



Wealth Architecture™ Digest

Often people do not plan because they see only what is, and they do not have a vision of what can be. Something is always possible. We believe that, with vision, the possibilities are almost unlimited.

Facing the Certainty of Uncertainty

We are fast approaching 18 months since the near collapse of the world financial system. Whilst Americans focused on their own problems and the elections that were held in the midst of the crisis, the freeze of the credit markets and the consolidation of the banking and financial companies was of epic proportions.

Many of the comments and predictions of “those in the know” turned out to be grossly inaccurate. Investors wanting answers received answers that were, in large part, inaccurate. This has shaken people’s faith in the probability of success of their plans for retirement and their estate plans. They are feeling less certain that they will be able to live the way they want to, while ultimately transferring what they wanted to.

After 40 years working with successful people I have come to accept the paradigm that life, be it the personal, business, or financial aspect, is dominated by uncertainty. Everyone seems to want *answers* to questions that are unanswerable. Having started in the business within the life insurance industry I was focused on the “what if” of unexpected death. By definition, an insurance policy is an aleatory contract, one that is essentially a gambling contract. The beneficiary gets paid (wins) if you lose (die early), and the insurance company wins if you have a long life and pay for many years.

The company can afford the gamble only by looking to the law of large numbers and careful evaluation of each applicant it will insure, rejecting adverse risks. It diversifies its risks, and attempts to match its investments (assets), with its liabilities (expected claims.) Most individuals cannot afford the gamble of self-insuring, as what may be a one-in-a-million loss for the company becomes a one-in-one loss for the self-

insurer. I’ve never known someone with a mortgage-free \$1 million home go without fire insurance, even though it is not required. Rather than deal with the uncertainty of even an extremely small risk of a major loss, people pay for peace of mind.

From the standpoint of investment portfolio construction most professionals will design an asset allocation based on the client’s risk tolerance and time horizon with a goal of creating a portfolio with a high probability of “success.” Usually the measure of success is at some terminal point, and not necessarily at every point along the way. For a person in or near retirement, it may be targeted to have \$1,000,000 “at death” to pass on to children; or simply to not run out of money before the undertaker arrives. But the variables are many. When will death occur – 85, 90, 100? Will she have unexpected expenses for herself, children, siblings or others, the payment of which would deplete the assets? What if.....?

Almost fifty years ago economists developed what is known as Modern Portfolio Theory which is used by many to create an “efficient” portfolio. Using decades of data (past results) and a good amount of statistical calculations, it is possible to design portfolios that have a high *probability* of success. The difficulty comes with understanding that a 90% confidence level does not mean that we can relax. Just like my comment about carrying fire insurance, comfort comes from being able to answer at least some of the “what-ifs.” Of course it can get ridiculous if we tried to plan for every contingency, because beyond those that we may think of – and plan for – the whole concept of uncertainty encompasses things we cannot plan for, things we’ve never seen before.

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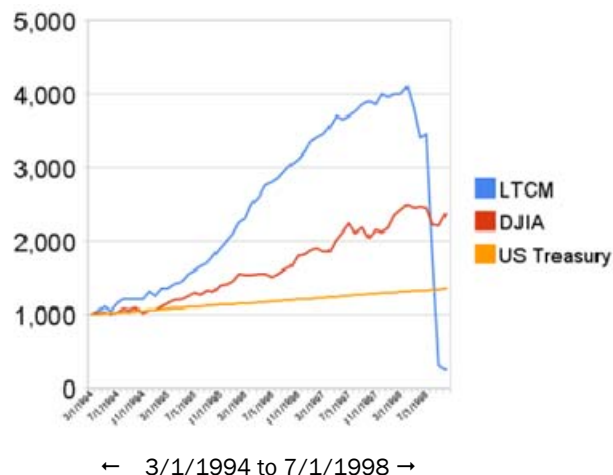
Let me give an example mentioned in the recently published *I.O.U., Why Everyone Owes Everyone* by John Lanchester. He wrote:

