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Benjamin Franklin:

▲ “Rather go to bed supperless than rise in debt.”

▲ “There are three faithful friends—an old wife, an old dog, and ready money.”

Speculation—
avoiding the tricks
of the illusion trade

▲
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Thoughts While in Philadelphia

July 4, 2000

Did ol' Ben do all of this? Of course he did. I learned that in books. But here it is, in front of me. The Franklin Stove, a simple structure for preserving heat previously lost up the chimney. The lightning rod, a property and life saver. The bifocal lens, a staple of my life for the past 15 years. Printer. Publisher. Author. Diplomat. As the nation's first postmaster general, he personally measured over 1,600 miles of postal routes using an odometer. The data about distances then became a component in postal rates. All this shown at the Franklin Institute.

▲ Fireworks are art, as pleasing to the eye as paintings. Here, the annual fireworks are launched from grounds of the art museum, at one end of Franklin Parkway. Beautiful.

▲ The morning ceremony honors both our country and important contributors. Today, Liberty Medals of Philadelphia were awarded to James Watson and Francis Crick, discoverers of the three-dimensional, double-helix form of DNA. This revelation led to the human genome projects, the codification of human genes. In his acceptance speech, Dr. Watson asked a powerful question: With the knowledge we have today, would Jefferson have proposed “the pursuit of happiness” and “all men are created equal” as the central tenets in a declaration of independence?

▲ At precisely 2 p.m., the bell in Independence Hall leads the ringing of more than 2,000 bells throughout the United States and on various American military locations throughout the world. Thirteen rings, thirteen colonies. Simultaneously, young descendants of declaration-signer John Morton touch the Liberty Bell thirteen times.

▲ The American Originals, a fife and drum corps from the Washington, D.C. area, perform. By far, the best I have seen.

▲ Why is the United States Senate called “the upper house?” Because it first met on the second floor of Congress Hall. Among the many early achievements of Congress while meeting in Philadelphia was formation of the United States Patent Office. This fact reminded me of the modern threat to copyright protection arising from easy, out-of-control, electronic transmission of almost anything.

▲ Independence Hall. Plain. Unimposing. At the time, it was a convenient place to meet, without unusual significance. A few words changed that. “When in the course of human events . . .” So, now it is the most important place of our history. It is where our ideals were put on paper.

Selecting Investments

Speculation is investing in something that is bound to fail while maintaining the illusion that spectacular profits are around the corner. Mark Twain said do not speculate during two periods. The first period is October. The second period is every other month. But, he did not tell us how to identify a speculative investment.

Investing in a speculation is effortless; it is too easy. The reason is illusion.



Sponsors of speculative investments create an aura of excitement and legitimacy. They fabricate images that make investors comfortable.

Defying Illusion

The capacity to defy illusion and to properly identify and quantify risk requires experience, attitude and reading. Direct experience is not available to young investors. Their sources of ex-

perience must be books about market history and conversations with persons who have invested many years. Formation of an attitude or philosophy is the act of drawing a line. On one side of the line are acceptable investments having personally tolerable risk characteristics. On the other side of the line are all other investments. Reading standard public disclosure documents gives investors the facts with which to place an investment on the correct side of the line.

To the experienced, some investments are clearly speculative. Clearly. Unequivocally. Two come to mind. The first is a packaged investment strategy specifically marketed to create an illusion. The second is a company managed from inception to exploit financial circumstances and techniques instead of to create enduring products that are useful to consumers. Both investments, one a stock, the other a strategy, transmit signals of impending doom, but those signals are heard only by receivers tuned to the appropriate frequencies.

The Role of Credibility

To market an investment strategy or "package," sponsors must create an aura of credibility. Genuine credibility always is based on a sound philosophy and a good record. Most of the nation's mutual funds have both. Their investment objectives and techniques make sense. Investors easily can determine whether mutual funds follow their declared strategies. If published portfolios match stated goals and objectives, then the mutual fund is credible. Done deal. Nothing to it. Still, credible enterprises must market and utilize imagery that appeals to potential investors. Hence, images of Lincoln, Franklin and Washington frequently appear in marketing documents. Words like "fidelity," "heartland," and "American" are common in mutual fund literature. Occasionally, the name of an individual such as Templeton or Gabelli, is used to convey unique in-

sight and skill. This form of marketing is OK. We can live with it, because the underlying efforts are legitimate.

