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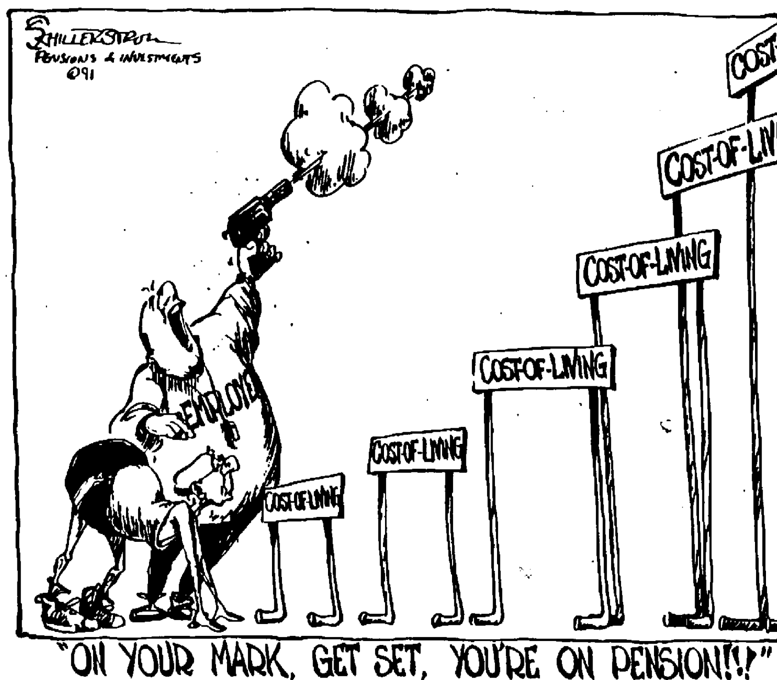
BFAS Money Line

Portfolios and Other Things



"ON YOUR MARK, GET SET, YOU'RE ON PENSION!!!"

Most people have eclectic portfolios made up of whatever they inherited or were sold when they had some money or whatever their co-worker, family member or neighbor recommended.

Thirty years ago, most people focused their attention on evaluation and selection of specific stocks or bonds rather than the portfolio as a whole. The **assumption was that sophisticated security analysis and adroit market timing could "beat the market**."

Most academic and industry research supports the concept that markets, in the broadest sense, are generally efficient.

But, you say, there are mutual funds which have outperformed their benchmarks. How can that happen in an efficient market?

I recently attended continuing education in Memphis which included an interesting exercise. The session leader asked all 100 of us simulated mutual fund managers to stand while he **flipped a coin**. We raised one arm if we guessed heads, the other for tails. All those wrong on the first coin flip sat down. The remaining 50 or so did it again, leaving about 20. After the third flip, six were standing.

The **final six** simulated mutual fund managers were declared **"Outstanding Managers" and awarded five stars from Morningstar. Money flowed into their funds, magazines wrote about them, CNNFN put them on TV and they became rich from the management fees.**

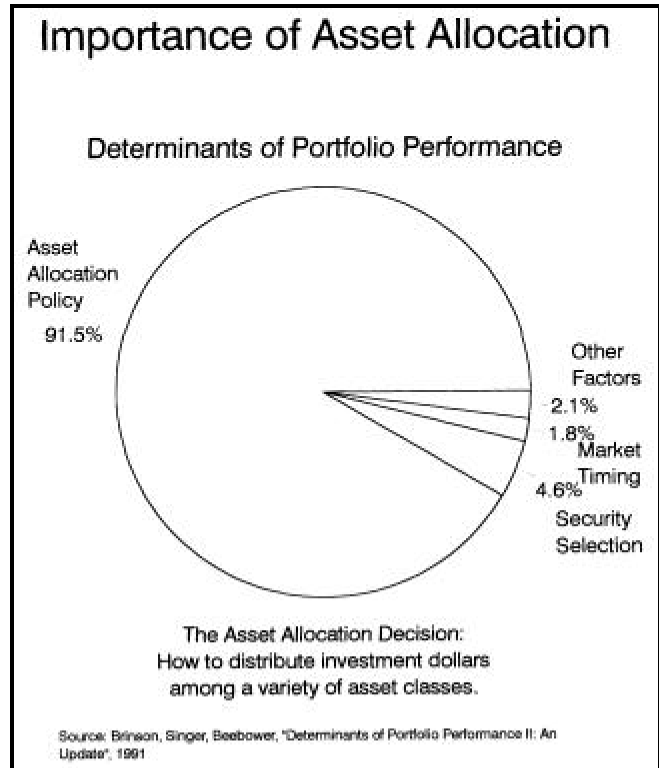
But, **were the six good managers or just lucky**? If you find some mutual fund manager who appears to be outperfoming, **how do you know whether it was luck or true excellence?** I submit that unless you have about ten years of performance, you probably do not have enough information to separate the lucky from the talented. Indeed, a recent article in Money magazine (May) showed that of 35 domestic stock funds on one discount broker's select list in the first quarter 1995, none were on the most recent list.

