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The Fun of Predicting

Investing is impossible without prediction, but predictions are futile. Our longing to know the future cannot be satisfied, but our desire to predict, and to accept certain predictions of others, has few limits. This conundrum pertains to stock market risk because the purchase or sale of an investment security takes place when a specific prediction is perceived to be reasonable. The process of concluding that a prediction is reasonable is controlled by random thought, temperament, personal propensities and points of view. Making decisions is a rocky road.

A large share of the budget of investment firms is dedicated to research and to accumulating data that leads to predictions. Investment firm and research service predictions are direct and indirect. A direct prediction is to declare that "Our target price for XYZ is . . ." An indirect prediction is to state that "The fair value of today's market is 9,750 on the Dow." These predictions are received warmly by investors who want to buy, and are ignored by investors who want to sell, because investors act only on predictions that fit a predisposition.

Both history and modern public institutions manifest our need to know and to predict. Julius Caesar had a soothsayer ("Beware the Ides of March"). President Clinton has a board of economic advisors. In Oz, the Cowardly Lion had a wizard (played by the same actor as the medicine man of Dorothy's Kansas). Brokerage firms have strategists and analysts who predict the economy, earnings per share and stock price trends. These are fortune

sellers whose profession is to make predictions.

Water, Water (and Predictions) Everywhere

According to William Sherden, author of *The Fortune Sellers*, "on a daily basis, we are showered with all types of predictions: Tomorrow will be unseasonably warm; next winter will experience record snowfall; the economy

"Our desire to accept certain predictions of others has few limits."

will stall next quarter . . . global warming will raise sea levels three feet . . . Microsoft will dominate information technology." Daily news-papers print weather forecasts and stories about new technologies, potential effects of eating habits on health, which horse will win or what college team will make the final four. A significant share of radio and television news is commentary that includes some form of prediction about politics, sports, economics and culture.

Predictions are a staple of human conversation and interaction. In a conversation about a potential investment transaction, seller and buyer predict outcomes. Each has personal beliefs about future benefits of a transaction. One wants in, the other wants out. Their personal views are enhanced or modified by opinions of others, such as people who run the

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business or who analyze the industry. Without opinions, conversation becomes impossible, for nothing stops the conversation more quickly than the cryptic response, "Who knows?" Social interchange also is dominated by pre-diction, as in "I think Bill will marry Susan" or "The Colts will do well this year because . . ." or "If George doesn't stop eating, he is bound to suffer from . . ." or "Steve won't amount to anything." One cannot imagine relationships between parents and children without predictions, such as "Your income will be higher if you go to college." "Drinking plenty of milk will make you strong." "You will get a cold if you go out without a coat."

And Not a Drop to Drink
(or Believe)

The powerful desire to ask for and to render forecasts is offset only by the futility of the task. Among sixteen

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"After turning-point events are known, prognosticators are not shy to predict effects."

types of forecasts studied by Sherden, "only two—one day ahead weather forecasts and the aging of the population—can be counted on." The rest, he says, are no more reliable than the fifty-fifty odds in flipping a coin. Only weather forecasting has scientific foundation. The rest are mere conjecture, usually simple projections called "naive forecasts" in which whatever is happening today is assumed to happen tomorrow—in proportionately greater magnitude.

Literary and intellectual prediction creates curiosity, influences politics, and sells books. Names like John Stuart Mill, Karl Marx, Malthus, Adam Smith, John Maynard Keynes, and H.G. Wells come to mind, as do such titles as *The Crash of 19??*, *The Coming Great Depression*, and other books appealing to a belief that the future is less attractive than the past. The investment industry is populated by prognosticators, such as Peter Lynch, John Templeton, Elaine Garzarelli, and over 200,000 investment advisors known as stockbrokers, money managers, financial planners, strategists and economists, who are taught from birth: "Do not go out in public without an opinion (about the future)." When I was a stockbroker, over half of each day's telephone callers asked me to predict the future price of a security, the level of future interest rates or inflation, or the result of a political contest. I learned to deal gingerly with these questions, because the caller has a yet-to-be-disclosed point of view. An example was the election-year question "What will happen to the market if Clinton is reelected?" My answer, "I

don't know," was not acceptable, especially for callers who believed that the market would decline because they favored Bob Dole.

