



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.

Chips, Meat, or Candy?

History has a way of teaching us lessons. It is often an eye-opener that shows us that are firm convictions regarding what will happen in the future are often wrong. This is an example of such a vision of the future.

Let me take you back to January 2, 1981. Let's imagine that a good friend who worked at Motorola was telling you about a great new product in development: the cell phone. Being a bit of a visionary this friend foresaw a time when most everyone would carry a pocket-sized phone that would allow them to make and receive phone calls from places as remote

as the plains of the Serengeti National Park in Tanzania; a time when you could always be "in touch."

As an investor, many people feel that buying the stock of a market leader developing the new new-thing is a wonderful way to make lots of money. In 1981 Motorola was a large, diversified company, and this new product line of cell phones just might propel it forward, generating great earnings and resulting stock performance. That would make sense to most people. So let's assume you made an investment of \$10,000 in Motorola stock on that date.* By the end of last year your investment would have been

worth \$112,300*, not including any dividends.

My wife is from Hawaii, and when I asked her what was popular in Hawaii in 1981 she said "Spam." As this was before e-mail and before health foods, I understood it to be that packaged meat that I had eaten as a kid (along with Velveeta). So I wondered what would have been the results of an investment in canned meats (Hormel), and the results surprised me. The same \$10,000 investment would have been worth \$336,900* without dividends, about three times the Motorola investment. And had I thought of my

lifelong chocolate obsession and invested instead in Tootsie Roll Industries, I would have had \$419,300* – enough to buy 41,330,000 penny Tootsie Rolls!

The point I have labored to make is that our beliefs in the future potential of any one company, or any one industry, are fraught with traps that can lead us to inaccurate conclusions. And inaccurate conclusions, combined with undue concentration in stocks we think we "know about," significantly increases risk.

Source: Wall Street Journal Online

*This is not to suggest that anyone made such a recommendation or such an investment, but rather to illustrate the way people see investment opportunity.

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Richard Haas and Judith Puette are Registered Representatives offering securities and Investment Advisory Services through NFP Securities, Inc. a Broker/Dealer, Member NASD/SIPC and a Federally Registered Investment Advisor. Richard Haas also offers Investment Advisory Services through Financial Catalyst Group, Inc. a Registered Investment Advisor.

Financial Catalyst Group was founded in 1977 to help successful people articulate their goals, and realize their dreams to protect and preserve their hard-earned wealth. At Financial Catalyst Group we provide unique Wealth Architecture™ services that result in the implementation of value-added plans for the responsible transfer of wealth through the generations. We specialize in working with families that desire to provide a legacy to their families and their communities, making gifts instead of paying transfer taxes. We work closely with these families and their advisors to form a strong, results-oriented team.

Wanna Bet?

Special Interest

"One of the most bizarre – or cynical – provisions in the bill would remove for one year – 2010 – the income limits on conversions of traditional IRAs to Roth IRAs, allowing many more taxpayers to convert."
WashingtonPost.com
5/13/2006

This could be one of the biggest tax gifts ever to people with significant IRAs and net worth. Watch for this to become a major planning opportunity and political football.

The provision was inserted in the legislation as a "revenue raiser," as it provides a tax windfall in 2011-12, but costs significant tax losses in later years past the 10-year budget window.

Special Report

Investing. The American Heritage Dictionary of the English Language defines investing as the act of purchasing of "Property or another possession for future financial return or benefit." Some people say it is a form of gambling. Some say it is way to profit by being "smarter" than the crowd – or finding a manager who is smarter. Others say investing is an art. The reality may be that it is a little of each, but one thing I believe you can count on is that *understanding* the dynamics of investing and setting appropriate expectations is essential.

Although this report may be complicated (and a bit dry), I decided to write it because at Financial Catalyst Group as we have worked with clients we have come to realize that few understand how the investments they own work, and how to have a better chance to "succeed" – whatever that may mean. It is notable that definitions of investing do not reference the concept of risk. Few people really understand what "risk" means to them, believing it is one-dimensional. It is not. And if a person does not understand what risk means to him (or her), he cannot properly differentiate amongst appropriate investments or investment strategies. He cannot differentiate between investing and betting (gambling).

