The Thoughtful Investor

Fourth Quarter 2005 | A publication of Financial Security Advisors, Inc. | Morris E. Vickers, CFP®, President

Bad Math and Bad Investment Advice

People who should know better make some amazingly foolish assumptions when it comes to investing. The problem is that they spread those assumptions as fact without looking at reality. For example,

If you invest for a long enough time, the good and bad returns tend to "even out" or "cancel each other out," and hence, time diversifies a portfolio reducing risk.

This argument sounds reasonable. After all from 1990 to 2004 — a period of 15 years in which total returns for the S&P 500 ranged from +37.4% to -22.1% — the average annual return was 12.4%. An investment of $1,000 at that rate of return, compounded annually over 15 years would leave you with $5,790 at the end of 2004. As the chart to the right shows, however, reality is significantly less. What happened?

The problem with using averages to estimate returns is that you overlook the mathematics of gains and losses.

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Year	S&P 500 Total Return	Growth of $1000
1990	-3.17%	$ 968
1991	30.55	1,264
1992	7.67	1,361
1993	9.99	1,497
1994	1.31	1,517
1995	37.43	2,084
1996	23.07	2,565
1997	33.38	3,421
1998	28.58	4,399
1999	21.04	5,325
2000	-9.11	4,840
2001	-11.88	4,265
2002	-22.10	3,322
2003	28.70	4,276
2004	10.88	$4,741

The returns shown above are historical data and should not be used to predict future market performance. Past performance is not indicative of future returns. The S&P 500 is an index and does not reflect an actual investment account's performance. All investments face the potential for loss as well as the prospect for gain.

Savings? What Savings?

Do parents still read their children Aesop's fables, the moral-based tales of a Greek philosopher born around 620 B.C.?

Among the fables is that of the ants and the grasshopper, paraphrased in shortened form below:

The ants were spending a fine winter's day drying grain collected in the summertime. A Grasshopper, perishing with famine, passed by and earnestly begged for a little food. The Ants inquired of him, "Why did you not treasure up food during the summer?' He replied, "I had not leisure enough. I passed the days in singing." They then said in derision: "If you were foolish enough to sing all the summer, you must dance supperless to bed in the winter."

U.S. workers have been steadily saving less and less every year since the late 1980s. In 2004, the average dropped to the lowest quarterly savings rate since World War II only to top that by falling to "0" in 2005.

Perhaps the miniscule savings rate is the result of the current generations' good fortune to have avoided economic hardships that shaped the savings habits

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Retirement Accounts Protect Assets from Creditors

Life is uncertain, which is why it makes sense to consider worst case scenarios when structuring your financial accounts. One way to protect your assets from creditors is to provide them with the shelter of a retirement account.

Social Security benefits, 401(k) plans and pensions have long been protected by bankruptcy law. Now, thanks to a recent Supreme Court ruling, creditors cannot seize the Individual Retirement Accounts of people who file for bankruptcy. All of which is even more reason to fully fund your retirement accounts each year.

Retirement Plan Contribution Limits for 2005

	Under Age 50	Over Age 50
Maximum annual IRA and Roth IRA contribution	$4,000	$4,500
Maximum 401(k), 403(b) and 457 plan elective deferral contribution	$14,000	$18,000
401(k), Keogh or SEP-IRA annual maximum (including company contributions)	$42,000	$42,000
Maximum SIMPLE salary-deferral limit	$10,000	$12,000

Check with your financial consultant on the legal requirements of the different retirement plans to make certain you qualify for contributions and how to calculate your maximum contribution for 2005. Early withdrawal penalties do apply to these plans.

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It doesn't take a 22% gain to recover from a 22% loss; it takes 28% because you are starting with a smaller after-loss base. It also matters when losses occur. A 22% loss early in the 15-year period has far less impact on your portfolio than a 22% loss in year 12 when your balance is higher and you have less time to recover.

To Recover from a Loss of	You Will Need a Gain of
10%	11%
25%	33%
50%	100%
75%	300%
90%	1000%

Suppose you looked at a different 15-year period, such as 1965 to 1980. The average return for the period was 8.2%. Compounded annually that would have resulted in the growth of $1,000 to $3,275. But, $1,000 investment in the stocks of the S&P 500 would actually have grown to just $2,637 due to the timing of losses and gains. You also have to remember that the S&P 500 is an index and does not include the impact of commissions or trading costs, which would have reduced your return even more.

The Dow Jones Industrial Average for the same period of 1965 to 1980 shows an average annual return of 1.4% for the 15 years. Compounded annually over the period, the average return shows $1,000 growing to $1,238. Based on the actual numbers, an investor would have had just $994 left at the end of 15 years. Here again, all the cautions of using index values apply, as do the mathematics of losses and gains.

This is the great fallacy of thinking that the longer your time period the less risk you assume. Losses always matter. You can't control the timing of a market downturn, nor can you predict how long it will take to return to break even.

