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Investing Basics, Part II

In part one of Investing Basics, I opened by discussing: "What color is your parachute?" Richard Bolles' book seemed an appropriate example to introduce the importance of determining your investing style before determining what investments you should be making. And, from the feedback I received, many enjoyed that segue.

For this letter, I will use another literary classic. Last month, with my younger son, I re-read "The Little Prince" and was amazed to be reacquainted with the valuable lessons found in it.

In Chapter 22 of this children's classic, the prince comes upon a railroad switchman at work. The dialogue seems to imply that, for adults, train rides are rushed voyages that never result in happiness because "no one is ever satisfied where [they] are". As trains rush towards each other from opposite directions, it is suggested that grown-ups are often preoccupied in their pursuits. Yet, viewing the world through a child's eye enables another perspective. It is the children, with their faces pressed hungrily against the windows taking in scenery that see the journey as more important than the destination.

Antoine de SaintExupery, writing at a level at which children comprehend, delves into a social and psychological discussion regarding the human experience. His effort reflects on how 'adults' sometimes narrowly view the world, its people, and what they have to offer. The lessons in this book range from personal relationships to business, touching on the subjects of guilt, greed, power, and love. This simple, 96 page story about a little boy speaks volumes louder than you could imagine.

For adults, this book can provide a lesson in the importance of self-reflection. For investing adults, gentle reader, starting your journey through self-reflection and determining your investing style will provide you increased chances of happy experiences in your journey toward your goals, into retirement and beyond.

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 will complete our two-part series touching upon various types of investors, how to find your investment style, and how to find an investing program that fits. From the comments received on our prior letter, I'm very happy many of you have found this topic useful. Thank you for your kind feedback. Lastly, we will finish with a review of the investing climate for the month past, our performance, and an overview of how our investment team will be preparing to take advantage of what we see in the markets lying ahead.

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Investment Style Categories

We left off last month discussing types of investors and some basic investment style categories: “Conservative investors, Moderate investors, and Aggressive investors”. Now we shall expand on this by discussing different profiles of investors in order to help you spot how some might be successful at investing and why others are not.

The following is a brief mosaic of researched articles from MotleyFool.com’s Selena, Psyconomics.com, Merrill Lynch and from the book “Mind Over Money”, written by John Schott and Jean Arbiter. Which of these, or combination thereof, sounds like you?

The Cautious, “Make-Me-Safe”, Worried Investor. Very conservative and often self-critical about their decision-making, these investors cannot stomach losing any money. These people will avoid high-risk opportunities as well as listening to professional advice. They won’t rush into investing and give every financial opportunity a great deal of thought. This often paralyzes them into inactivity. These people are destined to earn low returns that don’t keep up with inflation. This type might benefit from putting forth an effort to learn about investment risk or limiting themselves to money market funds.

The Emotional, Impulsive, Gambler. Easily attracted to fashionable investments or ‘hot’ tips, these investors act with their hearts and not their heads. They are very likely to invest based on past performance without considering risk. Often addicted to the thrill of the market, a whim or a gut feeling leads their decisions. They invest with the belief that things will come right in the end and are often willing to take bigger risks to try to make up for their prior losses. These people would certainly benefit by hiring a professional or by doing research before buying and writing down expectations and standards for selling.

The Busy, Technical, Power Investor. Overly confident and attracted to speculative situations, this type of investor is easily drawn to active trading based on price movements. As well, any tidbit of information they can glean is imbued with significance and a cause to take financial action. Unless trading gets the best of them, these people should excel in bull markets but are likely to get “wiped-out” in bear markets. Always looking to gain some advantage, they are inclined to buy the latest technology to help their efforts. These do-it-yourselfers should focus on doing thorough research and resisting impulsive trades.

The Casual, Informed, Psychologically Successful Investor. Self-confident and patient with reasonable expectations, they may sometimes miss the best opportunities but believe that knowledge and experience will always win out to give them long-term profits. They tend to believe that a good job or a profession is the way to make real money and often leave the running of their investments to their professional advisors. This investor listens carefully to financial opinions and expert assessments, only acting after weighing the pros and cons. Often hardworking and involved with work or family, they remain open-minded and treat mistakes as learning experiences. These people should continue what they’re doing.

The term “investment style” refers to an investor's basic approach to choosing investments, whether we’re talking about stocks, bonds, real estate, and so on. If you’re investing on your own, your investment style will dictate how you make your choices. Similarly, if you invest with a professional that makes the selections for you, you need to be sure that their style matches your own.

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By selecting a style that matches your attitude about money and financial situation, you boost your chances of getting what you want out of your investment program. As well, during your lifetime, you'll need to adapt your investment style now and then to match your changing needs and finances. Bear in mind, though, that your investment style must have a longer shelf life than a year or two. An investment style is not something to abandon because it's last year's model, or because you're impatient for better results. Being successful in investing depends on choosing an approach and giving it time to work for you. You should only alter your style when your life goals or circumstances change significantly. This will then call for making a similar shift in your investment approach.

Finding your investment style is the key to devising an investment strategy that takes you where you want to go. Before you adopt an investment style, however, you'll need to examine several factors. For instance, what is your risk tolerance? This will depend partially on your personality. Blunt realism is in order here. Would you be able to take losses in stride during the short term? Or, would any losses now leave you financially strapped and unable to pay your current debts and living expenses? Are you able to hang on for the long haul, even through the market's inevitable ups and downs?

