# WEALTH MANAGEMENT

CORE Wealth Management

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"HELPING YOU MAKE SMART CHOICES ABOUT YOUR MONEY"

## USE STOCKS, NOT BONDS OR GOLD, TO PRESERVE PURCHASING POWER

Legendary investor Warren Buffett delights in standing orthodoxy on its head.

Buffett has attacked the orthodox definition of investment "safety" as low fluctuation of principal.

As usual, Buffett nails the problem quite succinctly: rather than measuring risk by how much a potential investment might fluctuate in value, investors should concentrate on whether an investment has a "reasoned probability" that it will not cause a loss of purchasing power over time.

Buffett says stocks are the best way to preserve and increase purchasing power over time, while fixed income investments are not. "A nonfluctuating asset can be laden with risk," he writes.

### Value destroyers

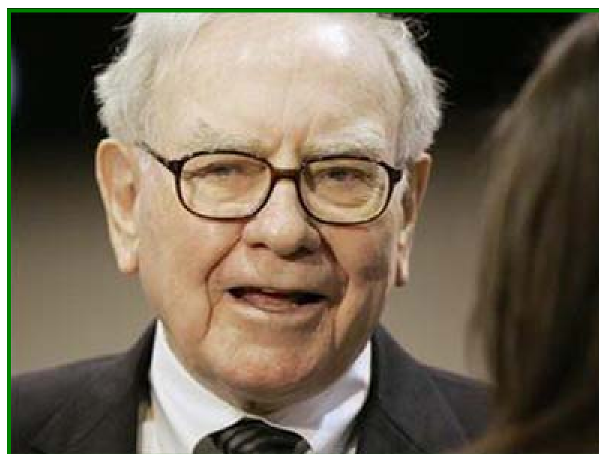
In an article in Fortune magazine adapted from Buffett's shareholder letter, he laid out the argument against bonds and for stocks.

Investments denominated in currency—bank deposits, bonds, money market funds—are usually thought to be safe. "In truth they are among the most dangerous of assets," Buffett writes. "Over the past century these instruments have destroyed the purchasing power of investors in many countries, even as these holders continued to receive timely payments of interest and principal."

How does this happen? It is the twin effects of inflation (in essence, government devaluation of its currency, he says) and income taxes on interest.

Buffett notes that it takes $7 today to buy the same goods and services that could be purchased for $1 in 1965.

Currency-based investments pay interest rates that do not keep up with inflation, once taxes are taken out of the interest. Thus purchasing power falls.



**Warren Buffett says low-interest-rate bonds and non-productive gold will not keep up with inflation, while stocks of productive companies will.**

Occasionally interest rates will be high enough to compensate for inflation, as they were in the early 1980s. But today's rates are very low and "bonds should come with a warning label," Buffett says.

### Forget about gold

He also dismisses gold as a store of value. "Gold, however, has two significant shortcomings, being neither of much use nor procreative," Buffett writes.

Gold prices go up due to fear and enthusiasm. "As 'bandwagon' investors join any party, they create their own truth—*for a while*," he writes.

"Eventually gold prices will form a bubble, and they will pop just as home prices did in 2008 and internet stocks did in 2000," he said.

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## USE STOCKS TO PRESERVE PURCHASING POWER

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**Compound growth**

Those who want their capital to grow should invest in productive assets like businesses, farms, or real estate. "Ideally, these assets should have the ability in inflationary times to deliver output that will retain its purchasing power value while requiring a minimum of new capital equipment," Buffett says.

"Consumer products companies," he says, "will do just that, while others, such as regulated electric and gas utilities, won't because they have heavy capital requirements."

Productive businesses, however, are like cash cows, delivering greater quantities of "milk" over the years. "Proceeds from the sale of the milk will compound" just as the Dow Jones Industrial Average went from 66 to 11,497 during the 20th century, he adds. He says stocks will be the runaway winners in the future, and "*by far* the safest."

## PASSIVE INVESTORS BEAT ACTIVE MANAGERS IN TEN-YEAR SCORECARD

Indexed and passive investing have gotten a bad rap from active managers out to protect their turf and the high fees they earn from buying and selling securities.

