



# TAKING CARE OF YOU

ISSUE#: *One Hundred-Sixty-Nine*

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## 1. *MARKETS*

### *Current Market Environment*

July ended up being the **best** month for the U.S. stock market so far in 2010, while August has taken a turn for the worst. As of August 18, 2010, here is where the major U.S indexes stood year-to-date: **DJIA = -1.1%; S&P 500 = -1.9%; Russell 2000 = +.4% and the NASDAQ = -2.4%**. Most of R.O.I.'s clients (those with a Moderate asset allocation) are about **+1.15%** year-to-date. **That brings us to the next issue, what we anticipate for the future.**

The debate on Wall Street is whether the recovery that spurred stock prices to nearly double between March 2009 and April 2010 is about to be snuffed out. Evidence for a **"double dip"** recession are such factors as: Europe's teetering economy; federal stimulus that propped up the credit and housing markets is nearly expended; and, retail sales and manufacturing are again declining. Plus, if the old saying is true, that the stock market is a predictor of the economy six to nine months down the road, then look out! Stock prices have tumbled about 10% since late April, and investor sentiment (by one measure), has fallen to lows not seen since 1987.

HOWEVER, before we start making **major** conservative adjustments in anticipation of another slump, some perspective is in order.

For starters, actual double dips are rare. There have been three since 1913, the last in 1981. What is common, on the other hand, is for recoveries to hit a **major rough patch** after the economy bounces off its lows. Nine of the 10 recoveries since 1949 hit a speed bump within 10 months of the rebound, **marked by dramatic drops in factory activity, consumer confidence, and stock prices. Sound familiar?** These soft spots tend to last for **several quarters**, as government stimulus efforts fade and private-sector growth slowly takes over as the economy's driver.

Though there's **certainly a possibility** that the U.S. economy could slip into negative growth if the housing and jobs markets fail to gradually recover, global competition for goods and services is likely to **maintain or slightly increase overall price levels**. For example, even if our job market fails to pick up, **increasing demand for oil from China, India and some other countries** with above average growth, is likely to keep pressure on oil prices, which feeds into the prices of many goods in the U.S., especially gasoline.

Here are two other factors to consider. First, while the numbers keep saying "loss of momentum", the indicators have not been uniformly following the same script. Yes, retail sales have turned sluggish. At the same time, the indicators of business investment spending are encouraging. **It is a mixed picture. Not inspiring, but at the same time not the prologue to a new downturn.** Second, earnings reports for the last quarter have been very strong.

A few months ago R.O.I. **trimmed its equity exposure** in order to control participation in a further down swing. We have maintained this conservative allocation, with a high allocation in cash, and we are looking for opportunities to buy in when the

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situation shows more things are stabilizing and beginning to improve.

## 2. ACTIVE INVESTMENT MANAGEMENT

### EVALUATING INVESTMENT ADVICE

#### ACTIVE INVESTMENT MANAGEMENT

##### OBJECTIVE

- Participate In Up Markets
- Control In Down Markets

##### ALLOCATIONS

- Asset Allocations  
(Secular/Cyclical Markets)
- Opposite Categories
- Different Classes
- Independent Classes

##### FILL ALLOCATIONS

- Use Best Funds
- Monitor Choices

##### CONTROL SWINGS

- Diversify Manager Styles•
- Control Sector Concentration
- Allow Fund Managers To Make S/T Decisions
- Rebalance
- Fine Tuning Strategies

##### ADVISOR/CLIENT

- Motivate Advisor
- No Conflicts
- % Of Assets Basis
- Help Build Business

At some point, the efficacy of investment advice is evaluated by the client. Individuals sometimes make evaluations that are *inconsistent with their well-being* and these inconsistencies can occur in systematic ways. In some instances, this systemic behavior is driven by:

1. **Emotions** that lead people astray; and/or,
2. **Cognitive failures**, that is, people make mistakes.

What are some of the primary **emotions** and **cognitive failures** that encumber investment advice evaluation? In the next few issues of “Taking Care of You”, we will discuss some of these emotions and cognitive failures – in this issue we will discuss **Hindsight Bias**.