Quants use these measures of probability all the time. According to the models in use by the quants, the Black Monday crash of 1987 was a ten-sigma event. Translated into English, that meant that, in the words of Roger Lowenstein's book When Genius Failed: The Rise and Fall of Long-Term Capital Management. Economists later figured that, on the basis of the market's historical volatility, had the market been open every day since the creation of the Universe, the odds would still have been against its falling that much in a single day. In fact, had the life of the Universe been repeated one billion times, such a crash would still have been theoretically "unlikely."

In September, 1998, almost exactly ten years before the collapse of AIG and Lehman Brothers, the hedge fund Long Term Capital Management had to be rescued by urgent negotiations headed by The Federal Reserve Bank. Even though its founders included two Nobel laureate economists and other leading experts in fixed income arbitrage, its commitment to complex calculations of probabilities doomed it when the Russian government bond default set off a panic in the markets. Lanchester wrote:

The 1998 default was a 7-sigma event. That means it should statistically have happened only once every 3 billion years. And it wasn't the only one. The last decades have seen numerous 5-, 6-, and 7-sigma events. Those are supposed to happen, respectively, one day in every 13,932 years, one day in every 4,039,906 years, and one day in every 3,105,395,365 years. Yet no one concluded from this that the statistical models in use were wrong.

This graph, prepared by Jay Henry for Wikipedia.com illustrates the effect of being leveraged, and being "surprised" by uncertainty.



The vertical drop took place in a matter of a few weeks, while the geniuses continued to believe that their models would prove them right and save their fund. It was eerily similar to AIG in 2008.

America is entering some uncharted territory as we struggle to regain economic stability. After the Great Depression and World War II we had a great expansion as families grew with a baby boom, and businesses thrived while we built the interstate highways, created whole new towns and suburbs, and manufactured most of what the newly formed families needed. Now there is real global competition, and with instant communication (especially the internet) and economic pressure to keep costs low, most manufacturing has moved overseas. This is an extremely important issue, because without well-paying middle class jobs, strong economic growth is not possible. Without real growth that includes rising personal incomes, personal uncertainty will be a real problem.

As many baby boomers get ready to retire, and as older Americans live longer, they require more substantial investments to take care of their own needs.

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If their children cannot find good-paying jobs, the onus may fall on the parents to help, further stressing the economic stability of the older generation. For those people who created the plans just a few years ago, the combination of the volatility in the financial markets, the decrease in real estate values, and the potential of family members needing help means that a new look is in order, with the additional contingencies added in.

Given the fact that uncertainty may be the most certain thing, we need to think about that very small possibility of failure. There is no way that most people can live today purely on the **income** available from guaranteed investments like FDIC-insured certificates of deposit or 28-week treasury bills. On February 26th the yield on those T-bills was just 0.18% (source: bloomberg.com). That means a \$1 million investment would return only \$900 over six months. Someone needing just \$10,000 per month of income would have to invest over *\$66 million* to maintain the absolute “safety” of a short-term treasury, hardly a possibility.

It has become increasingly important to discuss financial priorities from both the viewpoint of probability, *and* from the consequences of a catastrophic, but highly unlikely event. With companies failing and jobs lost, with markets gyrating and creating fear and greed, is it more important to stretch (take on more risk) to improve the chance of reaching goals, or is it better to reduce goals, accepting reduced expected returns? There is no right answer, but it is better to address the questions than to deal with the consequences of simple faith in computer models.

Human nature is one of emotional response to perceived risks. Managing wealth must be far more than tax and investment planning. It needs to include discussion of, and dealing with, the certainty of uncertainty.

