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However, when the purchase was for a \$400 suit the results were very different. Discovering they could buy the same suit for \$393 – the same \$7 savings – there were no takers. Is that rational? Should the percentage savings matter, or just the amount saved?

The second experiment was very interesting to me as a chocoholic. In a series of controlled studies Ariely sold both Hershey's kisses and Lindt truffles to students at MIT. The truffle, a luxury chocolate, was priced 14 cents more than the plebian kiss [15 cents versus 1 cent]. Knowing good chocolate, and a good deal, the students overwhelmingly selected the Lindt

truffles. However, when he dropped the price by one cent for each, making the truffle 14 cents and the kiss zero, the tables turned and the power of the free chocolate overwhelmed the willingness to pay 14 cents more. Was that rational?

All too often, Ariely maintains, we act irrationally. Time after time his studies showed that the irrational choices were quite predictable. Perhaps we need to understand that there are many factors that play in our decision-making, and that only by examining our choices more deeply are we likely to make more rational decisions. Prudence relies on rational analysis and behavior. Sound investment planning should also be rational.

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# 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.*

## Independence Day

Two hundred thirty-two years ago 13 American colonies declared themselves independent states -- the United States of America. From those early days our country has grown to the greatest economic and military power of the modern world. As I write this on July 4th, 2008, I have been pondering the significance of the term "independence," and if it is truly possible today.

The reason I periodically write about abstractions is because I believe that in order to make better decisions, be they personal, political, or economic, it is important to think more broadly about the significance of various aspects of the country and world in which we live. Like all of you reading this, I live a comfortable life, in an economically-advantaged community, with few serious concerns. We are, for the most part, independent.

One thing that encouraged me to do some research and write about this topic at this time was a movie I watched last night: *Maxed Out*. Filmed and released in 2006, it focused on the role of debt in America. It documented some amazing examples of the use and abuse of credit from the viewpoints of consumers, lenders, investors, regulators, and collectors. They interviewed a man who had been wealthy, but too leveraged. He lost it all and now writes and speaks about how to stay out of debt. They showed one severely

developmentally disabled man who had to be shown how to sign his name on loan documents. The film also showed the sausage-making process of the 2005 federal bankruptcy law that made it significantly more difficult, if not impossible, for consumers to free themselves of unpayable debts.

The saddest stories shared on the documentary were of three debt-triggered suicides. One was a 57-year-old woman who had secretly run up excessive credit card debts and was being hounded by debt collectors. Unable to face her husband and children, she drove her car into the local river. The other two stories were of young college students who were granted credit cards when they arrived at college, even though they had very limited incomes. After building up significant debt that they felt they could not re-pay, they became very depressed and committed suicide while still at school. They wanted to be independent as young adults, but were not ready. They never had a chance to learn the skills.

Economic independence is not just a personal issue. We are now in the midst of the widest economic/credit crises in more than a

*“Economic independence is not just a personal issue.”*

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generation. Unfortunately, while our country declared independence over two centuries ago, it is no longer even close to economically independent (virtually no country is). The real problem is that the US, regardless of its real or perceived power, has very little flexibility. The reason is similar to many consumers-- too much debt. While I do not believe that our country faces imminent disaster, I do think that we need to be better informed about the facts. As a society we will eventually be forced to make some difficult decisions.

We have always been economically "dependent" on other countries, both for imports and exports. We buy a lot from abroad, and we sell a lot of products and services (mostly services). Until 1970 our annual balance of trade was positive (balance of trade statistics source: www.census.gov). Except for 1973 and 1975 it has been negative ever since. The cumulative trade deficit for 2000 through 2007 was over \$5 *trillion*. That leaves a great deal of our dollars in foreign hands, both corporate and sovereign. Somehow that does not lead me to believe we are truly independent.

The movement abroad of all kinds of manufacturing and services has not only significantly decreased the cost of many things, but has increased our dependence on other countries. We no longer have the ability to produce what we need, as we cannot compete without employing low-cost foreign producers. But it is even more complicated.

Historically there was a separation between our commercial banks, investment banks, and insurance companies. The Glass-Steagall Act of 1933 not only created the Federal Deposit Insurance Corporation (FDIC), but it prohibited bank holding companies from owning other financial institutions. This prohibition was repealed by the Gramm-Leach-Bliley Act of

1999 (source: wikipedia.org). International financial concerns flooded the market with money to lend, especially in the US. Much of it ended up funding everything from huge leveraged buyouts to regular and sub-prime mortgages. Now, with this source of capital significantly diminished, new money for mortgages and business transactions has dried up. We have obviously become too dependent.

Finally, the most serious long-term problem that may negatively impact the independence of our country is the amount of the national debt. Since we don't see it in our day-to-day lives, many of us may not realize it is now over \$9.4 trillion, or more than \$31,000 for every person in the US (source: www.treasurydirect.gov). It first crossed \$1 trillion in 1982, and was \$5.8 trillion on September 30, 2001. It has increased almost \$4 trillion in seven years!