Categories of modern prognostication are economics, financial services, technology, business planning, weather, population, futurists and fortune-telling. The purveyors of predictions in each category work for institutions, such as the Federal Reserve Bank, stock brokerage firms, the Congressional Research Service, the Department of Commerce, the Weather Channel, university population centers, think tanks, and newspaper horoscopes. Unfortunately, according to Sherden, these services fail to either benefit or to protect from loss. Sherden's list of significant turning point events that no one predicted includes the stock market crash of 1987 and the

"A financial advisor without a positive outlook will not be an advisor for long."

subsequent rapid recovery, the fall of Communism, the entry of women into the work force, the Gulf War, all recessions and the crash of '29, use of lasers to transmit telephone messages, and floods in the Mississippi valley in 1993 and in California in 1995. The financial failure of Orange County, California, the Mexican peso crisis, and the present currency crises in Asia were not predicted. However, after these events were known, prognosticators were not shy to predict effects.

Despite a poor track record, prognostication is profitable because it satisfies two needs. The first is our human need to have an outlook, usually positive. Examples are "My child will be a lawyer." "Our retirement home will be in Tennessee." "Senator X will reduce taxes." Or, on the negative side, "Crime will increase," or "The stock

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Masters of Our Universe?

Back in the busy '70s when my wife and I managed four children and an intense business, we asked Chemlawn to keep green in and weeds out. Last year, we asked Terminix to deal with a few small monsters that were constantly seeking our friendship, and last month, while Chichi was away, I called Merry Maids to learn the cost of home cleaning. In each circumstance, a smartly dressed representative stopped by to give a quote and to describe the service—no hard sell, no “You must do it now,” just an air of professionalism and a pleasant smile.

“Among Globalstar users will be three billion people who live without telephone communications.”

These three organizations are parts of The ServiceMaster Company based in Downers Grove, Illinois, whose high school was my gridiron enemy. Over nine million commercial, institutional, and residential customers have needs similar to ours, making ServiceMaster number 373 in the Fortune 500.

How does an organization grow from a simple mothproofing and carpet cleaning business (1929) to one of the world's great service providers—and still project quality at diverse locations? The answer might be in two company philosophies. The first is the company's declared principle: “Honor God in all we do” or “Service to the Master.” The second is that the CEO's base salary may not exceed twelve times that of an entry-level manager, and that all managers must spend one day each year performing regular service work. This egalitarian atmosphere goes a long way to explain the smile of the Merry Maids representative. (In 1997, ServiceMaster's chairman had a base salary of \$1,350,021, and total compensation of \$2,077,763. These amounts are less than three percent of compensation paid last year to more famous executives.)

While diverse, the businesses of ServiceMaster operate under a single idea that living and working conditions

can be maintained professionally and inexpensively. The company's consumer services are Terminix, TruGreen-Chemlawn and Merry Maids, as well as American Home Shield, providing home warranties, relocation and move-related services, Rescue Rooter to handle plumbing and drain problems, ServiceMaster, which assists in residential and commercial disaster restoration and recovery services, AmeriSpec Home Inspection Service, and Furniture Medic, which repairs and restores on-site. The company also has divisions called

management services, employer services and international operations. Among the many projects of these divisions are hospital and nursing home cleaning and maintenance, facilities design, maintenance of educational buildings, airline industry services, such as airplane cleaning and pest control, logistics and energy management, and employer administrative services, such as workman's compensation and payroll processing. These combined businesses generated over \$5.5 billion in revenues in 1997, and over \$300 million in net income. Basic earnings per share in 1997 were up over 20 percent from 1996. Over 68 percent of 1997 operating income came from the consumer services that are available to you and to me.

Another company attempting to master our universe is Loral Space & Communications.

Loral is one of only five companies in the world that counts as a major satellite manufacturer. Its most prominent project is Globalstar, a system of 57 low orbiting satellites that will provide digital communications services to every populated area of the world. Globalstar users will communicate through a variety of user terminals, including hand-held and automobile-

mounted units. Among users will be the over three billion people who today live without telephone communications and for whom installation of land wires is impractical. The waiting list for presently available fixed services is over 45 million households, and the average wait time is over a year and a half. Meanwhile, only 40 percent of the world has cellular coverage. The remaining 60 percent is likely to obtain coverage through satellite-based systems, such as Globalstar. Meanwhile, the company is involved with the Orion, CyberStar, Europe*Star, Solidaridad, Morelos and Telstar systems having various commercial uses.

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Read *God Is My Stock Broker*

In addition to William Sherden's new book, investors should read *God Is My Stock Broker* by Christopher Buckley and John Tierney.

