

505 South Third St.
Suite 300
Louisville, KY 40202
(502) 589-1772
www.lifetimesolution.com



Capital Blueprints for the Future

Volume 14 Number 2
Second Quarter 2006

Over the Hedge

Lessons from the alternative investment world.

(1) Data from Chicago-based hedge fund tracker Hedge Fund Research, quoted by CNNMoney.com. ("Hedge Funds Hit Hard in May", CNNMoney.com, 1 June 2006)

(2) One study showed that reported hedge fund industry performance falls below the market average when subjected to mutual fund reporting standards. Using data from 1996 to 2003, the study corrected for backfill and survivorship biases, and found the average annual return of hedge funds declined from 13.5% to 9.7%—almost 3% less than the S&P 500's return for the same period.*

(Burton G. Malkiel and Atanu Saha. *Hedge Funds: Risk & Return*, Working Paper, 1 Dec. 2004)

Another study suggests that industry-reported performance should be viewed skeptically. The researchers examined the overall bias in the 1992–2002 period by comparing the reported 7.1% average return earned by actual investors to the Hedge Fund Research Composite Index's reported average return of 11.3%. The 7.1% return earned by actual investors was less than the 8.5% for the S&P 500 and the 7.3% for the Lehman Aggregate Bond Index over the same period.

(Richard M. Ennis and Michael D. Sebastian. "A Critical Look at the Case for Hedge Funds", *Journal of Portfolio Management*, Summer 2003)

THE INVESTING PUBLIC'S love affair with hedging goes on. There were signs in 2005 that investor demand was wilting.

But more recently the hedge fund industry seems to be regaining momentum. In Q1, hedge funds attracted another \$24 billion in new assets—their best quarterly showing in three years.⁽¹⁾ The industry now manages \$1.2 trillion of capital worldwide, with an estimated 8,000 to 10,000 funds catering to wealthy individuals and institutions.

Don't confuse popularity with prudent investing, however. Most hedge funds violate the most basic principles of financial management. The more obvious problems:

- **Ambiguous role in a portfolio.** Remember that hedge funds are not asset classes. Although funds are listed in categories, such as long-short, managed futures, event driven, convertible arbitrage or distressed, the managers operate without policy constraints. In fact, most deal in whatever market niche, strategy or asset group they deem appropriate.

Unlike small and large company stocks, value and growth stocks, bonds, real estate, foreign equities and other asset groups, hedge funds are a miscellaneous category lacking well-defined risk and return traits. This ambiguity makes it difficult, if not impossible, to structure, implement and monitor a portfolio according to the principles of Modern Portfolio Theory (MPT).

- **Failure to quantify and manage risk.** Managers often take risky positions to generate positive "absolute" returns—or returns above a market benchmark. This involves complex trading techniques and the use of options, futures and other derivatives. Strip away the exotic veneer, though, and you'll find

the same old tools of active management. These include stock picking, market timing, forecasting and aggressive trading.

All this activity exposes investors to excessive risk taking and inadequate diversification, which is one reason why many hedge funds tend to earn below-market returns. In 2005, the S&P hedge index gained 2.3%, compared to 4.9% for the S&P 500 index. This pattern of underperformance also is evident over longer periods.⁽²⁾

Worse yet, most hedge funds embrace even more risk by using leverage to compound returns. Although the leverage enhances gains, it also magnifies losses, increases the fund's volatility and subjects investors to total loss if performance falls below a normal range.

- **Down the cost drain.** Active trading in hedge strategies incurs high transaction and holding costs. Moreover, the typical hedge manager charges up to 3.5% in annual fees and gets as much as a 50% share in the gains. Investors may be willing to absorb the expense when their funds outperform the market. But the erosive effect of high fees—combined with uncompensated risk, lack of diversification and conflicting or redundant goals—virtually guarantees below-market performance over time.

Perhaps a lower return could be justified if hedge managers actually delivered on their promises to help diversify portfolios while providing low correlation to well-defined asset classes. But a recent analysis reveals that the average fund has a high correlation with U.S. stocks and produces a large return variability in most years.⁽³⁾

- **Traveling a well-beaten road.** The hedge fund

Continued on back



* The S&P 500 Index is an unmanaged basket of large company U.S. stocks. You cannot invest directly in an index. Past performance is no guarantee of future results in any asset group or individual security.

