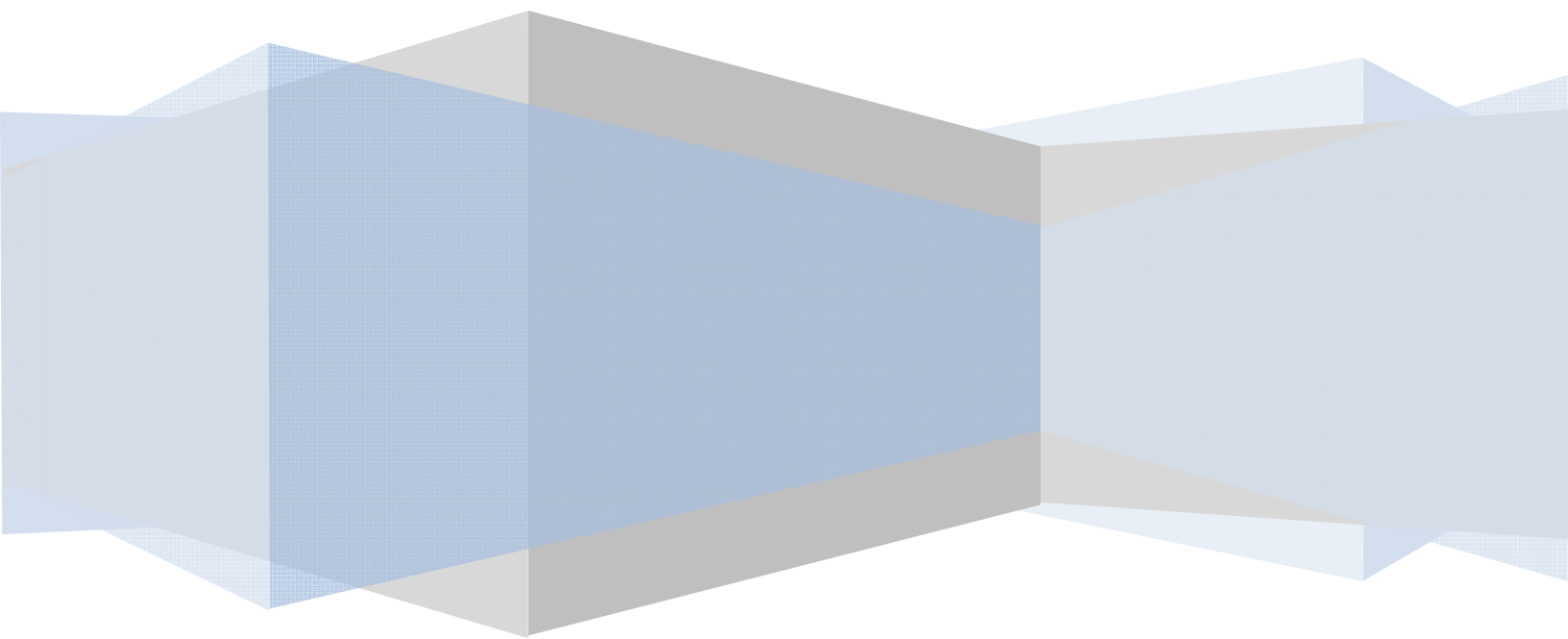




**PAULEY FINANCIAL SERVICES, INC.**  
*helping people make important life choices...*

**Michael and Kristin Smith**  
**Investment Policy Statement**  
**Capital Management Service**



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## THE INVESTMENT POLICY STATEMENT

### WHAT IS AN INVESTMENT POLICY STATEMENT?

One of the important purposes of this Investment Policy Statement (IPS) is to establish a clear understanding between you, the Client, and us, Pauley Financial Services, Inc., as to the investment goals and objectives and management policies applicable to your investment portfolio.

An IPS provides strategic and tactical guidelines for implementing, monitoring, and updating your investment plan.

As “life happens,” i.e. conditions change, it is important that we review/update this IPS in light of new circumstances.

### WHY SHOULD YOU HAVE AN INVESTMENT POLICY STATEMENT?

We find that market volatility can cause people to make poor choices based upon the emotions they are feeling at the time. In our language, “the emotional brain has overtaken the rational brain.”

