PART I

SETTING THE STAGE TO BE REEDUCATED

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CHAPTER 1

Tired . . . but Not Retired

That's what a majority of Americans predict for themselves. This book offers investors and financial advisors an investment philosophy and process to avoid that predicament. For advisors and for the do-it-yourself investor (by definition you are your own financial advisor), it allows insight into approaches and techniques that might just change the way you look at the investment markets . . . for the benefit of you and your family, for this generation and beyond.

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While investors save and invest for many financial goals, in my experience the most common one is retirement. While retirement means different things to different people, the common piece of each different person's retirement definition seems to be this: the point in life at which your desired lifestyle can be paid for without your having to work. That does not necessarily mean that you don't work; many have adopted the idea of a ''second career'' as something they always wanted to do, but were so entrenched in their current industry that they could not afford to give up their high income level. Retirement is as much a state of mind as anything else. It's a feeling that the pressure is off, that you can comfortably afford to support yourself and those you are financially responsible for, now and in the future.

In 2006, I wrote the book *Wall Street's Bull and How to Bear It* (Isle Press, 2006). There, I reviewed many of the threats to investors and their advisors. I then suggested ways they could work together to defeat the hurdles that financial markets and financial ''salespeople'' put in front of those who make an earnest effort to serve their

clients, so one day they can both retire. This, my second book, contains some sections of that first effort. I repeated them because today as then, they reflect my core investment philosophy.

The other reason I have duplicated parts of the first book is that so many of the warnings of that book did indeed come to pass during the awful period for investors and advisors that followed in late 2007 and 2008. My hope is that by reviewing what happened, you can learn how to be prepared for whatever comes next.

In early 2009, I read with much interest an article from Savita Iyer-Ahrestani in the April 23 online edition of *Investment Advisor* magazine. The article, ''Retirement Confidence Plummets,'' notes that a 2009 survey from EBRI, which studies, among other things, consumer financial behavior, shows that only 20 percent of those polled are ''highly confident'' they'll have enough income in retirement. This is the survey's 19th year, so the results and trends over time are based in reality, in my opinion.

In this book, I will draw out a blueprint for you to take on the most pressing financial issue of our time—will investors be able to retire? To start, I'll quote from the aforementioned article, then provide my feedback.

> According to the survey, workers who say they are very confident about having enough money for a comfortable retirement this year hit the lowest level (13%) since the Retirement Confidence Survey started asking the question in 1993. Retirees also posted a new low in confidence about having a financially secure retirement: Only 20% now say they are very confident about having enough to live on comfortably in their retirement, down from 41% in 2007, the survey noted.
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> As the general confidence level has plummeted, so too has peoples' desire to want to try and plan for the future, (Director of the study Matthew) Greenwald said. ''The time when retirement planning seems toughest is when it seems harder for Americans to focus,'' he said.

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Here is some tough love for those who may find themselves in this mind-set. Realize that if you are behind the curve on this, you don't have a choice whether to attack this problem. You have to! Sometimes investors and their advisors feel ''frozen'' and don't act to improve their lot when things go wrong. They become paralyzed

by the seemingly numerous possible roads they can take to work out of the problem.

The shifts that have occurred in investment planning, with 401(k)s on the rocks, jobs being lost, and so on, lead you to one conclusion: you **don't** have the option to do nothing this time. Okay, tough-love section over; let's move on to another piece from the article.

> Retirement finance experts like Francis M. Kinniry Jr., a principal in Vanguard's Investment Strategy Group, believes that clients should steer the course and not give up. On the contrary, focus and clarity of thought and planning are needed more than ever, Kinniry says.

Hey, that's what I said! Yes, clarity of thought and planning. That is why many investors have sought out professional advisors (not professional investment salespeople!) for partial or total help, after doing it themselves for years, or at least since 2002, when investors last threw up their hands—after throwing up their savings—in a market whose decline was as fierce as 2008's but took three years to collapse instead of one, so it hurt one third as much (my ''scientific'' estimate).

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> Kinniry advocates good old-fashioned investing in the stock market. ''We know that the stock market has outperformed the bond market in most 10-year periods and even more so in 20-year periods,'' he says.

