THE EDUCATED INVESTOR

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Weighing Your Index Fund Options

Readers of *The Educated Investor* know that we advocate passive asset class investing. The good news is that there are a growing number of index funds that attempt to incorporate the passive asset class investing we have been endorsing all along. The challenge is, as more passive asset class and index funds become available, how do you determine which ones are right for you?

In choosing passively managed funds keep in mind the ultimate goal – achieving your investment objective within an acceptable level of risk. While we believe creating a personal investment policy is a fundamental part of determining this goal, we believe that the careful selection of funds is also essential. The best funds should allow you to achieve your overall objectives with the following characteristics:

1. Low correlation between individual holdings
2. Effective diversification
3. Lower volatility
4. Greatest exposure to the risk factors being sought

A Good Buy vs. a Good Value

Some funds cost less because they have lower Operating Expense Ratios (OER). However, focusing solely on OER confuses the more important issue of worth. As the wise consumer knows, the lowest cost doesn't always mean the highest worth. To achieve the highest worth, we advise investing in funds that are expected to produce better returns for the risk being taken. The most likely way to achieve this goal is to incorporate funds with the greatest exposure to the small-cap and value asset classes — those expected to provide higher returns.

How much each person allocates to the various asset classes is different. Your investment advisor will work with you to make that determination. The key, however, is to have the right tools to work with to create a portfolio that is right for you and that holds low-correlated funds.

What Does the Fund Track?

By definition, an index fund's objective is to track or replicate a common index (the S&P 500 or Russell 2000, for example).

Unlike index funds, passive asset class funds track specific asset classes. These funds do not rely on an index to capture the asset class. They instead rely on rules established by academic research and common sense that dictate what we expect is

Continued on page 4

What's Inside?

Strengthen your investment know-how with our quarterly Investor Tester. This quarter's test involves the parable of the Tortoise and the Hare ... with an investment twist.

Thomas Tortoise, the slow and steady type, took a while to begin his savings. But once begun, he was a faithful saver. Stashing $10,000 per year from age 35 to his retirement at 65, he contributed $300,000 toward his golden years. Meanwhile, Harry Hare leapt out of the starting gate early. He began saving $10,000 per year at age 25. However, he quickly grew bored with his regimen and, at age 35, stopped saving. Thus, he contributed only $100,000 toward his retirement.

Assuming both earned an average annual 10 percent return on their savings (with earnings reinvested), who should enjoy the most comfortable retirement at age 65?

Turn to page 4 for the Investor Tester Instant Answer

Modern Portfolio Theory

Where It All Began

In 1990, the Nobel Prize in economics was awarded to Harry Markowitz, Merton Miller and William Sharpe for their contributions to the body of work known as Modern Portfolio Theory (MPT). Their studies helped demonstrate that investors can have a positive investment experience if they adopt passive asset-class investing – the strategy we help you implement. Here are MPT's components:

1. **Markets process information so rapidly when determining security prices that it is extremely difficult to gain a competitive edge.** What edge might be gained is typically lost to the higher expenses involved in the effort. In other words, if you are highly unlikely to beat 'em (the markets), you might as well join 'em (by indexing or passive asset class investing).

2. **New information affecting security prices is random as to whether it is better or worse than the market expected.** In the wild world of the market, a stock's price is determined not by whether the next piece of news is good or bad (a good or bad earnings report, for example), but whether it is better or worse than what was generally expected to occur — a slippery and unpredictable factor to grasp at best, and one upon which we do not advise investment decisions be made.

3. **Over time, riskier assets provide higher returns as compensation to investors for accepting greater risk.** The asset classes with higher expected returns are small-cap stocks (vs. large-cap) and value stocks (vs. growth). Human nature helps explain this phenomenon. After all, few would enter into ventures that are known to be more risky unless they expected to receive higher rewards.

4. **Adding high-risk, low-correlated asset class funds to a portfolio can actually reduce the volatility of a portfolio while creating an expectation for higher rates of return.** Among MPT's most intriguing and advantageous conclusions is that the sum is greater than its parts. By combining asset classes that are individually more risky but that have low correlation to each other, you can actually reduce overall portfolio risk and retain the expectation for higher returns. Perhaps there is such a thing as a free lunch.

Let Us Count the Ways ...

How do we, as our clients' Registered Investment Advisor, add value to their investment experiences? Following is a quick reference:

Education

- Education on the effectiveness of Modern Portfolio Theory and passive asset class investing
- Continued access to the latest academic research on financial markets
- *The Educated Investor* **Newsletter**
- *The Educated Investor* **Mid-Quarter Supplements** — A more in-depth analysis of investment topics, mailed to clients quarterly

Effective Portfolio Construction

- Access to institutional passive asset class funds that are low cost and tax efficient, including tax-managed funds
- Greater ability to diversify through more asset classes, particularly international
- Most effective diversification through lower correlating asset classes
- Greater exposure to the risk factors of size and value
- Alternative investment vehicles for special situations

Ongoing Service and Discipline

- Periodic rebalancing recommendations to maintain your investment policy while considering transaction costs and taxes
- Discipline necessary for long-term investment strategy
- "Concave vs. convex" investing (Buying low / selling high)
- Quarterly reporting and complimentary consulting on various financial issues
- Fee-only pricing structure aligns our interests with yours
- **And most importantly… A Trusted Advisor Relationship**

For Your Reading Pleasure

Devil Take the Hindmost: A History of Financial Speculation

By Edward Chancellor

An important lesson we gained from reading this book was never actually directly stated in the book: Should you ever feel that there is something new and different going on in the world of investing and investor speculation, think again.

