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Shaming the Bears

Lessons from the 2003 market advance.

INVESTORS in the U.S. stock market had a great run during 2003. Large cap U.S. stocks had their best return since 1997; large cap international stocks had the best annual return in 17 years; and small cap U.S. stocks achieved their best annual total return in 36 years.(1)

There was a shortage of famous stock experts giving the buy signal in late 2002. No one saw the rebound coming. Few acted on it. Once again, the market shamed the pessimists.

Who would have ever imagined this at the start of 2003? Perhaps the better question is, who predicted and acted on it? There was a shortage of famous stock experts giving the buy signal in late 2002—and many opinion shapers were counseling investors to avoid U.S. stocks altogether. From their perspective, all signs pointed to a gathering storm.

In early 2003, the Iraq War dominated headlines; the SARS virus was spreading through Asia and raising the alarm in North America; the investment company trading scandals had erupted; the dollar was plunging against most world currencies; the deficit was rising; the Japanese stock market hit a 20-year low; and the U.S. jobs picture remained bleak. It is not surprising, then, that many investors overlooked the market rebound.

The financial media fed the pessimism with reports and commentary that encouraged investors to flee stocks and rush to the safety of bonds, which were paying meager rates. On March 11, the Dow hit its 2003 low at 7,524. But, then, over the next eight trading days, it jumped 1,000 points. Even as stocks began this turnaround, more articles appeared, claiming that investors had missed the advance and the market was showing classic signs of topping-out. Some warned of a coming debt surge that would hurl the U.S. economy into depression.

And then, by the second half of 2003, the good news started coming—first in data trickles, then as a gushing river of good economic news. The financial media heralded the strongest economic rebound in 20 years. The Dow closed over 3,000 points ahead by year-end.

Learning from mistakes

There are many useful investment lessons to harvest from the surprise performance of the 2003 market advance. Here are three to consider:

• **Lesson 1: Many investors continue to focus on the wrong things.** The mainstream approach to investing ties success to accurately forecasting the economy and future stock performance—and holding the right investments ahead of time. This mentality has grown even more prevalent in the wake of the brutal bear market, when many investors began to question the strategy of diversification.

But predicting the future has time and again proven more difficult than envisioned. Indeed, the opposite strategy—one of extensive diversification—has consistently demonstrated its superiority in both theory and application. Uncertainty is best managed by spreading out the risk and capturing the performance of major asset groups.

• **Lesson 2: Many investors fail to diversify enough.** Their choices are shaped by financial news coverage and commentary that typically recites performance of the Dow Jones Industrial Average and S&P 500 Index when reporting on the "market". But these benchmarks reflect only a portion of the U.S. stock universe. The mass financial media virtually ignores other parts of the U.S. markets, and certainly the international markets.

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(1) As measured by the S&P 500 Index, the EAFE (Europe Australia and Far East Index) and the Russell 2000 Index, respectively. Past performance is no guarantee of future results. You cannot invest directly in an index.

(2) "Was Last Year's Rally A Headfake?", Financial Advisor, March 2004, p 81.

Values & Priorities

In The Thinker's Way, author John Chaffee describes the word "value" as "the general term we use to characterize anything that possesses intrinsic worth, that we prize, esteem, and regard highly based on clearly defined standards." He continues, "Thus you may value your devoted pet, your favorite jacket, and a cherished friendship, each based on different standards that establish and define their worth to you." In other words, we tend to think of our values in terms of what we treasure the most in life.

In addition, values are specific attributes or guiding principles that we highly revere such "integrity," "loyalty," and "generosity." Values are also the personal motivators that consciously and unconsciously influence how we behave, the decisions we make, and the degree of happiness we experience. These values vary from person to person, but include such intangibles as recognition, challenge, prestige, harmony, security, freedom, and creativity.

Lou Tice states in Smart Talk for Achieving Your Potential that each person who chooses to be centered and strong needs to identify their own hierarchy of values. "Sort out for yourself what the essentials are, why you are on earth, what is important to you, and what your life is worth. I encourage you to use affirmations and set goals to bring more of those things that are important to you abundantly into your life."

