The Thoughtful Investor

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How Much Are You Worth Today?

Do you have a current personal balance sheet—a listing of your assets and liabilities and determination of your net worth? If you don't, take some time as your year-end statements and property assessments come in over the next few weeks to sit down and put one together. Then make a habit of updating it every six months.

A balance sheet is an essential part of financial planning. It helps you see where you are with respect to reaching your goals, gives you the information you need to make important financial decisions, and alerts you to problems.

The assets on your balance sheet should include financial resources such as bank accounts, investment accounts, stocks, bonds, mutual funds, retirement accounts, debts owed to you and life insurance values. You also want to include the value of tangible assets you hold as investments, such as real estate, collectibles, ownership in a business, or other assets. The values assigned to these assets should be what you would realize if they were sold today, not some future value.

Your liabilities are your debts. Short-term debts include current bills, your credit card balance, personal loans made to you such as a home equity line of credit, and business debts for which you are personally liable. Long-term debts are typically mortgages, car loans or lease agreements and installment loans. Don't forget to include income taxes, personal property taxes and any other obligations.

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Fat Tails and Probability Statistics

Risk in the financial market is by and large measured by "beta," a measure of the covariance of an asset class with an index. Now beta has a number of failings as a measure of risk, one of which is that it considers upward volatility to be as much a negative as downward volatility. But there's another dark side to beta that is too often overlooked, its disregard of fat tails.

Probability statistics are based on grouping large numbers of variables to determine the likelihood of a specific variable or range of variables occurring. A normal distribution is the well-known bell curve, which is relatively accurate for financial markets most of the time. Given investment returns follow a normal distribution; you can identify the population average and determine the likelihood of returns varying from that average.

For example, with a normal bell curve distribution, 68.26% of the values will be at within one standard deviation away from the mean: 95.46% of the values are within two standard deviations and 99.73% will lie within three standard deviations. This is known as the "68-95-99.7 rule."

Using beta and historical stock price information, many investment consultants

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Make Your 2006 Retirement Contributions Now

It makes perfect sense to delay paying income taxes until the last bitter second, but that same logic does not apply to contributions to your retirement accounts. Retirement account contributions should be made as soon as possible, the earlier in the year the better.

1. The market's top returns on average have historically been realized during the months from December to May. While past performance is not indicative of future returns, by waiting until April 15th you miss the opportunity to profit from that time period.
2. The earlier you invest, the longer your funds have to compound. Compounding is the result of earning interest on interest on interest and so on. The longer you invest the steeper the curve becomes as compounding gains momentum.
3. If your employer is matching your contributions up to a percent of your compensation, you want to have your employer's contribution working for you as soon as possible.
4. By making retirement plan contributions as soon as you can, you are essentially paying your future first and not running the risk that when you get to the final contribution deadline, you won't have the funds available for your retirement account.

Fat Tails and Probability Statistics

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DOW JONES INDUSTRIAL AVERAGE: Normal Vs. Fat-Tail Distributions

Approximate Frequency (Actual Loss is Equal to or Greater Than)

Probability of Loss of	Normal Distribution	Fat Tail "Actual" Distribution
3 %	1 per Year	3 per Year
4 %	1 per Decade	1 per Year
5 %	4 per 1,000 Years	5 per Decade
6 %	7 per 100,000 Years	4 per Decade
7 %	1 per Million Years	3 per Decade

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develop portfolios for clients based on the probability of achieving specific returns. But these plans have a flaw that becomes apparent when it's too late. They overlook fat tails.

Fat tails in a probability distribution are those values that fall far to the left or right of the average. Statistically, they have an extremely low probability of occurring, often less than 0.01%. But they do happen and with dismaying frequency. The downfall of Long Term Capital was directly related to statistically "impossible" moves in the international currency market.

Statistically, it was next to impossible for the S&P 500 to fall -22.9% on October 19, 1987. The table above shows the probability of a loss from 3 to 7% occurring based on probability statistics, compared with actual historical results. While a 7% loss will occur only once in a million years according to a normal distribution, historically they have occurred at a rate of three per decade for the Dow Jones Industrial Average.

Fat tails are important to recognize because they remind us that there are no guarantees in investment performance. Putting your portfolio on autopilot on the basis of statistical probabilities does not guarantee that you will arrive at your destination. In the words of Mad Eye Moody from the Harry Potter series, "Constant vigilance" is required. And that comes down to active management.