Today, pension and institutional investors, and more and more individual investors are using modern portfolio theory and asset allocation to manage their assets. Simply stated, **asset allocation is the process of selecting a mix of asset classes and the efficient allocation of those assets by matching rates of return to a specified and quantifiable tolerance for risk**. **Risk tolerance is essentially the percentage of an investment portfolio that an investor is willing to risk to achieve a specific rate of return.** It is no longer a one-dimensional process of selecting the right stock, bond, or property to place in the portfolio.

Modern portfolio theory has four basic premises. First, that **investors are inherently risk averse**. Second, **markets are basically efficient**. Third, the **focus should be shifted away from individual securities analysis to consideration of portfolios as a whole predicated on explicit risk-reward parameters and on the identification and quantification of portfolio objectives**. Finally, **there is an optimum rate of return for each level of risk the investor is willing to accept.**

Thus, success as an investor requires the development of long-term plans arrived at in an objective and dispassionate manner. Too often, investment decisions are based on isolated, short-term considerations, without regard to the portfolio as a whole or the inter-relationships of the assets used.

Market timing and selection of specific assets do play a role, but their impact is largely overshadowed by the asset allocation decisions. Your pension funds and college endowments have been doing this for some time. The **spread of technology and financial information has made this sophisticated use of modern portfolio theory available to individual investors.**



Credit Cards

Not long ago I had a client whose love of the good life regularly outpaced income available. Plastic was the answer and the client had sizable debt. Since increasing income was out of the question, **controlling expenses was the key**. My recommendation was to **limit spending to X dollars per week in cash**. When that cash was gone, the partying had to stop.

Critical to the success of this approach was eliminating credit card purchases. I recommended the client **freeze the credit cards!** Yes, you read it right. I said fill a cup with water, put the card(s) in it and put it in the freezer. If the client really needed it, the card was available (as opposed to cutting them up), but the client would have to thaw the card out first. That would leave some time to think about whether using the card was a good idea.

Unique Christmas Gift!

How about a unique Christmas gift idea? Rather than giving the latest fad toy, consider giving a **gift of stock**. Some companies (Disney for example) have very colorful stock certificates and also provide discounts on products/services. There is even a company which will buy it and frame it for you. For a catalogue of up to 90 stocks, call **800-742-7311 or visit www.oneshare.com** on the web.

IRAs and Annuities, Just Don't Do It!

One of the **most common errors I see in retirement planning is an IRA in an annuity**. I have yet to see any justification for this other than it is the only way an insurance person can provide an IRA (they do not sell mutual funds but they do sell annuities).

My objections to this practice are two-fold. **Both IRAs and annuities are tax deferred**. Since you can only defer taxes once, the **second deferral is meaningless**. Secondly, the **higher costs within an annuity reduce your rate of return.**

I recently reviewed a situation where a client had a Fidelity mutual fund in a Variable Annuity IRA. Annual expenses in the Variable account were 1.86%. If the client had had the account in an IRA directly with the fund family (outside the annuity), the same fund's expenses would be .66%. Therefore, the client was losing 1.2% per year in performance and gaining nothing that I could see. I equate this practice to wearing two brassieres. After the first, what's the point?

Fiduciary Oath and Financial Advisors

As most of you know, **I am a Fee-Only advisor**. Consumer groups, Jane Bryant Quinn and the rest of the media have been educating you about the inherent conflicts of interest where advisors are compensated by the companies they represent rather than only by you, the client.

As consumers wake up to the need to pay fees to obtain unbiased advice, financial advisors are becoming very inventive in attempting to masquerade as Fee-Only advisors. Terms such as Fee-Based and Fee-Offset have sprouted like dandelions. **If you see these terms, be assured that products will be recommended for which the advisor will be compensated by the product company, either upfront or later**.

Some advisors are even going so far as to answer phone queries that they are Fee-Only. What they mean is they will provide the initial advice for a fee. The advice will invariably include a recommendation that you use commissioned products. The advice for a fee is considered a loss leader to get you in front of the advisor so that you will purchase a product.

How do you protect yourself? The Fee-Only organization I belong to, **NAPFA, has recently issued a fiduciary oath which you should require any advisor to sign before working with them**. It says:

"The advisor shall exercise his/her best efforts to act in good faith and in the best interests of the client. The advisor shall provide written disclosure to the client prior to the engagement of the advisor, and thereafter throughout the term of the engagement, of any conflicts of interest which will or reasonably may compromise the impartiality or independence of the advisor.

