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Now Is A Good Time To Reassess Your Risk Profile

The recent past has given investors an invaluable lesson in risk, which makes now an ideal time to reconsider your “risk profile,” the amount of volatility you’re willing to accept. From the happy heights of late 2007, the Standard & Poor’s 500 stock index lost 55% of its value by March 2009, and much of the damage came sickeningly fast, with a 40% freefall between September and November of 2008. Then came a dizzying recovery, as the S&P rallied 60% between March and December 2009. Yet even after the comeback, the large-company index remained some 30% below its record high.

How your portfolio has fared during this remarkable period depends on how much risk was built into your investments, and on how you responded when conceptual risks became all too real. Many investors, lured into volatile areas of the market when most investments were rising, were shocked when numerous sectors suddenly dropped by more than half. Some of these investors watched helplessly, unable to sell as holdings kept plummeting, while others got rid of everything, determined to stick with cash for the foreseeable future.

Neither predicted outcome was good or anticipated. The purpose of determining your risk profile is to use it to build a portfolio that minimizes disruptive surprises. If you think you can handle a 15% annual loss but would be apoplectic if your investments

dropped twice that much, then you need a portfolio that, in most economic and market scenarios, wouldn’t dip by much more than that “comfortable” 15%.

But markets don’t always behave as predicted. The recent financial crisis highlighted the reality that assets under duress can move together. All manner of stocks—from shares of enormous, normally rock-solid companies to those of small, fast-growing firms and stocks in once-hot emerging markets—headed down together. And while some bonds fared a little better,

Treasuries fared the best as safety-obsessed investors bid up prices and caused yields to decline considerably. And alternative investments, including real estate, commodities, and hedge funds, had major issues of their own.

As a result, most investment portfolios did worse than expected, and that exacerbated the problems of investors who had taken on too much risk. Panicking, many sold when investment values were at their lowest point, and with losses locked in, they’ve missed out on stocks’ historic rally.

Reassessing your risk profile now, and making appropriate portfolio adjustments, could help you prepare for the next financial upheaval. This process may involve several steps. The first is to understand how you really feel about risk. How did you react in September and October of 2008, when

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Rob Arnott And Kristin Ceva Will Address Nov. Forum

WMN is delighted to announce the confirmation of two nationally recognized experts as speakers at our next Wealth Management Forum.

Please save the date: Thursday, November 18, 2010, 5:00 to 8:00 p.m., for the discussion on “Inflation/Deflation: Outlook and Implications for Investors.” The Forum will be held at the Island Hotel in Newport Center, in the Portola Room.

This November 18 Forum promises to be among the most informative in our 23-year history. You won’t want to miss this opportunity to hear from two of the most-quoted individuals in the financial media.

Please start thinking of whom you’d like to invite as a guest and communicate their name to Cheri Billiet at (949) 720-9980 or cherib@theWMN.com. Seating is limited, so don’t hesitate in making your reservations.

Plan also to attend the post-Forum Speaker’s Reception. An array of food and beverage choices will await your consumption while rush hour traffic clears!

We wish you the happiest and healthiest of holiday seasons, and look forward to the pleasure of your company at the November 18 Wealth Management Forum!

NOTE: In accordance with the Investment Advisors Act of 1940, Brochure Rule 204-3, our firm is required annually to offer to each advisory client a copy of our Uniform Application for Investment Advisory Registration (Form ADV-Part II). If you would like a copy of this form and/or if there are any changes in your financial situation or investment objectives, please contact our office.

Yield vs. Risk In Emerging Market Bonds

Stock markets around the world improved in 2009, but the spectacular growth came in emerging markets, which gained more than 75%, according to Barron's. Foreign stocks and bonds swept up a record \$64 billion of American investor assets, with just more than half going into emerging market equities, \$2.7 billion into emerging bonds, and the rest into developed market bonds. Meanwhile, U.S. equity mutual funds lost \$40.3 billion in assets in 2009.

While the money flowing into emerging market bonds represented a small proportion of foreign investment, it was nevertheless a remarkable development. U.S. investors had paid little attention to those fixed-income securities until the global financial crisis reduced yields on U.S. government bonds to next to nothing. Because bonds of developing countries are considered riskier than U.S. Treasuries, they pay more—and recently, a lot more. Some emerging market debt now pays more than U.S. corporate high-yield bonds.

Emerging market bonds provide a good example of the trade-off between risk and return. U.S. Treasuries have historically been considered “risk-less” and pay little. Emerging bonds, which pay plenty, may bring

considerable risks. The Dubai scare, when Dubai World announced in December 2009 that it had to renegotiate at least some of its \$59 billion in debt, reminded investors of the 1998 crisis, when Russia defaulted on its bonds. Back then, some emerging market bond funds sported yields well into the double digits, as they did again in 2008, according to The Wall Street Journal.

Yet despite their volatility, emerging market bonds can serve as an effective tool for managing risk. They can squeeze a little extra yield out of the income portion of a portfolio while also decreasing risk, thanks to their diversification value, and may provide a hedge against the fluctuating value of the U.S. dollar, as long as the currency of the country issuing the bonds isn't pegged to the dollar.