### HINDSIGHT BIAS

#### DEFINITION

Hindsight bias is *the tendency for people with knowledge of what happened to have an inappropriately strong belief that they would have predicted that outcome*. This occurs because events that the best-informed experts did not anticipate often appear almost inevitable **after** they occur. “Financial punditry” (the “experts” on TV, radio and print) provides an unending source of examples every day, and a watcher/listener/reader could well draw the incorrect inference that the behavior of the market was so reasonable that it could have (even should have?) been predicted earlier in the day, week, month or year.

#### COMPLEXITY OF TASK

What clients need to be aware of is the **complexity of the task** relative to making investment decisions. For example, evaluating:

- Government deficits and spending                      Businesses’ cash reserves
- Changing and “up in the air” tax laws                      P/E ratios and other stock price valuations

- Political and media influences                      Unemployment rates
- Elections                      Inflation rates
- Investor sentiment                      Interest rates
- Fear                      Oil, gold, commodities and real estate prices
- Consumer spending                      International issues (financial, political, war)
- Corporate earnings                      Historical market trends, and the exceptions
- Corporate inventories                      Make money by buying low, selling high

After evaluating these factors, you must make decisions **on the spot** about what to do **today**, next **week**, next **month**, next **quarter**, the next **six months**, next **year**, during **elections, and other events**. How does an advisor (let alone an individual investor) possibly digest all of these factors so that good short and long term decisions can be made and good advice given?

#### THE PROCESS

The **process** of digesting these factors and making good short and long term decisions and giving good advice, is one that: You are familiar with; You may not fully understand; But is a **process** that has worked remarkably well for more than a

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decade and a half, and thus through many up and down markets. Sometimes we have referred to this process in shorthand terms like: “Staying in Your Lifeboat”, “Straddling the Fence”, “Pigs Get Fed but Hogs Get Slaughtered”. It is the **process** that is listed (and discussed in detail) in the left hand column of every “Taking Care of You” newsletter, a part of which is taught every month in the newsletter. It is titled “Active Investment Management”:

- Objective – (1) Participate In Up Markets; **AND**, (2) Control Participation In Down Markets;
- Allocations (Secular/Cyclical Markets) – Opposite/Different/Independent Categories & Classes;
- Fill Allocations – Use Best Funds and then Monitor Choices;
- Control Swings – Diversify Styles; Control Sector Concentration; Rebalance; Fine Tuning;
- Advisor/Client – Motivate Advisor (No Conflicts; % of Assets Basis; Help Build Business.)

### **TESTING THE PROCESS AGAINST HINDSIGHT BIAS**

Assume it is now is January 1, 2009 and the S&P 500 is at 903. Even though your portfolio beat by 6% one of the BEST (that’s right, BEST!) performing indexes in the world during 2008, i.e., the S&P 500, you feel beat up and battered, discouraged and fearful because you lost -32%. You’ve faithfully:

- Reviewed all the factors referred to under “Complexity of Task”, above; and,
- Have applied “The Process”, above, and even though valuations are **incredibly low** you feel things could get worse.

Therefore, you make your already conservative Moderate Allocations even more conservative, and you keep doing so till March 9, 2009 when the S&P 500 drops to 676 (another -25% drop in less than 3 months!). Relatively speaking, you feel good because your portfolio only experienced a fraction of that decline.

Next, it is March 9, 2009, and you really feel beat up and battered, discouraged and fearful. Again you faithfully:

- Review all the factors referred to under “Complexity of Task”, above; and,
- Apply “The Process”, above, and even though valuations are **EXTREMELY incredibly low** you feel things possibly could get worse, or, they could sky rocket!

Therefore, you make slight changes to your conservative Moderate Allocations so it is a little less conservative, and you keep doing so through December 31, 2009 by which time the S&P 500 has sky rocketed to 1115 (a +65% gain in 9 months!).

