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Dead Bolt

Risk and reward are the alpha and omega of investing—and of life. Most people accept that reward is problematic. However, many do not correctly identify risk.

Personal feelings and fears control our assessment of risk and the steps we take to eliminate risk. For example, a few weeks ago during a recreational outing at a marina, my wife entered a public shower, closed the door, and locked the dead bolt. I entered the same area after she was done and observed that with the dead bolt in place no person could enter the space without breaking down the door.

Locking the dead bolt is an act of permanent irrevocable isolation arising from the fear that a stranger might enter and cause embarrassment. My imagination took me in a different direction. I feared that I or my wife could not easily obtain help after an accident. I left the dead bolt unlocked.

My response to the risk of isolation came within the context of a recent health problem. My wife had experienced debilitating vertigo. So, I easily imagined her falling to the floor of the shower without any possibility of immediate attention and relief. I also foresaw that only professional firemen could get into the room, and only by carefully manipulating axes and other tools, because a straight-on attempt to charge through the door would cause additional injury to anyone lying on the

inside. After talking about the incident, Chichi still could not give up her fear of an intruder. The only solution was for me to guard the door while she was inside, dead bolt open.

(Bathrooms in many homes also are relatively inaccessible when locked from within. Teenagers are especially fearful of an unwanted intrusion, and most lock bathroom doors from inside. Fortunately, accidents seldom take place. When accidents do take place, the youth and resiliency of young people limit serious injury. The story is not the same for older persons for whom a fall in the bathroom and delayed attention can be serious indeed.)

Homeowners and apartment or condominium residents, especially persons over 50, sometimes go to extraordinary extents to prevent burglary and personal violation. Their fear of these potential events is so strong that they build almost impassable barriers into their private living spaces. One example is a condominium in Florida with a guarded gate outside the drive-in area, a guarded door in the lobby, an elevator requiring a key, and a living-unit door having a door knob lock, a dead bolt keyed inside and out, another dead bolt with no outside key, and a chain. These obstacles delay entry of emergency personnel, such as medics, by many minutes, and some of the interior dead bolts appear capable of blocking anything less than a Mission Impossible explosive.

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Stock Selection—Analysis of Management

“Quality of management” is a factor that book authors suggest investors consider when they select stocks. However, the lengthy, serious, pompous text books provide no standard, no measurement for determining the quality of management. No scale is provided, nor any method to determine whether the management team at Lilly is better or worse than the management team at Merck. Into this mine field of intellectual uncertainty we step forward with this proposition:

Good management is invisible and may be ignored as a factor in stock selection. Bad management is visible. Extremely bad management is highly visible. If bad management is suspected, avoid the stock.

The first side of this proposition is that good management is invisible. Good managers do not seek renown, and only a few seek undeserved fortune. Good management consists of appointing persons to various positions, giving them encouragement and support, making strategic decisions requested by subordinates, and acting prudently with respect to the capability of the balance sheet to fund new ventures and to acquire new companies.

Most chief executives accomplish these tasks quietly, without press releases and television interviews, without making exaggerated predictions about future earnings and growth. The best chief executives refuse requests for interviews with reporters. Giving an interview does nothing for the company, while a minor misstatement can cause misunderstanding among employees and shareholders. The most powerful CEOs in the country, the heads of oil companies, utilities, automobile and steel manufacturers, of chemical giants and technology companies, rarely give speeches or appear in newspapers. If a chief executive is visible, if he accepts speaking engagements and television interviews, if he and his wife frequently appear on the social pages, at big parties, horse races, or the front row of professional sporting events, if he or she needs their surname in lights, if his home is huge and the parties there are extravagant, if he seeks companionship with the rich and famous, if he flies the corporate jet on personal trips and has lavish vacations at company-owned properties, if he comes to believe that his management strategy should be the subject of a book, or if he starts writing his autobiography, *avoid the stock*. He is thinking about himself. He is thinking neither about the needs of his company nor the feelings of his executives. Meanwhile, if he is paid millions, he must spend company time managing the millions. His decision to buy a horse is time-consuming because he must visit horse farms, talk to trainers, then go to races. Truth is, most companies are better off with low-paid CEOs who have time to manage the company, to socialize with employees, to think ahead.

