

SILICON VALLEY / SAN JOSE

BUSINESS JOURNAL

JUNE 10, 2005
VOL. 23, NO. 19

96 N. Third St.
Suite 100
San Jose, CA 95112



E-DITION

Subscribers:
full content at
our Web site.



LEADS!

Critical data for running
your business.

STAY CAUGHT UP: Sign up for free e-mail news updates at sanjose.bizjournals.com

Diversification as a wealth tool isn't as easy as it seems

Early this year, we were referred to a gentleman, who we'll call "Harry." He and his wife owned an East Bay business for 15 years, and his life was turned upside down when his wife died unexpectedly.

Alone for the first time in more than 40 years, he sold the business and retired.

A friend of Harry's referred us to him to evaluate his financial affairs and determine if he was on the right track. Harry also wanted to know what if anything might be improved to ensure he

Wealth management

■ Hutch Ashoo and Chris Snyder

achieved everything that is important to him.

Harry was more scared now than ever before because he had never had to manage more than IRA assets and they had taken a serious hit during the market corrections of 2000-2002. Harry realized that he needed help. Not only was managing money new and scary to him, he was in no emotional state to be making these decisions.

When Harry sold his business, he structured a deal giving him \$200,000 for the next five years as well as \$1 million cash upfront. He also received \$1 million from his wife's life insurance.

Harry was a sharp entrepreneur, but he knew he needed help reaching his main goals: Income in six years, protection of the principal, inflation hedging, and legacy planning for his three chil-

dren.

When we reviewed Harry's investment statements to see how the \$2 million was handled, we were shocked.

Problem 1 was the lack of diversification. The assets that were now supposed to be safe were invested 100 percent in stocks. Most sophisticated investors understand the concept of not putting all their eggs in one basket. Still, common mistakes include filling up an investment portfolio with too much company stock, or buying shares in a sector — let's say shares of Cisco, Nokia, Yahoo, Microsoft and IBM and thinking that is diversification.

The truth is most lay investors fall into emotional traps along the way that prevent them from making sound decisions. Or they rely on professionals who, unbeknownst to them, load up on stocks.

Next, we pointed out that in 2004 one of his accounts had so many trades in it that the fees became exorbitant. And the securities being bought and sold during the year were the same. To make matters worse, the trades were taking place in his living trust, which meant they were taxable events. This was going to keep Harry's CPA busy and cost a lot of money not only in short-term capital gains taxes, but also in the costs of tracking down the trades for tax reporting purposes.

When we compared the performance of Harry's investments, we found the portfolio under performed the S&P 500 Index by over 55 percent, and his trading costs were well over \$40,000.

It was clear his professional money

managers fell into the "noise profile" among investors — the category of individuals and many financial journalists who believe that they can both time the market and select superior investments. The reality is they create excessive taxes and fees and generally under-perform an unmanaged index.

We lump investor mentalities into three other broad groups:

The "conventional wisdom profile" is where we find most financial planners, stock brokers and mutual fund portfolio managers — those who don't time the market because it is efficiently priced, but believe they can select superior securities using research and high tech information systems. History shows no additional value for assuming these higher costs for management.

The "Tactical Allocation Profile" is home to market timers and asset allocation funds. Here there is a belief the markets are inefficiently priced and value is created by timing when to get in and out of the market. Again history shows investors are not rewarded for timing the markets.

The "information group" is where you'll find 40 percent of institutional investors and many academics. This is full of investors who recognize that they cannot time the market, nor can they select superior investments. In this quadrant are those who research what works and follow a rational course of action.

For Harry, we recommended he follow the "information group." This would diversify his portfolio, significantly lower his trading fees, and reduce portfolio

turnover and thus taxes. These savings would therefore translate into greater returns on his money. We positioned his risk tolerance in a way that he can achieve all that is important to him and still sleep at night.

And, we described the concept of the "efficient frontier."

Modern Portfolio Theory — for which University of Chicago professors Harry Markowitz and Merton Miller and Stanford professor William Sharpe won the Nobel Prize for economics — holds that for every level of risk there is an optimum combination of investments, or portfolio, that yields the highest rate of return. That ideal combination is the "efficient frontier." Prudent investors will restrict their choice of portfolios to those that are on the efficient frontier and that are within their risk tolerance.

Harry wasn't looking to hit a home run with his savings. All he wanted was what most of us want: The peace of mind that no matter what the economy and the markets do, our money will be there for us and our loved ones to make use of. Through Harry's new plan he can now enjoy spending his retirement traveling or with his children and grandchildren. His only regret is that he didn't retire when Susan was still alive.

HAITHAM "HUTCH" ASHOO and partner **CHRIS SNYDER** are the principals of Pillar Financial Services Inc., a Walnut Creek-based wealth management firm. Reach them through their web site at www.exitingstrategies.com or at 925-356-6780.