

CONTENTS

How WP&M is
like Peter Lynch

The Story Man,
Screener Gal,
Approval Seeker and
Pattern Pusher

The Investment
Professional's Pie

The Benefits
of Losing

ADP

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The Way We Think

The two major stories in this issue arise from a belief that our frameworks for investment decisions are thought process and culture. "The Way We Think," which starts on this page, suggests that both consumer investors and professional investors look at markets through lenses that see only a small portion of available alternatives. Investors should not change their lenses. Instead, each investor should understand his or her lens so that the resulting picture is comfortable.

"The Investment Pyramid," which starts on page 3, is one view of the culture of investing. No investor can change the culture, but we can improve our effectiveness by being aware of its excesses.

Style and Temperament

Investment results arise from the way we think. The way we think is influenced by intellectual categorization. "Style" is a broad category of thought in investing, and consultants have divided professional investors (mutual funds and private money managers) into style groups. However, another category—temperament—is more important.

A "style" is a philosophical propensity to acquire securities defined by a broad objective. For example, a "growth" mutual fund has a "growth" style. It acquires stocks having high rates of earnings growth. Among the dozens of names for styles are "large cap," "small cap," "value" or "international," and subdivisions thereof. "Style" analysis is the intellectual structure in which nonprofits and retirement plans

write investment policies and select money managers. Consultants guide investment committees to create policy by using words that were born in modern port-folio theory, the language of style analysis. In addition, consultants recommend specific money managers having styles appropriate to the written policy.

A money manager who either is unable to declare that his style fits a

**"A 'style' is a
propensity to acquire
securities defined by a
broad objective."**

prescribed category, or who does not have a sufficiently long and well-defined record amenable to categorization by consultant computers, cannot play the style game. This manager is not a competitor in the institutional market.

An alternative analytical structure is to categorize the way we think by personal temperament or by the culture of an investment organization. Modes of thought, defined also as predispositions, biases, and methods of reasoning, powerfully affect human action and decisions. A person who believes "I do not like musicals" is unlikely to enjoy *Les Miserables* or *Miss Saigon*, just as the individual investor who does not eat at McDonald's probably will not seek potential profit in that company's common stock. Institutions also have predilections, internal processes that include and exclude investment opportu-

— continued on page 2

The Way We Think — *Con't. from page 1*

nities. Institutional modes of thought are included in the vague term "corporate culture." Modes of thought of individuals are similar to modes of institutional thought. For every mode of thought adopted by an individual, an institutional investor somewhere, someplace, has adopted a similar pattern.

In this discussion, modes of thought will be labeled "the story man," "the screener gal," "the approval seeker," and "the pat-tern pusher." These words do not imply opinion or judgment. They are words of convenience. They do not imply that one approach is better than another; only that they are different and produce different portfolios and different buy-sell strategies.

The Story Man

"The story man" searches for enterprises that stimulate his imagination. For example, an analyst or portfolio manager who early

encountered xerography might have been —should have been—personally stimulated to invest by a vision of millions of clean precise copying machines in every office and every

home. An individual investor or professional portfolio manager who was an early user of the Windows operating system might have been—should have been—excited by the incredible potential

of this idea (a concept so pervasive that it has become an object of government antitrust action.) Wealth Planning&Management, LLC, is a story man, and every issue of this newsletter contains a compelling tale of an "exciting" business. "Exciting" refers to a personal vision of business success, of continually improving sales of a valuable product or service.

Readers recall stories about Verifone, Cracker Barrel Old Country Store, savings and loans, Amazon.com and Cybercash. In the eye of WP&M, these companies will help

to define our futures. They are stories, as compelling as great novels and symphonies. A Story Man is so committed to this search for fundamental future value that he rejects other investment methods and is bored by financial statements, computer screens, economic forecasts and restrictions imposed by the policies of the company for which he works. A large proportion of individual investors are 'Story Persons,' who become personally attached to the businesses in which they invest. In the mutual fund industry, Peter Lynch is the most famous Story Man; his books advise that any individual investor, professional or amateur, can make money through personal observation of real business. Mr. Lynch might say "if the restaurant

parking lot is full and the wait time long, buy the company."