Indianapolis has seen at least two stellar characters who, by their personal actions, forecasted financial failure for their companies. The first installed a stock quote machine on his desk, thereby

broadcasting that his attention was on the market, not on his company. He also sought a prominent role in a charitable telethon, came close to violating insider trading rules, and had subordinates handle the “dirty” jobs like making phone calls to reverse or renege on previous commitments he had made in person.

His investors lost all their money. The second paid himself huge amounts, purchased company stock with company-guaranteed loans, acquired an estate with several buildings and a basketball court, and was pictured with horse owners at a Kentucky Derby just a few months before his company failed.

Chief executives have little effect on their organizations. Recognizing this truth, the outstanding CEOs are pleasant, low-key, even humble, individuals who rarely introduce themselves by their titles. Often, when asked “what do you do,” they respond by saying, “I work for Company A,” an accurate self-description and self-evaluation. CEOs work for the company, like anyone else. They also know that their day-to-day actions are not as important to future success as the dynamics of national and industry economics. Oil company earnings are more the result of relative prices than any decision by a CEO. The work of researchers in discovering and developing new compounds is far more important than any decision of the CEO of a pharmaceutical company. With few exceptions, people in the trenches, new discoveries and products, and the forces of competition and change dictate the future profitability of a company. The creative employees of Disney and the glorious products they produce are the drivers of future profitability. The decisions of highly-paid and somewhat controversial CEO Michael Eisner are a side show. If one

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The Ethics of Our Business

Once in a long while, WP&M loses a client to a competitor who, we believe, has made an unethical proposal. We cannot be specific about this phenomenon because, on departure, clients neither provide a complete explanation nor give us a sense of how thorough the competing professional might be. We see red flags, not details. Recently, we saw two red flags waved by a departing client.

The first red flag was moving his individual retirement account from a portfolio of individual securities to a single-premium deferred or variable annuity. We state categorically: An individual retirement account should not be invested in an annuity contract.

The important benefit of an annuity is tax deferral. This benefit is superfluous in an individual retirement account because the tax code provides deferral for retirement plans. On the other hand, investors can economically change the nature of their IRA investments to a load (expensive) or no-load mutual fund program that is not wrapped in an annuity contract. Usually, clients making this change, from individual securities to a mutual fund, either seek greater diversification or expect superior returns. However, by unnecessarily wrapping new investments in an annuity contract, annual expenses increase by 50 to 200 percent, depending on the contract. These expenses reduce future returns. The higher expenses come from contract fees and insurance premiums. Annuity contracts offer two types of insurance. The first is comfort for a beneficiary, not for the annuitant. It states that on the death of the annuitant, the beneficiary will not receive less than the original amount, or an amount later stepped up, in the

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Stock Selection—One Criterion

The important criterion for selecting a stock is nature of the business. Among the many businesses that are self-evidently useful are oil production and distribution, generation of electricity, production of essential chemicals and plastics, and manufacture and forging of metals. Companies in these industries produce necessities. Communications also are a necessity, but are extremely competitive and vulnerable to technological change. Companies that distribute information on the Internet do not produce necessities, only conveniences, and new competitors easily enter this arena. Therefore, many of the “dot-com” information companies died sudden deaths, having been given obscene valuations by ignorant, high risk speculators who sought instant rewards.

Oil companies on one end, “dot-coms” on the other. Two ends of the investment spectrum, with endless variations in between. If “the nature of the business” is easily described, that is a plus. If it is easily understood, that is another plus. If the fundamental business makes sense, look for the stocks, and buy the ones you like.

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of us (partners of WP&M) were named CEO of a company, we would pay ourselves the least and give the biggest salaries and bonuses to employees who create, who take us into the future.

