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Critical¹ Advice

In this newsletter, I criticize the work of others. One opinion is about a nationally syndicated writer on personal finance. Another pertains to a mutual fund manager, and the third is directed toward amateur investors who make outrageous claims. This is an odd approach for me, because I attempt to frame writing in the positive. Perhaps readers will understand my responses by first understanding the personal philosophies violated by the three targets of my literary wrath. Those philosophies are:

- *Prediction is not advice. Prediction is the prognostication of a specific event or trend. Advice is the rendering of common-sense philosophies.*
- *Accurate prediction is impossible. No person ever has or ever will make predictions that are consistently useful. Occasionally, a prognosticator will hit it right, but subsequent predictions will be incorrect. No series of predictions from any single source has been useful in improving net worth over a lifetime.*
- *General, one-point-of-view advice offered in the media usually fails when applied to an individual having unique circumstances and attitudes.*
- *The most successful investment managers maintain a consistent philosophy over an entire career. Midcourse changes spell disaster.*

- *Investors who broadcast that they have been earning 40 percent a month have not studied market history and are not aware of the chuck holes around every corner.*

But let us save criticism for inside pages. Instead, we will start with thoughts about the nature and value of advice.

A national organization of investment advisors promulgated this philosophy: *"Everyone needs objective advice to make smart financial decisions."*

Is it valid? Analyzed logically, the statement makes no sense. "Everyone" needs only air, water, food and shelter. "Objectivity" is impossible, and "smart" is more relative than "objective." For example, in "advising" my daughter to be home by 11:30 p.m., I was objective and smart, but her view is that I was irrational and dumb. Transmitters and receivers are not always on the same frequency. Let's try another way:

What is advice? My *Random House Dictionary* says it is "an opinion or recommendation offered as a guide to action, conduct, etc." OK. I can live with that definition with respect to personal finance, but I need to

critical adj 1. inclined to judge severely and find fault. 2. characterized by careful, exact evaluation and judgment. 3. indispensable; essential

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break it into parts: “bad advice,” “good advice,” and “useless advice.”

In my “objective” view, a recommendation to trade commodity contracts, or to sail around Cape Horn in winter, is “bad advice.” “Good advice” is a suggestion to have a current will, but even this advice can be “useless” to persons having a low net worth. “Useless advice” is any recommendation made to a person who cannot or will not act on that advice. Most advice is useless because the largest quantity of advice is rendered at cocktail parties. You can hear it now: “George, I think that you should (buy a Volvo, repave your driveway, use solid fertilizer, visit Tahiti, vote for me, yadda yadda yadda), and it would be wise for you (to send your child to Harvard, stop seeing Celia, take more vitamins, check your blood pressure more often, yadda yadda yadda), while you should know that I have had great success (building my deck, avoiding sales calls, trading mutual funds, yadda yadda yadda).” While George might be a good conversationalist, most of his advice is useless, because the cocktail party listener is not interested.

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Perhaps, then, the national organization should revise its concept to state that “Everyone who is interested should seek objective advice.” The downside of this declaration is that persons acting foolishly are not interested in advice, and they will continue to act foolishly until a dramatic, painful event forces change.

Good, useful advice is delivered by persons having a coincidental understanding of both reasonable practice and of the circumstances of the person advised. Since understanding of an individual is an important component, good, useful advice often is delivered in the form of a question, such as “do you have a will, is your net worth over \$650,000, how are you handling the possibility of disability?” Questions advance a conversation more effectively than such statements as: “You must have a will,” or, “You should purchase disability insurance.” In addition, advisors render good, useful advice repetitively. Few people learn or change habits after one lesson. One instruction does not improve a tennis stroke. New Broadway plays require rehearsals, and experienced casts need additional rehearsals to remedy mistakes that slowly, inexorably creep into the production. Repetition in dental care is crucial. An important reason that I have faith in my dentist is that he gives me the *same lesson every six months* because I constantly, imperceptibly abandon good dental practice. He repeats advice directly, unashamedly, but without scorn or impatience, because repetition is required to learn and to maintain a skill.