What else would you expect a partner at one of the biggest equity money managers in the world to say? Sorry, it's not that simple. ''Buy and Hope'' is not a strategy, especially after the emotional letdown investors have had with the markets and many of those who participated in it. I am generally bullish on the stock market over the next 20 years, but that's like saying I think the sun will come up 20 years from now. If you are right, that was to be expected. If you are wrong, no one will remember or care because they will have other things on their mind.

Also, there is bound to be a false sense of security involving bond investments, as the long-term threat of inflation from America's deficit buildup has the potential to put returns of high-quality U.S. bonds into the red, big time, for a long time, at some point.

> Granted, it is not going to be easy to get people to trust in the stock market, and according to Greenwald, belief in the efficacy of equities has a taken a huge hit this year.

Call me a blind optimist (no one has called me that in many years), but when people start doubting something that has been successful many times but just lost a big battle (like the stock market did), you should reach into the closet and grab your ''contrarian investor'' hat. The last time I put mine on was back in 2006, when everyone said that house-flipping and real estate in general was a no-lose situation, and those who doubted that were considered out of touch. In 2007 and 2008, the pendulum swung the other way in the stock market for sure, and the crowd always overreacts at the extremes.

> But Kinniry says that one of the key lessons to take away from this downturn is the importance of nuts-and-bolts investing, ''the kind of stuff we learned in investing 101.'' With the help of an advisor—and by and large, he says, advisors have done a prudent and careful job of getting their clients to diversify among different asset classes—clients need to get a savings plan in place, and that plan should include exposure to equities.

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Okay, I take back what we said earlier about our colleague from Vanguard. He made it up to us with that last statement. I think the next many years will be about two things:

1. ''Renting'' the stock market instead of owning it—that is, not committing to have some set percentage of money in the stock market all of the time, as static investment plans often do.
2. Applying a level of portfolio ''risk management'' that is not only uncommon to most investors, but foreign to some of those in the money management industry as well.

> Balancing stocks with a good dose of high-grade corporate bonds or Treasuries is the best way to go. Anyone who had done this would have seen that the mix held up far better in the downturn, and that bonds are by far the best diversifier for stocks, Kinniry says.

As you will see throughout this book, I take the opposite side of this argument about **how** to diversify. Investors cannot live by stocks and bonds alone. You must add investment styles that allow you to squeeze some of the juice out of the ''orange'' that is the stock market, but avoid most of the rind and pits. If you still feel the urge, combine these with more traditional long-term equity approaches and use bonds only for pure preservation of capital, if you use bonds at all.

This approach makes for a more proactive response to retirement planning for all who have the courage to inquire and adopt it. I am proud to be a proponent of such an approach (and one that is increasingly being recognized as such in our industry), and I am also very pleased that my industry is getting more innovative by the day. I sense that the message is getting out that the way investors made money in the past may not be the way they will in the future. Now, a final quote from the *Investment Advisor* magazine article:

> The fact that so many people were surprised that stocks could drop so much surprises us because there have been other times when this happened, he says. But we all have very short memories and right now, with confidence at an all-time low, it is very hard to have a memory that stocks rallied off the 2002 bottom by 100%.

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So true, and also a reminder that despite the cautious approach to growth investing that I espouse, you must always realize that the old rules could at some point return, for years at a time. The stock market could produce the kind of returns that get investors right back on track for retirement. As Mr. Kinniry correctly states, it has happened before.

But the question and concern this fine study and article raise is this: if the stock market fools the public again, and provides strong returns in the next decade when so many are on the sidelines, will most of them miss out, once again victims of thinking that leaves them one big step behind financial success? When the proverbial tree in the forest falls when no one is there, we must wonder, does it make a sound? Most critically for those interviewed for the EBRI survey, will it allow them to retire? If investors freeze and stay frozen, they won't hear the tree or anything else (like prudent and proactive portfolio advice) and the sounds they will fail to hear are those of the investors that shook off their fears, realized they had

no choice but to fight back, and achieved a satisfactory retirement lifestyle—or better.

Over my nearly quarter of a century in the investment industry, I have developed a core investment philosophy, which I will share with you. That philosophy became an investment process, and later I developed a set of investment strategies that investors could access directly through my firm. As time went on, financial planners around the country took an interest in what I had created, and my firm and I arranged for them to access these strategies for their clients, through separately managed accounts on ''wrap'' platforms and through a mutual fund as well.