MONEY & LIFE

LINKING FINANCIAL PLANNING & LIFE PLANNING



“Many people express greater financial success and satisfaction when they see a direct link between their financial planning activities and their life goals.”

In their book, *Life Matters*, authors Roger and Rebecca Merrill write, “Both what and how we spend dramatically impacts the quality of our lives, the quality of our relationships, and the legacy we leave to our children—not only in terms of dollars and cents, but also in terms of character, financial intelligence and the ability to interact in positive ways around money matters.”

Likewise, many people express greater financial success and satisfaction when they see a direct link between their financial planning activities and their life goals. They also feel more motivated to make improvements in their money matters when they view their financial resources as a means to express and support their values and priorities.

To make this critical link between financial planning and life planning, it is helpful to think of your life as being multifaceted. In addition, it is important to regard each “facet” or area of life as a significant component of your total “life portfolio.”

As you reflect on each facet of life, ask yourself these questions: What is my current level of satisfaction in this area of life? What “riches” do I currently enjoy? In what ways do my behaviors and attitudes influence my overall quality of life? In what ways can I “invest” in this facet so that I can enrich my life and the lives of others?

As you clarify for yourself what is most important in each area of life, you can begin to formulate life goals that are significant and meaningful to you at a very deep and personal level. You will discover that by identifying your values and clarifying your priorities, you will be able to make both the big and little decisions in life with greater clarity and purpose.

The next step is to think about the role that money can play in helping you to achieve each life goal. It is at this point that you will make the connection between your financial activities and your personal life goals.

As the Merrills remind us in *Life Matters*, our time and our money are important resources and both are “languages of value.” “They are highly interrelated, and the way we spend both communicates what’s important in our lives.” ■

© 2006 Money Quotient®, Inc. All Rights Reserved.

FINANCIAL LIFE PLANNERS

Because of the unpredictability of life and the complexity of financial markets, it is essential to work with a financial advisor who can help you to achieve your life goals. However, you will want to select someone who is exceptional, someone who will go beyond the traditional client/advisor relationship and seek to truly understand your needs, concerns, and aspirations.

As you focus on defining and designing your unique version of “quality of life,” it will be important for you to choose a financial professional who is “life-centered.” That means he or she is dedicated to understanding your unique history, circumstances, life transitions, values, and priorities in order to make the most appropriate financial planning recommendations.

Fortunately, there is a small, but growing cadre of advisors who are turning to this more holistic approach to client services. These forward thinking professionals are pioneers in a trend of integrating financial planning and life planning.

Rather than the traditional financial conversation focused on “more is better,” these unconventional financial planners will demonstrate a genuine interest in helping you to achieve your life goals. ■

© 2006 Money Quotient®, Inc. All Rights Reserved.

Boomer Bust?

Will U.S. stocks fall as baby boomers retire?

(1) "The Recent Decline In Labor Force Participation and It's Implications for Potential Labor Supply", Working Paper, Division of Research and Statistics, Federal Reserve, March 2006.

(2) Slower work force growth may bring less wealth creation and lower business profits. Also, as boomers leave the work force, they will gradually become net receivers of Social Security. Actuaries at the Social Security Administration are still predicting a much more modest slowdown in the number of Americans working or looking for work than the Fed: 1.1% compared to 3%. ("Revolutionary Fed Study Has Economists Rethinking Forecasts", Bloomberg News Service, 13 April 2006.)

(3) Boomer selling could ultimately prove to be higher or lower than the market consensus. An unanticipated level of selling might force a price adjustment. So, the issue is not whether an aging population will sell more stock, as this uncertainty is built into current prices. The more pertinent question is whether actual future selling will prove significantly higher or lower than anticipated. This is anyone's guess.

The dispersion of age within the boomer cohort should offer some stability, however. The oldest boomers reach retirement age in 2010. But the majority of boomers were born later (1957-61) and will still be working, investing and accumulating through 2020. This should smooth out retirement motivated stock selling. ("Demographics and the Market", Economic Insights, Lord Abbett, 2 Sept. 2005.)

