The Thoughtful Investor™

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

Can You Trust the Experts?

One interesting human characteristic is the need to anticipate the future. As we go through life, we look for ways to influence and shape our future in the direction we want. Saving for retirement is one example. But in making the decision to save and invest, we also establish expectations for the future, often based on the advice or opinions of experts in the field.

One story related by Peter L. Bernstein in "**Against the Gods: the remarkable story of risk**" was the experience of Kenneth Joseph Arrow, an American economist and joint winner of the 1972 Nobel Memorial Prize in Economics.

> *Some officers had been assigned the task of forecasting weather a month ahead, but Arrow and his statisticians found that their long-range forecasts were no better than numbers pulled out of a hat. The forecasters agreed and asked their superiors to be relieved of this duty. The reply was: "The Commanding General is well aware that the forecasts are no good. However, he needs them for planning purposes."*[1]

Philip Tetlock, a psychologist at the University of California, Berkeley, has literally spent a lifetime looking at how well experts in their field do with respect to their professions. Over a period of 20 years he collected the predictions of 284 people who made their living "commenting or offering advice on political and economic trends," including journalists, foreign policy specialists, economists and

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Something Has to Change

Over the years, ***USA Today*** has kept a running total of the amount of government debt accumulated per household. The following figures are from the June 7, 2011 article, "*Government's mountain of debt*," by Dennis Cauchon. With the exception of Federal debt, which is funds spent to date, these costs are the unfunded liability over the lifetime of those now in the program

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Your Household's Share of Government Debt

Program	Unfunded Liability	Obligation Per Household
Medicare	$24.8 trillion	$212,500
Social Security	21.4 trillion	183,400
Federal debt	9.4 trillion	79,900
Military Retirement/disability benefits	3.6 trillion	31,200
Federal employee retirement benefits	2 trillion	17,000
State, local government obligations	5.2 trillion	44,800
	$66.0 trillion	**$568,800**

Debt Can Limit Retirement

When the paychecks stop coming in, you want the flexibility to control your expenses. The more debt you have, the less your flexibility.

Which is why it is so important in planning for retirement to minimize debt.

One way to minimize debt is to take advantage of today's record low interest rates to refinance. In the week ending Sept. 29, the average rate on the 30-year fixed-rate mortgage fell to 4.01%. The average rate on the 15-year fixed-rate mortgage was 3.28%, and 2.83% on the 5-year Treasury-indexed adjustable-rate mortgage.

To make sense, refinancing should save you money over the remaining term of your loan INCLUDING your costs to refinance. This is where it really makes sense to shop around. Closing costs and points vary between lenders. Tell your prospective lender your goal is the lowest out of pocket and the greatest savings over the life of the loan. Avoid extending the term of your loan. If you have 18 years remaining, refinance into a 15-year loan or a 10-year loan if you can afford the payments. If your payments are less after the refinance, continue making your prior mortgage payments to shorten the term of your loan.

Taking advantage of today's low interest rates to refinance existing loans and pay off high interest rate loans saves money over the life of the loan and better positions you for retirement. You might be able to cut back on vacations, eating out and other expenses to afford retirement, but debt payments are typically non-negotiable.

The More Things Change the More They Stay the Same

Feeling discouraged with the direction of government, the new generation of politicians, the outlook for the financial market and the kids today? Well if it's any consolation, throughout history, people have felt much the same, and yet we seem to muddle through. The good old days are typically the good old days only when looking through the haze of time. With that thought, we present quotes from the past that sound much like the concerns of today.

"Now more than ever before, the people are responsible for the character of their Congress. If that body be ignorant, reckless and corrupt, it is because the people tolerate ignorance, recklessness and corruption. If it be intelligent, brave and pure, it is because the people demand these high qualities to represent them in the national legislature." ~ James Garfield, the twentieth president of the United States, 1877

"George Washington is the only president who didn't blame the previous administration for his troubles." ~Author Unknown

"The hardest thing in the world to understand is the income tax." ~ Albert Einstein (1879-1950)

"Those who expect to reap the blessings of freedom must, like men, undergo the fatigue of supporting it." ~ Thomas Paine (1737-1809)

"October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February." ~Mark Twain (1835-1910)

"Education: the inculcation of the incomprehensible into the indifferent by the incompetent." ~ John Maynard Keynes (1883-1946)

"I see no hope for the future of our people if they are dependent on the frivolous youth of today, for certainly all youth are reckless beyond words. When I was a boy, we were taught to be discrete and respectful of elders, but the present youth are exceedingly wise and impatient of restraint." ~ Written over 2000 years ago by the Greek poet Hesiod

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intelligence analysts. By the end of the study, Mr. Tetlock had quantified 82,361 predictions. How did the experts do? The vast majority of the predictions were worse than random chance. Post graduate degrees offered no advantage. Famous experts tended to do the worst.

Where did these individuals go wrong? According to Mr. Tetlock the main reason was overconfidence. Convinced that they were right, the experts ignored evidence suggesting they might be wrong. Another important bias is that most experts find it very difficult to make a negative prediction. Fear of "crying wolf" may be part of the reason, but there is also a desire to please the audience and be re-elected, or asked to speak again. Another important cognitive bias, Mr. Tetlock points out, is that most of us find it very difficult to change our minds.