A basic concern for our independence is that over \$2.6 trillion of our country's IOUs (treasury obligations) were held by foreign countries at the end of April, 2008 (source: www.treas.gov). Almost half the total, or \$1.24 trillion, is held by three countries: Japan, China, and the UK. While China, at \$502 billion is now number two behind Japan, it closed the lead by over \$120 billion in the last year alone, and will likely be the number one holder of our debt by this time next year. That will make it even harder for us to dictate the terms of trade agreements, political differences, etc.

All things being considered, I think it has been a long time since we could really feel independent, but that's not necessarily bad. Perhaps in the world of the 21st century we could redefine success as *interdependent*. Internationally we really need each other. Political and economic stability, peaceful coexistence, environmental protection, as well as adequacy of food and energy will all

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went up or down. Investment grade bonds, especially of shorter maturities, tend to be fairly stable in value. But long-term bonds or lower grade (and therefore higher risk) bonds would have greater swings. Bonds go up in value – a profit. Bonds go down – a loss. Even though the bonds remain in the portfolio, their simple changes in value generate profit or loss.

For me, what's important here is that even though no disposition of the underlying asset has taken place, the value must be marked to market and the resulting change shown as a gain or loss. Also, when the asset is marked down the company has less "capital," impacting how much the company can invest – and in the case of banker/lenders this means how much they can lend to others.

In the chaotic environment of the past year the reality of mark to market has taken on new prominence. With the exotic repackaging of all kinds of loans – mortgages, leveraged buyout debt, credit card debt – there has been a great deal of confusion as to exactly what the "value" of these holdings really is. Auditors, needing to be conservative, are requiring write-downs that have severely impacted the GAAP statements of

## Are We All Irrational?

I am close to finishing a fascinating book, *Predictably Irrational: The Hidden Forces that Shape Our Decisions* by Dan Ariely. It is instructive in better understanding how we do things, but not necessarily why. It is important, especially given the current emotional overlay of the global financial markets.

Ariely, a professor at MIT's Sloan School of Business, gave results of studies he conducted in many areas. Two that stood out for me was how rational people are when it comes to making even small financial decisions. Before I share

those holding these assets. Maybe the value is correct, or maybe they been overly punished.

The write-downs have caused profits to turn into significant losses, and the book value, or net worth, of the companies has gone down accordingly. With the net worth of the companies down, many need to raise new capital to be able to restore greater balance between assets and liability – the level of leverage. Confidence is low, business is slow, and stocks have been severely punished. So what might this kind of fair market value accounting do going forward?

I believe that, at some point, the real estate and debt markets will bottom, and then turn up. When that happens (and no one knows when it will), the marked to market debt values will increase. That change will lead to higher GAAP profits and the likely affect will be a recovery in both confidence and stock prices. It is difficult to assess what is important and what it not. The changes dictated by FASB from time to time are meant to make for greater transparency, but they generally follow a breakdown of the previous rules. In the current credit crisis it will be important to understand how something as mundane as accounting standards affects the survival and performance of financial companies. Time will tell.

the first study, I'd like you to think of saving \$7 by driving ten minutes to a cheaper store to make a purchase. Now, while you may not do this, I am sure that many average Americans would do so (at least before gas reached over \$4/gallon).

Professor Ariely ran an experiment where people were asked if they would drive to a nearby store to buy a pen for \$23 rather than purchase it for \$30 in the store where they were. Most were willing to drive to the other store to save the \$7.

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-- or we can recognize that interdependence ties us together.

The root word "depend" can be extraordinarily charged, especially by those who believe that we are taking something away from them when they are asked (or required) to provide help for someone not totally independent. I remember years ago talking to a retired man whose wife and daughter had both taught in public schools. When discussing a local school bond proposal he said he was voting against it because "I don't have any children in school." But I queried back, "don't we *depend* on an educated populace to remain an effective and competitive nation?" Are we not, locally, regionally, nationally, and globally interdependent? I maintain we have a duty to ourselves, and each other, to at least take the time to think about it. Thanks for taking the time to let me share my thoughts.

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tility. When times are good, people have a tendency to overestimate their tolerance for risk and volatility. Tough times test resolve and risk tolerance.

I have made several points above and have offered what I believe to be prudent advice. I

## A Phrase for All Seasons

There is a phrase of which you should be aware that has greatly contributed to the volatility of the markets, especially over the past year: *Mark to Market*. This refers to the accounting practice that requires a firm to adjust certain asset values on a current basis, even where those assets are not needed for current liabilities. Public companies are required to publish financial statements on a GAAP (Generally Accepted Accounting Principles) and the Financial Accounting Standards Board (FASB), an independent, not-for-profit organization, was created in 1972 to establish such principles.