(4) James M. Poterba, economics professor at MIT, compared yearly U.S. market returns (1926 to 2003) to changes in demographic indicators. He found little evidence that population demographics affects stock returns. He projects that boomer-induced selling might reduce the market's total annualized return by .5% over the next two decades. ("The Impact of Population Aging on the Financial Markets", James M. Poterba, Working Paper, Oct. 2004.)

THE BABY BOOM GENERATION'S massive demographic weight has reshaped the culture and economy over the last six decades. The leading edge of this cohort is now approaching retirement age and a debate simmers about how their future investment decisions may collectively affect U.S. stock values.

About 83 million boomers—or 40% of the adult U.S. population—will reach age 65 between 2010 and 2030. During their peak earning years, they have poured money into stocks. Some analysts expect this trend to reverse as boomers become net consumers of their wealth over the next two decades. The U.S. markets could enter a prolonged retreat as millions of boomers sell stocks to generate cash flow and reduce their portfolio risk exposure as they age.

Worse yet, this possible mass liquidation may occur when the economy is losing the benefit of boomer participation in the workforce. An upcoming study by the Federal Reserve warns that retiring baby boomers may reduce work force growth even more than currently expected.⁽¹⁾ This could depress corporate profits and stunt the economy while pushing Social Security and Medicare farther down the road to insolvency.⁽²⁾

A measured view

While demographics can affect business profits and the economy, it's unlikely that an aging American population will wield enough force to induce a massive and prolonged stock sell off. Here are factors that will likely mitigate the effect:

• **Stock market dynamics.** Population is only one of many factors affecting stock prices. Others include the prevailing cost of capital, risk/return expectations, immigration flows, foreign demand, corporate profits, company success and industry trends. Moreover, if stock prices reflect all available news and investor expectations, the risk of future age-driven stock selling should be reflected in the prices. The uncertainty lies in whether the market has accu-

rately assessed the future impact of net stock liquidations among retirees.⁽³⁾

• **Global capital flows.** Predicting a collapse in demand for U.S. equities ignores the potential role of global capital. Foreign investors should keep buying shares in American companies if they expect U.S. stocks to deliver higher relative returns for the risk assumed. Also, economic growth in developing regions could boost demand for U.S. securities as the middle class expands and their investment capital pours into the global markets.

• **Changing retirement trends.** Future retirees are expected to live longer and lead more active lives.

This longevity may prompt boomers to keep working and own more stocks to maintain lifestyle and offset inflation through a later age. Boomers also are expected to inherit substantial wealth from their parents. This asset transfer could raise boomers' risk tolerance and blunt the need to sell stocks.

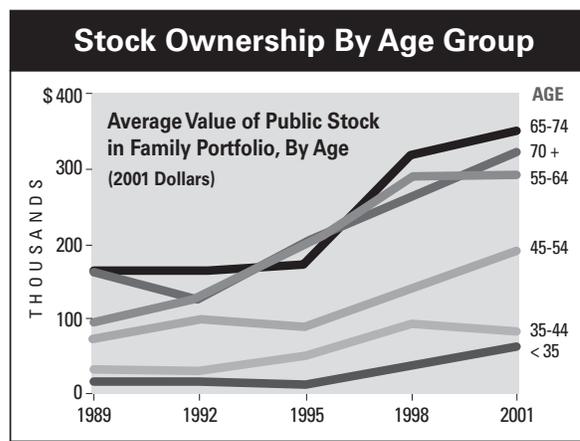
• **Academic evidence.** Research offers scant evidence that demographics drive the

market either direction. For instance, the Federal Reserve's analysis of consumer behavior shows that investors do not abandon equity investing in their senior years. (See the above graph.) Moreover, one major study of historical returns concluded that past changes in the senior population had only a modest effect on stock returns.⁽⁴⁾

Keep in mind that both the gloomy forecasts and optimistic views are rooted in guesswork. The predictive models do not capture the complexity of the issue and the assumptions may not hold up in the future. Indeed, many events and trends that may drastically impact markets are yet to be known. While there's little evidence to justify fears of a baby boomer market meltdown, projecting stock price levels 20 years from now is tenuous, at best.

Investors should be more concerned with their own assumptions. For example, will Social Security and Medicare benefits keep flowing? Will your company fulfill its future pension obligation? How much money will you need to maintain your lifestyle? Are you building enough wealth to fund 20 or more years of consumption? Is your portfolio structured to manage potential demographic risk?