An individual should understand his risk tolerance as well as his risk capacity. A forty-year-old with \$20 million can usually afford to lose \$5 million (25%) without

jeopardizing his or her lifestyle, while a 70-year-old with \$200,000 could not afford a 25% loss. However, the younger multi-millionaire may not be emotionally able to tolerate the loss for any of a number of reasons. One person I know who has high capacity and tolerance for risk says he is not a "gambler," as he only takes *calculated* risks. I like that paradigm and would suggest in order to calculate risk, an investor must understand the dynamics of the investment alternatives and their associated risks. Otherwise he is gambling.

"Few people really understand what 'risk' means to them."

Professor Jeremy Siegel's book, *Stocks for the Long Run* documented the significant historical evidence that shows that **over time** stocks have outperformed bonds, and that stocks are *riskier* (more volatile) than bonds. In order to attempt to earn higher returns, investors must accept higher risk, and "modern portfolio theory" is based on this assumption. There have been shorter periods where bonds have outperformed stocks. But as we all know, past performance does not guarantee future results. As investors generally have a choice of assets, if they did not believe that stocks would provide better returns over the long term, they would simply buy bonds until stock prices dropped to the point where they felt the "expected" return on stocks was adequate to reward them for the added risk.

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Wanna Bet? (from front page)

Another paradigm with which I agree is that investors should not take a risk if there is little likelihood they will be properly compensated for the risk taken. Taking on uncompensated risk becomes more like gambling, and less like investing. Often investors will attempt to reduce risk (or increase return) by searching for a manager who has a good track record (*past history*) of picking stocks, creating an actively managed portfolio that has “beaten the benchmark” that comes closest to the style of the fund (e.g. small growth, large value, etc.). The idea is to find a “guru,” that rare manager who seems to know better than others what stock to buy, when to buy it and when to sell it.

In 1997 Peter J. Tanous wrote a book titled, *Investment Gurus*. The book is a compilation of interviews, mostly with active managers who he had identified as having exceptionally good track records. He also interviewed a number of academicians who looked at the markets from different perspectives. Tanous was trying to promote (he is a consultant who selects managers for clients) the idea that you can achieve superior results by searching for top managers who you believe can, in turn ferret out the top stock choices. On the

front cover he quotes the legendary Peter Lynch saying, “Investing is an art. This book shows you how proven performers do it.” I thought it would be interesting to look back over the nine years since it was published to see if it was predictive or prophetic.

My research indicates that Tanous’ selection of “gurus” was anything but prescient. However, the points made by the academics he interviewed (Merton Miller, William F. Sharpe, Eugene Fama, and Rex Sinquefeld) seem to be verified by history. Before I continue I need to clarify one point. For many years I had been trained to believe that “top managers” could be found, and using them could add long-term positive value – they could beat the market. The complete market cycle of the past decade has convinced me that such effort does not consistently provide positive, risk-adjusted return.

Using data provided by Morningstar I spent time researching the results of the managers that Tanous suggested were the “best of class.” It turns out that none of the managers featured (who are still managing money in mutual funds of managed accounts) have track records placing them even in the top half of their peers over the past five years.

Several, while having stellar pre-1997 results, were in the bottom 20% of their peers in two or more years since the book’s publication. I felt it would be of little benefit to detail the specific managers and their numbers, because study after study has shown that it is extremely unlikely that you can predict that any given manager will consistently add value over time.

Near the end of his book Tanous proposes an “aggressive” strategy for which he recommends three funds actively managed by men he considered gurus: Brandywine Fund (25%), MFS Emerging Growth (25%), and Mutual Shares (50%). He wrote, “Note that in our Aggressive Strategy, we have significantly outperformed the S&P500... over ten years and, interestingly enough we did not assume a great deal more risk...” (*Investment Gurus* page 397).