Financial advice is not as objective as dental advice, but repeti-

tion is as important. After eleven years of rising markets, investors forget risk. Investors need reminders. They need to remember lessons of economic history, especially the importance of conservative diversification. They should look at estate documents periodically because laws and personal circumstances change. In the absence of an outside objective view and of consistent coaching, good investment habits can evolve into bad habits. The professional investment advisor is the coach. He or she *sees* problems developing. Like the dentist who *sees* problems, or the artistic director who *sees* minor deterioration in repeated performances, an investment advisor observes circumstances that are impossible for the client to see alone. The human need for checkups is the convincing reason that *“everyone needs objective advice to make smart financial decisions.”*

Whence ROI?

“Return on investment” is a popular phrase. Where did it come from? A breakfast companion tells me that it comes from the East India Companies of the 17th century. Investors then acquired shares of a specific boat having a specific mission. Their fervent hope was that the boat would return, a “return of the investment.” From there, it was a short intellectual leap to want a “return on the investment.” My breakfast companion also wondered whether the phrase “sunk cost” can be traced to the same era. “Sunk costs” are costs incurred that cannot be recovered in the event the project is terminated. A boat that sinks terminates the project. Its costs are sunk.

Necessity, the Mother of Reinvention

How does a professional investor earn new business and sell books when his theory is out of favor? Answer: He changes course. Here is the story:

In 1991, author-investor Michael O'Higgins wrote *Beating the Dow*, a bestseller. The book described a theory that had been floating around brokerage offices for years. The theory is that investors will earn above-average returns by acquiring "The Dogs of The Dow," which are the recently worst-performing 10 stocks among the 30 stocks that comprise the Dow Jones Industrial Average. The "recently worst-performing" are the stocks with the highest dividend yields (i.e., the lowest prices relative to cash payouts). They are "bargains."

O'Higgins' presentation of "The Dogs of The Dow" theory is practical and useful. Followers are relatively certain to acquire quality companies at low prices. More important, the theory provides a system or discipline having at least two benefits. The first benefit is that investors can make investment decisions without hours of study. The second benefit is a reduced probability of becoming discouraged in bad markets or of constantly chasing fads.

Unfortunately, the theory did not work well in 1997. So, a new theory—and a new book: "Beating the Dow with Bonds" (HarperCollins, 1999), plus the following promotional letter dated December 16, 1999:

Dear Friend of *Beating The Dow*: We continue 'Beating The Dow With Bonds' with our 0% U.S. Treasury Bonds

+26% so far in 1999 compared to +11.6% for the DJIA, and +7.4 % for the 'Beating The Dow' 10 stock strategy. As I expected, the "Dogs of the Dow" are no longer beating the Dow.

The "Dear Friend" letter goes on to recommend purchase of the book and investment in the O'Higgins Fund. Curiously, the second paragraph of the letter states that the bond theory might not work any more. It says:

While bonds remain slightly undervalued, espe-

cially compared to stocks, our inflation barometer may [sic] be signaling a rough time ahead for long-term bonds. As a result, we may [sic] be switching to riskless U.S. Treasury Bills by yearend [sic] unless conditions change by December 31st.

Summary: in less than ten years, O'Higgins has switched from being a disciplined investor in stocks, to an advocate of zero-coupon bonds, to a market timer having a barometer, and he has written a book that is out-of-date on publication. In addition, he is advocating an expensive way to purchase U.S. Treasury Bills. What theory and what book are next?

