

March 3, 2004

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Investing Basics, Part I

What color is your parachute? Answer that riddle, and you will have opened the door to understanding your life, your work, and perhaps what kind of investor you are or will be.

In 1970, Richard Bolles published the business book "What color is your parachute?" It was one of the first job-hunting books on the market and its impact has become the mantra for many. In fact, in 1991, the Library of Congress had noted it as one of "25 books that have shaped readers' lives". And, in the October 2004 airing of NPR's Motley Fool Show, it was revealed that the book "has sold over 8 million copies to date and continues to remain popular to this day".

The main emphasis of Bolles' book is that the job-hunter can improve their effectiveness by figuring out what they like to do and can do well, then searching for a place that needs people like them. He also emphasized, in a FastCompany magazine article, "if you don't take the time to figure out who you are and what you want to do with your life, you will be at the mercy of all those forces out there today".

So, you might ask, what does a book on job-hunting have to do with investing?

Everybody has his or her own unique personality characteristics. Some people are extroverted, while others are introverted. Some people are warm and friendly while others are short and to the point. The same is true in investing. Investors have their own investing styles. Some are risk takers, willing to gamble large amounts of money on speculative investments. While others prefer the security of cash "under their mattress" even if it means that the actual buying power of their money is being eaten away by inflation.

Most people fall somewhere in between these two extremes, willing to assume some risk, with the expectation that they'll be rewarded with higher returns. The amount of risk you're willing to take, both in terms of amounts at risk and types taken, has a lot to do with your particular investing personality and style. When these traits are well matched with an investment program, greater opportunities for success will exist; and, when not well matched, the result can often be disastrous.

As mentioned in our prior newsletters, we strive to provide articles on various aspects of wealth management to assist your understanding of why planning for the present and for your future has importance. Yes, we also promote our services; yet, you will find that we always seek to present thought provoking topics that are relevant to our wide audience.

This month's letter is the first of a two-part series that will touch upon various types of investors, how to find your investment style, and how to find an investing program that fits. I suspect that new or novice investors should find this letter useful, and I'll not be surprised if the more experienced find it interesting as well. Lastly, we will finish with a note on why this year might be challenging for speculators and we'll also update on our investment activities.

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Investor Category Types

To begin, let's start by taking a look at the types of investors competing for investment opportunities in the marketplace:

Individual investors. People who fall in this category are persons who manage their own portfolio with or without help from professionals. In terms of investment knowledge, personality and style this is the most diverse group. This group would not include a corporation, partnership or any other entity; nor would it include any person in the business giving investment advice or services for compensation.

Institutional investors. This group is responsible for managing portfolio investments on behalf of an organization or entity. And, the organizations or entities they represent come in a number of various types and sizes. Some of the more common "institutions" are described as follows:

Companies. Traditionally, banks, insurers and private investment companies (AKA "hedge funds") are the largest in this group. However, according to Wilmington Trust Company, many corporate treasurers are currently holding cash in their coffers and turning to outside investment managers rather than expanding payroll costs to manage the cash "in-house".

Pension funds. The New York Times reports, "An estimated \$5 trillion sits in thousands of pension funds across the nation, run for the benefit of private company, state or municipal workers who rely on the funds for retirement income. Some funds are huge, with billions of dollars under management, and are overseen by a board of finance professionals. Many, however, are tiny, with just a few million [or less] invested. These funds are often run by company executives or volunteers less versed in the ways of Wall Street."

Endowments. These are investment funds established for the support of institutions such as universities, colleges, private schools, museums, hospitals and foundations. Like pension funds, the larger ones are generally overseen by a board of finance professionals and the smaller ones, by volunteers.

Trusts. There are many types of trusts, and they can be complex. But the best way to think about a trust is simply this: A trust is a flexible and advantageous way for a person to leave his or her assets to future generations and simultaneously reap certain benefits, if he or she so desires. The trustee is responsible for carrying out the terms of the trust, and for its investments.

Registered Investment Advisors and their representatives. This group is comprised of professional investors who make investment decisions on a client's behalf and are often paid fees from assets under management. These professionals devote full time and attention to managing your portfolio. They can watch and assess the market and the different types of securities far better than those who do so only part time. As with any endeavor, the characteristic of being specialized provides benefits in the form of knowledge, contacts, access to unique investment opportunities, computer support systems and experience.

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Broker/Dealers and their representatives. This group is comprised of investment professionals who offer recommendations and can help clients make decisions. These professionals supply institutional and individual clients with pertinent facts to assist them in buying or selling stocks, bonds, commodities, and options. When acting as a broker, a broker/dealer executes orders on behalf of his or her client; and, when acting as a dealer, a broker/dealer executes trades for his or her firm's own account. They may also provide introductions to registered investment advisors. While most commonly paid commissions from the transactions they facilitate, some may offer fee arrangements. Unlike institutional investors and registered investment advisors, this group has no fiduciary responsibility to the investors they serve.

Investment Style Categories

The term investment style refers to an investor's basic approach to choosing investments. Understanding your cognitive investment style will allow you to take a planned approach to investing. It will give you a framework to follow, without which, you'll be making random investment selections based on an advertisement you read or a "hot tip" you've heard from a friend, relative or acquaintance.

As I was gathering available research on this subject, I was quickly getting lost to a dizzying array of explanations for various investor styles. Despite the many explanations to be found, most people fall – more or less – into one of three broad categories: conservative, moderate and aggressive.

For each of these categories, I will use the descriptions provided by the Foundation for Investor Education as follows:

“Conservative investors. Generally, conservative investors feel that safeguarding what they have is their top priority. More formally, this approach is called *capital preservation*. These investors want to avoid risk – particularly the risk of losing any *principal* – even if that means they'll have to settle for very modest returns.”