Manipulated Words

Unfortunately, aggressive marketing using powerful but misleading language also is used to create illusions, to motivate investors to put an investment on the wrong side of their personal line of risk demarcation. Disclosure documents of speculative programs usually tell investors, "Don't buy me," but these important words are buried under an avalanche of misleading words and concepts, such as "alpha," "benchmark," "modern portfolio theory," and "hedge." The use and misuse of these terms becomes the beautiful Persian rug that hides an unstable floor.

An example is a recent offering of "limited liability company interests" that proposes to provide investors with a "superior risk-adjusted rate of return" by first "allocating the Fund's assets among multiple investment managers," then trading options, futures and other financial instruments to reduce risk. Persons investing may choose among "sleeves" representing different magnitudes of risk. The company may invest in commodity contracts, and may borrow. At the time of printing the offering circular, investor funds were allocated to nine investment managers not identified. To reduce risk, "the manager seeks to hedge against the market risks associated with the Sub-Funds by (i) assembling a diversified portfolio of Sub-Funds that has a low overall correlation with the public securities markets and (ii) taking positions in derivative securities which it believes will reduce the systematic risks inherent in the Sub-Funds."

Literature distributed with the offering circular states that a goal is to "create a high alpha, zero beta, low volatility portfolio of investment strategies

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Selecting Investments, *continued*

that will have a high probability of producing *alphas* within an acceptable target range (5-15 %). In addition to having a *zero beta* (after hedging), it is important that the returns are derived from radically different processes. This helps insure that a number of strategies would not be adversely affected by the same non-market factor.”

The reason that neither you nor I understand this language is the indiscriminate misuse of words. Every important word (italicized above) is used to convey an impression of sophistication and above-average insight. For example, the word “sleeve” is original, never used before in any text or offering circular I have read. Meanwhile, the word “systematic” is misused. The accepted definition of “systematic risk” is an unavoidable risk, such as a tornado or earthquake. It is a risk of the entire system, or of the totality of potential investments within a market. It is the form of risk that no one can escape. Systematic risk was demonstrated during the massive declining market of 1987 that negatively affected almost every stock. The sponsors confuse “unsystematic risk,” a risk believed to be subject to management, with “systematic risk” that cannot be avoided under any circumstance. But clarity is not the point. The sponsors are manipulating words to their advantage, to convey credibility where no credibility exists.

Alpha and Beta Explained

The sponsors also flippantly use “alpha” and “beta” to convey a possible benefit to investors. Both terms came from serious theoretical work in the 1950s to more precisely define risk and the value added by investment managers. Portions of those studies were honored by a Nobel Prize in economics. With time, the words found their way into marketing literature.

“Beta” measures relative volatility. It compares the price movement of a single

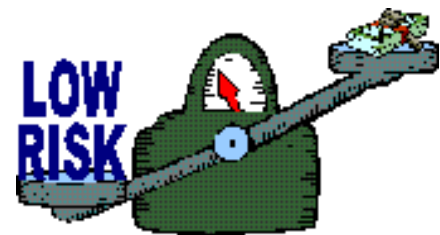
“The best way to prove skill is to pick a standard that is easy to beat.”

asset to the results of all assets in a defined universe or market. If stock A has a beta of 1.1, it rises and falls approximately 10 percent more than the stock market as a whole. The goal of achieving a “zero beta” sounds good, but is a benefit of little merit. Investors want to make money and to avoid losing money. The degree to which investor results are more or less volatile than a standard has little long-term significance.

“Alpha” measures the theoretical difference between the investment results of a manager and what results would have been without the skills of the manager. The statistic is developed by comparing a manager’s results to a popular index or average. To prove skill, every manager wants to beat a standard, to have a positive alpha. The best way to do that is for the manager to pick a standard that is easy to beat. My “alpha” as a speaker of Spanish depends on the standard I pick. I speak Spanish better than most Americans, a very positive alpha, but I am nothing compared to native speakers, a negative alpha. I can compare myself to either group. I can choose my alpha. The sponsors of the proposed investment have picked standards that are easy to beat. In addition, to prove skill, they have chosen to report results over a period in which they did well. They have mined the data to find the best possible supporting information.

If indiscriminate misuse of investment terms is not enough to discour-

age investors from purchasing interests in this program, the following precise language from the offering circular should do the job: “A purchaser must be able to bear the risk of a significant loss of the investment. These securities are speculative and involve a high degree of risk. These securities have not been registered under any securities laws. A claim of exemption . . . has been made . . . that relieves the fund of certain disclosure and reporting obliga-



tions.” These words, combined with the impossibility of understanding the proposed strategy, declare in sum: “do not buy me—I am speculative, and I will lose money for you some day.”