You Can Take It or Leave It—Taxable Capital Gains

Following is the text of a speech delivered to "MoneyWatch," a financial planning seminar sponsored by the *Indianapolis Star/News* on January 16, 1999:

Taxes, including taxes on realized capital gains, reduce your net worth. Personal net worth is the most important information about your financial life. Net worth is your financial capacity, a measure of your capacity to borrow, to acquire real assets, such as a home, to retire comfortably and to live and to travel confidently. Your net worth is directly reduced by the amount of tax you pay on realized capital gains. Look at total gains on Schedule D of your last three years' tax returns. You probably paid taxes of between 20 and 28 percent on those gains. Now, imagine that you did not pay those taxes. Imagine that those funds remain in your possession, growing and earning income, for ten, twenty or thirty years into the future. You will be astounded at the future value of taxes not paid. In one study, I estimated that investable net worth would have been 40 percent higher in ten years if capital gains taxes had been avoided.

You can manage one tax, day by day, year by year, dollar for dollar. That tax is the tax on realized capital gains. A realized gain occurs when you sell a security at a profit, or the manager of an investment package, such as a mutual fund or unit trust, distributes a gain to you. The investor who holds only individual securities—meaning stocks of individual companies directly held and managed by the investor—can determine the exact amount of capital gains paid or avoided. When an investor holds only individual securities in a taxable account, he or she determines the magnitude and the timing of gains and losses. The capital gains tax burden for a year is a

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result of securities sold during the year. If an investor makes no sales of individual securities, no tax is owed. If an investor chooses to sell securities at a loss, and if the investor finishes a year with net realized losses, Uncle Sam even permits a minor reduction of taxes owed on other income.

In declaring that losses are good, gains are bad, note that we are speaking only of realized gains and losses. In general, net worth cannot grow without gains and/or reinvestment of income. The goal is to distinguish between realized and unrealized gains. In the past ten years, most of the portfolios of which I am personally aware have increased net worths of their owners by be-

tween 10 and 25 percent per year, but many of those portfolios have finished some years with net realized losses because the investor held on to profitable securities and sold only unprofitable securities.

This strategy is difficult to implement with packaged investments. Therefore, investors should acquire packaged investments in tax-free environments, reserving funds for individual securities in the taxable portions of their net worths, thereby putting themselves in position to avoid or to defer capital gains taxes by one of these strategies:

1. Hold profitable securities; sell unprofitable securities. Attempt to finish the year with net realized

losses.

2. Donate heavily appreciated securities to charity, possibly to a charitable remainder trust.

3. Recognize that at the end of life, capital gains taxes are not applied because the cost basis of a security is increased, "stepped up," to present market values at death.

4. Realize losses when economic.

Conclusion: You can increase your net worth more rapidly by managing realized gains and losses in the taxable portion of your investment account.

Advice for "Everyone"

Professional speaker and syndicated columnist Jane Bryant Quinn appeared in Indianapolis on January 16. She was introduced as the best-known financial commentator in the United States. She commenced by declaring that she is not an economic prognosticator. She then prognosticated about Asian crises and Y2K. Her major advice, frequently repeated in columns, is that "everyone" should acquire index mutual funds.

Ms. Quinn's work is practical and useful to the extent that it motivates investors to consider new ideas. Her work is not useful to the extent that it closes minds to some ideas and to the subtleties of the investment world. For example, index mutual funds usually have imbedded, unrealized capital gains that taxable investors easily can avoid using other strategies. This and other subtleties, including individual circumstances, temperaments and preferences, are reasons that her blanket has holes.

(Literati will be curious about a metaphor in a *Newsweek* column in which she compared the Asian crisis to a hurricane that might hit the U.S. "with gale force winds." Apparently, she optimistically envisions a reduction from hurricane force to gale force the instant Asian difficulties strike our coasts.)

A Word to the Wise

Recent market action has a powerful effect on investor psychology. The positive results of the past three years have exaggerated expectations of some investors. At the "MoneyWatch" seminar, an investor privately proclaimed that he has been earning 40 % per month, the equivalent of more than 480 % per year. Uh huh. Meanwhile, *Forbes* quoted investors who "cannot wait" to get up in the morning to make electronic trades on their home computers." Right! Is this reasonable? Is this real? Do we need a little humility here?

Did someone say, "pride goeth before the fall."

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