By the way, my online dictionary defines risk as: the possibility of suffering harm or loss; and also, the expected variability of returns from an investment.

“Moderate investors. Moderate investors want to increase the value of their portfolios while protecting their assets from the risk of major losses. They usually buffer the volatility of growth investments, such as stock, with a substantial portion of their portfolio allocated to produce regular income and preserve *principal*...If you're not a risk taker by nature, a moderate investing style may be suitable in any circumstance or financial situation.”

“Aggressive investors. Aggressive investors concentrate on investments that have the potential for significant growth. They are willing to take the risk of losing some of their principal, with the *expectation* that they will realize greater returns...An aggressive investing style is not for the faint of heart. It's best suited for investors with a long-term investing horizon of 15 years or more, who are willing to make a long-term commitment to the stocks they buy.”

Your cognitive investing style already exists! You just have to learn how to become familiar with it. Your style is developed from a variety of things, including your age, personality,

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experiences and current financial situation. "For instance, if you're approaching retirement, have burdensome financial responsibilities, or you've lived through major economic upheaval, such as a massive recession or currency devaluation, chances are you may be a more risk averse, or conservative, investor... On the other hand, if you're young, earning a high income, have few financial responsibilities, and have seen little in the way of economic hardship, you might be more inclined to take risk."

Some Part I Concluding Thoughts

As you can see, there is much information to cover when trying to touch upon various types of investors, how to find your investment style, and how to find an investing program that fits. At least, when trying to keep my newsletter to its normal length.

If after reading this introduction, you come away with a good idea of investor types and some basic investment style categories, then we're off to a good start. Next month, we'll try to expand and discuss more about investment style and try to offer some insight on how to recognize investment opportunities that match your style.

For my experienced readers, some who have been aggressive investors most of their lives, it may be time to take a second look at your portfolios and re-assess. You may feel that you have plenty of guts in terms of risk tolerance, although it may be timely to ask yourself: Are you still able to take losses in stride? Are you still able to hang on through the market's inevitable ups and downs? Can you still withstand the possibility of your nest egg taking a severe hit? If not, you may want to revisit your appropriate investing style and strategy!

We're At Your Service

At Hoffman, White & Kaelber Financial Services, our focus is to help our clients achieve a more certain future. As such, our wealth management clients gain comfort in knowing that we've helped them identify their investment style and that they've hired disciplined decision makers whose objective favors consistency of returns and capital preservation rather than magnitude of returns. And, we're always thinking of ways to help our clients' keep what they've earned!

Hoffman, White & Kaelber Financial Services Investment Performance Update

More and more, I am reading about interviews with some of our nation's more seasoned economists warning that the US stock market is going through a "topping out" process. The bull market rally that began in October 2002 seemed to have reached its initial high somewhere during March of 2004. Then the market went sideways for most of the last year until after the presidential election when it reached new a new two-year high. It should be interesting to note that, these experts do not believe the rally will extend much higher and expect the market to correct with a probable bear market bottom being reached sometime in late 2006. I don't know about you, but I've learned to respect the warnings of these "old timer" finance professionals over my 20 plus year career. When we began to position our client portfolios defensively last May, indeed, it was too early. We took a "rather be safe than sorry" approach. Since then, the US economy has shown some strength despite the negative pressures of increase energy prices and short-term interest rates. We'll be keeping

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our eye on valuation levels and may take some measured risk, but it can be expected that we may also take further steps to benefit from a marked down turn in the US stock market. History shows that up markets often grow gradually, and down markets can be very abrupt. In this kind of market environment, one really needs to do their homework!

For the month ended February 28, 2005, our one-month performance is up 0.59%, our three-month return is up 2.11%, our one-year return is off 1.88%, and our average annualized return since inception is up 9.40%. While volatility (risk) steadily continues to increase in the equity markets, our risk profile has crept downward further to +/- 6.18%. This conservatively low risk level remains consistent with our strategy. With our expectation that this statistic gains increasing importance, our Sharpe Ratio improved to a very respectable 1.31.

About Measuring Risk and Sharpe Ratios

Investment pros borrow a tool from the statisticians—standard deviation—to measure investment risk. It shows the *range* of returns that investments are likely to earn over a given period of time and it has two sides, the out-performance and the under-performance of an average rate of return.

The Sharpe Ratio is a commonly used measure of portfolio earnings quality. In short, the Sharpe Ratio is a measure of return achieved per risk taken. Sharpe ratios can be better than just looking at performance because it incorporates the issue of risk. Some would say it is a measure of a manager's ability to perform consistently. The number by itself, however, is hard for many to understand without comparing it to something.

Let's take a look at the S&P 500 Index for a quick comparison. The Standard & Poor's 500 Index is usually considered the benchmark for US equity performance. As the name suggests, the S&P 500 consists of 500 companies from a diverse range of industries. Contrary to popular belief, the S&P 500 is not a simple list of the largest 500 companies by market capitalization or by revenues. Rather, it is 500 of the most widely held US-based common stocks, chosen by the S&P Index Committee for market size, liquidity, and sector representation. For the last ten years, the Sharpe Ratio for the S&P 500 is less than 0.40 and it doesn't look much better when looking over the past thirty years.

Are you familiar with Morningstar, Inc.? They are a Chicago-based, global investment research firm, providing information, data, and analysis on the mutual fund industry. They say that a Sharpe Ratio of over 1.0 is "pretty good" and outstanding funds achieve something over 2.0. Using this "yardstick", we are more than pleased with our accomplishment to date.

For most investors, the Sharpe makes good intuitive sense because they not only hate to lose money but they often compare the returns to risk free investing. You owe it to yourself to understand and consider this measure when making investment decisions.

**Is a comfortable retirement or preservation of wealth important to you?
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