The Securities and Exchange Commission has designated FASB as the organization to establish the accounting standards for public companies. Over the years, as various issues have come to the forefront, the FASB has studied them to determine how best to assure companies' financial reporting is meeting standards. "The final product of most technical projects is a Statement of Financial Accounting Standards. The Statement sets forth the actual standards, the effective date and method of transition, background information, a brief summary of research done on the project, and the basis for the Board's conclusions, including the reasons for rejecting significant alternative solutions." (Source:fasb.org)

For example, back in the 1980s insurance companies were permitted to carry debt instru-

ments (bonds, etc.) on their books at whatever they paid for them (considered to be cost). The companies worked hard to match various bonds, which they carried as assets on their books, to the generally long term liabilities to pay insurance or annuity claims as they came due. As far as they were concerned, the intermediate fluctuations in value would not matter as the bond was purchased to pay a future liability. Looking back to earlier times, most insurance companies purchased investment grade bonds, so default was rarely an issue.

After the debacle in the high yield bonds (pejoratively referred to as junk bonds), where there were more than normal defaults, FASB began to change the rules. It is important to note that insurance companies used to report one way for the insurance regulators (book accounting) and a different way for GAAP. FASB decided that it was important for the public to understand the value of the financial assets every quarter as the companies published their income, expenses, assets, and liabilities. Under FAS 115 for certain financial assets they began to require fair market value adjustments every quarter, or mark to market.

The consequence of this, which is extremely valuable in understanding today's credit crisis, is that a company using GAAP accounting would see its profit or loss fluctuate dramatically as the *value* of the bonds in its portfolio

have suggested that we use history as our guide, but I realize that every situation is different. I urge you to call me to discuss your current portfolio, reconfirm your financial goals and objectives, reassess your risk profile and be prepared for the stronger markets that I believe our corrected vision will see in the future.

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require greater cooperation and less hegemony. I doubt we'll ever see any country gain real independence as each has something to offer others. It may be naive to think we'll learn to really cooperate rather than simply compete, but one can hope.

Domestically we face a similar struggle which has recently become clearer as more people lose their homes, and many well-paying jobs are replaced by lower-paying or part-time positions. Healthcare costs are bankrupting families and squeezing profits at the major companies who provide comprehensive benefits. The significant drop in home prices leads to lower property taxes at the local level, which in turn leads to reduced services of all kinds. Education suffers. Public safety is impaired. We are all in it together, and can either see "the others" as dependent -- "too bad"

## Myopia, Lasik, and Markets

People who suffer from significant myopia have an extraordinarily difficult time getting around without help. Both my wife and my daughter suffered from vision that was so bad, they could not identify a known person across a normally sized room without glasses or contact lenses. Several years ago, I met a woman in Ethiopia who could not tell how many fingers I was holding up from five feet away. They all had myopia, otherwise known as nearsightedness.

My wife and daughter were fortunate. They received successful Lasik surgery and can now see clearly, unaided by corrective lenses. It was a magical and an altogether high tech intervention. The woman in Ethiopia is not so fortunate. There is no chance of Lasik surgery for her and virtually no chance of getting corrective lenses. She must get by with imperfect vision.

Investors are subject to the same imperfect vision as they view the global financial markets. We cannot see that which is far away, but we want to be sure that we are not walking over a cliff. Unfortunately, as we walk on our path towards lifetime financial goals, cliffs appear unexpectedly. Of course, some investors will say that they see tough markets coming. While they may have seen some difficult markets coming, they fail to see them all. We all would like to have (or know someone who has had) a Financial Lasik surgery, making it possible to see far ahead. Instead, most are lucky to see a short distance ahead.

As I write this in early July 2008 we have just been informed that we have reached bear market territory. By definition, a bear market envi-

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ronment exists when the market drops at least 20% from a peak. That is where we are today relative to the highs reached at the end of October 2007. Some experts have also suggested that we are in a recession. We are not officially in a recession since by definition a recession is two consecutive quarters of negative gross domestic product (GDP) growth. The overall economy has been flat but not negative, so we have not met the *technical* definition. Regardless, the consumer is definitely in a funk and does not feel like spending. As a result, banks are not lending and businesses are contracting and laying off workers.

Energy prices are at record highs. Food prices have skyrocketed, causing hunger and riots. All that people see is bad, and they make decisions based on how they feel because they are unable to see where it is safe to step. Myopia creates fear, and fear often drives people to head in a different direction, only to encounter a different cliff. The year 2008, even though it is only six months along, has had more than its share of negative news. Presidential campaign rhetoric has caused the bad news to come in to even greater focus than usual.