By creating an IPS (when the rational brain is dominating), we establish a basis of understanding and an agreed upon map for executing financial choices in a disciplined, objective way.

Recognize that this doesn’t mean we blindly adhere to the policy we’ve created. It simply means that barring a client’s circumstances changing (other than anticipated market volatility) that we should continue to execute the agreed upon plan.

## STEPS FOR ESTABLISHING AN INVESTMENT POLICY STATEMENT...

Thus far, we have:

- Gathered information from you, using our Client Data Form, which describes your current financial position to include account statements, tax returns, etc.
  - Conducted a Pre-Investment Seminar in which we described to you our firm's investment strategy and how we arrived at it.
    - Strategic Asset Allocation using Exchange Traded Funds (ETFs) as the primary implementation tool.
    - Time horizon is the primary determinant of the investment vehicle in accordance with our four portfolios:
      - Near-Term
      - Short-Term
      - Medium-Term
      - Long-Term
    - We are not market-timers.
    - We are not individual stock or bond pickers. Instead, we prefer the diversification and other benefits associated with ETFs and mutual funds.
    - For the Long-Term Portfolio:
      - We design an Asset Allocation which should enable you to achieve your goals with the least amount of risk.
      - We rebalance to target when asset classes exceed 15% of the target (high or low).
  - During our Goals Meeting, we worked with you to reach an agreed upon, achievable set of goals and a required savings or distribution amount which should enable you to meet those goals. The results are enumerated later in this report.
  - Reviewed your FinaMetrica Risk Questionnaire which provides us insights as to how you view different risk scenarios.
  - Assimilated the information and interactions we've had to draft this IPS for your review. As stated, we will iterate over this Investment Policy until you and we are satisfied that it best suits your current situation.
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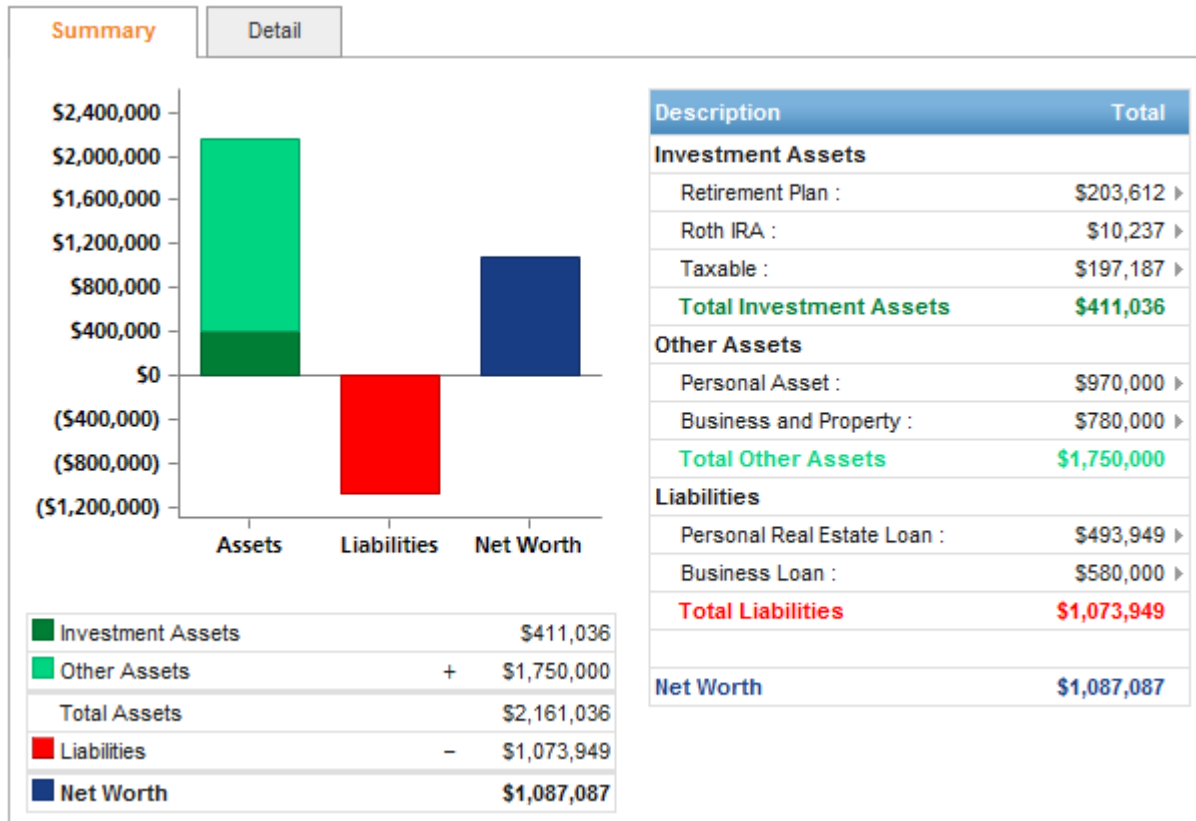
**WHERE YOU ARE...YOUR CURRENT FINANCIAL POSITION**