The Screener Gal

The Screener Gal starts from different data. She first defines specific numeric qualities of a good investment (like maximum price-to-earnings ratio, minimum yield or minimum price-to-book value, or a combination of these and other criteria) that are published and subject to analysis within her available time. For her, no investment is attractive unless it meets the stated criteria, and she is uncomfortable acquiring companies outside stated parameters. Individual investors who seek minimum ratings by Value Line or by Investors Business Daily are screener gals. Institutional investors often utilize sophisticated screens because screening is a way to acquire many stocks for thousands of different clients. Screening might be the only way to run a large

mutual fund, because no professional investor can follow the particular stories of hundreds of different securities owned by the fund. Screens employed by mutual funds usually are

proprietary, although the nature of a screen might be implied by the name of the fund. Examples are "Dividend Growth Securities," or "High Yield Fund," or "The Dogs of The Dow."

The Approval Seeker

Most often found in large organizations, such as trust departments, the approval seeker must select investments from a list compiled by colleagues who are believed to be competent and impartial. The trust-department approved list is the best example. Trust officers may only purchase securities from the approved list (unless the client authorizes a non-approved security, in writing). Approved lists contain securities believed to be prudent investments under

— continued on page 4

" 'Story people' become personally attached to the businesses in which they invest."

"Screening may be the only way to run a large mutual fund."

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The Investment Pyramid

One View of the Culture of Investing

To the doctoral committee, Stockwell College, from Professor M.J. Keynes:

Attached for your review is an outline of a proposed doctoral thesis by my student, A. C. Nielson. In my opinion, the committee should endorse Mr. Nielson's proposal. His hypothesis, when fully developed, will provide a new way of looking at both financial history and modern investment practice.

Doctoral Thesis Proposal
A.C. Nielson
April, 1998

To the distinguished members of the doctoral review committee:

My doctoral thesis will prove that "The Investment Professional's Pie" explains the history and functioning of investment banking and personal financial counseling. "The Investment Professional's Pie" (TIPP) is that portion of risk capital that an investor is willing to share with intermediaries, such as agents, analysts and financial planners. An ingredient of the pie is not capital sent to an enterprise. An ingredient is a distribution system or source of personal advice and evaluation. My belief is that in the 1940s and 1950s, this portion of-ten was 8 1/2 percent or higher, representing commissions charged on popular investment products, such as mutual funds. I further hypothesize that today's TIPP is approximately 3 percent, a significant decrease. However, the volume of trading has grown substantially since 1950, thereby providing adequate revenues to both maintain and to significantly enhance the financial services infrastructure.

I will develop the hypothesis by a review of financial history. Following is an outline of that history.

A Brief History of Evaluation

In the sixteenth and seventeenth centuries, investors acquired securities

directly from issuers. Hence, investors evaluated risks without third-party advice. By the nineteenth century, issuers had developed methods to distribute securities, especially stocks and bonds of railroad companies, to large numbers of people. During those years, determination of merit was made at three levels: by an issuer's willingness to sell, a salesperson's willingness to represent, and an investor's willingness to buy. These three levels constituted ingredients of The Investment Professional's Pie. Since unbridled enthusiasm governed this system, money was lost, but railroads were built.

Enter the Professional Agent

In the late nineteenth and early twentieth centuries, ingredients were added to TIPP. The first new ingredient was the professional agent, or stockbroker, a member of an exchange who represented numerous securities and charged commissions. The next addition was the mutual fund portfolio manager, an intermediary between the investor and the issuer, who charged fees. At first, portfolio managers operated only with advice from brokers. Soon, however, mutual fund managers demanded assistance, leading to creation of staffs of analysts at both mutual fund companies and brokerage firms. At this point in financial history, analysts evaluated companies, portfolio managers evaluated analysts, and investors evaluated mutual funds. To

finance this system, cost, the measure of the size of TIPP, began to rise.

