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Individual Securities vs. Investment Packages

After ten years, your net worth might be 40 percent greater if you acquire individual securities instead of packaged investments. The reason is fees and taxes.

The important word is “might,” for no professional investor, and no academic study, can prove whether one approach *will* be superior to another. Instead of proof, we must rely on intuition and common sense. My common sense is that maintaining a portfolio of stocks and bonds is less expensive than maintaining a portfolio of packaged investments. Reducing expense increases net worth.

The premise rests on three legs: 1) An individual managing taxable assets privately can make sell decisions with reasoned reference to personal income tax consequences, but managers of a packaged investment owned by thousands of taxable and tax-exempt investors ignore tax consequences. 2) A manager of a packaged investment cannot consistently, year after year, buy and sell with sufficient profit to exceed the reduction in yield caused by inevitable errors of judgment. 3) An additional challenge for the packaged-investment manager is to produce competitive rates of return net of management fees and other expenses.

The biggest burden is taxes charged to non-qualified accounts (personal wealth, not Individual Retirement Accounts and other retirement plans). In 1993, Robert H. Jeffrey and Robert D. Arnott questioned whether mutual fund managers can add value of sufficient magnitude to exceed the income tax cost of their management

decisions. In the article “Is Your Alpha [value added] Big Enough To Cover Its Taxes?” Jeffrey and Arnott concluded “that both theoretical and empirical evidence . . . suggests quite clearly that the answer is generally—although not universally—negative. Because the preponderance of evidence is so convincing, we conclude that the typical approach of managing taxable portfolios as if they were tax-exempt is inherently irresponsible, even though doing so is the industry standard.”

“If we assume that all professional money managers are smart, then only genius can rise above the average.”

The dilemma facing packaged investment managers is that value may be added continuously only by attempting to identify and to purchase the next most profitable stocks. A source of money for new investments is sale of older investments perceived to have less profit potential. Selling investments usually produces a taxable gain that is forced on taxable investors. The tax reduces current net worth. However, mutual fund managers do not play to the idol of personal net worth. Instead, they play to the idol of total return, regardless of how part of that total return is taxed. Turnover rates, a measure of buys and sells, run from approximately 25 percent per year to over 200 percent in most mutual funds. Unfortunately, most tax damage is done

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What Percentage of Assets Should Be in Bonds?

A popular answer to this question is your age divided by 100. Hence, a 20-year-old would have 20 percent of investable net worth in bonds and the rest in stocks, but a 70-year-old would have 70 percent in bonds. This prescription is appealing, its simplicity attractive. However, it is difficult to find anyone who has implemented it.

Three justifications support advice that younger persons with longer time horizons should own more stocks. The first reason is that time tends to smooth results; time allows for recovery from bad markets and poor selections. The recent history of K-Mart is an example. A second reason is that persons with a specific wealth target initially may assume above-average risk to achieve the target, but may switch to more stable investments when enough resources to reach the target are accumulated. The third point is that young persons may use wage income to offset potential losses in stocks, provided that their income is not highly correlated with investment returns.

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A sophisticated study of these justifications appears in the *Quarterly Review* of the Federal Reserve Bank of Minneapolis, vol. 20, no. 3 (summer 1996):11-23.

Authors Ravi Jagannathan and Narayana R. Kocheriyakota argue that only the third reason is valid and practical. Their model shows that an average investor having 85 percent of wealth in stocks

at age 36 should gradually shift to 40 percent by age 64. On the other hand, time diversification is not a valid justification for telling young persons to acquire more stock. The problem is that even though the probability of loss is reduced with time, the potential magnitude of loss offsets potential gain, and their model of real human behavior shows that risk-averse investors do not change allocation based on time horizon. Their model also shows that regardless of how close an investor is to

achieving a financial target, only in limited circumstances do people allocate less to stocks, and many increase stock ownership by applying the income from

bonds to new stock purchases.*

My advice: If you are considering a major switch from stocks to bonds, or from bonds to stocks, or if you are a new investor trying to figure out a lifetime strategy, read about asset

allocation; then listen to your inner voice. If your inner voice—whether you are young or old—says buy or hold stocks, do it. If your inner voice tells you that you will be more comfortable with bonds, do it, and ignore this advisor's belief that people make more money, and have more fun, in stocks.

