The Thoughtful Investor™

James W. Olsen, CFP® | **Legacy Investment Strategies** | **Third Quarter 2011**

Fat Tails, Black Swans and Your Portfolio

Do not put your faith in what statistics say until you have carefully considered what they do not say. ~William W. Watt

Portfolio design is largely concerned with trying to manage risk and return to have a reasonable assumption of how much your assets are likely to earn over the life of the portfolio and the probability of success. In traditional portfolio design, statistics and the bell curve typically make their appearance to answer these questions. By analyzing past returns, a distribution of returns is developed and the probabilities of achieving a range of returns are calculated according to standard deviation. The resulting bell curve is typically skewed to the positive because throughout the history of the stock market there have been far more positive days, weeks, months and years than down periods.

There's just one problem with this approach. It hasn't worked very well. Historically, extreme events have happened at a far higher rate than the bell curve model predicts. For example, the October 1987 market crash was sta-

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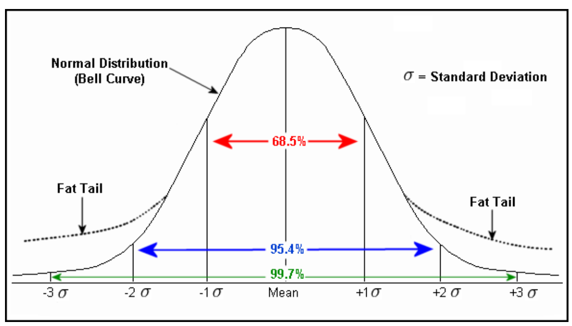

In a Year of Disasters, Be Prepared

2011 seems to have had more than its share of major disasters, with nearly half the year yet to come. While there may not be much you can do to save your home from a tornado, flood, or other natural disasters, you can make certain that your life goes on with as few problems as possible afterwards, and that often comes down to having the right documents accessible.

If your home were destroyed today would you have proof of your identity? What about financial account numbers and insurance information? If your spouse disappeared in the disaster, would you have a power of attorney to act for him/her in their absence?

Ideally, you should keep these documents in a safe deposit box away from your home. But as recent disasters have demonstrated, there is always the possibility that you will not be able to reach your safe deposit box location or that the safe depository itself could be destroyed.

To prevent a disaster from becoming even more disastrous, photocopies of all documents in the safe deposit box as well as passports, account numbers and contact information, inventory of home possessions and other vital documents that would be difficult or impossible to replace should be in a readily accessible file in your home. In the

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Gasoline Consumption is at 2001 Levels

Here's some news from the Economist Magazine, reporting on a U.S. phenomenon that hasn't receive much play in our media…

"Following all previous recessions, petrol consumption has been a leading indicator of recovery, bouncing back sharply as people started using their vehicles more to shop, to dine out, to seek the curious and the entertaining, and, above all, to take vacations. Despite the American economy's belated and still timid recovery…the amount of petrol being consumed across the country has tumbled to 2001 levels, and shows every sign of falling further.

"The Bureau of Economic Analysis, the federal agency that churns out monthly reports on how the economy is faring, believes the 2008 spike in petrol prices and the subsequent recession have changed the consumption patterns of American motorists irreversibly. How so? The short answer is that technology and marketing have altered the type of vehicles Americans are now buying."

The article goes on to say the 4-cylinder engines now dominate car sales with their greater fuel efficiency. In a time when we are more likely to be berated for wasteful consumption, it's nice to see that we have made a tremendous difference in fuel conservation.

The Difference Engine: Four bangs for the buck, by J.P.; *The Economist, June 2, 2011.*

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tistically impossible. It couldn't happen. Yet it did. The same impossibility applies to the back-to-back market crashes of 2000-2002 and 2007-2008. In fact, severe losses (defined as 20% or more) happen about five times more frequently than estimated by most statistical models.

The failure of the stock market to conform to the bell curve has resulted in "fat tail" analysis and black swan events. Fat tails are designed to compensate for the failure of market risk to drop as substantially as the bell curve predicts. Instead of tapering off, the potential for extreme events remains high at the ends of the bell curve.

The term "black swan" originated with the publication in 2007 of Nassim Taleb's book, "The Black Swan: The impact of the highly improbable." Taleb calls the rare extreme events that investors rarely plan for and models don't predict "black swans," after the long-held belief that black swans didn't exist. Then with the discovery of Australia, black swans turned out a lot more common than people thought. The same applies to the financial markets. Extreme events are considerably more frequent than many financial advisers believe and destroy expectations created by a statistical bell curve analysis.

Why don't financial markets conform? Part of the reason is that markets are not random nor are returns symmetrical. In a bell curve analysis, the order of the data doesn't matter. You are just looking at frequency. As a result, a one-time extreme down day becomes statistically unlikely. Often, statistical models deliberately exclude rare results as outliers. Bell curve analysis also overlooks the importance of cycles in the market. Because statistical accuracy typically increases the more observations you include, a bell curve may include data from 80 years of market history. The problem is few people invest for 80 years. Think of the investments you've held over the years. How many of those were held more than 10 to 20 years at most?