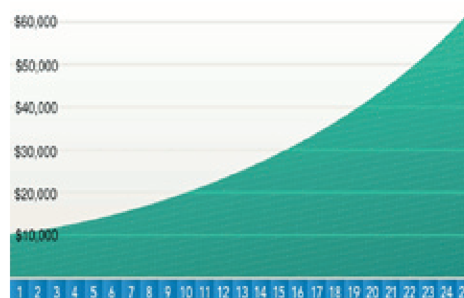
The S&P 500 Index is an index of 500 of the largest exchange-traded stocks in the US from a broad range of industries whose collective performance mirrors the overall stock market. The Dow Jones Industrial Average is a widely watched index of 30 American stocks thought to represent the pulse of the American economy and markets. Investors cannot invest directly in market indexes.

Compounding is a Powerful Tool for Accumulating Wealth

The more time your investments have time to grow, the greater the impact of compounding. That's why it is so beneficial to begin saving early.

The example at right is a hypothetical illustration of compounding and is not meant to show the result of an actual client account. All investing carries risk. Your account could lose money as well as gain value.

Growth of $10,000 at 8% annually compounded over 25 years



How Much Are You Worth Today?

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Your net worth is the difference between what you own and what you owe. This is the value that will provide you with income for retirement, help you start a business if that is your goal, or become your estate should you die. With this number, you are equipped to see how close you are to achieving your financial goals.

Do you have the net worth you will need for retirement? If not, what will it take to reach the margin of safety you want — increased savings, a more aggressive investment strategy or reducing debt levels to free up funds? If your net worth is in the very healthy realm, perhaps it's time for that dream vacation.

Individuals with net worth in excess of $2 million who are averse to having their heirs face steep estate taxes (beginning at 37% and rising to 55% at the federal level) need to put estate plans in place. On the basis of your financial statement, you may want to change your will or establish trust accounts or educational funds for children and grandchildren.

By charting your progress from year to year, you can make certain that you are building your net worth and not adding assets and liabilities at the same rate. Without a financial statement that details where you are, you're just guessing. That's not a good basis for decisions that can affect the rest of your life.

If you need help determining where you are today financially and where you should be, give us a call and let's talk.

Net Worth Calculation

Assets

- Cash ______
- Real estate ______
  Home, land, other
- Investments ______
  Stocks, bonds, retirement plans, other
- Personal property ______
  Autos, jewelry, furs, collectibles, rv, etc.

Total Assets ______

Liabilities

- Current debts ______
  Credit cards, taxes, medical bills, other
- Mortgages ______
  Home, land and other
- Loans ______
  Auto, education, personal line of credit, etc.

Total Liabilities ______

Total Assets - Total Liabilities = Net Worth

Lessons from Katrina – Minimizing the Financial Impact of a Disaster

Disasters come in many different forms from wildfires to hurricanes, earthquakes, severe weather conditions and more. Even when they don't impact us directly, side effects, such as the loss of electricity for hours or days can profoundly affect our lives.

While there is little we can do to prevent natural disasters, with a little bit of forethought we can be prepared to weather their effects more or less intact. The following are some ideas for you to consider with respect to surviving a disaster financially.

Are You Underinsured?

First and foremost is to have adequate property insurance in place. Marshall & Swift/Boeckh, which provides rebuilding cost estimates to insurers, maintains that more than half of all homes in the U.S. are underinsured.

In a widespread disaster, the costs of rebuilding are often driven higher due to the extra expense of scarce materials, contractors, and clearing an unsalvageable building. Most replacement value insurance policies will only pay up to 120% of your coverage limit, no matter how much it actually costs to rebuild your home.

Your insurance needs to be adequate to replace both damaged buildings AND their contents. Homeowner's insurance policies have specific limits as to the value of contents covered under the general policy. Know what those limits are and make certain values in excess of that amount are covered by insurance riders. To substantiate the value of your property in the event of an insurance claim, you should also have photographs or videos showing your home and property.

Only FEMA Provides Flood Insurance

Flood losses are not covered under homeowners' insurance policies. Federally backed flood insurance is available through the National Flood Insurance Program, managed by the Federal Emergency Management Agency. However, your community must have agreed to adopt and enforce floodplain management ordinances to reduce future flood damage to qualify for the insurance.