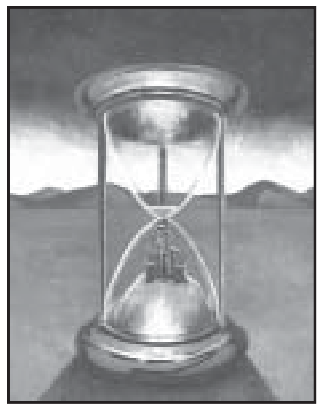
In a nutshell, your values are what you identify as being most important to you, and your priorities are those same values placed in a ranking of importance. In addition, your values and priorities can be described as an internal compass that guides both the big and little decisions in your life.

When you are on a course of action that isn't aligned with your values and priorities, you will experience a sense of inner conflict. In contrast, when your decisions and behavior are in harmony with your internal compass, you will experience greater life satisfaction. ■

Life Planning

How the Sandwich Generation Can Endure the Financial Squeeze

A GROWING NUMBER of individuals and couples are entering the ranks of the Sandwich Generation. What they have in common is that they are "caught in the middle" between the competing needs and wants of their dependent children and aging parents. As a result, they often fail to prepare for their own retirement years and potential long-term care needs.



Most members of the Sandwich Generation value higher education and feel compelled to provide that opportunity for their children. Other "sandwichers" are pressed into service to give financial assistance to a divorcing adult child or to help raise a grandchild. In addition, as life expectancy increases, their aging parents are likely to survive well into their 90s and outlive their own financial resources.

Increasingly, it is the middle generation that bears the responsibility for addressing the financial needs of both the younger and older generations. Unfortunately, the unintended result is that the financial needs and wants of the middle generation are squished, squelched, and squeezed out.

As an alternative, is it possible to balance financial responsibilities across generations? Are there ways we can help our children and our parents without sabotaging our own long-term financial security and quality of life?

There is no magic formula, but a proactive approach can improve communication, build financial resiliency, and nurture resourcefulness in all family members.

Here are a few ideas:

1. Encourage and reward independence. In an effort to demonstrate our love, we often do too much for our children and for our parents. The more we do for others that they can actually do for themselves, the more we undermine their autonomy. When we do too much for a loved one, we communicate to them, "You are not capable." Nurture a spirit of self-reliance and self-confidence in those you love—that is the best gift in life that you can give.

2. Start early. The negative impact of big expenses can be mitigated by planning ahead. Expenses like college tuition for your kids and long-term care for mom and dad are huge. Therefore, it is essential to research your options and make preparations well in advance of the event.

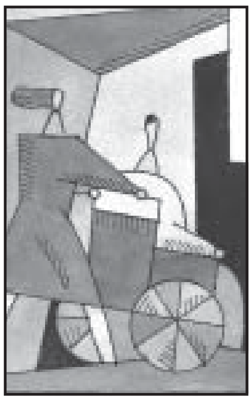
3. Expect involvement and cooperation. Involve your kids and parents in the planning and preparation for their needs and wants. Ask them (and expect them!) to contribute what they can. For example, encourage the older generation to think about their eventual needs and to plan ahead both financially and emotionally for their later years and the possibility of frailty. ■

Fading Capacity

Preparing to step in for your parents.

If your parents live long enough, they will need assistance from the family. Are you up to the task of overseeing their care? More importantly, have they taken the functional and legal steps to make the power transition easier for caregivers?

Mental capacity describes a person's cognitive skills and abilities. This includes memory, logic, calculation, reasoning, self-awareness, attentiveness and ability to understand situations and consequences of actions. In legal circles, capacity has replaced competence as a more descriptive indicator of ability.



A senior can have varying levels of capacity across a spectrum of functional abilities. You may not have much warning that your parent's mental capacity is failing.[1] But the process often becomes visible through an event, such as a stroke, injury or cognitive failing. Such events awaken children to a new reality—one in which they will assume an increasing burden for care.