Regulation Follows

In the third and fourth decades of this century, the value of stocks declined precipitously. In my thesis, I would like to call this "The Big OOPS," but I am willing to use more worldly language if the committee requests. The Big OOPS was so profound that investors clamored for a better system. We call this system "regulation." Now, regulation is an ingredient of TIPP, financed by taxes and fees.

"Private services use letters and Roman numerals and alphas and betas to help investors decide how to invest."

"Investors formerly evaluated risks without third-party advice."

During the late 1940s and the 1950s, investors became confident in both regulation and in the potential appreciation of investment securities. Mutual funds became popular, leading to creation of services to evaluate mutual funds. At first, these services were financed by the mutual fund industry. Then popular magazines provided ratings of mutual funds, and most recently, private \$400 per year services provide massive, computer-derived information on thousands of funds. These private services use letters, numbers, and roman numerals, as well as betas, alphas and standard deviations, to help investors decide how to invest. (I am enthusiastic about these innovative services. Investors today can choose from dozens of different published rating sources, each giving slightly different opinions. The system is so comprehensive that an investor can find any desired opinion. If you look long enough, you will find your opinion in print.)

— continued on page 5

The Way We Think

— *Con't. from page 2*

various conceptions of fiduciary responsibility. Trust company supervisors feel confident that management by approved list eliminates inappropriate speculation by subordinates. Many individual investors and advisors to individual investors, such as brokerage firm financial consultants, also rely on approved lists. A large share of brokerage firm business comes from clients who call their consultant to ask, "What do you think of XYZ?" The consultant responds by providing information from his company's research department or from such organizations as Standard & Poor's or Value Line. The investment is acquired if the outside source provides sufficient support. (Unfortunately, research opinions on stocks often are vague and indecisive, as in the statement, "We like this stock in the long run, but it might be weak in the short term.")

The Pattern Pusher

The last mode of thought is The Pattern Pusher, who invests only upon encountering a logical pattern of historic business activity. Pattern Pushers are similar to Screening Gals, but patterns sought are not as specific and measurable as is

"Visualizing a 'head and shoulder' pattern in a price chart is similar to visualizing constellations."

data from screens. A familiar Pattern Pusher is the investor who searches charts of historic price and trading volume to find an orderly, sensible progression that might lead to higher prices. For example, a pattern pusher might visualize a 'head and shoulder' pattern in a graph of recent prices of a stock. (Visualizing a head and shoulder in a price chart is similar to visualizing constellations.) Having

previously made profits by investing when graphs show a completed right shoulder, for example, the investor is willing to buy a new stock having this pattern of recent prices. Trading volume, dividend and earnings trends, macroeconomic data, and compilations of analysts' forecasts are forms of data in which a pattern may be identified.

Consumer investors should understand whether their provider-advisor is A Story Man, A Screener Gal, an Approval Seeker or A Pattern Pusher. The best relationships occur when the mode of thought of the client is similar to the mode of thought of the advisor. This symmetry of temperament produces easy-going relationships and effective decision making. ▲

The Benefits of a Losing Transaction

"The pain of loss is greater than the joy of gain" is a reality that limits both individual and professional investors. The pain of loss prevents investors from following the rule "cut your losses; let your profits run." Professional investment advisors know that clients stick with advisors who realize gains and dismiss advisors who realize losses. Nevertheless, for taxable investors, realizing losses can be a benefit.

Example: On September 15, WP&M purchased 1,500 shares of Seagate Technology for client A at \$37.05 per share. Seagate is the premier manufacturer of memory storage devices, such as disk drives. Seagate subsequently announced over-capacity, and the stock declined sharply. Client A's shares were sold November 11 at \$24.76, a realized, short-term loss of \$18,437.20. Shares were repurchased December 15 at \$19.34. On April 3, these shares were trading at 25 7/8.