**CURRENT LIFE STAGE**

Michael (41) and Kristin (39) are married with two children (Meredith, 11, and Cole, 8).

Michael is a partner in TX Solar and Kristin is a homemaker. They are looking for a plan to help them achieve their goals of retiring comfortably, educating, their children, and traveling.

**NET WORTH**



Important “assets” which do not appear on a net worth statement but which hold great potential value:

- Credit Rating
- Social Security
- Human Capital

## ACCOUNTS

Shown below is the list of your existing accounts:

### Investment Assets

[easy ways to enter assets...](#)

The program only keeps one copy of Assets. This means that you don't have to enter assets separately for each Plan. You can enter (or change) an asset once and then use it in whichever Plans you want.

Description	Owner	Current Value	Annual Additions	
401(k)	Michael	\$203,612	\$45,000	Delete
529 Cole	Kristin	\$69,286		Delete
529 Meredith	Kristin	\$75,882		Delete
BOA Joint Checking	Joint Community Property	\$51,504		Delete
BOA Joint Money Market	Joint Community Property	\$102,083		Delete
BOA Savings (Car) - Cole	Joint Community Property	\$7,142		Delete
BOA Savings (Car) - Meredith	Custodial	\$6,851		Delete
BOA Savings - Kristin	Kristin	\$16,342		Delete
Schwab Brokerage	Joint Community Property	\$14,115		Delete
Schwab Checking	Joint Community Property	\$6,001		Delete
Schwab Roth IRA	Michael	\$10,237		Delete
<b>Total All Assets</b>		<b>\$563,055</b>	<b>\$45,000</b>	

## TAX STATUS

Federal marginal tax bracket: 35%

Federal effective tax rate (tax/AGI): 26.5%

**PORTFOLIO VOLATILITY TOLERANCE – FINAMETRICA PRO RISK  
EVALUATION**

Michael's Score 06/30/2011: 65

Kristin's Score 06/30/2011: 46

Your scores indicate a willingness to accept an above average amount of portfolio volatility in order to achieve higher returns over the long-term.

We typically ask you to re-do the questionnaire when major life changes occur (or annually) as people's tolerance for volatility changes over time.

WHERE YOU WANT TO GO... LIFE GOALS:

My Financial Goals

Acceptable Range

Importance	Goal Description	Ideal	Acceptable	
<b>Needs</b>				
10	College - Meredith Smith 5 year(s) starting in 2018	\$35,000	\$30,000	Delete
10	College - Cole Smith 5 year(s) starting in 2021	\$35,000	\$30,000	Delete
9	Retirement - Living Expense Retirement Age / Year - Michael Homemaker - Kristin 2031 thru 2070 (Both retired) 2071 thru 2072 (Kristin alone - retired)	61 / 2031 \$120,000 \$120,000	66 / 2036 \$84,000 \$120,000	Delete
8	Vehicle - Michael at Michael's retirement Recurring every 5 years until end of Michael's plan	\$50,000	\$30,000	Delete
8	Vehicle - Kristin at Michael's retirement Recurring every 5 years until end of Kristin's plan	\$50,000	\$30,000	Delete
<b>Wants</b>				
7	Travel at Michael's retirement	\$15,000	\$15,000	Delete
6	Meredith's Wedding in 2028	\$80,000	\$80,000	Delete
6	Cole's Wedding in 2025	\$10,000	\$10,000	Delete
<b>Wishes</b>				
3	Boat in 2012 Recurring every 10 years for a total of 4 times	\$45,000	\$40,000	Delete

GOAL FEASIBILITY

“IDEAL” GOAL SCENARIO

With all goal values set to **Ideal** and saving \$105,000/year (including \$60K of savings to your TD Ameritrade Institutional brokerage account), there is a **74% probability** of being able to achieve all your goals.