*This data was taken from an abstract published in *The CFA Digest*, Spring 1997.

“Real human behavior shows that investors do not change allocation based on time horizon.”

The Faces of Investing

When faced with the question, “What is the market going to do,” investment advisors have two answers.

The first answer is delivered in the presence of cameras, microphones, and journalists. It goes like this:

“The market is trading within a range defined by the present level of inflation, the value of the dollar, and expectations for corporate earnings. If the Fed is believed to be contemplating an increase in rates, the market will perform positively, provided investors believe that the Fed has acted soon

enough. If investors believe that the Fed is too late, we might see a decay in equity prices. On the other hand, more strong earnings reports from corporations could offset Fed action, giving either a positive or negative tone to subsequent market results.”

The second answer, usually provided to friends or colleagues at private gatherings, goes like this:

“I don't know.”

Or, if blood alcohol influences the answer: “It will either go up or down.”

The Future of Building Construction—Erector Sets?

Men like to build.

Construction and assembly from prefabricated parts fascinates men. Look around your neighborhood. Somewhere nearby a professional man is using prefabricated parts and sections to build a deck, remodel a basement, or assemble a backyard recreational center of slides, swings, and ladders. Sears sells tools to these folks, or to their wives and children for gifts. Some garages have so many tools that the family car is parked outside.

Perhaps the fascination starts at youth. There were years that I tried to put together Heath Kit amateur radio receivers, or a complete stereo system. The cost of soldering irons and other tools to accomplish these sophisticated tasks, plus the cost of the final trip to a professional technician to correct my mistakes, added up to an amount far higher than the price of an off-the-shelf model. But, I was proud.

Proud men have used prefabricated parts in the real world. Since World War II, companies have “prefabricated,” or manufactured, permanent homes, commercial buildings and factories, and mobile homes. With names like Butler Buildings or National Homes, these companies have served millions of people well, but they have not captured the imaginations of investors. At least two phenomena have restrained investors. The first is the cyclical nature of construction, an industry that goes from feast to famine, and back to feast, faster than skirts and ties change length and width. The second is a perception that manufactured buildings are less permanent, less creative, less classy. For these reasons, stocks of building manufacturers have very low ratios of price to earnings.

New materials and techniques have changed this industry, and might soon change perceptions. For example, Butler Manufacturing built the complex skylight of New York’s Guggenheim Museum. Other recent Butler projects include the Roseburg High School

(Oregon) stadium, a Coleman, Inc., facility in Wichita, Kansas, a shopping mall in Franklin Mills, Pa., a fire station in Flint, Michigan, as well as facilities for country clubs and YMCAs. The annual report of American Buildings Company shows photographs of an attractive manufacturing plant in Nevada, an impressive church in Georgia, a day care center in New York, an Olympic rowing venue near Atlanta, schools in Georgia and Alabama, and the indoor practice facility for the NFL’s Buffalo Bills.

According to the Metal Building Manufacturers Association (MBMA), in 1996 metal buildings accounted for approximately 70 percent of low-rise, nonresidential structures of up to 150,000 square feet, compared to 65 percent in 1995 and 54 percent in 1987. It appears that technological advances in products and materials are helping architects to combine metal building systems with masonry, glass, and wood exterior facades to meet aesthetic expectations. New computer programs have had two positive effects. First, the design process is faster. Second, architects have a better tool to imagine, to create, and to develop structural and roofing systems that are more compatible with traditional construction materials.

Construction time is short because outdoor site preparation proceeds simultaneously with indoor manufacturing, and the risk of weather delays is reduced. In most cases, the time between receipt of an order and shipment of a completed building is only four to eight weeks. Materials and construction costs are less. Factory labor rates tend to be lower than on-site labor rates, and some argue that superior quality is achieved in a factory because adverse weather does not affect the result. Metal buildings can be modified

quickly, either during construction, or years later when more space is needed. Also, metal buildings do not deteriorate as quickly as other materials, and they resist cracking, peeling, chipping, chalking, insect damage, damp rot and fading.