The realized short-term loss has a greater economic benefit than an unrealized loss. Losses may be used to offset future realized gains, or, within limits, to reduce ordinary taxable income. The economic benefit of the loss (the amount of income taxes to be saved) is at least 20 percent of the loss, and probably more. Hence, this client is likely to save at least \$3,680 in income taxes over time. Meanwhile, he still owns Seagate, and the other stocks in his portfolio have performed so well that his invested net worth has risen despite the loss.

The rule is that losses should be realized if economic. "Economic" means that the income tax benefits of realizing the loss exceed costs (commissions and fees on the sale and the repurchase). ▲

"Losses that are 'economic' should be realized."

The Investment Pyramid — *Con't. from page 4*

Simultaneously, mutual funds, institutional investors, investment committees of nonprofits and retirement plans, and some individuals, needed more support. Persons who provide support today are called analysts, economists, strategists, or technicians, and their work is subdivided into domestic, international and global arenas. These professionals evaluate companies and economies. The business of analysis attracted so many persons that someone had to figure out who is best. Two hundred-dollar

“The business of analysis attracted so many persons that someone had to figure out who is best.”

per year magazines took on this task. They ask subscribers to vote for the best analysts (one publication calls them “All Americans”). The vote now is so important that some analysts and their sponsors campaign to be named the best.

In addition to acquiring mutual funds that evaluate securities, investors began to subscribe to investment newsletters that recommend stocks. With the proliferation of newsletters, investors began to ask “Which newsletter is best?” This question led to creation of digests that evaluate newsletters.

A TIPP Summary

The current ingredients in The Investment Professional’s Pie: Investors subscribe to digests that evaluate mutual funds and to newsletters that evaluate opinions of analysts who evaluate information sources such as balance sheets and annual reports and who talk to information officers of corporations who state that everything is going well.

Distribution of pieces of TIPP’s requires agents called brokers, financial consultants, personal financial advisors and financial

planners. These advisors deliver TIPP’s to investors within the context of individual client circumstances and objectives. Their tools are the ingredients of The Pie. To select appropriate tools, advisors evaluate digests and newsletters, as well as asset allocation and personal financial planning software. Increasing numbers of financial advisors has produced the question, “Who is best?” Hence, professional periodicals and popular magazines have begun to evaluate advisors. The result

has been that popular magazines print feature stories about advisors, and both brokerage firms and trade associations give out names of advisors who are qualified by meeting educational standards and by paying fees or dues to the referring source. Last year, a private, independent company evaluated financial planners by reviewing applications, statistical information, and recommendations of clients. Out of more than 32,000 individuals having the CFP designation, this company was able to name the one best planner of 1997. Presumably, personal financial advisors, like stock market analysts, will campaign to be named the best and to be included in recommended lists.

My Thesis

My paper will describe these developments and related costs. I will compile statistics about evaluators and about whether they receive fees or commissions. I will consider how these evaluators interact with one another within trade associations and informal networks. (For example, a group of 71 financial planners has been trying to rearrange the costs of ingredients of TIPP. They have been arguing

that mutual fund sponsors should charge less to their clients.) I will attempt to prove that the cost of TIPP today is about three percent, the total of various fees and/or commissions typically charged by advisors and by the investment products utilized. I also will demonstrate that the relative price of ingredients is changing, but that the total cost is remaining constant.

The committee will be interested in the practical application of the information and hypotheses generated by my thesis. Following my designation as a Ph.D., I will start a new business to be named Intelligent Investment Evaluators. Using sophisticated techniques, we will identify which digests, periodicals and private companies provide the best lists of TIPP ingredients. We will determine which organizations are most adept at approving, recommending or referring the best agents and financial planners. We will evaluate the evaluators.

Respectfully submitted,

A.C. Nielson

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The Way We Think: A Decade Is Not Enough

Memories are quantified in ten year blocks. There is no reason for elevating a decade into a convenient reporting period, but we all do it, perhaps because we are accustomed to a census every tenth year, or our language is filled with references to the "roaring 20s," and "the turbulent 60s," as if years ending in zero always are the start of something major.