When you start looking at smaller market time periods, persistence of performance comes into play. High volatility months tend to be followed by high volatility months. Low volatility months tend to be followed by low volatility months. Momentum tends to push returns to extremes before correcting. Periods of low price earnings (P/E) ratios tend to be followed by periods of market gains. Periods of high P/E ratios tend to be followed by years of low market returns. Cycles abound in markets. And of course there is also the unpredictability of life.

If you can't predict the returns of your portfolio over time, what should you do? First and foremost is to use an investment approach that strives to reduce the risk of losses. Every investment has the potential for loss as well as gain over its lifetime or selected time periods. Any time you reduce the impact of periods of declining values, you increase the leverage and compounding power of your investments. Second, you want to have an opportunistic investment approach that looks for opportunities for gain and doesn't expect the future to follow the patterns of the past.

This is really the core of active investing – seeking to minimize risk and optimize opportunities for profit, recognizing that life happens in ways we can't always anticipate. With that said, we need to add the caution that an active approach to investing can't guarantee that your investments won't lose value or that the approach will be successful in capturing gains. Investing always carries risk. Active management recognizes that risk and strives to counteract its corrosive impact on portfolio values.

Maximize Your FDIC Insurance

As of 2008, deposits in FDIC member banks are insured by the Federal Depository Insurance Corporation up to $250,000 per individual. Because an "individual" is defined in a number of different ways, your accounts can be insured well in excess of $250,000 at the same bank, if they are structured under different ownership forms and, if applicable, beneficiary designations.

FDIC coverage is $250,000 for the total of all single accounts owned by the same person at the same insured bank. This includes those opened under the Uniform Transfers to Minors Act, for a sole proprietorship or established for a decedent's estate.

Joint accounts are insured up to a maximum of $250,000 for each co-owner. To reach that number each co-owners' share of every account jointly held at the same insured bank is added together. Joint owners must be people, not legal entities such as corporations, have equal rights to withdraw funds, and sign the deposit account signature card.

All self-directed retirement funds owned by the same person in the same FDIC-insured bank are combined and insured up to $250,000.

Each participant in employee plans that are not self-directed is insured up to $250,000 for his or her non-contingent interest.

Revocable Trust Accounts, Payable-On-Death (POD) accounts, living or family trust accounts and irrevocable trusts are insured up to $250,000 for each named beneficiary as long as "qualifying" requirements are met.

The FDIC uses the insured bank's deposit account records (ledgers, signature cards, CDs) to determine deposit insurance coverage. So make sure your banks have the correct information that will result in the highest available insurance coverage.

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event of a mandatory evacuation, this file should also be portable.

To make certain you always have access to critical information, you may want to scan key documents and save them to a memory card that can be kept in your wallet. Or you may want to upload your files to an online digital storage service that would be accessible should anything happen to your hard copies. Just remember to always encrypt data stored digitally! The last thing you want is to have your information available to an identify thief who hacks into the online storage or someone who steals your wallet. There are a number of programs available that allow you to encrypt images, text documents, spreadsheets, etc. to store them more securely on portable or online media.

Listed below are some of your critical documents that should be readily accessible in the event of an emergency, whether in hard copy form, on a portable memory storage device or online. With this information accessible, you will be able to pick up the pieces and recover from a disaster with at least a little less stress.

- List of safe deposit box contents
- Location of your safe deposit box key
- Copies of personal identification documents – this includes passports, birth certificates, driver's license
- Proof of homeowner's policy with policy number and emergency claim phone numbers
- A CD or DVD disk with photographs or video of your home and possessions for insurance purposes.
- Purchase and appraisal records for collectibles
- List of accounts —investment accounts, checking and savings, loans, credit cards, debit cards, life insurance policies, etc. Ideally you should include the account number, company and a phone number.
- Auto titles
- Stock and bond certificates
- Wills — keep only the most current copy
- Durable power of attorney — if you are incapacitated and unable to make important decisions, this gives someone else the right to act on your behalf. That individual does not need to be an attorney.
- Health care proxy — this includes directives on what medical care you do not want to receive.
- Trust documents
- Original marriage certificate — this may be required to file for survivor benefits under Social Security and pension plans, to change the title of real estate, automobiles, etc.
- Military discharge paperwork — to be granted military honors at the burial
- Property deeds — this includes any cemetery plots
- Burial instructions

Once you have those documents recorded and available, remember to update them periodically, and then go enjoy life. While we don't know what tomorrow will bring, we have much to be grateful for today.

Disaster Prep Includes Home Insurance

Continuing on the line of being prepared for disasters, your single most valuable asset is most likely your home. To protect that value, you need to be certain your home insurance is all it should be.