Overconfidence and "confirmation bias," where experts ignore evidence suggesting they are wrong, are of particular concern to investment advisers. With the financial security of our clients at risk, we can't afford to become "prisoners of our preconceptions," as Mr. Tetlock puts it. This is one reason why active management relies heavily on technical analysis and mathematical relationships within the financial markets. Our goal is objectivity and discipline. The most important information for an active manager is not where the market has been or where we believe it is going, but where it is today.

By setting very specific investment rules as to when an asset will be purchased or sold, or when it is safe to be invested in equities or bonds or a specific sector, or when a defensive posture is better, our goal is to avoid letting our biases influence our decisions. I may be right in my belief that the market will recover from its current malaise, but to base a client's portfolio on that belief ignores the consequences of being wrong. What if I am right on the market's direction but completely wrong on the duration of the problem?

Active management is risk management. As with all tools to limit risk, it can also result in lost opportunities if conditions change quickly. But without risk management, without basing investment decisions on where the market is today, the risk of a major drawdown impacting the client's future increases.

[1] Against the Gods, Peter J. Bernstein, page 203.

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as workers and retirees. To meet the promises made by federal, state and local governments, each household in the U.S. will owe $568,800 over the next 20-30 years. And that is most likely an underestimate.

If you pay income taxes…it gets worse.

Under our current tax system, roughly 45% of households pay no income taxes, although they may be contributing to Medicare and Social Security via payroll taxes. That puts the obligation for unfunded government liabilities on the remaining 55% of households, upping their burden to in excess of $1 million per income-tax-paying household.

One option of paying government liabilities – soak the rich – runs into a problem in that the rich pay the most in taxes on capital gains, not income. In the past higher tax rates have resulted in less capital gains to tax.

The intractable problem is excessive debt. Something has to change.

The Problem with Correlation

The most widely acclaimed investment management theory is Modern Portfolio Theory, introduced by Harry Markowitz in a 1952 article "Portfolio Theory. " MPT's primary contribution to investment theory was the use of diversification to reduce portfolio risk. By diversifying among assets with low correlation – meaning the assets' values tended to move in opposite directions, one declining while the other is increasing and vice versa – MPT maintained that risk, or the likelihood of major draw downs in the portfolio would be reduced.

The optimal portfolio was thus calculated using an Efficient Frontier to determine the ideal portfolio mix to achieve the best performance at the lowest risk.

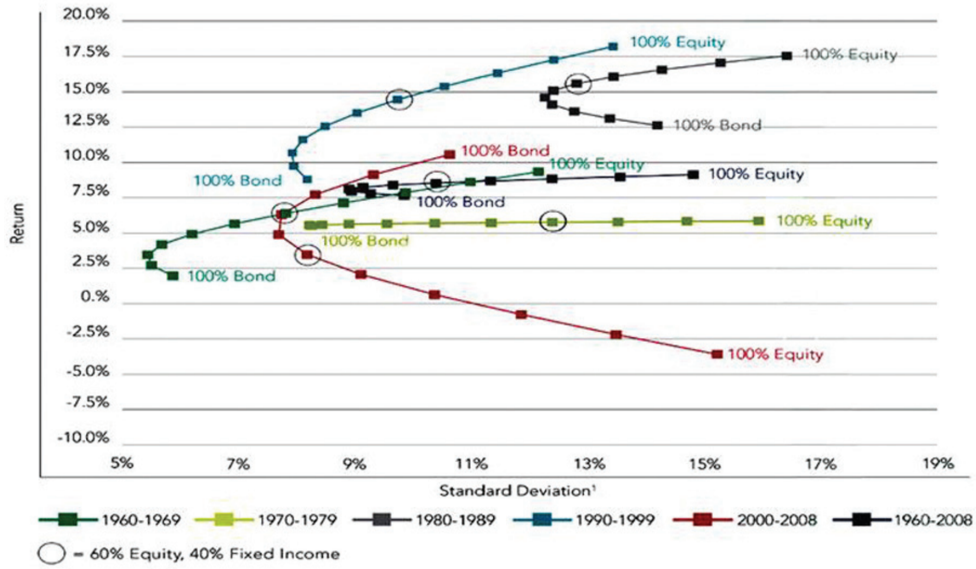
In understanding the value of MPT, it is important to understand what the theory does not do. MPT is designed to deal with **unsystematic risk** – the possibility that an investment or a category of investments will decline in value without having a major impact upon the entire market. Diversification typically does not protect against **systemic** risk or market risk – the possibility that the entire market and economy will show losses negatively affecting nearly every investment.

The problem with the Efficient Frontier is that correlations change making the optimal portfolio a moving target. In the graphic above, Rydex Investments calculated the Efficient Frontier over the decades from 1960 through 2008 based on 10% increments of an equity bond portfolio. In each decade, the optimal portfolio is considerably different.