The governments of many developing countries have received

high marks for their handling of the global financial crisis, and if they can follow up with sensible policies as economic growth returns, investors may be more willing to hold their bonds. At the end of 2009, the “risk premium”—the additional return investors receive

for putting money into less stable holdings—on developing world bonds, as measured by JPMorgan's Emerging Markets Bond Index Global, had fallen to just under 3 percentage points above Treasuries.

Many investment experts believe U.S. holdings should account for a smaller proportion of investors' assets than they have in the past, and increasing exposure to international markets could include buying debt in developing countries. We can talk to you about the risks and rewards of such investments and help you review your portfolio mix. ●



Fighting For Lower Credit Card Rates

For beleaguered credit card users, help has arrived. The Credit CARD Act (officially, the Credit Card Accountability, Responsibility, and Disclosure Act), signed into law in May 2009, is being phased in, and major new rules went into effect in February 2010. Banks and other card issuers must now give you 45 days notice before a change to your card agreement can take effect, they can no longer raise interest rates on existing balances unless you're more than 60 days late with a payment, and they aren't allowed to hike the rate on a new card during the first year.

But these changes come at a tough

time for banks. The recession has pushed millions of consumers to the brink of bankruptcy, and credit card losses are soaring. In advance of the new rules, credit card issuers have raised rates, slashed credit limits, and demanded higher minimum payments. To avoid paying punitive fees and rates, consider these tactics.

Don't be late. If your payment arrives even a day after it's due, you'll likely be hit with a steep fee and a harsh interest rate increase—in some cases to annual rates exceeding 30%. On a \$10,000 balance, that comes to more than \$250 a month. The simplest way to avoid being hit with these extra

charges is to be vigilant about paying up, perhaps by arranging for automatic payments. And if there's no time to mail a check, pay by phone or online. Even if there's a small fee, you'll come out ahead.

Read your mail. Card companies can't make changes without notifying you in writing—but that's what fine print is for. Don't throw away inserts that come with your bill or delete email notifications without reading them. If you don't want to accept a higher interest rate or a lower credit limit, write back to say you're closing the account.

Ask for a better deal. Banks have

Japan's 20 Years Lost: Can It Happen In The U.S.?

Twenty years after Japan's "economic miracle" collapsed, the Asian nation still has not recovered its once-vaunted economic clout. Japan's debacle involved a spectacular jump in stock and real estate prices followed by an equally spectacular fall as those bubbles burst, much like the twin "pop" that sent the United States into a recessionary spiral in December 2007.

Does that mean Americans are doomed to spend the next two decades struggling to get their economic lives back? And what lessons can investors learn from the Japanese experience?

Echoes of a debacle in Japan. The start of Japan's so-called "lost decade" in 1990—which has stretched to two decades since that phrase was coined to describe Japan's extended economic malaise—was triggered by a period of irrational exuberance in the 1980s. Loose monetary policy fueled a rapid rise in stock and real estate prices. Driven by speculation, leveraged assets, and investing excess, Japanese industrial production rose by 50% during the 1980s, and by 1989 Japanese banks had become the largest in the world. When the bubble burst in 1990 and the economy collapsed, investors belatedly realized that much of the growth had been illusory.

The same thing happened in the

United States during the period 2002 to 2007, as "easy money" policies, consumer spending, and foreign investment pushed real estate and stock prices ever upward—until the bubble burst, sending over-leveraged financial institutions to the brink of bankruptcy and the U.S. economy to the edge of systemic failure. Two years later, the U.S. jobless rate surpassed 10%, businesses have trouble obtaining credit, and government officials are weighing further intervention in the economy even as the national deficit soars to unprecedented levels.

From an investor's point of view, the story is illustrated vividly by looking at the most-quoted stock market averages in the two countries. Japan's Nikkei average hit an all-time high of 38,957.44 intraday Dec. 29, 1989, then fell off a cliff. In 2009, the Nikkei never exceeded 10,800, and it nearly fell below 7,000 in March. In the United States, the Dow Jones Industrial average soared to a record intraday high of 14,198.10 on Oct. 11, 2007, then plunged as the economy deteriorated, dropping as low as 6,547.05 in March 2009 before rallying back above 10,000 in the last few months of the year.

Why the U.S. should fare better. While the similarities between the countries' boom-and-bust debacles are striking, there are also fundamental

differences. For instance, the U.S. crisis is unlikely to be as deep and long-lasting as the Japanese downturn largely because the U.S. boom period did not even approach the stupendous price increases seen in 1980s Japan. During the 1990s, Japanese real estate lost an average two-thirds of its value. In contrast, U.S. real estate prices are expected to fall 30% to 40%, although some areas, including Las Vegas, Phoenix, and Miami, have seen steeper declines.

Moreover, the U.S. economic structure is more open and fluid than that of Japan, where banks and major industries had a tendency to sweep problems under the rug. In the United States, major banks have quickly (with the push of the government) written off billions in bad debt in an attempt to get a recovery going without unnecessary delay.