You have more control over these decisions than over macroeconomic trends. ■



Over the Hedge

(Continued)

industry shows signs of following a classic investment fad cycle. The boom began in 2000 just as the bear market took hold. Investors burned in the tech stock bubble were lured by hedge managers who had made well-timed contrarian bets. Low barriers to entry and minimal regulation brought a surge of hedge fund startups in 2003-04. Capital poured into these funds at record levels. Small investors, pension funds and fiduciaries embraced hedging with hopes of avoiding downside risk in a rising market. Many of these entities lacked the expertise and personnel to evaluate strategies and monitor their risk exposure.⁽⁴⁾

In mid-2005, net inflows to funds slowed considerably as more hedge managers reported lackluster results. A record 484 funds closed down in response to forced liquidations.⁽⁵⁾ The final stage of the cycle would be a widespread investor run on funds triggered by an economic or market crisis. Although we don't hope for this scenario, it's a typical ending to an investment craze.

Hedge funds may always appeal to certain investors whose appetite for adventure exceeds their market sense. And the industry's products will surely evolve to exploit new market niches. This may prove true especially when stock and bond volatility increases and the fear of downside risk dominates investor sentiment.

During those times, many investors will forget about the high costs, excessive risks and lack of accountability characterizing the hedge fund industry. Their short memories could prove costly. ■

(3) "Choose Wisely"; Bloomberg Wealth Manager, Sept. 2005, p 102.

(4) In June 2005, Harvard and Yale had 12% and 25% of their respective endowments earmarked for alternative investments. Schools with endowments of \$1 billion or more had an average of 21.7% in hedge funds in 2005, according to the nonprofit National Association of College & University Business Officers (NACUBO).

("Investing: Big Risk on Campus"; Business Week Online, 3 May 2006)

(5) "Hedge Funds: The Pool Is Shrinking"; Business Week, 30 Jan. 2006, p 32.

In My Opinion . . .

Robert J. Cole, Jr., CLU, ChFC, CFP®

Hurricane Season

The media was quick to announce that the 2006 hurricane season has arrived. There is no way that this bit of information could not draw up emotions of anxiety (which is what it was designed to do). All of us will forever remember the awesome might of Mother Nature as she devastated our coastal areas with destruction not witnessed in quite some time. But the devastation had happened before—we just may not remember it.

Today we live in an unprecedented era of instant communications and global news coverage. News of past tsunamis probably took months to reach everyone. Today we have pictures taken from home video cameras on our television screens within the day of it occurring. In fact, we are deluged with information about every possible occurrence on a daily basis. All of this data tends to invade our minds and feed the human tendency to worry. This, in turn, fuels our desire to have more data, which makes us turn to the technologies of the day. For the most part, at least in our culture, these technologies are thinly disguised tools for selling us products and services through advertising, which supports the entire process.

As I write this, we are going through another market correction. The media (using the same approach) is in a frenzy, focusing our attention on these short term fluctuations, hardly mentioning the long term implications. Yes, Virginia, stocks do go up and down. That is why the long term investor is always rewarded with superior returns.

With the advent of cell phones, the internet, cable television, satellite radio, email, texting, etc., we now can get information anytime and anywhere. Unfortunately, many of us are doing just that, and doing so at the expense of living our daily lives in a relaxed and focused manner. I am of the school that thinks we should use technology, not have technology use us. I don't watch the evening news. I barely read the newspaper. I don't answer my cell phone every time it rings (they do have voice mail). I check my email and internet information three times a day. Instead I try to focus my energy on my Circle of Influence, that is, people and things that my efforts can affect. I look at my activities daily to filter out the environmental distractions and assure that they support my stated goals and values. A mentor of mine once said, "Be careful what you let close to your mind, it might be listening". I couldn't agree more.

In the Life Planning process, we attempt to define these goals and values and construct a program that will support their achievement—regardless of the atmosphere. This allows a person to have a sense of confidence about the future and enjoy the present. Before you allow outside information to influence that, make sure that you do so with purpose.

Until next time, that's my opinion.

Robert J. Cole, Jr. CLU, ChFC, CASL, CFP®
President