Internet stock mania? In the 1600s, Europe was trading tulip bulbs with equal fervor — the prices of the most prized bulbs grew as out of proportion as the value of some recent Internet high flyers. The book lists many similar investing "bubbles," both modern and historic.

Day Trading? A quote from a Dutch newspaper reporter about the 1700s South Seas Company investing venture: "The owners of capital prefer to speculate on shares than to work at their normal business."

Extended Trading Hours? We've seen recent press releases announcing this "innovation." Yet, Chancellor's book describes evening-hour trading in 1860s New York, spurred on by "state-of-the-art" advances in communication, such as the advent of the telegraph and the stock ticker.

Such history lessons teach us that, investors unaware of the history of financial follies are doomed to repeat them. Chancellor's book provides an excellent and entertaining way to avoid this fate.

A Timeless Classic …

The Only Guide to a Winning Investment Strategy You'll Ever Need

By Larry E. Swedroe

An essential resource for anyone who would like to know more about the benefits of passive asset class investing. Larry provides in his book a simple and comprehensive description of the passive asset class investment approach to which we adhere — along with practical advice on how to implement such an approach. The book has received positive reviews from the likes of *The Wall Street Journal* and the *Library Journal*.

Insuring Your Future

As your investment advisor, among our major roles is to help you map a plan for "getting from here to there." An important part of this objective is insurance. How much do you need? What kind do you need? When do you need it?

Working with other professionals, your investment advisor can assist you in making these types of decisions. In this and future issues of *The Educated Investor*, look for tips to help you incorporate insurance into your overall financial goals.

Know Thyself

It is estimated that the average family spends two to five percent of its assets on insurance. Yet, investors admit that they often purchase insurance without having a definite objective. For example, for your life insurance policy, do you seek:

- ▲ A death benefit?
- ▲ Estate planning funds?
- ▲ Gifting funds?

Another important consideration when comparing life insurance options is to decide whether you need benefits in the near or distant future. As with investing, your time horizon can affect the type of policy that is best for you.

Insurance Inventory

It also is a good idea to be aware of and understand insurance plans you may already hold. Based on your personal situation, ask yourself the following questions:

1. What do I have?
2. What do I need?
3. Where do I want to go (what insurance will help me meet my objectives)?

For example, you may have originally purchased life insurance to serve as a death benefit. But because of asset accumulation, you may decide insurance could now better serve you as a way to relieve the inheritance tax burden rather than pay actual survivor benefits. Based on your answers to the above questions, you may decide to keep, eliminate or add to your existing policies.

Your Investment Advisor Ally

We encourage our clients to come to us with their insurance questions. We can work with clients to determine the best course to get answers to those important questions. Contact your investment advisor at any time for more information.

Weighing Your Index Fund Options (cont.)

the best manner to achieve the desired exposure to an asset class. We advise our clients to include these types of funds in their portfolio since they best achieve our four objectives of low correlation, effective diversification, reduced volatility and optimum exposure to risk factors.

Additional Benefits From International Funds

The importance of proper diversification cannot be overstated. Including international exposure is an important element in meeting this objective. Not all international funds maximize such benefits. Studies have shown that using international funds with exposure to the international small, value and emerging markets can help accomplish the desired diversification. Most international index funds track the EAFE (Europe, Australia and the Far East) index, which primarily captures only the international large-cap asset class. We don't believe this provides sufficient diversification.

The construction of emerging market funds is also of particular importance. Some index funds replicate Morgan Stanley's emerging market index, which is market-cap weighted. For example, if Brazil represents 40 percent of the current emerging market capitalization, then 40 percent of the index's holdings will be in Brazil. Thus these funds can have a very high percentage of their investments in just a few countries at any given time, resulting in less effective diversification. Particularly in the high-risk arena of emerging markets, we believe a more effective strategy is to own a fund that is equally weighted, where all included countries are equally represented.

Tax-Managed Options

For your taxable holdings, it's also important to invest in an array of tax-managed funds in both domestic and international markets. We expect tax-managed funds to improve long-term after-tax returns, and thus we advise including them in taxable portfolios.

The Advantage of Institutional

Even with the many index funds available, it is still difficult to find passive asset class funds that incorporate risk factors, international investing and tax-managed options. For our clients, we turn to institutional funds typically unavailable to the general public. We believe institutional funds offer investors important benefits, including reduced exposure to possible "panic" selling by the public, particularly in bear markets, that could leave remaining shareholders with higher taxable distributions.

Good, Better, Best

As in so many other areas, the theory of "caveat emptor" should prevail in deciding how to invest your assets. There are lots of index funds available, and we feel that any index fund is likely to prove a better investment than its actively managed counterpart … should you adhere to a long-term, buy and hold strategy. Some, however, are definitely better than others. Your investment advisor can help you gain access to, and stay invested in, the best.

Instant Answer
(from page 1)

For a change, Harry the Hare is the big winner in this parable. Harry put aside less money in a shorter spurt. But because he did so earlier in life, by the time they both reached age 65, Harry achieved a portfolio more than 1.5 times larger than Thomas the Tortoise's portfolio: $2.8 million compared to $1.6 million. (Of course the biggest winner would be neither the tortoise nor the hare, but the wise investor, who begins saving early *and* continues to save throughout his or her career.)

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- ▲ Fee-only investment management
- ▲ A disciplined investment strategy
- ▲ Access to institutional no-load passive asset class funds
- ▲ An academic Nobel Prize-winning investment approach
- ▲ Continued access to academic research
- ▲ A tax-efficient focus, with valuable tax and estate-planning ideas
- ▲ Risk tolerance assessment
- ▲ Periodic portfolio rebalancing
- ▲ Regular communications and state-of-the-art reporting
- ▲ MOST IMPORTANT …
  A TRUSTED ADVISOR RELATIONSHIP