With the reality that June has been a very negative month, I have again been asked what I think is happening and what should investors do? The S&P 500 Index and the MSCI EAFE Index (Europe, Australia, and the Far East) represent most of the market value of the developed countries. Their year-to-date performance is down 12.9% and 13.1% respectively (source: wsj.com). The China stock market has been hot for the last several years. That is not the case for China so far in 2008. China makes our domestic indexes look good. The Shanghai Composite index is down 47.8% year-to-date with the other significant China market indexes down about the same (source: wsj.com). The Canadian stock market is the only developed market that is up this year and it is up less than

4%.

What has been instructive to me this year is the way our market (as represented by the S&P 500) gyrated this year, and how clients responded to the various moves. The index reached an all-time high of 1561.8 on October 12, 2007, after having fallen from 1552 to 1433 in just over two weeks from July 13th to August 3rd. The index finished the year at 1468, up about 5% for the year (source:finance.google.com).

*“What should I do in this market?”*

As 2008 began, the markets started to behave awfully. In the first three weeks, the index dropped about 11%, recovered almost half within the next 10 days, only to go to a low of 1273 on March 10th. Less than a week later, Bear Stearns was taken over, and the market rallied for two months, clawing its way back to 1426 by May 19th --a 12% increase which left it down less than 3% for 2008. On June 5th the index was at 1404, but by the end of the month it had fallen back to 1280, just above the March low and a stunning 9% drop from the June 5<sup>th</sup> peak. (source:finance.google.com).

When the market collapsed in January, we received many calls from concerned clients, and several adjusted their portfolios to be less volatile. In March, there were virtually no calls. However, in late June the fear factor was raised to new heights, sparked in part by the falling markets and the skyrocketing prices of oil, gas, and food. Our clients wanted to know what to do. Their fear was that the losses would continue and possibly accelerate.

The answer to the question “What should I do in this market?” requires a degree of farsightedness or Lasik surgery to improve your market vision. History suggests that markets serve as

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an early predictor of the future economic environment. Presently this suggests that the markets will advance before the economy, meaning that the market could reverse direction while we are still experiencing a difficult economic environment. One challenge for investors who modify a strategic plan by getting out until the markets recover, is that few can really identify the turning point where it seems safe to get back in, and they often miss a meaningful part of the recovery. We can always look back with precision, but there are no guarantees about the future.

I decided to do some historical research to see what one of the last great bear markets looked like. The downturn of 1973-74 was the first significant bear market of the post-World War II period. The S&P 500 Index on January 11, 1973 closed at 120.24 and the bear died on October 3, 1974 at 62.28, down 42.8% (source: finance.yahoo.com). What interested me was, not the depth of the drop but, what was going on in the press at the time. In the early 70's, there was no cable TV, no internet, and only a few hundred total mutual funds. Therefore, I dove into the online archives of The New York Times. Join me as we go back to the future.

On Sunday, January 7, 1973, Edward Cowan wrote, *“Whenever the shortage of fuels and electric power is discussed these days, someone invariably asserts that what this country needs is ‘a national energy policy.’* The market (the market refers to the S&P 500 Index) was up almost 70% from its low on May 26, 1970. The US was still unhappily at war in Vietnam, but things were looking up and just twenty days later President Nixon signed the Paris Peace Accords. It should have been a great environment for peace and prosperity.

On the same day that Cowan wrote his piece on energy policies, The New York Times also published an interview with three market ana-

lysts. I.W. Burnham, 2nd, who was senior managing partner of Burnham & Co. said, “I am increasingly more optimistic than I was two or three years ago...because I think very few of us have lived through a time of world peace.” Stanley Currie, vice-president of Tri-Continental Corp. said, “I think I can see through 1973 and 1974. I think the market will be higher than most of us believe.” Wow, was their vision impaired!

The third person, Edson Gould, editor of the newsletter *Findings and Forecasts* got it right. He said, “I think 1973 will be a bear year and a bad year.” He was right on that, but made another prediction in the same paragraph that proved wrong when he said we would not have another bull market until we got back on the gold standard because, “...the world can't live with floating currencies.” Twenty-one months later, amidst the chaos and gloom of the end of the Nixon administration (Watergate and the impeachment proceedings that took up most of 1973 and 1974, until Nixon's resignation on August 4, 1974), the oil embargo in late 1973, and the stagflation of 1974, the stock market bottomed. However, what was being written at the time?

On September 4, 1974, 26 days before the market turned up, William V. Shannon wrote in a New York Times editorial, “the economic outlook is now increasingly grave...there is now a discernible possibility of a severe slump with unpredictable consequences...” He went on to postulate, “Such a slump, if it occurs, could precipitate a worldwide economic catastrophe.” Nine and a half months later, those who ignored the pundits and maintained their strategic plan, saw the S&P 500 Index up 51%.

Dismal economic news is very depressing. It is our current state. It is real. There is no way to know what will make things better, or when that will occur. Part of determining risk tolerance is how one responds to the *emotional* part of vola-

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