March Forecast Madness

March 8, 2010 was a very special day. It was one year ago that the S&P 500 Index hit bottom and started its unprecedented climb, and roughly ten years ago that the NASDAQ Composite reached an all-time high. On March 9, 2009 the index closed at 676.53 (source for index data: finance.google.com). The news a year ago was of a possible return to the Great Depression. Since that time there have been remarkable changes. However, the question remains: what does it all mean?

Pundits and economists alike point out that the stock market is usually a “leading indicator.” They say that the economy should rebound about six months following a market recovery. Well, based on the changes in the US and global economies, one might expect that the blossoms of spring are a sign of sunny days. In the US, Bureau of Labor statistics show that we lost 5.4 million jobs in the eight months from October 2008 thru May, 2009, while in the ensuing eight months the losses were just over 300,000. In February, 2009 unemployment rose by 795,000, while last month net unemployment rose by only 25,000.

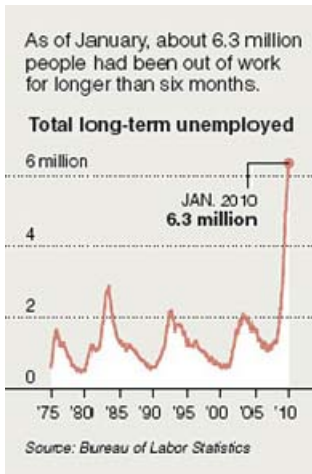
But just as people prognosticate how much longer winter will last based on whether the pudgy prophet Punxsutawney Phil sees his shadow on February 2nd each year, economists are reading tea leaves (data) trying to see how long the current economic pain will continue despite the technical end of the Great Recession. Over the past two quarters US gross domestic product grew, with 4th quarter growth revised up to an annual rate of 5.9% (source: bea.gov). One would think this is a very good sign.

However, while the stock market is up dramatically, and unemployment has stopped growing by hundreds of thousands per month, net employment has yet to rise. On February 20th The New York Times wrote about the problem and included this incredible graph on the next page:

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The historically high level of long term unemployment is staggering. While “official” unemployment is at 9.7%, the estimate for total unemployment (including part-timers who want full-time work, and those dis-



couraged workers who have given up looking for work) is estimated to be over 17%. The pressures are enormous, and with long-term unemployed losing their health insurance, their homes, and their hope, the current recession is creating a real chill, one that could cause the blossoms of spring to wither and die.

There is general agreement that much of the problems being faced here and abroad were created by a cheap-money fueled asset bubble. The cheap money was in the form of debt, and the main asset bubble was real estate. It was even worse in United Kingdom, Ireland, Spain, and elsewhere. The collapse of real estate demand (and values) led to foreclosures and bank failures, followed by the contraction of construction with the loss of millions of construction-related jobs. On March 5th the Bureau of Labor Statistics reported,

“Since December 2007, employment in construction has fallen by 1.9 million.” The report showed that the unemployment rate for construction workers rose from 9.4% in December, 2007, to **27.1%** in February, 2010.

In my opinion, before the recovery *in jobs* can get under way, the horrific leverage (debt) in the individual and banking sectors must be reduced. There is little credit available for individuals and small businesses. Until the banks have reduced their leverage (hard to do with so many bad loans on their books), they don’t have a lot of money to lend. Individuals with mortgages that are under water, credit cards at their limits with interest rates of 29%, and fear of losing their jobs, are neither in the mood, nor the position, to purchase anything of significance. Without demand, businesses cannot increase production to a level that will require them to hire new employees.

So, even though the NASDAQ closed today up 80% from one year ago, and the S&P 500 was up over 66%, caution is still prudent. As I talk with you to review your situation, we will look at your needs, not just the movements of the markets or the debates over the future of the economy. It is easy to focus on an incredible year, but instructive to note that the NASDAQ Composite, even after the run-up of the past twelve months, is down 52% from March 10, 2000.

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Unless otherwise noted, market statistics and data used in this newsletter were obtained from finance.google.com, and interest rate information was derived from www.treasurydirect.gov.

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