% | 1.32%  | 4.07%  | 0.64%   | -4.47% | -1.65% | 5.36%   | 5.50%   |
| 2008 | -5.17% | -0.97% | -1.35% | 4.80%  | 1.06%  | -7.64% | -1.63% | 2.88%  | -7.30% | -15.03% | -7.29% | 0.67%  | -32.58% | -37.00% |
| 2009 | -5.94% | -7.15% | 7.14%  | 9.44%  | 6.75%  | 0.89%  | 6.73%  | 2.23%  | 3.31%  |         |        |        | 24.31%  | 19.26%  |

## Statistical Summary

|                               |       |
|-------------------------------|-------|
| QEM Mean Return               | 0.54% |
| QEM Standard Deviation        | 4.37% |
| S&P 500 Mean Return           | 0.19% |
| S&P 500 Standard Deviation    | 4.27% |
| # Months QEM Return > S&P 500 | 31    |
| # Months S&P 500 Return > QEM | 29    |
| Sharpe Ratio QEM              | 0.42  |
| Sharpe Ratio S&P 500          | 0.15  |

## Sector Weightings as of October 1, 2009



BETA QEM (as of 10/1/09) 0.99

**Ken Stern & Associates**

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# IMPORTANT DISCLOSURES

*The model shown on these pages was traded in an actual account from the date of May 2, 2005 to the present. For the period October 1, 2004 to May 2, 2005, the model was "mock" traded and the returns shown are entirely hypothetical and for illustrative purposes only. Ken Stern & Associates believes that the returns illustrated are substantially similar to those an actual client would have received had they invested in the model at its inception, held it throughout the entire period and been charged fees at the same rate that the model assumes. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities on this list. For a listing of all stocks included in the model since its inception, please contact Ken Stern & Associates at 1-800-529-2884.*

*The results shown here reflect the inclusion of a Management Fee of 1% annually, which is shown as monthly fees of .0833% of the Beginning of Month Portfolio Value. The fees that an investor would pay for these or similar services may vary. The model results illustrated assume that Ticket Charges for trades made in the account have been waived. Ticket Charges for actual client accounts are negotiable and may be waived at the discretion of the Portfolio Manager. The additional expense of any Ticket Charges would negatively affect the returns that an actual client would receive.*

*The results shown here reflect the inclusion of any dividends that would have hypothetically been received had the issue listed actually been owned during the period in question.*

*Investment accounts substantially similar to the model illustrated here were first offered to clients of Ken Stern & Associates beginning in May of 2005. No actual accounts were allocated to this model from the model's inception in October 2004 to May 2005.*

*Trades made for the account (both buys and sells) are assumed to have been made at the Opening Price on the first trading day of each month. The prices that an actual client would receive for similar trades could potentially differ from the prices illustrated. This deviation could negatively impact the return to the client.*

*For the period from inception of the model to February 2007, performance was reported from the opening price on the first day of trading each month to the opening price on the first day of trading the next month. Beginning in March 2007, KS&A began reporting their performance numbers from the closing price on the last day of trading each month to the closing price on the last day of trading the next month. This change was made in order to more closely compare to the way that Standard & Poor's reports the performance of their S&P 500 Index. Due to this change, performance for the month of March 2007 is reported from the opening price on the first day of trading to the closing price on the last day of trading.*

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*The performance of the portfolios illustrated is benchmarked to the Standard & Poor's 500 Index, an index that contains a representative sample of 500 large-cap stocks involved in leading industries of the U.S. economy. An index is a portfolio of specific securities, the performance of which is often used as a benchmark in judging the relative performance of certain asset classes. Indexes are unmanaged portfolios and investors cannot invest directly in an index. The index returns are "Total Returns" with dividends re-invested, which means the return is not only the change in price for the securities in the index, but any income generated by those securities. The performance of an unmanaged index is not indicative of the performance of any particular investment.*

*As of the publication date of this model, individuals involved in the research of this model, employees of Ken Stern & Associates and its' affiliates and / or members of their households held positions in every single common stock included in the model.*

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