

Summer 2010

MANAGEMENT

"HELPING YOU MAKE SMART CHOICES ABOUT YOUR MONEY"

INFLATION, NOT THE BEAR MARKET, IS THE REAL PORTFOLIO DESTROYER

Consumer prices in March were virtually unchanged from a year earlier, as the core rate of inflation rose just 1.1 percent. You had to go back to January 1966 to find a smaller year-over-year price increase.

A savvy investor would not assume from this that inflation is dead, but rather that it is merely taking a breather. The inexorable long-term rise in prices almost surely will gain momentum at some point in the future. Investors who don't take that threat of inflation into account when planning their portfolios may someday find themselves short of enough spending money.

Although many investors who suffered through the recent bear market are still focused on stock market volatility as a threat to their portfolios, it is inflation that is the real threat, says Kent Smetters, a risk management professor at The Wharton School.

He notes that the worst decade for stock market investing was *not* the Great Depression, or the recent double-bear decade, or the Panic of 1987.

The ugly 1970s

Instead, it was the 1970s, a period of double-digit inflation touched off by the OPEC oil crisis. The purchasing power of a dollar fell by 50 percent then, he says.

For every additional percentage point of inflation, he says, an investor loses 20 percent of his purchasing power. And more often than not, this purchasing power erosion occurs in the background.

"Inflation lurks in the shadows," he writes. "It destroys value, gradually eroding real returns over time. It is financial death by a thousand cuts."

Unwary investors look at the numbers in their portfolios without accounting for what their dollars



The inexorable rise in prices due to inflation can silently diminish a portfolio's real worth and purchasing power.

can buy over time, a mistake the famous economist John Maynard Keynes termed "money illusion."

What portfolio strategies should you use to combat inflation?

TIPS, not gold

A traditional answer has been gold, oil, and other commodities whose prices go up with inflation. However, Smetters and others say that although commodities are well correlated with inflation, they don't offer enough extra return to compensate for their higher risk.

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Commodities are about twice as volatile as the U.S. stock market, he says.

Gold is currently a darling of the hard-money, inflation-fearing crowd. Historically, however, it hasn't been a great inflation hedge.

A dollar invested in gold at the end of 1977 would have grown to \$1.84 by the end of 2009. But a dollar invested in much safer cash reserves would have grown to \$1.91, while a dollar in U.S. common stocks would have hit \$8.87.

Smetters thinks Treasury Inflation Protected Securities (or TIPS), stocks, and corporate bonds are better bets.

TIPS are unique: although they carry a fixed interest rate, their principal value is increased along with inflation, which thereby increases the interest payments over time.

Stocks, although not well correlated with inflation, have a long-term record of growing faster than the inflation rate. Smetters likes emerging markets stocks especially, because they have the hedging power of stocks and allow you to diversify out of the U.S. dollar.

Short-term bonds also tend to adjust their interest rates to keep up with inflation at an acceptable pace, he says.

HOW TO SUCCEED IN RETIREMENT: STOCKS AND 4 PERCENT WITHDRAWALS

How to invest a nest egg and what is a safe withdrawal rate are the two biggest questions for anyone in or near retirement.

Although the answers are far from simple, a lot of recent academic research continues to shed light and offer guidance to the perplexed.

The uncertainties of future inflation, investment market returns, and individual life expectancy can make it a bewildering calculation for many would-be retirees.

Will inflation be a big factor, in which case should they take risks with stocks in order to keep up? Or will the stock markets suffer a spectacular fall, so that a more prudent approach would be keeping everything in the bank? And, most of all, how much can be taken out of an investment portfolio so that it will last for 25 years or more?

Stick with stocks

One finding that consistently appears in academic research on retirement income suggests that stocks should be in most retirees' portfolios, despite their high volatility.

In fact, most research suggests that the only two investments that can be relied on to match or beat inflation are stocks and Treasury inflation protected bonds, or TIPS. TIPS keep up with inflation but rarely pay a premium. Because medical inflation can run ahead of the official inflation rate on which TIPS adjustments are based, retirees may need some stocks to provide excess returns.