Therefore, something which happened more than ten years ago, such as the dismal stock market performance of 1974 and the extreme volatility of 1987, have been removed from memory. These years are no longer recognized in most reports of mutual fund performance and hardly noticed in current literature about

the stock market. Yet some have said that 1974 was the worst year in stock market history, even tougher than 1929 or 1933, and that 1987 was the most emotional year.

For example, a truly unlucky investor could have purchased stocks on January 11, 1973, with the Dow Jones Industrial Average at 1051.70, and he could have sold on December 6, 1974, when the Dow reached its low of 577.60, for a loss of almost 50 percent. In 1987, an average investor acquiring stocks in August experienced a decline of almost 50 percent by November.

The message of 1974 and 1987, however, is not pessimistic. Instead, the

lesson should be found in words such as "patience," "perspective," and "understanding," for the recoveries teach these qualities. The recovery after 1974 was impressive, the Dow having rocketed to 1014.79 by September 21, 1976, hardly two years later. The losses between August and November of 1987 were recovered by the end of 1988.

An actual result from a mutual fund—not an average representation like the Dow—is shown in the performance of a large, famous fund, which had a value of \$18,584 for the investor who had started with \$10,000 at the end of 1970, a rather spectacular two-year result. This investor then had quite a ride, with total value, including reinvestment of dividends and capital gains, falling to \$9,552 at the end of 1974. However, this was the only time that his investment dropped below his cost, and he was back to \$11,897 by the end of '75. Therefore, he only could have been seriously hurt had he sold at the low. More to the point, had he held on until March, 1987, his total value would have risen to \$120,961, a phenomenal result.

Patience and perspective are qualities which produce good results in good years and bad. Investors who have the capacity to properly place today's events in the long perspective of economic activity usually do quite well. These are the individuals who have developed a sense of value, a feeling as to whether today's prices are fair and are justified by fundamental circumstances.

Of course, perspective, patience, and understanding are hard to teach. These are learned through experience, the actual experience of purchasing and selling securities, backed by a willingness to admit mistakes, to take losses, and to learn by doing. Unfortunately, those who did not personally experience the frustrations of 1974 and/or 1987 must look to the record book, they must read about events which teach investment attitudes, not an easy task due to our tendency to keep recorded experience in ten-year blocks, a period of time which no longer includes important stock market experiences, the extraordinary years: 1974 and 1987. ▲

Data Is Your Life

Odds are approximately one in five that Automatic Data Processing, Inc., affects your life. Here is why:

- In 1997, ADP (stock symbol AUD) processed paychecks to over 23 million workers and W-2s to over 35 million.

- It electronically moved over \$200 billion dollars from clients to government agencies, accompanied by over 13 million employer tax returns.

- ADP's brokerage services division processed more than 120 million trades, 20 percent more than in 1996. It also handled mailing of corporate annual reports and proxies to more than 285 million shareholders.

- The claims service division served 14 of the 15 largest auto insurance carriers, and added 1,500 new users of PenPro Laptop, an auto repair estimating system.

When WP&M opened in July, 1997, our accountant said, "If you have pay-roll, go to ADP. They do everything. You just

send them a check, and they pay employees, withhold taxes and FICA, report to the government—they do it all." With more than 400,000 accounts, Automatic Data Processing, Inc., is the top payroll-services provider in the world. It also processes securities transactions for more than 1,600 brokerage firms. In addition to assisting automobile insurance companies, ADP handles accounting and inventory records for more than 18,000 auto and truck dealers.

ADP has performed these and other tasks since its founding in 1949 by a 22-year-old. The company's first eight accounts generated \$2,000 of gross revenues that year. Today, revenues exceed \$4.1 billion. It has reported over 144 consecutive quarters of record highs in both revenues and earnings per share, and 36 straight years of double-digit earnings per share growth.

Need we say more?

AUTOMATIC DATA PROCESSING

CLOSING PRICE *	P/E RATIO	RANGE
67 1/4	36	26.56-70.68

*April 3, 1998