Passive managers buy a portfolio that matches a market index or that covers an entire asset class. Plenty of academic research suggests that they will do better than the average active investor who tries to beat the market by either selecting the "right" investments or by timing when to buy and sell.

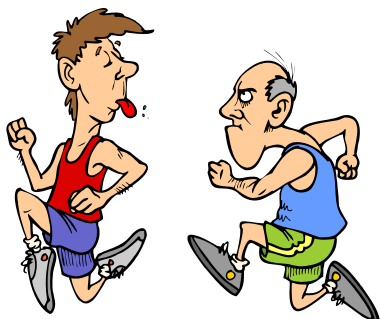
The passive investment managers now have a 10-year real world test to back up their theory: the Standard & Poor's Indices Versus Active scorecard, known as "SPIVA."

For a decade S&P has tracked the performance of its stock and bond market indexes compared to the performance of active mutual fund managers. The results have given strong backing to passive management proponents.

**Bear market myth**

Active managers have long argued that they do better during bear markets, because they have flexibility. Unlike passive managers, who must continue to be fully invested, active managers can buy and sell and play defense.

But in the two bear markets covered by the SPIVA scorecard, the majority of active fund managers failed to beat their index benchmarks. For instance, in the 2008 bear market almost 84 percent of small-cap stock funds failed to beat their index, while 53 percent of large-cap managers were bested by their relevant index.



**In the race for investment performance, passive stock and bond indexes have outpaced the average active mutual fund manager in recent years.**

**Muni funds fail**

Municipal bond funds turned in the worst performance: Just 9 percent of national muni bond funds outperformed their indexes, while not one New York or California muni fund did so.

This points out one of the arguments for passive investing: it is cheaper than active investing because trading and management fees are low. Active muni bond funds may not have done so bad vs. their indexes on a gross return basis, but since returns on munis are modest, after subtracting fees they ended up trailing the indexes.

**Passive small-cap**

The SPIVA scorecard demolishes another myth: that managers investing in stocks of small companies are more likely to outperform their relevant indexes. This myth is based on the claim that while large company stocks are priced efficiently because they are so widely followed, small company stocks are less well known and therefore provide an opportunity for savvy managers to select the best stocks.

Over the decade covered by the scorecard the majority of small stock funds were beaten by their indexes.

**Five-year advantage**

During particular years or short periods active managers sometimes do beat their indexes. However, on average, given a five-year period, it appears that the majority of active managers fail to beat their indexes, SPIVA shows.

For instance, from June 2006 through June 2011, 63 percent of large stock funds were beaten by the S&P 500 Stocks Index. During the previous five years, almost 70 percent of the big company managers lagged behind the index.

Finally, the scorecard may make active managers look even better than they really are. Each year during the study up to 20 percent of active funds went out of business. If they were included in the study, active management would have looked worse.

## Is There A 'Free Lunch' waiting in Inefficient Stock Markets?

Are there areas of the stock market where stock prices are not efficient and skillful investors can scope out bargains overlooked by other investors?

That argument is commonly used to justify active stock selection among small stocks and emerging markets stocks.

Proponents accept that prices on big U.S. and overseas developed market stocks are probably efficient, meaning that there is so much competition among investors that all relevant news is immediately priced into the market. Any individual investor's information or insight on a particular stock is probably already factored into its price.

If that is true, an investor is better off using an indexed mutual fund for large U.S., European, and Asian stocks.

Two top investment academics say that there is no evidence that smaller markets - such as those of small stocks or stocks of emerging markets like Brazil, Poland, and India - are inefficiently priced.

Eugene F. Fama of the University of Chicago and Kenneth R. French of Dartmouth College made their reputations studying returns of small stocks.

One argument for inefficient small stock prices claims they are often neglected. "If no one is paying attention to a group of small stocks, for example, how could their prices possibly be accurate?" French asks. He said the argument "may have had some merit 150 years ago," but seems out of date in an era where "hundreds of billions of dollars" are spent by investors each year looking for pricing errors."