As you look back on 2009, you feel very good about your +25% gain for the year, you are grateful you didn’t miss that desperately needed upswing, especially during a time of continuing fear, anxiety and gloom. BUT, you realize that on January 1, 2009, and March 9, 2009 – **and every other day of 2009** – you **DIDN’T KNOW** what was going to happen the **next day, week, month, six months or year**, which increases your appreciation for “**THE PROCESS**” that overcomes **HINDSIGHT BIAS**, and keeps your long term portfolio performing better than almost anyone else’s.

### **3. CURRENT BEST FUNDS**

	<b>LAST MONTH</b>	<b>’10 YEAR TO DATE</b>	<b>1/1/97 THROUGH ’10</b>
<b>ROI’S MPT INDEX*</b>	+6.0%	+2.9%	+88.1%
<b>ROI’S “BEST FUNDS”**</b>	+5.8%	+2.2%	+123.3%

\* ROI’s MPT INDEX = An index based solely upon one Modern Portfolio Theory type of Asset Allocation to each of the following 12 Asset Classes, assuming from: (1) 1/1/97, an 11% Target Return (i.e., 70% in Stocks; 15% in Bonds; 15% in Anti-Inflation); and, (2) 3/1/03, a Moderate allocation (i.e., 50% in Stocks; 25% in Bonds; 25% in Anti-Inflation); using the average returns of all mutual funds in each Asset Class, Rebalanced on a monthly basis (data supplied by Morningstar).

\*\* ROI’s “BEST FUNDS” = Using the accumulated yearly IRR % of an actual client’s account that uses the same Moderate Asset allocation as in ROI’s MPT INDEX, but includes all of ROI’s other strategies.

### **ISSUE# ONE HUNDRED-SIXTY-NINE BEST FUND CHANGES & WHY?**

(Funds or % in < > are new funds and allocations replacing prior choices. Current through Newsletter date.)

**STOCKS**

**BONDS**

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<b>Aggressive Growth</b>	<b>US/LT, ST, Mtg, Convertible</b>
Fidelity Capital Apprec 1 <sup>st</sup> Source (117%)	Fidelity Convertible (67%)
	DWS Short Duration (33%)
<b>Growth</b>	<Pimco Lt U.S.> (33%)
Wells Fargo Adv (100%)	
<Oppenheimer Equity Inc.> (125%)	<b>Junk</b>
	Security High Yield (50%)
<b>Small Cap</b>	
<Eagle Small Cap Growth> <131%>	<b>Global</b>
AIM Triamark Small Co (119%)	Alliance Bern Glb Bond (100%)
	TCW Emg Mkts (62.5%)
<b>Equity Income</b>	<b><u>ANTI-INFLATION</u></b>
<Pimco Stock Plus Total> <106%>	<b>Asset Manager</b>
	Oppenheimer Global Opp (100%)
<b>Stock Index</b>	
Fidelity Spartan Market Index (100%)	<b>Ntrl Res, Utilities &amp; Metals</b>
	Gabeli Utilities<50%>
<b>Overseas: Int’l, World, SC, EM</b>	Fidelity Sel Material Port <100%>
Janus Overseas <177.22>	
Oakmark International Gth (69.8%)	<b>Real Estate</b>
Oakmark International <64%>	Fidelity Advisor Real Estate <103%>
Causeway Emerging Markets 52.65%	Dryden Global Real Estate (14.5)
AIM Dev. Mkt (85.7%)	

### **THE “WHYS”**

**Allocation Changes** – We decreased our allocation to our **US Small Cap asset class (Eagle Small Cap Growth)** and our **U.S. Equity Income class (Pimco Stock Plus)** in order to protect our portfolios from a further drop in the U.S. stock market. We also decreased our allocation to our **Utilities class (Gabeli Utilities)** to control participation in a further drop in this class due to the strengthening dollar. We increased our allocation to our **International Overseas asset class (Janus Overseas)** and our **International Overseas Small Cap asset class (Oakmark International Small Cap)** in order to participate in potential gains in these areas. We also increased our allocation to the **U.S. Real Estate asset class (Fidelity Real Estate)** due to the strong recent performance in this class that we anticipate will continue.