The premise is that a Wall Street tycoon retires to become a monk, Brother TY. Unfortunately, he soon learns that his monastery is broke and about to go out of business. In the middle of the crisis, Brother TY reads a passage of scripture predicting that pork bellies will decline in price. He borrows \$2,000, shorts bellies, and makes \$57,000 for the monastery, enough to cover operating expenses for a few weeks and to produce a television commercial proclaiming the excellent attributes of the monastery's product, wine. (“Never sell a wine before it is devine.”) As money comes in from new wine sales and from additional securities transactions, consultants are employed, a theme park built, and an audit conducted. But, the ecclesiastical auditor is No. No more. Read the book.

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market is too high." The second need is to seek reinforcement of our opinions and predictions by requesting the views of others who have authority, credibility, stature, or a recent record of making accurate predictions.

The Accidental Guru

Nowhere is the payoff for a correct prediction higher than in the stock market, a business directly affecting everyone. While Sherden makes no comment about the economic importance and personal benefits of investing, he sees little value added by market gurus. He states, "Given that there are thousands of stock market predictors, pure chance guarantees that at least one of them will make what seem to be remarkably accurate calls and attain guru status. Being a market guru, however, is a short-lived honor, because the likelihood of a repeat performance is remote. The odds of making a truly spectacular prediction in any year are one in a thousand, the odds of a repeat performance are one in a million, and the odds of getting it right three times in a row are one in a billion. The eventual fall of the market guru is inevitable." He lists names of fallen gurus, and he cites wave theories, timing techniques, "All American" analysts, doom mongers and almanacs that have consistently failed to make forecasts that are accurate to a degree greater than random good luck.

In the culture of prediction, personal financial advisors walk a tight rope of conflicting needs. We predict, then deny that our predictions are valid. To present the potential benefits of an investment, we use graphs and asset allocation models to show how successful our proposal would have been if it had been implemented at an earlier date. "Mountain charts" demonstrating historic growth and graphs of the "efficient frontier" showing historic risk are primary tools of the financial planner, stockbroker and investment advisor. These tools necessarily convey a message to the investor/client that the future will be as profitable as the past. Investors demand this

information. They demand a positive forecast. A financial advisor without a positive outlook will not be an advisor for long.

However, advisors know that the future will not be like the past. We state this in private consultations, in public discourse, and in printed materials. Prospectuses disclose specific risks and restate that past results might not be indicative of future performance. Of course we want people to invest. Our nation cannot exist without investors who assume risk. But we also want our clients to understand that an investment might not work out as planned. (Most investors leave the offices of investment advisors acknowledging that they understand risk. Nevertheless, three to five years later some investors claim at trial or at arbitration that they did not understand the risks. In filing cases, claimants, as well as the dispute resolution system, assume that the investment advisor should have known the future and should have made more accurate predictions.)

In Sherden's concluding chapter, "The Certainty of Living in an Uncertain World," he reiterates that "almost ev-

erything . . . that touches our lives is filled with uncertainty, and becomes less predictable as we try to look weeks, months, and years into the future." Chaos and complexity pervade weather, climate, droughts, erosion, floods, mud slides, volcanic eruptions, earthquakes, ecosystems, disease, politics and government, societies, economies and organizations. Uncertainty is the only certainty.

Dealing with Uncertainty

Sherden believes that we should deal with uncertainty by asking five questions of those who predict. The first question is whether a forecast is based on hard science. Reputable scientific forecasting is expressed in equations based on proved laws of nature. Newton's laws of motion are examples. Predictions that cannot be reduced to equations are not scientific predictions, and science itself specifically acknowledges elements of doubt. Heisenberg's uncertainty principle of quantum mechanics and use of abstract concepts such as imaginary numbers, arbitrary constants and infinity are examples of scientific doubt. Projections of economies and social systems are not scientific

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"I just downgraded my relationship with Richard from a 'hold' to a 'dump.'"

Drawing by Eric Teitelbaum; © 1996
 The New Yorker Magazine, Inc.

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principle of quantum mechanics and use of abstract concepts such as imaginary numbers, arbitrary constants and infinity are examples of scientific doubt. Projections of economies and social systems are not scientific because they are not based on proved natural laws.

The second question is whether methods used to make projections are sound. Projections that extend present trends into the future are "naive." Projections based on cycles or waves are almost sure to be erroneous because

few phenomena are governed by regular periodic cycles. Two additional questions are whether the forecaster has credible credentials, or a proved track record. Credentials, such as implied by the title "Doctor (Dr.)," are misleading if the degree was earned in a discipline unrelated to the subject of a current prediction. Words such as "consultant," "economist," and "expert" are too vague to indicate a specific competence. Newspaper statements that a prognosticator "is known to have successfully predicted [a specific event]" are particularly mislead-

ing because details are not provided. Track records also are not easy to judge because most track records, notably the prophecies of Nostradamus, may be interpreted in countless ways. The claim of *The Old Farmer's Almanac* that its forecasts are accurate 80 percent of the time is powerful, but reflects no unusual skill because mere use of seasonal averages would result in accurate forecasts 85 percent of the time.