When it comes to emerging markets, the argument is "that investors in some markets are ripe for the picking because they are just not as sharp as the rest of us," Fama says. But that argument is flawed: "People are bright and highly motivated in markets around the world," making those markets efficient too, he adds.

Competitive trading probably means that all investment markets are efficiently priced.

## Only Foolhardy Mutual Fund Investors Aim to Beat the Market

The justification for investing in indexed and passively allocated mutual funds is powerful: funds that attempt to capture the market's overall returns—rather than beat the market– regularly outperform their competitors.

Yet that long-term evidence doesn't seem to dissuade the proponents of active mutual funds—those that attempt to beat the market through stock selection, industry allocation, or market timing.

### A satellite approach

One group of active investors has partially conceded the argument and agrees that investors should use indexed funds for their portfolio core, the part invested in large stocks.

At the same time, they argue that investors should use actively managed funds for the supposed "inefficient" areas of the market, such as the small and emerging market asset classes.

Proponents have dubbed this the "core and satellite" investment approach.

After doing an extensive study of this strategy The Vanguard Group, a large mutual fund manager, found that "indexing is a powerful strategy in all segments of the market." Only those very few investors who are skilled enough to pick the best actively managed mutual funds will be successful using them, it concluded.

Vanguard looked at mutual fund managers operating emerging market and small-cap stock funds from 1995 through 2009. Only one-third of the emerging market funds survived the entire period *and* beat their benchmark. Findings for active small stock funds were similar.

### A skillful 5 percent

Then the company estimated the chances of an individual investor selecting a fund that survived the period and outperformed its market index.

Only 5 percent, or one out of 20 investors, would have been that skillful, it said. The rest of the investors would have failed to select the right active funds as their satellite choices, it found.

"We conclude that on a median basis, all investors would have benefited from having indexing as part of their portfolio, and that the 95 percent of investors with less than perfect skill would have benefited from having a majority of their portfolios in a market index," Vanguard said.

*"Only one-third of the emerging market funds survived the entire period* and *beat their benchmark."*

## SAVINGS GROW, OPTIMISM IS UP AND MORE

Americans boosted their retirement savings by 5 percent in the last quarter of 2011 as the values of IRAs, 401k plans, government and private pension plans and other savings reached $17.9 trillion, said the Investment Company Institute, the mutual fund industry's trade group.

More than half of that was held in Individual Retirement Accounts and employer savings accounts such as 401k and 403b plans. Most 401k owners are still in the savings phase of their lives; only 3.4 percent of participants took withdrawals during 2011, the ICI said.

**Optimism grows**

More Americans think it is possible for a typical middle-income family to save for a secure retirement than in recent years, according to the latest survey by Illinois-based insurer Country Financial.

It said 35 percent responding to its survey were optimistic, up six percentage points from last year and the first increase in five years.

About 57 percent of the 3,000 respondents have maintained or increased their retirement contributions.

**IRA confusion**

Younger retirement savers are confused over the relative advantages of tax-deductible traditional IRAs and tax-free Roth IRAs, says mutual fund company T. Rowe Price.

Many were not sure which IRA offers tax deductions for contributions (traditional IRAs) and which allows for tax-free withdrawals of principal at any age (Roth IRAs), the Baltimore-based company said.

## SPRING . . . PLANTING THE SEED TO YOUR FINANCIAL WELL-BEING

Spring is the time of year in which we all anticipate and enjoy the new life that surrounds us. We do new plantings of gardens, shrubs, flowers, and the like. We, also clean up the dinginess left by Winter. Our thoughts turn to planning summer vacations, golf, and outings with family and friends.

This should also be a time for you to think about your financial well-being and how it might be enhanced with some planning. It is also a good time for us to help you with this planning. This might include: reviewing or developing your financial plan, reviewing your insurance policies and needs, reviewing your current investment portfolio including retirement plan investment options, and/or estate and retirement planning. Let us help you plant, nurture, and grow your financial well-being. If you are interested, please give us a call to set up an appointment.

### 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

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