Play Zone™

Use the Sliders or enter your own value to see how changes to your Goals and Savings will affect your Probability of Success.

Total Spending for Life of Plan

**\$6,525,000** is the amount needed to fund all Goals as listed below. [View Preference Details](#)

There is a **74%** likelihood you'll have this amount or more.

SUPER SOLVE™ for  % Probability of Success

Acceptable Range Set all Goal values to **Ideal** Go

Description	Ideal	Use the sliders to select values	Acceptable	OR enter any value.
Michael - Retirement Age	61		66	<input type="text" value="61"/>
<b>Needs</b>				
College - Meredith Smith	\$35,000		\$30,000	\$ <input type="text" value="35,000"/>
College - Cole Smith	\$35,000		\$30,000	\$ <input type="text" value="35,000"/>
Retirement - Living Expense	\$120,000		\$84,000	\$ <input type="text" value="120,000"/>
Vehicle - Michael	\$50,000		\$30,000	\$ <input type="text" value="50,000"/>
Vehicle - Kristin	\$50,000		\$30,000	\$ <input type="text" value="50,000"/>
<b>Wants</b>				
Travel	\$15,000	<i>There is no Acceptable Range.</i>	\$15,000	\$ <input type="text" value="15,000"/>
Meredith's Wedding	\$80,000	<i>There is no Acceptable Range.</i>	\$80,000	\$ <input type="text" value="80,000"/>
Cole's Wedding	\$10,000	<i>There is no Acceptable Range.</i>	\$10,000	\$ <input type="text" value="10,000"/>
<b>Wishes</b>				
Boat	\$45,000		\$40,000	\$ <input type="text" value="45,000"/>
You are currently saving \$45,000, and are willing to save up to \$80,000 more, for a total Acceptable savings amount of \$125,000.				
Extra Savings	\$0		\$80,000	\$ <input type="text" value="60,000"/>
This result includes \$105,000 of total savings, which is \$20,000 below your Acceptable savings amount.				

“ACCEPTABLE” GOAL SCENARIO

With all goal values set to **Acceptable** and saving \$105,000/year (including \$60K of savings to your TD Ameritrade Institutional brokerage account), there is a 99% probability of being able to achieve all your goals.



Play Zone™

Use the Sliders or enter your own value to see how changes to your Goals and Savings will affect your Probability of Success.

Total Spending for Life of Plan

**\$4,195,000** is the amount needed to fund all Goals as listed below. [View Preference Details](#)

There is a **99%** likelihood you'll have this amount or more.

SUPER SOLVE™ for 92 % Probability of Success

Acceptable Range Set all Goal values to **Acceptable** Go

Description	Ideal	Use the sliders to select values	Acceptable	OR enter any value.
Michael - Retirement Age	61		66	<input type="text" value="66"/>

**Needs**

College - Meredith Smith	\$35,000		\$30,000	<input type="text" value="\$ 30,000"/>
College - Cole Smith	\$35,000		\$30,000	<input type="text" value="\$ 30,000"/>
Retirement - Living Expense	\$120,000		\$84,000	<input type="text" value="\$ 84,000"/>
Vehicle - Michael	\$50,000		\$30,000	<input type="text" value="\$ 30,000"/>
Vehicle - Kristin	\$50,000		\$30,000	<input type="text" value="\$ 30,000"/>

**Wants**

Travel	\$15,000	<i>There is no Acceptable Range.</i>	\$15,000	<input type="text" value="\$ 15,000"/>
Meredith's Wedding	\$80,000	<i>There is no Acceptable Range.</i>	\$80,000	<input type="text" value="\$ 80,000"/>
Cole's Wedding	\$10,000	<i>There is no Acceptable Range.</i>	\$10,000	<input type="text" value="\$ 10,000"/>

**Wishes**

Boat	\$45,000		\$40,000	<input type="text" value="\$ 40,000"/>
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You are currently saving \$45,000, and are willing to save up to \$80,000 more, for a total Acceptable savings amount of \$125,000.