Perhaps the best CEOs have little to do from day to day. Strong organizations run themselves. The absence of a daily routine leads to the best and worst of human nature. The best CEOs work to stimulate their organizations. When Sam Walton had a few extra hours, he worked at a checkout line. Dave Thomas routinely popped into various Wendy’s for a hamburger and a day behind the stove. He also pioneered a company program encouraging employees to adopt children. (OK. He was visible in television advertising, but in a down-to-earth manner.) Charming stories such as these always emanate from well-managed companies. Unfortunately, some CEOs

don’t get it. In their search for growth and personal recognition, they make deals. These are the kinds of executives to whom Peter Drucker referred when he said “it is more fun to make a deal than to manage a company.”

We forgive a CEO who makes one or two deals, such as strategic acquisitions within their industry. We do not forgive CEOs who make deal after deal, piling large organizations on top of others, with no fundamental improvement in day-to-day business, but with constant turmoil as workers and managers adjust to the new organizations. The most famous of these types always have failed, and always will. They make one deal too many, because making a deal is addictive. No matter how successful these types appear, avoid them. Do not buy stocks of their companies.

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A second example is another gated community of homes. This community has all the barriers mentioned above, plus homes have burglar/fire alarm systems that sense window and door openings and motion anywhere, including outside. Activation of the alarm is something to behold, an extravaganza of light and sound not unlike a fireworks display. These homes are no place for a heart attack, because medics would be significantly delayed. As someone once said, "Fences keep the bad guys out, and the good guys."

Fortunately, investment risk is not a risk to life. Unlike risks to health and welfare, investment risk is created by the investor, not by the environment.

An investor chooses the risks to assume as well as the magnitude of the risks. In our view, only one serious investment risk exists: that funds for personal life will not be available when needed. A serious market decline generates psychological pain for everyone but causes tangible effects only for persons who need money at the time of the decline. A loss at the time of retirement directly affects personal plans and life styles, but a decline ten years earlier has no such effect. The personnel of firms like Wealth Planning&Management are trained to assess financial risk. Many of us believe that risk assessment is our most important job, more important than the popular presumption that we are in business to make money for

our clients. Of course, we want client accounts to grow, but growth is beyond our influence. We cannot affect the national and international events that determine market returns, and we cannot make management and administrative decisions for companies in our portfolios. What we can do, and what we do well, is to diversify client accounts to minimize financial risk. We also can tell over-enthusiastic clients with limited resources that they should accept no risk at all. We give the honest and objective independent appraisals that help individual investors select the risk appropriate to their lives. We help them to understand that sometimes the dead bolt should be left unlocked.

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unlikely event that the investments have declined in value. If an investor pays \$100,000, acquires a mutual fund within the contract and the fund is worth only \$80,000 on the death of the annuitant, the insurance company makes up the loss by paying \$20,000 to the survivor. This coincidence is rare. The other insurance is guaranteed lifetime payments, a practical benefit only if the annuitant outlives the life expectancy tables.

The same departing client waved a second red flag. Instead of ordering transfer of his personal, non-IRA, investment account to a new custodian, he ordered complete liquidation and gave the impression

that proceeds would go to a mutual fund. We also noticed an urgent appeal for payment of proceeds, probably because a new investment had been purchased prematurely and a settlement date was pending. Again, we lack details, but most ethical and thorough financial advisors first would have received the current assets, then evaluated each asset, one by one, both for quality and appropriateness as well as, most important, for the tax effect of liquidation. The liquidation generated long-term capital gains of over \$20,000. We do not know if these gains are offset by losses coming forward. We hope so, for, if not, the client will pay \$2,000 or more

in additional income tax, plus a level of future tax expense that the client might or might not understand.

The client did not question us about our performance, philosophies and fees. He just left. He conducted the trial without hearing the defense. Since we were not given a chance to defend our program, we can only hope that the client was given a balanced presentation by the competitor. By the way, the client earned 7.98 percent annually from his inception date in 1999 to his termination in June, compared to negative returns in the Dow Jones Industrial Average and The Standard & Poor's Index of 500 companies.

Good night, Dorothy. You done good.

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