Since the cost of metal building systems compares favorably to that of conventional construction, metal building manufacturers believe that personal preference determines whether the end user selects a manufactured or a traditionally constructed building. For example, I asked a developer what he thought about “manufactured” buildings. Apparently, the term was not

“Investment opportunities appear when image trails reality.”

familiar to him. He delayed a moment before saying, “Oh, you mean a Butler building,” in a slightly disdainful tone, perhaps reflecting a feeling that manufactured buildings are lower quality or less classy. I have seen similar reactions to the word “mobile home,” now more appropriately termed “manufactured” home.

Image and personal preferences also affect investors. Investment opportunities appear when image trails reality. Investors pay low prices for companies having a poor image, but prices rise as image improves. Clearly, manufactured buildings have gained market share, reflecting both improved quality and attractiveness. With time, investors will recognize the improvement and will be willing to pay higher prices for shares of manufactured building companies.

I have identified seven manufactured building companies. LTV and Nucor are diversified steel manufacturers. United Dominion Industries, Inc., is a large, world-wide provider of industrial and building products. The other four companies (see table) represent the best

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O P I N I O N

When Is Disclosure Not Disclosure?

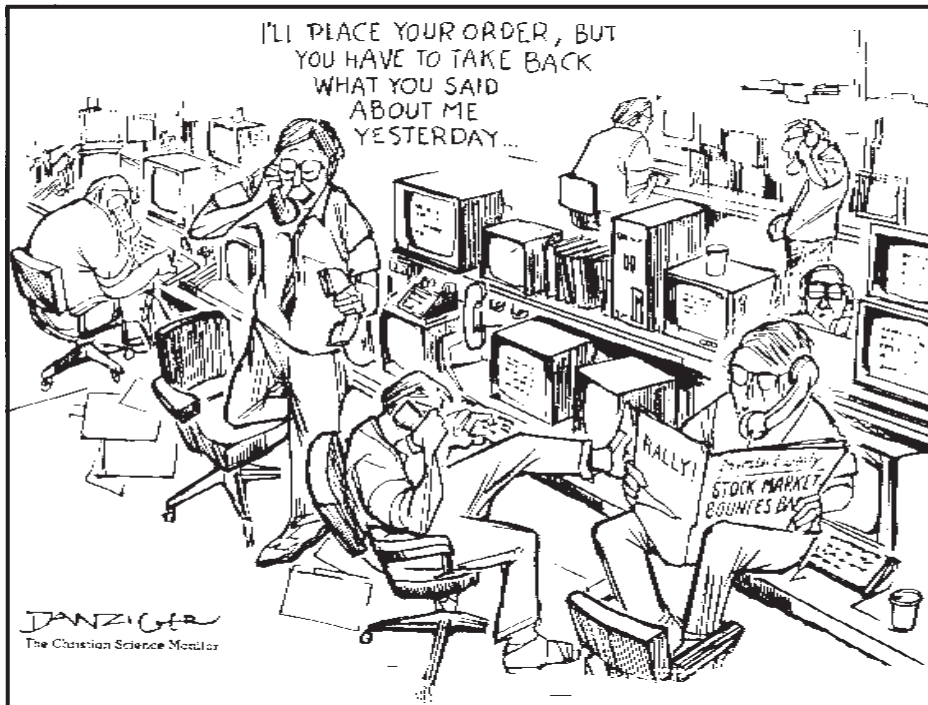
A few years ago, investors subscribed to a new stock of a health-care trust based on a prospectus that included names and brief biographies of management. One of the biographies stated that Mr. XXX had served as chairman of Company A, a well-known, important financial institution, and chairman of Company B, a financing entity affiliated with Company A. This was impressive information. However, the biography did not state that under his leadership Company A had severe difficulties threatening its existence, and that Company B lost money, declined in value, and ultimately ceased to exist. Furthermore, Company B had been a new issue with a high yield that was purchased by thousands of conservative investors, including many older people who thought that the income was safe. The biography also did not state that Mr. XXX was known for a lavish life style, expensive suits, and fancy directors' meetings at luxurious resorts. Had these facts been

disclosed, investors might have been dissuaded from acquiring the health-care trust that lost money, declined in value, and was reorganized after substantial losses to investors. Mr. XXX was allowed to step to the plate a third time because the prospectus did not mention his failures on the first two trips.