Extra Savings	\$0		\$80,000	<input type="text" value="\$ 60,000"/>
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This result includes \$105,000 of total savings, which is \$20,000 below your Acceptable savings amount.

“BASELINE” GOAL SCENARIO

As a result of our discussions, we settled on the below as our **baseline goal plan**. We can adjust it as “life happens” and/or run alternate scenarios as you desire. You have agreed to save a total of \$125,000/year (including \$80K/year to your TDA Brokerage account). With the goals set per below, you have an 85% probability of success.

**Play Zone™**

Use the Sliders or enter your own value to see how changes to your Goals and Savings will affect your Probability of Success.

Likelihood of Funding All Goals

Probability of Success: **85%**  
In Confidence Zone

**Total Spending for Life of Plan**

**\$6,322,527** is the amount needed to fund all Goals as listed below. [View Preference Details](#)

There is a **85%** likelihood you'll have this amount or more.

**SUPER SOLVE™** for  % Probability of Success

Acceptable Range

Set all Goal values to  **Go**

Description	Ideal	Use the sliders to select values	Acceptable	OR enter any value.
Michael - Retirement Age	61		66	<input type="text" value="61"/>
<b>Needs</b>				
College - Meredith Smith	\$35,000		\$30,000	\$ <input type="text" value="35,000"/>
College - Cole Smith	\$35,000		\$30,000	\$ <input type="text" value="35,000"/>
Retirement - Living Expense	\$120,000		\$84,000	\$ <input type="text" value="116,170"/>
Vehicle - Michael	\$50,000		\$30,000	\$ <input type="text" value="47,532"/>
Vehicle - Kristin	\$50,000		\$30,000	\$ <input type="text" value="47,447"/>
<b>Wants</b>				
Travel	\$15,000	<i>There is no Acceptable Range.</i>		\$ <input type="text" value="15,000"/>
Meredith's Wedding	\$80,000	<i>There is no Acceptable Range.</i>		\$ <input type="text" value="80,000"/>
Cole's Wedding	\$10,000	<i>There is no Acceptable Range.</i>		\$ <input type="text" value="10,000"/>
<b>Wishes</b>				
Boat	\$45,000		\$40,000	\$ <input type="text" value="43,362"/>
You are currently saving \$45,000, and are willing to save up to \$80,000 more, for a total Acceptable savings amount of \$125,000.				
Extra Savings	\$0		\$80,000	\$ <input type="text" value="80,000"/>
This result includes \$125,000 of total savings, which is equal to your Acceptable savings amount.				

**REQUIRED SAVINGS TO MEET GOALS:**

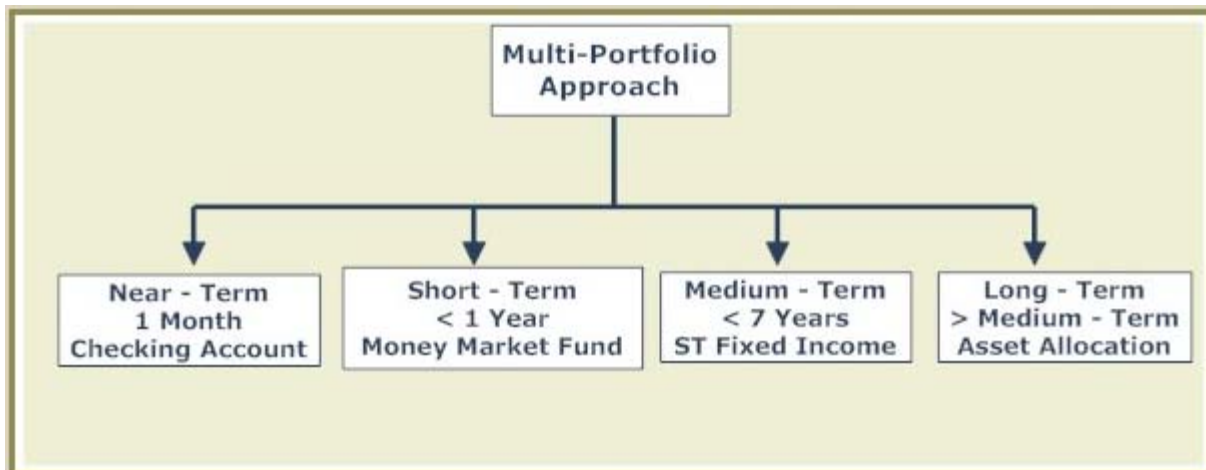
Michael should maximize his 401(k) contribution (as he currently is).