In the immediate wake of the trauma, the prime goal is to help your parent receive the best medical care and rehabilitate to the fullest extent possible. Planning and organization can make this task easier. Specifically, you should know the location of important information, including your parent's Social Security number, Medicare card, supplemental health insurance, medical contacts and hospital preferences. Also know how to contact your parent's legal and financial advisors.

If your parent successfully rehabs, the physician, therapists and social workers will assess his prospects for returning to an independent life. If they determine that he shouldn't live alone, your first challenge will be to arrange a support system that enables him to live with dignity, meaning and purpose.

These support areas include personal care, business coordination and wealth management. Let's consider these:

• **Personal care.** Most elderly people want to return home, which may be possible with an appropriate level of preparation and support. Someone must handle this coordination. For instance, the house will need updating for handicap access. If moving closer to a family member is advised, someone must coordinate home and asset sales, and oversee the relocation. Regarding care, you must research, interview and choose an in-home caregiver.

But contracting professional services is only part of the solution. The need for personal, ongoing involvement exists, regardless of whether care takes place at home or in an assisted living center. You must regularly monitor those in charge of your parent's daily routine. Moreover, some errands, activities, duties and decisions require a family member's direct input. This necessitates that a family member or trusted friend live nearby.

• **Business coordination.** Your aging parent may become less active as capacity declines. But someone must handle his personal business and provide operational support. Maintaining the house and automobile, paying bills, managing bank deposits, budgeting, and responding to a host of less routine duties and obligations all require an overseer.

Neither an in-home agency nor an institution will fill this role. Although a trust company, accounting firm or financial services provider may offer certain services, you will personally do more than expected. Advance preparation, such as maintaining a joint checking account, appointing a durable power of attorney and accompanying your parent to financial planning meetings, can lay the groundwork for a smoother transition.

• **Financial and estate management.** An estate plan directs the distribution of assets after death through a will and possible trust arrangement. But the plan also should consider incapacity and prepare others to manage finances and protect assets for your parents. A power of attorney, health care directive, living will and trust arrangement all may serve important functions to enable a smooth transition of legal authority without having to endure the cost and time drain of a public court proceeding.[2]

Your parents should document their financial wishes and choose a trusted individual or institution to act as their agent. This agent performs quasi-personal functions, such as filing taxes, applying for Social Security and Medicare benefits, signing contracts, making investment decisions, coordinating retirement distributions, processing mail and conducting legal business.

Documentation makes the agent's job a lot easier. Trusted family members should know where to find legal papers, as well as other important documents, such as brokerage and bank accounts, life and property insurance, titles to home, auto and other assets, loans, credit cards, income tax returns and other papers designating proof of ownership.

Planning for dependency and incapacity can be emotionally taxing for parents and children alike. But it's a wise move. Preparing to manage the three main areas of support is most effective and economical when your parents can still clearly understand the issues and make decisions that work best for them.

If they wait too long, fate may put the wrong people and impersonal systems in charge of their life. ■

(1) Signs of fading capacity may include difficulty with conversation, reduced attentiveness, memory loss, poor hygiene or appearance, less tidy surroundings, loss of weight, depression, reduced social contact, irregular schedule, lack of physical activity, unpaid bills and financial mistakes, frequent falls, and failure to take prescribed medications.

(2) The power of attorney authorizes another to handle personal financial and legal matters for the dependent. A durable power covers a broad range of activities, while a limited power has specific rights. A medical power gives one the authority to make important health care decisions, and a living will documents one's preferences regarding life support and other end-of-life issues.

Shaming the Bears
(Continued)

A diversified portfolio may include other categories and sectors within the U.S., as well as a risk-appropriate mix of asset groups within international equity markets. According to portfolio theory, this extended diversification can reduce volatility while enhancing your compounded return.

To understand this point, look beyond the S&P 500's 28.7% annual return in 2003. The Russell 2000 Index, which reflects small company U.S. stocks, gained over 45%; the U.S. microcap sector, which reflects the smallest 20% of stocks, returned over 60%; and the MSCI EAFE Index returned 38.6%.