“Biographies in a prospectus describe position, not results.”

Biographies in prospectuses also fail to describe success. Following the departure of Mr. XXX from Company A, Mr. AAA took over and saved the institution. In fact, Mr. AAA has been an outstanding community leader with an excellent business history who also has resolved serious crises in a nonprofit organization and in a sporting event. Unfortunately, these facts do not appear in a prospectus because

biographies of management describe position, not result. Nevertheless, a little research and a few phone calls might be enough to suggest that when Mr. XXX asks for money, run away, but when Mr. AAA asks for funds, give what he asks, and more. 📌



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at low turnover rates of 5 percent to 50 percent. According to Jeffrey and Arnott, “\$100 compounding at 6 percent per year grows to \$321 in twenty years if there is no turnover and thus no tax diminution, but with just 5 percent turnover the after-tax terminal value drops by 12 percent to \$284. (About two-thirds of this shrinkage is due to the taxes themselves; the balance is lost compounding.)” At a 50 percent turnover rate, the after-tax terminal value drops to barely above \$215, and remains about the same up to a 100 percent turnover rate. “Beyond 100 percent, there is no further tax diminution, because the cost basis of the portfolio, having been increased by the reinvestment of after-tax sales proceeds . . . now equals the market value, and there is no unrealized gain left to be realized and taxed.” The authors go on to say:

“My common sense is that maintaining a portfolio of stocks and bonds is less expensive than maintaining a portfolio of packaged investments.”

“With very few exceptions, our comparison of the ten-year results of seventy-one actively managed mutual funds with a passively managed S&P 500 index fund gives no indication that turnover adds enough value to compensate for the turnover-generated capital gains taxes. In fact, the evidence is quite to the contrary,” because the ten-year pretax return for seventy-one active funds was 16 percent per year, but dropped to 13 percent when income tax assumptions were applied.

On the other hand, professional managers of private portfolios of stocks, or individuals managing their own funds, can arrange sell transactions to reduce or to eliminate the impact of taxes. Four techniques are available. First, investors may decide not to sell at a gain, or to delay realizing a gain until a subsequent tax period, on the assumption that a replacement security

cannot appreciate by a magnitude sufficient to compensate for taxes paid. Second, the investor may give appreciated securities to charity, thereby completely avoiding capital gains tax. Third, an investor may hold a security indefinitely, planning to avoid tax through the stepped-up basis at death. Fourth, investors may consciously realize losses for immediate application against realized gains or against ordinary income. Losses also may be escrowed for future use. For example, in mid-1994, many investors could have realized substantial losses for use against gains in 1995 through 1997.

A second question about packaged investments is: are professional investors capable of producing above-average results? The answer may be yes, but genius is required. If we assume that all professional money managers are smart, and that the totality of actions of smart money managers determine securities prices and averages, then only genius can rise above the average. Of the few great money managers, most produced superior returns over short periods of five to fifteen years, less than one-fifth of the investment lives of consumer-investors. Also, years pass before greatness is recognized, and then it is recognized only by the extremely well-informed. Hence, consumer-investors probably will not own a packaged investment managed by a great investor.

The last challenge for a packaged investment is to overcome its own weight (expenses). In 1985 Charles Ellis wrote a seminal book, *Investment Policy; How To Win the Loser’s Game*, in which he argued that clients must understand the challenges of investment

management. One of the challenges is cost, which he estimated to be more than 1.6 percent per year, including commissions on transactions, the spread between bid and ask, plus a fee for active management of 0.4 percent, far below fees charged to most packaged investments today. According to Ellis, “Recovering these costs is surprisingly difficult. For example, assuming an average annual rate of return of 15 percent for equities, of which six percent is the equity premium return (i.e., about the way it has been for the past 50 years), then the active manager must recover the 1.6 percent annual operating costs by increasing the 6 percent equity premium return by more than 25 percent.” The probability that *our* smart packaged investment money manager will outperform every other smart money manager by 25 percent—every year—must be small.