But correlations really change when markets make dramatic declines. In virtually all recent declines, sectors across the board have fallen. The graph to the right shows how correlations increased in 2008 between asset groups typically considered non-correlated resulting in very similar returns:

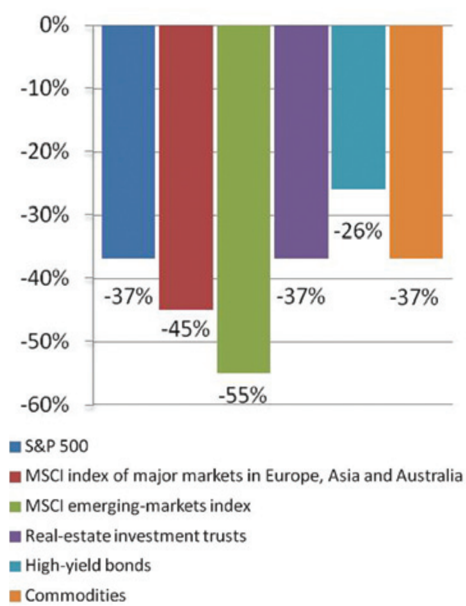
The Shifting Frontier – 1960-2008

Efficient frontier of equity and bond portfolios illustrated in 10% increments



Calculated by Rydex Investments using information and data presented in Ibbotson Investment Analysis Software. All rights reserved. Used with permission. Standard deviation (risk) is a statistical measure of the historical volatility of an investment that measures the extent to which numbers are spread around their average. Equity returns are based on the S&P 500 index, including the reinvestment of dividends and adjusted for inflation. Bond returns are based on the Ibbotson Long-term Government Bond index with dividends reinvested, adjusted for inflation. Both indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

Index declines in 2008[2]



Index returns are for illustrative purposes only and do not represent actual performance of an account. Past performance does not guarantee future results. One cannot invest directly in an index. Index performance returns do not reflect any management fees, transaction costs or expenses, the incurrence of which would have the effect of decreasing indicated historical performance results.

In August 2011, the *Wall Street Journal* reported that "macro issues such as the solvency of European countries and fears of a global economic slowdown have overshadowed fundamental differences between companies. The consequence is that stocks are moving in tandem, indicating a high degree of correlation."[1] Perfect correlation, meaning investments are moving lockstep, is 1. In early September 2011, the stocks of the S&P 500, which are supposed to represent a broad spectrum of industries, had reached a correlation of .81.

When investments begin moving in tandem, MPT fails when risk management is needed most, in times of the greatest risk.

1 Traders Seek Salvation From Correlation, John Jannarone, *Wall Street Journal*, August 29, 2011

2 Failure of a Fail-Safe Strategy Sends Investors Scrambling, Tom Lauricella, *Wall Street Journal*, July 10, 2009

Be Careful Where Your Parents Die

Much has been made of the transfer of wealth to the baby boomer generation as their parents die and pass on wealth accumulated during one of the best times to be invested to their heirs. But, before you start counting on that wealth, you need to also recognize the tax bite that may well come with the inheritance.

Estate Taxes

Estate taxes are paid out of the property the deceased owns when they die. For 2011 $5,000,000 is tax exempt from federal estate taxes, with the remainder taxed at 35%. But, 13 states plus Washington, DC have estate taxes as well, with exemptions starting as low as $675,000 in New Jersey. Typically, these taxes exempt $1 million or less per estate and carry a top rate of 16%; but in Minnesota, $1 million is exempt from estate taxes with a top estate tax rate of 41%.

Inheritance Taxes

Inheritance taxes occur after the estate is dispersed and is a tax on the amount received by an heir. These taxes are levied by the states and are paid by the heirs. Inheritance taxes sometimes depend on the relationship of the heir to the deceased. Children, grandchildren, parents or siblings may be exempt. As of 2011, the following states have inheritance taxes:

- Indiana
- Iowa
- Kentucky
- Louisiana
- Maryland
- Nebraska
- New Jersey
- Oregon
- Pennsylvania
- Tennessee

New Jersey and Maryland charge both an estate and an inheritance tax.

Hawaii was the latest state to enact an estate tax, which became effective May 2010. But with state budgets strained to the limit, many other state legislatures are looking to estate taxes for relief.

The gross estate on which taxes are calculated includes the value of all property in which the individual had an interest at the time of death, as well as:

1. Life insurance proceeds payable to the estate or, if the deceased owned the policy, to the heirs,
2. The value of certain annuities payable to the estate or heirs,
3. The value of certain property transferred within three years before death,
4. Trusts or other interests established by the deceased in which the individual had certain powers.

From that, an estate can deduct:

1. Debts and other claims against the estate, funeral expenses, costs of administering the estate;
2. Losses from fire, storm, and other casualty or theft during the settlement of the estate;
3. The amount of money or property left to charitable, religious, and educational organizations; and
4. The amount of money or property passing without reservation to a surviving spouse that qualifies as the "marital deduction."
5. Other deductions on a per state basis, such as a portion of ownership in a family business.

Depending upon which state an individual is resident of at the time of death, the resulting proceeds to the heirs can vary substantially.

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