What you can do is use an investment strategy that strives to minimize losses. This means using stop losses in your personal portfolio or working with an investment advisor who appreciates the fact that averages are not reality when it comes to investing. Minimizing losses are essential to successful investing. You can't count on time to bail you out.

Savings? What Savings?

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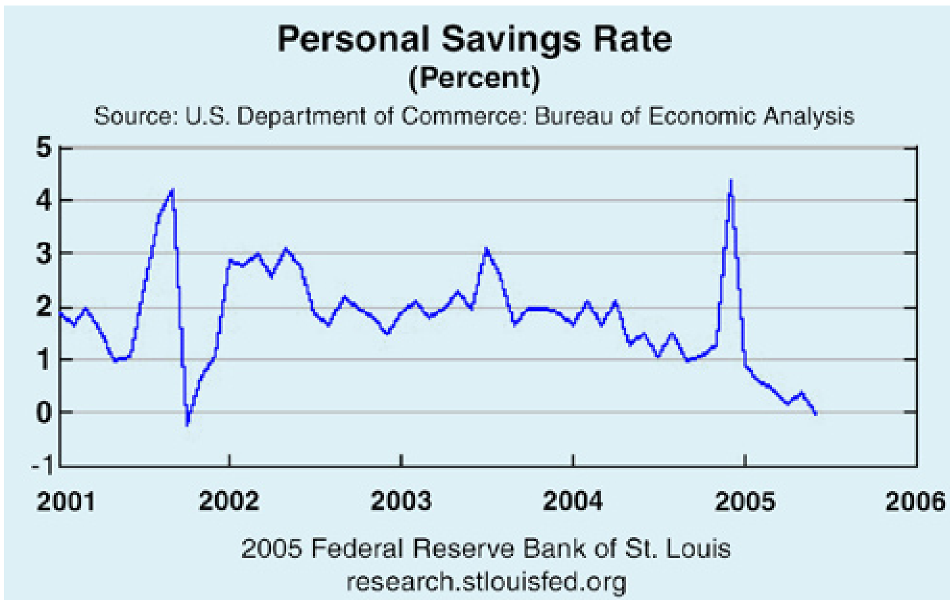

of earlier generations. It could also be, as some claim, the result of easy consumer credit or expectations that a rising market will produce all the net worth future retirees will need. Regardless of the cause, a great many people are in danger of playing out the role of the grasshopper in retirement. Like the ants, we need to be saving for the future. And, with market returns down from their double-digit levels of the 1990s, having enough reserves for retirement means we must save more aggressively.

The most common reason for not saving is the inability to find the extra dollars to save. Rather than accept this as an excuse, you need to force yourself to save by saving first and then adjusting your lifestyle to the remaining income. That means overcoming inertia and setting up automatic savings plans.

When companies automatically enroll their employees in voluntary savings plans (letting them opt out if they choose) rather than requiring people to sign up actively, participation rates rise dramatically. The same happens in our personal lives. Automatic payments can keep us on a disciplined path of saving so that we pay our retirement life first.

1. Take full advantage of any and all employee retirement accounts that provide employer matching dollars by establishing automatic payroll deductions. If you have self employment income, you may be able to establish an Individual 401K plan or SEP-IRA.
2. Set up automatic payments into your personal Individual Retirement Accounts to assure that you donate the maximum allowable. See chart on page 1 for maximum donation limits.
3. Contribute to personal investment and savings accounts, again, through an automatic payment plan that pays your future first.
4. Reinvest dividends.
5. Roll tax refunds and other unplanned income into investments rather than celebrating.

Remember that you have a lot of tomorrows to look forward to and it would be nice to be able to relax when you retire, knowing you have the assets to enjoy life.

15 Ways to Reduce Your Current Expenses and Save More

Having trouble finding extra monies to fund your retirement and investment accounts? There may be a number of ways you can reduce your current expenses, freeing up money that can be invested for your future:

1. Have an energy audit performed on your home. Free audits are often available from your local energy company, or the company may recommend firms that can provide a high quality audit at a reasonable cost. A home energy audit can identify ways to save hundreds of dollars each year on energy costs including heating, air conditioning, electricity use and more. For example, replacing incandescent bulbs with compact fluorescent lamps (which fit a standard socket size) will use 1/6th the kilowatts resulting in substantial energy savings.

2. When you travel, compare low-cost carriers with major airlines that fly to your destination and consider using alternative airports. Purchasing tickets 14 days in advance and including a Saturday stay over typically results in lower prices. Compare the costs of booking your flight at the airline's web site rather than through an agency or online travel firm. Sign up for the airlines' email alerts on reduced fares.

3. Check hotel costs through the online booking services and then call the hotel directly to see if lower rates are available directly through the hotel. Often individual hotels will have special reduced rates available. Sign up for free "preferred" guest programs even if you don't use the hotel chain on a regular basis. Special offerings to preferred guest cardholders are often available.