Most homes built after 1950 are covered with replacement value insurance. The catch is that you set the value at which you assume you could replace your home (although your insurance company will check to make certain it isn't over-insured). Many policies will allow up to 20% over the insured value in the event of a disaster, however, you want the base value set correctly. While home values have declined over the last five years, building materials and construction costs have not seen similar drops and have increased in many areas. As a result, market value may not cover the cost to replace or repair your home.

Homes built before 1950 are often covered on an actual cash value basis because of the potential for outdated wiring, plumbing, etc. Make certain you understand how your home is valued in the insurance policy and talk to your insurance agent if you believe the value is inadequate to protect you.

Homeowner, condo and rental insurance policies do not cover damage caused by an earthquake or flood. Coverage must be purchased as an endorsement or a separate policy. Earthquake insurance policies are available from insurance companies. But flood insurance is typically provided through the National Flood Insurance Program (NFIP) created by Congress in 1968 to offer flood insurance to homeowners, renters, and business owners…if their community participates in the NFIP.

If you have a basement, sewer backup coverage is a good idea. Even if your home isn't damaged in a disaster, sewer problems can easily result from broken pipes in the area, a high water table, or other circumstances beyond your control.

Home insurance does not automatically cover everything within your home. You will need to have riders to cover personal items of exceptional value such as jewelry valued over $1000, furs, artwork, guns, computer equipment in excess of $7,500, and collectibles. And, you need those items and their value documented.

It also helps to have a visual recording (photographs or video tour) of your home and its contents stored outside the home. This will help substantiate a claim. Remember and update this record as needed!

How to Live Like a Millionaire

The lives of the "rich and famous" tend to be quite a bit different from the lives of the merely "rich." In fact, studies show that being rich often results from a rather low-profile lifestyle.

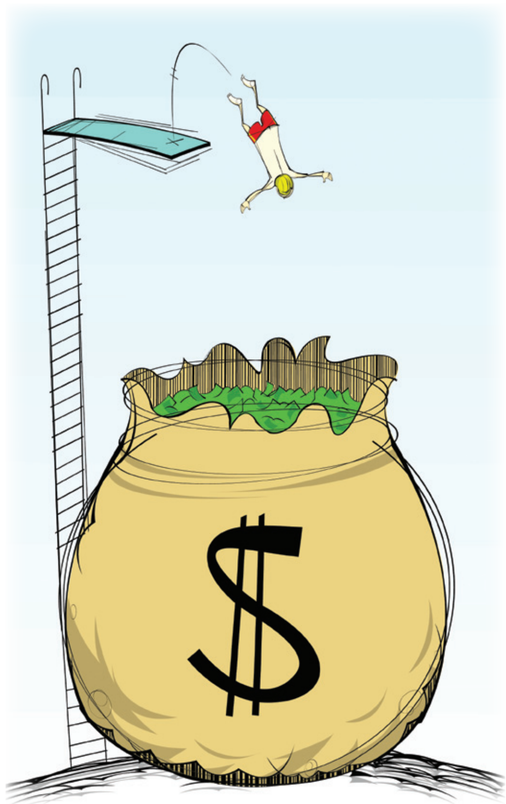
With that said, if you want to live the life of a millionaire:

Work hard.

According to "The Millionaire Next Door," by Thomas Stanley and William Danko, 80% of the millionaires worked and saved to generate their wealth and 80% of them are still working. About half of all millionaires are self-employed or own a business. Nearly half of working millionaires plan to toil part or full-time during the retirement years, according to a survey from Northern Trust Corp. Millionaires are also less likely to waste time during the day; instead they are reading and doing things that contribute to their success.

Be very conservative with your money.

Individuals who build wealth tend to live well below their means. Affluent households are heavier coupon users than those with lower incomes, according to a 2009 study by Nielsen and market research firm Inmar. In researching for the book cited above, Thomas Stanley reports that he found 11% of vehicles purchased by US millionaires were Toyotas. Most millionaires buy and drive used cars and have never spent more than $55,000 (in 2010 dollars) on a new car. Their homes are typically worth less than $300,000 (in 2010 dollars), according to Stanley.



Worry.

More money doesn't necessary solve money worries. According to surveys, few millionaires feel rich. They worry about having enough money in retirement, increasing health-care costs, funding their kids' college education and paying the bills.

Take Calculated Risks.

Millionaires tend to be aware of their personal income and net worth statements, and have taken strategic risks to earn and grow money. They take calculated risks with an exit strategy and plan to protect the downside.

Be a bit rebellious.

To become wealthy, you have to have the ability to resist the peer pressure to spend and accumulate possessions. You need to be willing to be different, to look for opportunities outside of the mainstream and take those opportunities when they present themselves. Perhaps this is why many male millionaire entrepreneurs had been in trouble with school authorities or the police during their adolescence, according to one study.

Delegate.

Millionaires recognize that they can't be experts at everything and hire the best resources they can find.

LEGACY INVESTMENT STRATEGIES

RETURN SERVICE REQUESTED

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