Tuning In to Danger Signs

Like packaged investment strategies, companies tell investors “don’t buy me” on frequencies available to anyone who tunes in. Examples are a company that absurdly builds both a ski resort in Indiana and a pizza parlor in Indianapolis, or a company that pompously proclaims possession of alternative fuel technologies “unknown” to large energy companies. Both appeal to innate desires (“boy, would I like to ski in Indiana,” or, “this company has the secret”), while challenging common sense (“by the way, it does not snow often in Indiana,” or “the big guys have more resources to develop fuel technologies”). In both cases, application of common sense would have saved investors lots of money because the proposed business concepts lacked the fundamentals for success.

Selecting Investments, *continued from page 3*

Fat Salaries

Another indication of high risk is seen in the actions of management. Of all management indiscretions, the most obvious is acceptance of exorbitant compensation. However, exorbitant compensation alone is not enough to indicate high risk. The important element is compensation relative to other firms in the same industry or to all firms having similar sales and profits. Also, when high compensation is coupled with extravagant spending, investors should know that the personal interests of managers are diverted from day-to-day corporate issues to the acquisition of property and enjoyment of “the good life.”

Knowing When a Salary Is Fat

Compensation theory has two elements. The first is that companies must pay a certain sum “to attract the best talent.” The second is that the compensation of all officers and managers is partially influenced by the amount paid to the top officer. These elements are related. If the top officer is paid \$80 million per year, the compensation scale permits payment of seven- or eight-figure sums to many key officers, some more important for success than the top officer. Since most organizations insist on paying the highest amount to the top officer, all other officers, managers and workers must receive less, according to a scale perceived to be logical. In other words, if the bottom exec is paid \$1 million, and if 10, 15 or more executives are perceived to be higher in the hierarchy between the bottom exec and the top, the top person must receive a very high figure to facilitate ever-increasing compensation among all executives. An example is Disney, whose CEO fre-

quently has been criticized for receiving high compensation, much in the form of stock options. For Disney, high compensation at the top might be justified by the need for high compensation at the bottom, because Disney’s success depends on the creative talents of hundreds of creative producers, directors, actors, animators and others who have scarce talents much in demand. Hence, Disney must pay very well at the bottom end of the management hierarchy where creative talent dominates.

Unfortunately, compensation systems are easily subject to abuse by management. The problem is that compensation is established by a committee of the board of directors. The top executive, who might be called president or chairman, has a large voice in the nomination of directors. The result is a circle in which persons who want to be a director determine the compensation of the person who nominates. In crude terms, if I want to be a director of XYZ, I must vote in favor of paying the top officer a certain amount. If not, I’m out.

More Danger Signs

Abuse of the compensation system is clear to persons who read proxy statements and compare compensation among companies. Whenever compensation reports indicate the possibility of relatively exorbitant pay, potential investors should look for additional signs of disease. Those signs might be loans from the company to pay for condominiums, seemingly unnecessary use of luxurious helicopters, airplanes and limousines, construction of homes that exceed standards of the local market and business community, and per-

sonal interest in race horses and race cars.

If the above circumstances are present in a company, the risk is very high that the top executive is spending huge amounts of time dealing with personal interests, even if time is spent only to hire others to do these jobs. The top manager is unlikely to take note of basic changes in his/her company or industry and is more likely to miss a management issue that must be resolved. The question is whether managers commit their minds to complicated issues such as balance sheet management, or whether they take a call from the horse trainer in the middle of an important meeting. Were it I, the telephone call would be more fun than the balance sheet.

Other indications are business decisions that appear to be in conflict with the founding philosophy or continuing operations philosophies of a company. An example is an insurance company that invests in casinos. Insurance and gambling do not mix. They are two businesses having opposite services, the first to protect, the second to fund greed and speculation.

Frequently, investors will find one additional virus in the midst of an already-diseased company. This virus is debt (called leverage). Commonly, companies, especially financial companies, fund high compensation, personal accouterments, elaborate employee incentive plans, and giant acquisitions and mergers by using debt. If large amounts of debt appear on the balance sheet of a company showing all of the previously mentioned habits, the message is not merely “don’t buy me.” The message is “stay away, run fast, do not get in, get out now, save yourselves from my Carmen-like allure. Please, do not speculate in me. I will hurt you in the end.”

Good night Dorothy. You done good.

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