One of his choices, the MFS Emerging Markets Fund was managed by John Ballen, about whom he wrote, “Ballen ascended guruhood in the simplest manner possible – he outper-

formed his peers over a very long time. Indeed, his fund achieved a growth record of 30.5% a year for the five years ended 1995 and 20.3% for the ten-year period.” However, Ballen’s rank in his category then sank to the bottom 25% for three years, and after a brief surge towards the top in 1999, he proceeded to lose **74% from 2000 through 2002**. Over the ten years ended March 31, 2006 the fund was in the *bottom 13%* (Source: Morningstar, Inc.)

The Brandywine Fund fell to the bottom 20% about the same time as the 1997 publication of the book, and now ranks almost in the middle of the pack over the past ten years. While since 1998 Mutual Shares has performed better than the other two choices, its guru Michael Price departed less than a year after the publication of *Investment Gurus*. Merton Miller (Chicago) and William F. Sharpe (Stanford) are both Nobel laureate economists. Along with Rex Sinquefeld and Eugene Fama in *Investment Gurus* they said that their research, and that of many others, proved that very few managers outperform their benchmarks over time, and predicting which manager will do so moving forward is statistically improbable.

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Wanna Bet ? (from page 2)

When Tanous interviewed William Sharpe he asked him if one researched managers and found ten with top risk-adjusted track records, what would the probability be that in the future all of these managers would consistently be in the top 1/3. Sharpe replied, “I would say that the probability is, basically zero.” (Tanous, *ibid* pg. 99) Even when giving 10% to each of the ten chosen top managers versus 10% to each of ten random managers, Sharpe insists that the probability of the portfolio ranking in the top third of returns is less than 50%.

I started evaluating managers about 18 years ago, and over those years there has been a significant increase in managers, mutual funds, and analytical databases. I’ve attended conferences where managers spoke and explained their disciplines, their research, and their trading processes. Because most managers assert that they add value over their benchmarks by either stock or sector selection, we can track what a manager does, versus what he says he does. What we see quite often is that a manager who is underperforming his benchmark will frequently buy stocks outside the designated style if he feels it will aid performance. That’s why

for example we often find a “small cap” manager with 10% or more of a portfolio in large cap stocks, etc.

This brings us back to the active vs. passive debate. Active management *assumes* that by being better informed or “smarter” than others, a manager can capture more upside, or avoid losses before a stock drops. It assumes that the markets are *inefficient*, an argument that the Nobel laureate economists say

“I’ve never met a manager who says he’s wrong half or more of the time.”

research shows is invalid. In all the years I have been advising clients, I’ve never met a manager who says he’s wrong half or more of the time, or who says he won’t add value by his discipline. But if you want to try an interesting experiment sometime during a dinner party, ask everyone if they think they are a *below average* driver. You will rarely get anyone to admit it, but obviously everyone can’t be average or above!

Having a stock, mutual fund, or money manager who significantly outperforms the benchmark is exciting to talk about. We all like to hit an occasional home run, and it is certainly more fun to talk

about owning Google stock which is up four-fold, than it is to talk about owning “the market.” But this gets us back to the beginning where we discussed **risk**. Anyone without the iron-clad stomach to accept major losses should not maintain a portfolio that is set to attempt to achieve significantly higher than market returns. A diversified, passive portfolio removes the guesswork (see following article) and improves the probability of being compensated for

risks taken – of course no guarantees.

The academic research I’ve

mentioned indicates that, for the most part, the financial markets are efficient, and that risk and return are closely associated. The 1986 Brinson, Hood, and Beebown study, “Determinants of Portfolio Performance,” indicated that approximately 93% of “expected return” is attributable asset allocation and the movements of the markets.

History also tells us that no one asset class, no one style, and no one region of the world consistently outperforms the other. By owning most asset classes in varying percentages, the research implies that overall portfolio

volatility can be decreased, while maintaining reasonable return expectations.

I hope this special report has helped give you a better appreciation of the factors that go into our process of assisting our clients *invest* in accordance with their needs and risk tolerance. Perhaps the bottom line of investing is that it is not an art or a science, but a dynamic process that weighs the individual’s ability to “stay the course” of any long-term strategic plan along with an appropriately diversified portfolio.

The indices mentioned are unmanaged and cannot be directly invested into. Historical performance numbers do not include any potential commissions or loads. Past performance does not guarantee future results.

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