As markets have exploded and imploded over the years, my growing frustration with traditional investment approaches and investment products led to my developing a set of solutions that I believe strike right at the heart of what investors and financial planners truly want from their investment strategists. View this book primarily as an educational tool to help you sort through the maze of financial products and determine to what degree, if any, it fits into your portfolio (or, if you are a financial advisor, into your practice). Importantly, understand that all of this emerged from my experience as a wealth advisor, so I understand quite well what financial advisors of all types grapple with daily. My hope is that, in cases where an investor is working with a financial advisor, both can unite behind the principles and guidelines put forth in the following pages.

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Bulls, Bears, and Pigs

The world of finance and investing is stereotyped in many ways. When you hear the term *Wall Street*, what do you think of? What image first comes into your mind? Is it people in slick suits walking into skyscrapers in New York City? Is it a crowd of traders huddled around a trading pit at the stock exchange? Or perhaps it's one of the stockbroker movies: *Bonfire of the Vanities*, *Trading Places*, *Wall Street*, and so on. Whatever the image is, it carries no more than a shred of truth for most individual investors. More likely, Wall Street to them is more about the reading and research they might have done for their own investments, or the investment advisor they have worked with. But all of the supposed glamour of the

investment world has led, in my opinion, to a huge misconception about what it means to invest your hard-earned money and seek advice in doing so.

To start our journey to demystify some of the financial world's greatest stereotypes, and help you to separate reality from mythology, let's take a quick look at the history behind the terms *bull* and *bear,* which are commonly used in financial jargon.

A fellow named Cecil Adams wrote the following explanation on the website straightdope.com. Ironically, he wrote this back on July 11, 1986, which was right about the time I started my career in New York City:

> ''Bear'' is thought to have originated in a proverb that goes along the lines of, ''Don't sell the bearskin before you've caught the bear.'' This is roughly equivalent to ''Don't count your chickens before they're hatched,'' which is precisely what stock market bears do. Anticipating declining market prices, they sell stock they don't own yet, gambling that the price will fall by the time they actually have to buy the stock and deliver it, netting them big bucks. The term had become popular among London stock traders by the early 1700s, when the bearishly inclined were called ''bearskin jobbers.''
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> The origin of ''bull''—i.e., somebody who buys stock in the expectation that the price will rise—is not as clear. The term appears to have arrived on the scene a bit later than bear, and some believe it was suggested mostly by alliterative analogy to the earlier expression. The usual explanation for the choice is that bulls habitually toss their heads upward, but you could just as easily make the case that bulls get their way by bulling their way ahead—they create a stampede of optimism that prices will rise, and the inevitable result, the laws of supply and demand being what they are, is that prices do rise. However, this theory could be a load of you know what.

Investing and financial planning are not black and white. They are very gray. That is an important theme of this book. Just as achieving a balanced life is the healthiest approach, so, too, is finding the balance between potential reward and risk. The two concepts are inseparable. Trade-offs are what investing and asset allocation is all

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about. Otherwise, you could just load up on the investment that appears to be the best, and sit back until it pays off. People once thought of Enron that way.

Despite the importance of ''gray investing,'' a lot of advice is given to people every day that is based on what is presented as certainty. ''Invest in stocks for a decade and you'll make a lot of money. Grow your assets by 7 percent a year and you'll be able to retire at age 60.'' As of the end of 2008, this was nothing but a promise unfulfilled for many investors. They were understandably angry, and they should be.

I don't want to deemphasize planning. It is important. I do want to deemphasize treating the outcome of a projection as if it were reality.

Bulls and bears have ways to reach their objectives. But those who turn into investment ''pigs,'' always trying to make a quick buck or extrapolating their recent returns into the future (''I just made 50 percent on this last year, so I'm not going to sell it—I think it will go up even more this year''), are ultimately doomed to failure.

Keep this in mind as well. The bull and bear are Wall Street's long-time symbols. The pig is also a symbol of the leanings of some investors. And as the expression goes, ''Bulls make money, bears make money, pigs get slaughtered.''

My work is intended to help investors get what they really want from their wealth! With that in mind, let's reexamine a year in which most investors did not get what they wanted from their wealth: 2008. In fact, by the end of February of the following year, 2009, with many stock indexes having lost over half of their value, they were probably wondering if they'd soon have much wealth left at all. And, in financial and economic environment that seemed surreal, except for the fact that it was real, they were wondering who and what they could trust.

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