### **Fund Changes and Why-**

- 1. Oppenheimer Equity Income for Hotckis & Wiley-** Oppenheimer has performed well over the last few months, has an emphasis on income (dividends), and has a high star rating. Hotckis’s performance has been lagging its peers and it is time for a change.
- 2. Eagle Small Cap Growth for Marshal Small Cap Growth-** Eagle has performed well recently and has a low expense ratio. Marshal’s performance has fallen out of the top 25% and we anticipate this might continue during a slow recovery.
- 3. Pimco Stock Plus for Invesco Mid Cap Value-** Pimco has a high star rating and has performed well recently. Invesco’s performance has been lagging and we feel this will continue during a slow recovery.
- 3. Pimco LT U.S. for Delaware Corporate Bond-** Pimco has a strong risk/return ratio and has recently performed well. Delaware Corporate has struggled recently when compared to its peers.
- 4. Fidelity Select Material Portfolio for Black Rock Energy Resource-** We held both Fidelity and Black Rock, but Fidelity has been performing better, so we sold Black Rock and moved all of those assets to Fidelity. More of a consolidation move.

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[R.O.I. tracks each month’s consensus predictions for the Dow Jones Industrial Average (DJIA) for the upcoming six months, by the panel of “experts” in the Investment Advisor Magazine.]

<b><u>THE PREDICTION WAS:</u></b>			<b><u>THE DJIA WAS:</u></b>	<b><u>THE PREDICTION WAS OFF BY:</u></b>	
<b><u>MADE</u></b>	<b><u>FOR</u></b>	<b><u>DJIA</u></b>	<b><u>ACTUALLY</u></b>	<b><u>POINTS</u></b>	<b><u>PERCENT</u></b>
02/09	08/09	9152	9325	-173	-1.8%
No Issue					
04/09	10/09	8641	9713	-1072	-11.0%
No Issue					
06/09	12/09	8668	10428	-1760	-16.8%
07/09	01/10	8824	10067	-1243	-12.3%
08/09	02/10	8808	10325	-1517	-14.7%
No Issue					
10/09	04/10	9332	11009	-1677	-15.2%
11/09	05/10	9440	10136	-696	-6.87%
12/09	06/10	9728	10143	-415	-4.1%
01/10	07/10	9894	10465	-571	-5.5%
<b>TWELVE MONTH ERROR RANGE =</b>				<b>-1760/-173</b>	<b>-16.8%/-1.8%</b>

**!!R.O.I. believes it is impossible to predict the short-term future. If the “experts” can’t reliably do so, what chance do you or R.O.I. have? Should we make large bets on short-term predictions?**

### **4. COMPREHENSIVE FINANCIAL PLANNING**

#### **THE MOST BORING (IMPORTANT) FINANCIAL SUBJECT OF ALL**

In the previous issue we talked about “Protecting Yourself from Very Inconsiderate Relatives” (financial emergency planning). This time we want to discuss “The Most Boring (Important) Financial Subject of All” (**budgeting**, i.e., managing income **and expenses**). This subject used to be called boring, but **now** it effects the lives of so many of us or the lives of our children and grandchildren (and if it doesn’t now, it will in the future), that it **deserves** our: (1) Attention; (2) Time; and, (3) Efforts; before things get so bad that it **takes** all our: (1) Attention; (2) Time; and, (3) Efforts.

The controlling principle about budgeting can be stated as follows: “Before you can influence your **financial future**, you must first control your **financial moment**.” Another way to state this principle is: “Your budget provides the **fuel** (i.e., the **resources**) to drive your financial future → **No fuel = No future**.”