One recent study by John Okunev, an Australian portfolio manager, found that the optimal portfolio for a retiree should have as much as 80 percent of its holdings in stocks. This is even higher than earlier studies that suggested a retirement portfolio hold from 50 percent to 75 percent in stocks.

Okunev based his research on 140 years of stock market returns, beginning in 1870. He found that portfolios



A healthy exposure to stocks can help someone reach their retirement goals and leave the work force successfully.

with more stocks than bonds had a good chance of surviving an annual withdrawal rate of 4 percent over 30 years.

If more than 40 percent of a portfolio was held in fixed income investments, it was more likely the portfolio would not last, he found.

Where to withdraw

Retirees also need to know which assets to tap for their withdrawals. Traditionally money is withdrawn from the asset classes which are doing the best in the portfolio at the time; therefore acting somewhat as a portfolio rebalancing technique.

During periods when the equity markets are suppressed, the bulk of the withdrawals are taken from the fixed income portion of the portfolios giving stocks the opportunity to grow when the market begins to rise.

MUTUAL FUND INVESTORS GET THEIR MARKET TIMING ALL WRONG

Investors are a sorry lot when it comes to market timing. They tend to push money into stocks just before the market declines, and take money out of stocks just before the stock market begins to rise.

Several academic studies have looked at the timing of mutual fund investors and come up with similar results.

A frequently cited study by Lipper Inc. showed that although the average stock mutual fund gained 11.3 percent per year from 1973 through 2005, the average stock fund investor earned just 3.9 percent a year due to poor timing.

Bet against the crowd

Now a forthcoming study has concluded that this poor timing by mutual fund investors is so pronounced that you can make extra money by moving in exactly the opposite direction as the crowd.

The study by three Israeli finance professors, to be published in the *Journal of Financial Economics*, looked at the exchanges between bond and stock funds within individual mutual fund families. Their findings suggest that investors on average tend to follow the stock market as it goes up, switching money into stocks near the peak in the market.

After the market falls, they begin switching money

out of stocks, often just before the market turns around and starts heading up again.

An investor who followed these patterns and did the opposite might be able to make more money than just buying and holding stocks, they conclude.

Tax and other costs

Of course, this notion highlights the other folly in trying to time the market. After paying taxes on making frequent market timing switches, and after paying transaction fees, investors probably won't make much more than just buying and holding a diversified portfolio.

Plus, the buy-and-hold strategy guarantees that your money will be in stocks during the typical intense, brief jumps in prices that account for most of the stock market's long-term gains.

Any trading system that relies on cues to get you into and out of stocks at specific times runs the risk of backfiring just at the wrong time and magnifying losses while leading to missed long-term opportunities.



Average investors sell and buy mutual funds just at the wrong times, studies show.

FRAUD PROTECTION SERVICE IS A FRAUD

It isn't so just because someone says it is. At least that's the case with LifeLock, the identity theft protection company famous for publicizing its CEO's Social Security number in its advertisements.

LifeLock's screaming television ads have been attracting consumers to its \$10-a-month service since 2006, based on its promise to prevent credit theft.

Instead, hundreds of subscribers ended up becoming victims of fraud, while the company mishandled its clients' confidential information, says the Federal Trade Commission.

\$12 million in fines

The company in March settled an FTC complaint by paying an \$11 million fine to the FTC and an additional \$1 million fine to 35 state attorney generals in one of the largest coordinated settlements on record.

"While LifeLock promised consumers complete protection against all types of identity theft, in truth, the protection it actually provided left enough holes that you could drive a truck through it," said FTC Chairman John Leibowitz.



Todd Davis, CEO of LifeLock, displaying his Social Security number in one of his company's ads for its fraud protection service.

He called LifeLock's marketing campaign "a fairly egregious case of deceptive advertising."

The settlement raised doubt about the effectiveness of similar ID theft services, said Illinois Attorney General Lisa Madigan.

The FTC said LifeLock put fraud alerts on customers' credit files but that only protected them from new account fraud, which comprises only 17 percent of identify theft.