You will need to contribute \$80k/year (increasing by the rate of inflation) to your TD Ameritrade Institutional brokerage account.

The other key funding component is the value of Michael's partnership interest in TX Solar. We are projecting that its current value of \$780,000 will grow at 5% per year, essentially doubling, by the time Michael retires.

We are not counting the home as a goal funding asset – reserving it as the “lender of last resort.”

**HOW TO GET THERE... PFSI TOTAL PORTFOLIO MANAGEMENT SYSTEM**



### **NEAR-TERM PORTFOLIO (CHECKING AND SAVINGS ACCOUNTS):**

The primary focus of this portfolio is liquidity – easily accessible (checks, debit card, bank wires) and no risk of principal loss.

As a general rule, you will want to minimize the number and amount in these accounts because they pay so little in interest. However, you do want to keep enough in these accounts that you avoid monthly fees and cover your monthly expenses.

As we discussed, are you planning to move to Capital One as your primary checking account for your near-term portfolio?

We will open a brokerage account with a money market fund at TD Ameritrade Institutional and will want to link that to your primary bank account so we can move funds back and forth as needed.

### **SHORT-TERM PORTFOLIO (MONEY MARKET ACCOUNT):**

Your Short-Term Portfolio is the funding source for your Emergency Fund plus any cash needs that you do not anticipate that you will be able to meet out of cash flow in the next 12 months, i.e. these funds will need to come from your portfolio.

The real value in the emergency fund is that it serves as a "buffer" fund. While income tends to be fixed monthly, expenses tend to vary. With an adequate emergency fund, you can "borrow" money from the emergency fund to avoid having to carry a balance on a credit card. Then, savings can be directed toward re-establishing the emergency fund to its target level.

This is also the account to accumulate funds for needs that come up over the course of the year that are not regular monthly expense items, e.g. vacation, holiday gifts, property taxes, etc. To save towards them, convert the annual or semiannual expense to match your pay frequency and then set up an automatic investment into this account to meet those needs. That way those funds will be available when payment is due.

Again, our planning focus for this portfolio is liquidity (accessibility) plus a small rate of return since the funds may remain in the account for up to a year. Still, we want to limit principal risk. To that end, we encourage you to use a money market account as the funding vehicle for this portfolio.

Currently, bank money market accounts are paying more than brokerage money market accounts – historically, that has not been true. So, we should plan (for now) to use your Capital One Money Market for your short-term needs...

*Your short-term needs/goals:*

- \$50,000 - Emergency Fund
- \$45,000 – Boat (trade in)

### **MEDIUM-TERM PORTFOLIO (SHORT-TERM FIXED INCOME):**

The Medium-Term Portfolio is the funding source for those needs that you anticipate in the next one-to-seven years *that you will not meet out of cash flow*.

Our planning focus for this portfolio is earning a slightly better rate of return than on the Short-Term Portfolio, while still limiting principal risk.

Normally, we recommend a short-term bond fund as the funding vehicle for this portfolio. However, due to the current market conditions, we prefer to hold funding for medium-term needs in savings, money market accounts, or short-term certificates of deposit (CDs). We will transition your medium-term portfolio to bond-funds when the market conditions appear to be more favorable for this asset class.

*Your medium-term needs/goals:*

- \$35,000 – College (freshman year) - Meredith

For now, we should use your Capital One money market account to hold these funds.