The advisor, or any party in which the advisor has a financial interest, does not receive compensation or other remuneration that is contingent on any client's purchase or sale of a financial product. The advisor does not receive a fee or other compensation from another party based on the referral of a client or the client's business."

If your advisor can not sign this oath, you know there may be conflict of interest problems.

Variable Universal Life Insurance

I have seen quite a lot of hype lately directed towards high income clients as well as their advisors to use Variable Universal Life Insurance. Variable Universal Life Insurance is a life insurance product where the cash value is placed in investment type sub-accounts. The sub-accounts are similar to mutual funds and can be invested in various US and foreign stocks or bonds.

The **pitch is that by placing your money in VUL you can get tax deferral and a tax-free income for retirement.** They say you can even withdraw your premiums with no penalty or taxes if you get into a cash bind.

Business Week (April 13) recently had an article evaluating VUL policies. Looking at a $1 million policy from Equitable Life, a 35-year old non smoker pays a premium of $9,540 a year for ten years before the policy is fully funded. That compares to a 20-year level term policy premium of $920 per year.

In the VUL policy, the insurer deducts a 4% sales charge from each premium. The insurance cost is $1,685 the first year and goes up as the policyholder gets older. A $300 administrative fee plus monthly expense of $6 further reduce the cash hoard, as does the ongoing mortality expense, a state and federal premium tax of 3.5% and, of course, fund management fees. There is also a back-end surrender charge if the policy is surrendered in the first 10-15 years. After all this, the **rate of return if cashed in within 5 years is - 2.2%, 4.9% at year 10 and 6.6% in year 15**.

I have performed analysis on a low load policy (no sales commission), so it should perform even better than the Equitable policy. **I could find no tax bracket where the client would be better off financially in a VUL policy rather than investing in a taxable account and paying the taxes**.

Yet, some serious commission money is made preaching the gospel of tax free income for retirement. You can be sure they will have illustrations showing the advantage of VUL. How much should you trust the assumptions behind those illustrations?

A Fee-Only advisor can use either VUL or taxable investments to fund a client's retirement. The advisor can even earn money management fees for the money within VUL sub-accounts. Yet, **no Fee-Only advisors I know use VUL**. **Maybe that should tell you something**.

Roth IRAs

I could not let a newsletter go out without talking about the Roth IRA. **Everyone who has earned income this year of at least $2,000 should put it into a Roth IRA**. The Roth is so advantageous, you should even put money into it before investing in a pre-tax account (401k, 403b, Traditional IRA) **with the possible exception of where your employer matches your contribution.** If your employer matches, maximize that first.

Most fund families have Roth Analyzers which can show the advantage of contributing or converting to a Roth. After reviewing about a dozen, I find them basically okay but somewhat simplistic.

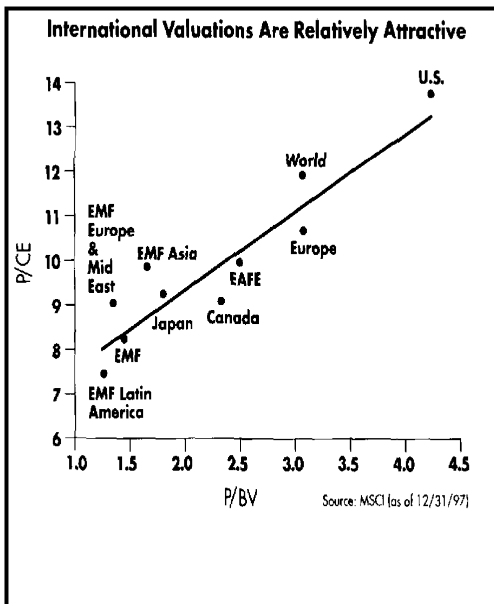
Only the most complex software can evaluate "Stretch-out" IRAs for children or grandchildren, inflation adjusted/after tax retirement distributions and strategies for minimizing the tax consequences of converting to a Roth IRA.

Bottom line, set up your Roth IRA and start contributing. Take a hard look at converting your Traditional IRA to a Roth IRA.

Investing, Bubble or No Bubble?

You are a country with very low unemployment, excellent work ethic and a good education system. Business is booming with no end in sight, everyone buys your country's products, people come from all over the world to learn your management secrets.

The U. S. in 1998? No, Japan in 1988. The **Nikkei was 30,000 on the way to 40,000** in the next year. Then, the bubble burst. The market went down, real estate crashed, banks and financial companies went bankrupt. The **Nikkei is currently trading at 16,000 plus or minus**.



Everyone knows to stay away from Japan, right? In reality, there are some companies in Japan whose stocks can be bought for less than the cash available in the company. Bargains are available. The accompanying chart shows some relative valuations of the US and foreign markets.

Something to think about as you decide where to put new money into the market. **Should you put it where is performed well in the past or use a balanced portfolio knowing that some sectors (currently emerging markets) will occasionally be out of favor?**

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