While mutual fund performance and performance of specific stocks and stock indices are available for standardized periods, no reliable data exist about *real* investment results of individuals. No reliable long-term survey or index exists to reveal how private portfolios contribute to individual net worth. Some have tried to generate this information. Since 1970 *Money* magazine has published “The *Money* Small Investor Index,” which shows a 9.3 percent average annual rate of return from December 31, 1970 to December 31, 1996, but this index assumes that investors hold stocks, municipal bonds, CDs, money funds, real estate and gold; it does not track results of specific private portfolios of stocks, bonds and packaged investments.

The S&P Index of 500 stocks might be the proxy for results earned by individuals who purchase stocks. The S&P 500 started in 1923 with 26 groups and 233 stocks. In 1941, it included 416 stocks, and since 1957 it has included 500 stocks. Some believe that the S&P was designed to replicate results of an average investor because it is market

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weighted. Large companies with more shares outstanding have greater impact on the index than small companies. On average, individual investors probably have portfolios similarly allocated, but no one knows for sure, and the S&P gives us no hint about results earned by investors in emerging companies. Furthermore, it is an index, not a real portfolio. However, the index does effectively demonstrate the value of a buy and hold strategy, for only rarely are stocks eliminated (sold) from the index. If the S&P can be accepted as a rough proxy for individually managed stock portfolios, then the average investor earned 15.3 percent per year for the ten years ending December 31, 1996. Expenses would have been minor, and capital gains taxes practically zero.

Another place to look for results that *might* have been earned in private stock portfolios is at popular strategies, such as “The Dogs of The Dow.” In this strategy, individuals purchase the highest-yielding stocks in The Dow Jones average of 30 industrial companies. Unfortunately, this strategy and others like it may be implemented in different ways and on different dates. For example, one investor might purchase the highest yielding Dow stocks and sell the lowest yielding, thereby creating a tax effect, while another investor might purchase the highest yielding stocks with new money while keeping lower yielding stocks indefinitely. Again, we cannot use standard results of this strategy to give us even the slightest idea about how individuals do on their own. Our search for proof is further compromised by changing circumstances. For example, the Jeffrey and Arnott study assumed a capital gains tax rate of 28 percent. This rate was changed to 20 percent or less,

and could be changed again. Fees and commissions can change too.

Since relevant data do not exist, our only reference is a “common sense” that it is unlikely that any professional investor (such as a mutual fund manager) in combination with a monitoring manager (such as an asset allocator) can *consistently* achieve results sufficiently spectacular to overcome expenses generated by their services and taxes.

Using the 15.3 percent S&P results, \$50,000 would have grown to \$207,617 during that ten-year period. If Jeffrey and Arnott are correct, the capital gains

taxes associated with mutual fund turnover reduce yield almost 3 percent per year from 15.3 percent to 12.3 percent. At 12.3 percent, \$50,000 would have grown only to \$159,502, a reduction in potential net worth of almost \$50,000 *before* subtracting additional costs of management and monitoring fees. I cannot believe that any packaged investment manager is good enough, smart enough, genius enough, to rise above these heavy burdens. I believe that privately managed, individual portfolios of stocks and bonds, managed economically and tax-efficiently, do better. In this case, I believe that *might* is right. 📌

Future of Construction – Con’t. from page 3

opportunities for investors because they are smaller enterprises that derive most of their revenues from manufacturing buildings and from related businesses, such as transportation, roofing, and computerized building design. 📌

Note: This information was extracted from Form 10-K of NCI Building systems, Inc., and American Buildings Company, as well as from information on various Web sites. While we believe that the information is accurate, we do not guarantee its accuracy or completeness. Clients of WP&M own one of the stocks listed in the table.

CUSTOM BUILDERS’ STOCKS				
COMPANY NAME	American Buildings Co.	Butler Manufacturing	NCI Building Systems, Inc.	Robertson-Ceco Corporation
Symbol	ABCO	BBR	BLDG	RHH
Price*	28 ⁷ / ₁₆	33 ³ / ₄	36	11 ³ / ₄
PE	12	7	12	4**

* September 30, 1997
 ** Erratic

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