Sherden's final question is most important: "To what extent is my belief in a particular forecast influenced by my own personal beliefs and wishful thinking? Is our belief in a prediction a function of hearing what we want to hear?" In the 1970s, economist Elliott Janeway and market strategist Joe Granville earned large honoraria by predicting disaster, and doom-and-gloom books sold well. The context was withdrawing from Vietnam, the resignation of a President, high oil prices and inflation. Pessimism reigned. Positive speakers earned only yawns. In contrast, I recently heard an author predict twenty years of continuous prosperity, his context being relative peace, low inflation and unemployment, and the longest bull market in history. His "naive forecast" will sell well in these wonderful times, but in listening to his powerful words, in enjoying his reinforcement of my views, I still wonder: Would I not be more realistic by accepting the principle that I don't know?

Personally, I love to predict. Stories in this issue about ServiceMaster and Loral count as direct predictions, as do all of the recommendations in past and future newsletters. Predicting is fun. It is the heart of human interaction, and it becomes more enjoyable as one understands and appreciates the risks of making decisions. Hopefully, my predictions and actions will benefit investors, but I also presume that investors understand the risks.

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remaining 60 percent is likely to obtain coverage through satellite-based systems, such as Globalstar. Meanwhile, the company is involved with the Orion, CyberStar, Europe*Star, Solidaridad, Morelos and Telstar systems having various commercial uses.

Purchasing Loral common stock is an investment requiring faith in both the future demand for communications services and in technology. The company's documents disclose numerous risks, from design to launch to maintenance and reliability. The failure of a pager system in May is an example of these kinds of risks. These companies also face political risks, such as the current brouhaha in which Loral's chairman has

been accused of making political contributions in exchange for favorable decisions by government. Political turmoil such as this is inevitable in a business that combines space travel and telecommunications, businesses that are regulated by every government in the world.

I have owned ServiceMaster many years. The stock will be held in some client accounts beginning in June. Loral also is a candidate for purchase in client accounts. The information about these companies comes from annual reports, SEC documents, professional research services and Web sites. The accuracy or completeness of the information is not guaranteed. The companies are subject to various risks that could result in losses to investors.

RECENT DATA

COMPANY	PRICE *	PRICE TO EARNINGS RATIO	52-WEEK RANGE
Loral	25 1/4	**	33 15/16 - 14 1/16
ServiceMaster	33 1/8	29	33 5/8 - 21

* June 3, 1998 ** Not meaningful; currently operating at a loss.

A Tale of Good Intent

This story was told to me by a financial advisor, with lessons for both advisors and clients.

Two years ago, a client called the advisor with an order to sell a large block of bank stock.

Knowing that the client's cost basis was almost zero, the financial advisor asked "would you be better off donating these shares to charity?" (A donation of appreciated securities avoids the capital gains tax, then 28 percent.) The client responded affirmatively, and gave the advisor permission to speak to the client's attorney and accountant, as well as to a charity. (In suggesting that the transaction should be avoided or delayed, the commission-based financial advisor gave up over \$2,000 of personal income.)

Thinking that the client was committed to a making a charitable gift, the financial advisor made the phone calls, inadvertently entering a hot bed of family politics. While the advisor was making professional queries and seeking expert advice, the client was calling family members having interest in the same charity. As aunts, uncles, attorneys and accountants became involved, a simple concept turned into a human relations nightmare. Before it was over, the financial advisor was criticized for attempting to influence family charitable activities and was directly told to stay out of charitable giving and estate planning matters that were "outside of his expertise." The story concluded late last year when the client and other members of his family transferred assets—including the bank shares—to another firm.

Client-investors and advisors can benefit from this story. The advisor was on strong moral, ethical and economic ground by suggesting a charitable donation. However, the advisor would have been better off by asking the client to pursue the matter; by hindsight, the advisor understands the perception that he was treading in forbidden waters. Meanwhile, the client and his family have failed to recognize the value of those few words ("would you be better off donating these shares to charity?") By holding on to the bank shares, the client saved over \$300,000 in capital gains taxes, the bank stock has risen in price since the date of the original discussion, and the tax rate applied to long-term capital gains has been reduced.

Sometimes, the most sloppily-delivered advice is the best advice.

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