But the most basic difference between Japan in 1990 and the United States today lies in the speed in which interest rates were lowered. American economists, most notably current U.S. Federal Reserve Chairman Ben Bernanke, have criticized Japan's central bank for failing to reduce interest rates quickly enough during the early 1990s, with the delay spawning rampant, long-lasting deflation. Eager to avoid that mistake, the Fed has taken several steps to cut interest rates and keep money flowing. And both the Bush and Obama administrations have pumped billions of dollars into the U.S. economy in the form of corporate bailouts and economic stimulus plans.

Even though the crisis in the United States seems unlikely to mirror the Japanese experience, it's impossible to know what will happen to stocks, real estate, commodities, and currencies in the near term. That's why we advise you to continue protecting yourself from the vicissitudes of the stock market and the world economy by remaining broadly diversified in your investments. That's the best way to ensure you are in a good position to benefit when the economy starts coming back to life. ●

the right to raise rates and fees arbitrarily. But you have leverage, too, and simply requesting more favorable terms may pay off. Suppose, for example, you're a long-time customer with a good payment record. If you mislaid a bill or you're having trouble meeting your monthly minimum, a call to customer service to explain your situation could win you a reprieve. Faced with the prospect of a defaulted account, credit card companies fairly routinely cut rates and extend repayment periods for

responsible cardholders.

Try some legal muscle.

Sometimes card issuers are just wrong. They may charge late fees for payments that arrived on time—and then penalize you for exceeding your credit limit. If you dispute a bank action and aren't getting anywhere, ask to speak to a supervisor, threaten to hire an attorney, even consider hiring an attorney to write a strongly worded letter on your behalf. Lawyers' fees aren't cheap, but here, too, a successful resolution could be well worth the cost. ●



Beware Of Homeowner's Insurance Gaps

Disaster may strike your home when you least expect it. There could be damage from flooding, an earthquake, termites, or even mold—just to name a few possibilities. And though you probably assume repairs will be covered by your homeowner's insurance policy, they may not be. Your policy may exclude more events than you realize. Even when you are covered—for, say, flood damage—there may be “gaps” in your coverage that limit the amount you can recover.

The good news is that a typical homeowner's policy covers losses resulting from fires, tornadoes, and severe storms. But the list of what it normally doesn't cover may surprise you. For instance, coverage may not extend to floods and earthquakes, although you can usually add a policy rider for such events. The rider's cost will vary based on whether you reside in a high-risk area.

Similarly, if you have to clean up a mess created by a water or sewage backup, the expense won't be covered by standard homeowner's insurance. But here, too, you can purchase a

special rider to avoid this headache, often for less than \$100 a year.

The list of other types of damage that usually aren't covered range from mold to insect and termite infestations to acts of terrorism, war, and nuclear attack. Dig your policy out of your files and take a few minutes to assess your risk exposure for these events.

Even if you're covered for damage—through standard insurance or a rider—payments from the insurance company are based on the property's replacement cost, not its fair market value. Also, if your home is destroyed and it's insured for less than the replacement value, you'll have to pay some of the rebuilding cost. In addition, deductibles and maximum dollar caps may affect reimbursements for possessions that are destroyed or stolen.

In terms of liability exposure, one way to avoid dire consequences is to supplement your current coverage with an umbrella liability policy. As the

name implies, the umbrella policy sits on top of your homeowner's and auto insurance policies to provide additional protection. For instance, if a neighbor slips and is injured on your icy sidewalk or a tree topples onto a car parked in front of your home, an umbrella policy may pick up the slack.

Just like other forms of insurance, you'll need to shop around for the best umbrella policy. And keep in mind that

umbrella coverage kicks in only after other insurance is exhausted, and umbrella policies usually carry deductibles equal to the required underlying limits for the auto and homeowners policies. Still, the cost of umbrella coverage usually isn't prohibitively expensive. You may be able to obtain \$1 million in liability coverage for \$200 to \$300 a year. And you may get a discount for using the same carrier. That could prove a small price to pay for plugging the gaps in policies. ●



Reassess Your Risk

(Continued from page 1)

account balances slid lower almost every day? Were you able to take a long view, assuming that even this bear market would pass, or did you treasure safety above all else? Would you rather stick with less volatile investments even if that means accepting lower long-term returns?

Your answer to that last question depends in part on what you need your portfolio to achieve, and re-examining your financial needs is step two of this process. Perhaps the prospect of postponing retirement or spending a little less during your later years seems like a reasonable trade-off for the comfort of holding less volatile investments.

Once you've figured out how much risk you're willing to accept, and how much you need to reach your goals, the third step of the process is to incorporate your readjusted risk profile into a formal “investment policy statement.” This document puts your strategy in writing and commits you to the discipline of a plan built around your financial objectives, risk profile, and investing timetable.

You'll also need to rebalance your portfolio, selling some holdings and buying others, first to get in line with your new risk profile and then to keep

allocations steady as markets fluctuate. Finally, it's important to monitor your investments, periodically re-evaluating what you own in light of your evolving personal circumstances.

We have the tools, experience, and expertise to help investors successfully

complete this crucial post-crash process, helping position investments for a potentially smoother ride through the next crisis and steady progress toward financial goals. If you would like to speak with us about your portfolio, please give us a call. ●