Once your Capital One money market account gets above the amount for the short- and medium-term needs, additional funds should be sent to your TD Ameritrade money market account to deploy as part of your Long-Term Portfolio.

### **LONG-TERM PORTFOLIO:**

Your Long-Term Portfolio is the funding source for your long-term goals. These funds should be money that you don't anticipate needing for at least six years as these funds are subject to the more volatile swings of the equity markets. Within your Long-Term Portfolio, your Asset Allocation is designed to help your long-term portfolio grow at an acceptable rate with a suitable level of risk.

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#### ASSUMPTIONS:

- Inflation = 3%
- Real return (above inflation) = 4.8%
- Nominal return = 7.8%
- Social Security benefits will be available
- You will not sell your primary residence to fund goals

*INVESTMENT POLICY: FOR YOUR LONG-TERM PORTFOLIO, WE RECOMMEND THE FOLLOWING INVESTMENT POLICY...*

<b>Asset Category</b>	<b>Target Long-Term</b>
Cash	Sample
Fixed Income	Sample
Equity	Sample
Speculative	Sample

**Cash.** Since this is your long-term portfolio, we want to keep little in the cash asset class because of the inability for returns on cash-type holdings to outpace the negative effects of inflation and taxes over the long-term.

**Fixed Income.** For tax-efficiency purposes, we will want to hold these funds in your qualified retirement plans to the extent possible.

**Equities.** We prefer to use index investments as the primary funding means for this category because of their low cost and tax efficiency.

**Speculative.** Unless someone has “special” knowledge about a particular security, we discourage investing in them, preferring the benefits of diversification until your long-term goals are funded.

INVESTMENT OBJECTIVE:

Given your investment policy, your long-term portfolio should, over the long-term, be able to achieve a rate of return of approximately **4.8%** above inflation – about **7.8%** nominally with inflation of 3.00%

Please do *not* become fixated on the target return – it is actually possible to achieve the target rate of return and *not* be able to achieve your goals because of the timing associated with the good years and the bad years. ***Instead, the focus should be on goal achievement.***

At the 68% assurance level (one standard deviations), we can expect the range of your expected portfolio returns *in any particular year* to be between **-4.6%** and **20.2%**. This broad range is indicative of the volatility in a ***single*** year associated with an equity-heavy portfolio. *However, the standard deviation decreases significantly when examining longer holding periods.* While it is sometimes hard to stay focused on the long-term (when the short-term is smacking you in the face), this discipline is the key to achieving your long-term goals.

There is a 2.5% probability that your portfolio could be down 17% or more in a single year.

ASSET ALLOCATION:

Using the Investment Policy as a start-point, we have put together an asset allocation, matching specific asset classes with the broader asset classes of the investment policy and assigning target percentages.

<b>Asset Class</b>	<b>Target %</b>	<b>Lo Tgt%</b>	<b>Hi Tgt %</b>
US Large-Cap	Sample	Sample	Sample
US Mid-Cap	Sample	Sample	Sample
US Small-Cap	Sample	Sample	Sample
Natural Resources	Sample	Sample	Sample
US Real Estate	Sample	Sample	Sample
Global Real Estate	Sample	Sample	Sample
Int'l Developed Mkts - Large Cap	Sample	Sample	Sample
Int'l Developed Mkts - Small Cap	Sample	Sample	Sample
Int'l Emerging Mkts - Large Cap	Sample	Sample	Sample
Int'l Emerging Mkts - Small Cap	Sample	Sample	Sample
Fixed Income	Sample	Sample	Sample
Cash	Sample	Sample	Sample
<b>Total</b>	<b>100.0%</b>		

---

ACCOUNTS:

We recommend you consolidate your non-401(k) and non-banking accounts at TD Ameritrade Institutional except for the childrens' 529 Plans with Nevada.

*Non-Retirement Accounts*

- Since your brokerage account at Schwab is titled "Joint Tenants with Rights of Survivorship," we will set up the same account for you at TDA as it is necessary to have like titled accounts to be able to do transfers. We'll prepare the account application and transfer form for you. Our experience is that most estate planning attorneys in Texas (because it is a community property state) have clients title their joint accounts as "Tenants in Common" (or "Community Property" if the application form supports that). We can always assist you with switching the titling once your attorney advises us and the transfer is complete.