Minimize Potential Damage

If you have to evacuate, take steps to minimize the potential that disaster-related events will damage your home. Shut off electricity, gas and water coming into your home. Dispose of perishables that could turn your refrigerator or freezer into a toxic waste storage. Move more valuable possessions to safer locations.

Protect Hard to Replace Information

Ideally, you should keep hard-to-replace documents such as birth certificates, wills, deeds, stock certificates, Treasury notes, bonds, loan documents, insurance policies and other vital papers in a safe deposit box away from your home. However, there is always the possibility that the safe deposit box location could be destroyed.

Copies of all documents in the safe deposit box as well as passports, account numbers and contact information, inventory of home possessions and other vital documents that would be difficult or impossible to replace should be in a readily accessible file in your home. Everyone in your family should know where to find the file and be prepared to take it should evacuation be required.

Because of the danger of document destruction in a disaster, it is best not to hold stock certificates in person, but rather with your brokerage firm or the company's transfer agent. While certificates can be replaced, there are charges to do so and delays you have to anticipate. By holding stock in certificate form, you also run the risk that you or your heirs will lose track of the investment.

Have Accessible Emergency Funds

Have a liquid emergency fund. Problems are always easier to cope with if you have money. If a disaster forces you to relocate, you will need funds for rental deposits, to replace lost property and clothing and to pick up the pieces of your life. You might need to pay for short-term repairs to your home to prevent further damage. Even if your homeowners insurance covers those costs, you typically will not receive any settlement until after an adjuster visits the property. In a widespread disaster, that could take weeks.

To prevent fraud, financial institutions will often only mail checks to your home address or require a call to your home to verify a request to transfer funds to another account. That will present a bit of a problem if you have been evacuated. To make certain funds will be accessible, establish in advance authorized fund transfer arrangements that will allow you to send funds to your checking account. If you have an ATM card attached to your account, you will be able to access those funds wherever you end up.

Depending upon the disaster, you may be able to tap funds in your retirement accounts without early withdrawal penalties. Because these balances can be hard to rebuild, use retirement funds only when absolutely necessary.

Let Us Know If We Can Help

Keep our phone number with you if you face evacuation. Often we will be able to assist you with accessing the funds you need to minimize the trauma of a disaster and helping you contact your financial institutions.

How Much Are You Willing To Lose?

Making a profit should always be the goal of an investment and it's easy to think about how much a new investment could potentially make. But the most important question to ask yourself when it comes to investing is also the last question you want to face. How much are you willing to lose?

No matter how good of an investor you are, not every investment decision will be a profitable one. It will always be much easier to lose money than to make money. Even when you make the right decision, there will be times when a good investment turns sour.

Rather than tying up capital in losing positions, you need to have your money working for you.

Making up big losses is hard. Sometimes, it's impossible. Remember, a 25% loss doesn't take a 25% gain to get back to breakeven. It takes a 33% gain. A 50% loss requires a 100% gain. Investments that make those kinds of gains in a year are a very small minority.

Waiting to get back to breakeven also means losing opportunities for gains. Rather than spending a strong upward run with your investment making up lost ground, wouldn't you rather see those gains actually growing your portfolio?

That's why it's so important to start every investment with an understanding of how much you are willing to lose. Set your limits and follow them.

Why do investors watch positions lose value without doing anything? The first reason is simply because they have never set a limit to how much they are willing to lose. They just know they feel sick the further their investment drops. The second reason is often because they have sold themselves on the wisdom of the investment. They are convinced that the investment will perform over the long run and perhaps even over the short term. Rather than risk missing a bump up in price, they let their equity erode. But that doesn't do their portfolio one bit of good in the meanwhile.

Just because you sell doesn't mean you can't reinvest later. Selling a position is not like getting a divorce. You can go back without any emotional involvement as long as you still have your principal.

William O'Neil, editor and founder of the *Investors Business Daily* recommends that investors never let a position lose more than 8% without selling. Many active managers limit losses to 3 to 4%. Other investors may be willing to accept a 10% loss.

Whatever your loss limit, you need to follow it as a strict investing rule. If you are buying individual stocks, place a stop loss order to sell your position at your limit. As your investment gains value, move your stop loss up along with the appreciation.

If you are purchasing mutual funds or other investments that don't accommodate stop losses, you need to know your loss limit, monitor your position every day and execute the minute your investment reaches your limit.

If you don't have the time to follow your investments on daily basis, find an advisor who will. If your advisor tells you there's no need to use stop losses because the long-term direction of the market has always been up, find another advisor.

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