Of course, these and other indexes reflect different levels and types of risk. But the argument stands for diversifying beyond the most familiar U.S. benchmark. Investors and professional managers who focused exclusively on large cap U.S. stocks missed the opportunity for higher portfolio returns in 2003. Experience also shows that a globally diversified strategy also helped limit the pain felt during the 2000-02 market decline.

• Lesson 3: Individual behavior has a major influence on the investment return you receive. You can diversify according to modern financial principles. But investors must also manage their emotions and behavior to avoid the poor decisions that have spoiled investment returns time and again. This is the key to building wealth over a long time horizon.

Moving into the second quarter of 2004, many financial experts in the media are again highlighting the economic and geopolitical uncertainty bubbling in the market. Some skeptics claim that the 2003 rebound is a classic "sucker's rally" that typically appears during a longer bear market stretch.[2] They warn that the market's overall price-earnings ratio is too high, and stocks gained too much value too quickly in the past year.

Some forecasts and predictions for the remainder of 2004 will shake many investors' confidence. For the seasoned investor, the pundits' words will have a familiar ring. But keep your perspective. With a solid investment strategy and hard-earned discipline, you have everything needed to endure the unpredictable market. ■

In My Opinion…

Robert J. Cole, Jr., CLU, ChFC, CFP™

Chasing the Horizon

I was playing golf with a few of the club members last week when I had an interesting insight. It seems that most golfers can't accept any of the perfection of their golf shots. After almost every shot, they seemed to immediately point out how the shot could have been better. This constant comparison to the "ideal" golf shot leads to a disappointment in the whole round. The fact that we were outside with perfect weather, on a beautiful course, and in great company seemed to be lost on them.

I recently attended the Financial Planning Association's 2004 Retreat. This is a wonderful meeting attended by the top people in our industry. Since only three hundred attend, there are plenty of opportunities for social activities. This year the event was held at Cheyenne Mountain Resort in Colorado Springs. We all were looking forward to several outdoor events in the clear mountain air. Instead, we were treated to three days of a low pressure system that left us socked in a foggy, damp cloud. The event planners moved most of the events indoors and, judging from the participants' enthusiasm, no one was worse for the wear. What makes us decide what we focus on?

It appears that human nature, in its effort to achieve perfection, always concentrates on what is "wrong" with something. It seems that we all harbor a concept of the "ideal" and we spend most of our energy in trying to attain it. Yet, most of the time, the ideal is unattainable. I have heard it compared to the horizon. We all can see it, but the closer we get to it, the further it moves away. We all agree it exists, but we can't actually arrive there. By comparing our current situation to this unattainable ideal, we place a great deal of stress on ourselves. We feel inadequate and frustrated with our status. It seems a much better approach would be to focus on the progress we have made in the past, rather than comparing our present to an ideal future. This approach allows you to feel confident and a have a sense of accomplishment.

Take the dieter who is comparing their progress against their "ideal" weight. They see themselves as "fat" people trying to lose weight, getting frustrated and feeling unsuccessful. Now look at the person who is comparing their progress to last week's or last month's weight. They can see themselves as a thinner person than they were then, and feel confident and successful.

We all suffer from this problem when it comes to investments. Everyone always wants to focus on the investment that is doing "bad" rather than the overall growth of their portfolio. In a well diversified portfolio, there are always a few investments that are out of favor. Still, when taken as a whole, the diversified portfolio usually has a positive performance. Once again it is an issue of focus.

In *Financial Life Planning*, we try to get our clients to focus on the overall quality and progress that they are making with their lives. Instead of worrying about the couple of investments that aren't "working", we ask the questions, "*How satisfied are you with your life?*" and "*What progress have we made since last year?*" In most cases, this frames their situation in a better context and the result is that they gain satisfaction with the present and confidence about the future.

The truth is that this change of focus is a matter of choice. The next time you find yourself absorbed with the negative, ask yourself, "*What is it that I can find in this situation that is positive?*" Then focus your energies in that area. Stop chasing the horizon and enjoy the perfection of the moment. Finally, celebrate the progress that you have made and be confident that it will lead you where you are supposed to go. Trust the process, *not* the plan.

Until next time, that's my opinion.

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President