*Retirement Accounts*

- Michael's 401(k) through TX Solar
- Michael' Roth IRA (ROTH) at Schwab. We will prepare the account application and transfer paperwork for you to move this to TD Ameritrade Institutional. We will also set up a Roth IRA for Kristin (see below).
- Traditional IRAs for Michael and Kristin. While we're not big fans of nondeductible contributions to IRAs, we can take your annual contribution amount and then convert it to a Roth IRA under current law. Since the funds withdrawn from Roth IRAs are tax free, this is a worthwhile, albeit two-step process.
- Beneficiary designations on your retirement accounts should be in accordance with (IAW) your estate plan.

---

INVESTMENTS:

- Michael's 401(k) – we start with this account as it is the largest and we are bound by the investment selections available to the plan

- 24% - Sample
- 12% - Sample
- 17% - Sample
- 17% - Sample
- 12% - Sample
- 6% - Sample
- 12% - Sample
- Michael's Roth IRA – buy sample
- Kristin's Roth IRA – buy sample
- Joint Tenants with Rights of Survivorship account – we can sell the existing holdings with essentially no tax implication (\$28) and purchase sample.

---

**FUTURE CONTRIBUTIONS TO YOUR LONG-TERM PORTFOLIO:**

- Continue to maximize Michael's 401(k) contribution - \$16,500 in 2011.
- We will assist you with making nondeductible Traditional IRA contributions which we will then convert to your Roth IRAs - \$5000/each for 2011.
- We will coordinate with you to determine the easiest way to automate your remaining \$80,000 per year to your portfolio.

**IMPLEMENTATION/MONITORING/RE-BALANCING**

As part of the Capital Management Service, we will oversee this process for you.

Minimally, we review your portfolio:

- At the end of each quarter when we prepare your quarterly report

- When you provide us updates to your Short- and Medium-Term Needs/Goals as requested in your quarterly report.
- During periods of high market volatility
- At any time upon your request

When asset class percentages move outside the target range, we will look to rebalance to the asset class targets. This rebalancing may be accomplished by buying/selling investment positions, by adding new funds to the long-term portfolio, or removing funds from the long-term portfolio. This discipline forces a “buy low, sell high” tactic for the management of the portfolio.

NOTE: There may be times where we do not rebalance due to tax considerations or short-term market conditions which we anticipate changing.

#### INVESTMENT POLICY STATEMENT REVIEW/UPDATE

We recommend you contact us whenever “life happens” to change the premises upon which this Investment Policy Statement was designed.

**INVESTMENT POLICY ACKNOWLEDGMENT**

**Please initial in the space provided and sign and date at the bottom. Retain one copy for your records and return one copy to me.**

I/We understand the negative impacts of inflation and taxes, and know that in order to grow wealth that a portion of our portfolio needs to be in stocks or stock funds. However, funds that we anticipate needing in the next five years are not to be placed in the stock market.

I/We recognize that invested funds bear the greatest risk of loss in the short-term. However, over time, short-term losses have historically been overcome by the larger positive swings in the market. As such, the greatest risk to wealth (defined as ability to purchase goods and services) in the short-term is market volatility but over the long term the greatest risk is inflation's impact on one's ability to purchase goods and services.

I/We understand that both fixed income and equity investments possess the potential for loss of invested principal.

I/We acknowledge that my Investment Policy of **x% equity investments, y% fixed income, z% speculative, and a% cash** investments is likely to produce high portfolio volatility.

I/We understand that the investments recommended for this portfolio are neither guaranteed nor protected by the federal government.

\_\_\_ \_\_\_ I/We understand that past performance of an investment is no guarantee of future performance.

\_\_\_ \_\_\_ I/We have ***not*** been promised or guaranteed a specific or minimum rate of return on the individual investments or the recommended portfolio as a whole.

\_\_\_ \_\_\_ I/We recognize that changes in the assumptions or facts used to develop this plan may negate the validity of the plan.

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Date

\_\_\_\_\_  
Date