The company's other claims that it would prevent unauthorized access to a customer's address and that it monitored activity on customer credit reports were false, the

agency said.

Information misuse

LifeLock also gathered sensitive customer information and failed to encrypt and protect it, and its data system was vulnerable to hacking, the FTC said.

The fines collected by the FTC will be used to provide refunds to customers and it said it will soon be contacting those who are eligible.

Information on the refunds can be found at 202-326-3757 or at the FTC's website at: www.ftc.gov/lifelock.

The FTC says consumers should take their own steps to prevent identity theft. Its booklet, "Fighting Back Against Identity Theft," has tips on defending against ID theft and is available on the agency's website.

LONG-TERM CARE COSTS ARE DEVASTATING

A lot of attention has been paid to lifetime health care costs during the recent debate over the federal health care overhaul plan.

The group with the most concerns may be those in or nearing retirement, because health care costs tend to go up with age.

Retirees have to deal with the costs of Medicare premiums, supplemental coverages, out-of-pocket expenses, and potential long-term care costs.

How much should a couple have set aside for retirement health care costs at age 65?

Wild card costs

Many experts have tried to quantify this amount for the average retiree. The problem with such predictions, however, is that not all retiree experiences will be alike. Health, of course, is a big factor in ultimate costs, but the ultimate wild card is whether one or both members of a couple will need long-term care, says a recent study by the Center for Retirement Research at Boston College.

“The cost of long-term care represents a substantial financial risk for all but the poorest households,” the Center noted.

It predicts that about a third of individuals turning age 65 in 2010 will need at least three months of nursing care at some point, while 24 percent of those turning 65 will need more than a year’s care. An unlucky 9 percent will need five or more years of care.

It notes that in 2008, the latest year for which national statistics are available, the average one-year nursing home stay cost \$79,000 for a private room.

Employing a home health aide for four hours a day, five days a week, would cost about \$22,000, the Center says.

Few alternatives

The Center says the average 65-year-old couple needs about \$197,000 at retirement to handle lifetime health care costs, but that there is a 5 percent probability that the cost of all care including nursing care will exceed \$570,000. It notes that fewer than 15 percent of households have total financial assets in excess of that amount at retirement.

The best alternative is to explore buying long-term care insurance well before hitting age 65. Although the insurance is costly, the annual premium is lower for buyers who are younger and healthy. Costs go up dramatically for older buyers.



Without the help of long-term care insurance the costs of long term care will eat up all of a retired person’s assets.

LIFE-CHANGING RECESSION

Young people who grow up in a recession form life-long economic and political beliefs, including the belief that success depends more on luck than effort, says the National Bureau of Economic Research.

Its study said that those between the ages of 18 and 25 may also come out of the recent recession as greater supporters of government wealth redistribution efforts.

THINK VALUE, NOT GROWTH

Value stocks—those whose prices are low in relation to their earnings—give you more bang for your buck during earnings season, says veteran investor and financial writer David Dreman.

Growth stocks, probably due to investors’ higher expectations for them, tend to fall much more than value stocks do when there is a negative earnings surprise.

When there is a positive earnings surprise, value stocks tend to gain twice as much as growth stocks, he says.

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors’ returns within their tolerance for risk. Here is what sets us apart:

- ◆ Fee-only investment management
- ◆ A disciplined investment strategy
- ◆ Access to institutional no-load passive asset class funds
- ◆ An academic Nobel Prize-winning investment approach

- ◆ Continued access to academic research
- ◆ A tax-efficient focus with valuable tax- and estate-planning ideas
- ◆ Risk tolerance assessment
- ◆ Periodic portfolio rebalancing
- ◆ Regular communications and state-of-the-art reporting
- ◆ No front-end loads, no back-end loads, no surrender fees, not locked in
- ◆ **MOST IMPORTANT ...**
A TRUSTED ADVISOR RELATIONSHIP



INTRODUCTIONS—REFERRALS ARE ALWAYS APPRECIATED.