4. Use free checking accounts with no minimum balance requirements. Make certain, however, that you understand all the additional fees that are charged on these accounts to make up for the "free" service.

5. Avoid credit cards with annual fees and always use companies that provide at least a 25-day grace period. Often by stepping down from a platinum account to a gold account you will get the same benefits without an annual fee.

6. Banks and credit card companies make a fortune on special charges such as overdraft and late payment fees. Establish a line of credit on your checking account to cover any unintended overdrafts. Often there is no charge for these accounts if not used.

7. Set up an automatic payment of the minimum payment requirement on your credit card accounts from your checking account to avoid late payment fees. You still want to pay your balance in full, but this assures you that if a payment goes astray or is delivered late, you don't have to pay exorbitant late payment fees.

8. If you are carrying a balance on your credit card, pay off as much as you can and shift the remaining balance to a credit card with a lower annual percentage rate (APR). You may want to take advantage of an interest-free balance transfer, but be aware that one late payment can eliminate the "free" status of your account.

9. Avoid using ATMs that charge transaction fees. Instead, get cash back with grocery purchases and other store transactions and visit your bank for cash withdrawals.

10. Raise the deductibles on your automobile and home insurance coverage to at least $500 and make certain you receive all qualified discounts for burglar alarms, smoke detectors, non-smoking, and multiple policies with the same insurer, etc.

11. If you are looking for insurance protection versus an investment, buy a term life insurance policy with a guaranteed renewal term that meets your insurance needs. Term life is considerably less expensive than whole life, universal life or other cash value policies, but does not have a residual value.

12. Shop with lists to avoid impulse purchases.

13. Make your own coffee. A $3 latte or expresso every day adds up to more than $1,000 a year.

14. Use your public library rather than purchasing books or renting movies. Most public libraries now have online catalogues that allow you to request that a book or movie you want be held at your nearby branch library for you to pick up.

15. Water bills are one expense that can easily be cut by 30-50% or more. You may also be eligible for rebates by installing more water efficient devices such as toilets. Simple water saving measures include washing only full loads of laundry and dishes; installing low-flow shower heads and toilets; turning down the water pressure for bathroom and kitchen faucets and using an aerator in the kitchen faucet.

Remember that a lot of little amounts add up to major money over the course of a year. Following all of the preceding ideas could easily net you an additional $3,000-$5,000 a year that can go into savings.

Cautions When Investing in Real Estate

As a general rule, the best time to avoid an investment class is when it is sold as a "can't lose" proposition. That is certainly the case recently with investment real estate. Real estate has been the bright light in many portfolios, showing double-digit gains while equities have largely gone sideways. But before you decide real estate is the way to go, there are some factors you should consider.

Real estate, unlike equities, has some hefty carrying costs, including property taxes, insurance, maintenance and interest expense if you have financed the property. Your annual rate of appreciation must exceed these combined costs or else your cost basis will increase.

Your home should typically not be considered a part of your investment portfolio because it cannot be liquidated without the need for you to replace it with another roof over your head. While it would be nice to sell your home and end up money ahead, all too often the cost of buying a new home neutralizes that gain.

An exception would be if you own multiple properties and use one for your home with the intent of selling it after two years to take advantage of the tax-free gains on the sale of personal residences of $250,000 for single taxpayers and $500,000 for couples.

If you purchase a property with the intent of renting it to offset your carrying costs, you need to consider whether you want to manage the property yourself or pay someone else to worry about tenants. Depending upon the property and the local rental market, your rental income may be insufficient to cover your

carrying costs. You need to consider how you will pay ongoing costs should you run into problems with your renter and do not receive payments for a period of months. With renters, the risk of damage to the property must also be considered.

While real estate markets are less likely to see dramatic declines such as the stock market has experienced in recent years, there are no guarantees that prices will always go up. Often when real estate becomes overpriced, values dip, then plateau, leveling out for a period of years until the market is back to more normal levels. During a flat market, your investment goes nowhere, while expenses typically continue to increase.

Among the arguments for real estate continuing to increase is the comparison of the U.S. housing market with Western Europe, where restrictive zoning makes new construction more difficult than in most areas of the U.S. According to a recent study by consulting firm ISI, Western Europeans pay seven times their annual salary to purchase a average home providing its occupants with 325 square feet per person. Americans on average pay 3.5 times their annual salary for an average 650 square feet per person.

While that certainly makes U.S. real estate appear a bargain in comparison with Western Europe, Japan shows us another picture of how a real estate market can go sour. Since 1991, residential land prices have declined about 43%, and commercial prices about 67%[1].

If you chose to invest in real estate, you need to make certain it represents only a portion of your total portfolio. Remember, real estate is a relatively illiquid asset, which makes it harder to cut your losses when the market turns against you.

[1] Japan's Ministry of Land, Infrastructure and Transport.

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