ROI believes there are four “**Budgeting Priorities**”:

- 1<sup>st</sup> = **Pay the Lord** (you can’t take it with you, and, faith precedes the miracle);
- 2<sup>nd</sup> = **Pay yourself** (any fool can spend – no talent and no discipline is required – it takes a wise person to **save**);
- 3<sup>rd</sup> = **Pay those who have to be paid** (the required payments to have food, shelter, clothing, i.e., **the necessities**);
- 4<sup>th</sup> = **Be selective and wise with the rest!**

The sooner we learn and put into practice these priorities, the better off we will be. The rest of this discussion will be about the 4<sup>th</sup> Priority = **Be selective and wise with the rest!** Specifically, we are going to discuss: (1) Controlling debt; and, (2) Using “Sinking Funds”.

**CONTROLLING DEBT**: Remember, debt is a **mortgage on your future**, i.e., something becomes so important for you to have it **now** that you are **sacrificing some of your future income** → **the HAVE NOW, PAY LATER SYNDROME**. Something this important should provide you with future value or income → that is why it is usually o.k. to borrow for a home

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(it will **almost** always grow in value over a long time), or education (it will almost always generate more income), but why it is probably wise to **save for everything else** (including transportation, because vehicles go down in value and don't produce more income). For example, instead of driving a “clunker” for a few years and saving to buy the new car, you buy the new car right now:

### **HAVE NOW, PAY LATER SYNDROME → THE NEW CAR**

<b>Down Payment</b>	<b>Amount Borrowed</b>	<b>Interest Rate</b>	<b>Payback Period</b>	<b>Total Cost Of Car</b>	<b>Cost of Credit \$</b>	<b>Cost of Credit %</b>	<b>Worth of Car When “Paid For”</b>
\$ 2,000	\$18,000	8%	48 months	\$22,953	\$ 2,953	13%	\$10,000

**In this example, a person pays an extra 13% in the form of future income for the privilege of owning an asset NOW that is probably going to lose 50% of its value in about four years. A bad syndrome!**

**SINKING FUNDS:** What is a “sinking fund”? There are many expenditures over the course of a year (or years) that do not happen monthly, e.g., real estate property taxes, car and house insurance premiums, vacations and anniversaries, Christmas, home improvements, buying a car, etc. Most of these non-monthly expenses are foreseeable (you know about when they will happen) and can be valued (you know about what they will cost). A “sinking fund” is simply taking the value of the non-monthly expense, dividing it by the number of months till it happens, and setting that amount aside each month so the total value will be there when the non-monthly expenses needs to be paid, e.g., car replacement cost of \$20,000 - \$10,000/future sale value of current car, in three years =  $(\$20,000 - \$10,000)/36\text{months} = \$278$  set aside/month.

### **COMPREHENSIVE FINANCIAL PLANNING**

#### **INCOME & EXPENSE**

- Emergency Planning
- Budgeting
- Taxes

#### **KIDS/GRANDKIDS' GOALS**

- “Teach Them To Fish”
- Missions, Education, Marriages, and Home Down Payments

#### **RETIREMENT**

#### **LONG TERM CARE**

#### **DEATH & DISABILITY**

#### **IDENTITY THEFT PROTECTION**

#### **ESTATE PLANNING**

#### **BUSINESS & ASSET PROTECTION PLANNING**

Sinking funds are in addition to Emergency Funds, i.e., your minimum six months of Emergency Funds is over and above the total value of your sinking funds. If you have a Quicken type software package it is easy to set up an “asset account” for each sinking fund item, including your Emergency Fund, and to set aside each monthly contribution to each “asset account”, and to draw from the “asset account” when it comes time to spend that particular chunk of money for real estate property taxes, car and house insurance premiums, vacations and anniversaries, Christmas, home improvements, buying a car, etc. If you don't use a Quicken type software package, you can set aside each monthly contribution by writing a check to a separate envelope, or, set up a money market account for all of the sinking funds (and keeping tract on paper or in a ledger what part of this money market account is for each sinking fund item), and a separate money market account or savings account for your Emergency Funds.

Getting accustomed to using sinking funds is such a blessing to your finances because the money for these non-monthly expenses is “always there” when you need it, and, you never drain your Emergency Funds for a non-emergency expenditure that was simply not planned for. **Life is good, but even better when you use wise and simple accounting techniques to minimize financial surprises!**

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