Other factors to consider are your age, financial goals, and time frame. When will you need to use the money you're investing? If you still have a few decades before retiring, or if you'll have ample opportunity to regain whatever short-term losses you might incur, an aggressive investment style might serve you well. But if you'll need the bulk of your retirement money all at once, or you'll be sending a child off to college in five years, you simply can't afford to let your nest egg take a severe hit. You will be better off with a less risky style.

Finding Suitable Investments

Look at any investment journal or Morningstar report and there is enough technical jargon and numbers to make you cross-eyed. How do you know what measures or indicators to consider when selecting investments?

First, it is important to know that different types of investments perform better under different economic conditions. By choosing investments that are generating the highest returns at any given time, you may not end up with a broadly diversified portfolio. When conditions change over time, investment results are likely to change as well. Before focusing on individual investments, it is important to determine an overall strategy that will include investments of different types, styles, sectors and/or geographic influences. This is referred to as a portfolio or asset allocation.

Second, and most importantly, annualized returns or average returns over time do not tell the whole story! By focusing the selection process on performance only, the average investor is ignoring risk. Some of the top performing investments may also have higher risks associated with them. One measure of risk is standard deviation. I know it sounds like a highly technical term, but it boils down to measuring how results vary in the return of a particular investment over time. The higher this number is, the larger the variation in results. Volatility is not always bad, but what level is acceptable will depend on how long it will be before you might need to use the money and how sensitive you are to seeing negative returns.

Other factors to consider beyond performance for professionally managed investments include: how long a particular manager has been managing investments and what their

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experience level is, how closely they stay within their stated investment style, how many or how broad are the portfolio holdings (the broader the holdings, the lower the presumed risk) and how high the management fees are compared with similar investments.

Concluding Thoughts

To invest successfully, you need to assess your own attitude to risk when you start out, then regularly reassess this factor in the light of your changing circumstances. You can do this with your investment adviser, but if you want to be guided rather than led, you can do it on your own and I hope that this article gave you a few pointers.

Most peoples' attitude to risk is defined by two of the basest human emotions, greed and fear. Greed drives the profit motive while fear of losing capital should control the level of risk we're prepared to take. Yet attitudes can differ when it comes to how much risk we should take. For instance, an aggressive investor might view buying individual stocks as being moderately risky and see futures and options trading as high risk. While a more conservative investor might see individual stocks as being a high-risk strategy and would prefer diversified investments like mutual funds, which they would define as moderately risky. This divergence of opinion exists not only between individuals, but also between investment advisers; so what common standards exist?

The most accurate are those used by the investment industry and the best known measures of risk are Standard Deviation and Sharpe Ratio. These are specific and excellent for comparing relative performance and investment volatility. However, for many investors they may represent two more terms used by professionals to confuse the public!

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. Our best clients are those who are moderate to conservative risk takers. And, we're always thinking of ways to help our clients' keep what they've earned!

Hoffman, White & Kaelber Financial Services Investment Performance Update

Both stock and bond markets sold off during the month as fears of inflation grew stronger. The Federal Reserve's decision to raise the Fed Funds rate to 2.75% on March 22nd marked the seventh consecutive meeting at which it raised short-term rates. What made the markets react worse this time than the previous six times was new language in the Fed's statement voicing concern about increased inflation risk. The yield on the 10-year U.S. Treasury note, which had actually declined during previous tightenings out of fear that the Fed's actions could lead to an economic slowdown, now shot up out of fear that the economy was overheating. It now appears clear that the Fed intends to continue raising interest rates until a "neutral" interest rate policy is in effect. What short-term rate currently constitutes "neutral" for the economy is unclear, but most economists agree that it is at least 4 percent, which is 125 basis points above the current level.

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What does a rising interest environment mean for an investment portfolio? With regard to the fixed income portion of the portfolio, it means that interest rate risk should be minimized and replaced with more credit risk. Thus, U.S. treasuries, which have no credit risk and substantial interest rate risk, should be replaced with instruments such as: (1) bank loans, whose repayment terms reset to a higher interest rate every few months if prevailing interest rates are increasing; (2) higher-yielding equity-like bonds whose performance depends more upon a strong economy than upon the interest-rate backdrop; and (3) foreign bonds that can benefit from a weaker dollar as a cushion against higher rates.

With regard to the equity portion of the portfolio, some caution is warranted because higher interest rates mean higher borrowing costs for businesses, thus reducing future profits, as well as lower price-earnings multiples, because future-year earnings are discounted more heavily in valuation models as a result of eroding effects of inflation. However, higher interest rates also signify a strong economy in which current earnings and profits can grow significantly. Thus, we are expecting low, single-digit equity returns over the coming 12 months, with most of this return occurring in the second half of the year as the market rejoices at the prospect of the Fed ending its current tightening cycle.

The key to investment success is to focus on those industry sectors that perform best in the late stages of an economic cycle and that can benefit from inflation by means of raising prices. Among the sectors that we like now are health care, industrials, technology, and energy. Sectors we are avoiding or using as a hedge include interest-rate sensitive spaces such as electric utilities, financials, real estate, and consumer discretionary. International equity markets remain somewhat attractive, both from a diversification standpoint and as a currency play. However, higher U.S. interest rates may cause the dollar to strengthen, thus hurting foreign equity returns.

Of course, a time always comes when the Federal Reserve overshoots and raises interest rates too much and chokes off economic growth, resulting in a recession. We remain on guard for such a scenario because the detrimental effect on equity markets is so severe when it does occur. However, we do not believe that the dangers of recession are great at the current time given that the treasury yield curve (i.e., the spread between the Fed Funds rate and the ten-year treasury note) is not only upward sloping but the spread has recently begun to increase.

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.

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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?
Want better long-term results from your investments?
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