

Financial Planning
Retirement Planning
Portfolio Management

Investing Basics

The beginning of a new year is a good time for each of us to review the basics of investing to see if we are adhering to the principles that will make us successful investors over the long run.

Compounding to Wealth

Most wealth is built steadily over long periods of time. There are exceptions such as some of the dot com wealth that was built in the second half of the 1990's. (At least for those that were smart enough to protect their assets from the downturn.) That was a unique period in time that allowed for the growing of companies and investments faster than has normally been possible. However, more common are those people that have compounded to wealth steadily and meticulously year after year after year.

Preservation of Capital

To put it simply, if we don't have any chips left, we can't play the game. I have been referred clients that lost 50% or more in the downturn of 2000, 2001 and 2002. If an investor loses 50% of his portfolio, then he must earn 100% just to get back to his baseline. This is very difficult to do. As most of you know, I believe strongly in "compounding to wealth". When you lose 50%, it is close to impossible to get back on track with your original compounding model.

Long-Term Trending

As most of my clients know, I am a believer in "making the trend our friend". I do my best to use long-term trends to help us better our performance and beat the indexes. There are many trends going on simultaneously, such as stock market trending (Dow, Nasdaq, S&P), interest rate trending (long-term rates and short-term rates), real estate trending, metals and commodities trending, as well as the trends of the general business cycles. In a successful diversified portfolio, knowledge about each of these trends can serve to better performance. As an example, it was widely recognized that the Federal Reserve had intentions to raise short-term interest rates throughout 2005. Alan Greenspan announced it publicly and then carried out his intentions per his public announcements. Some trends such as this one are fairly obvious, however others are much more elusive. To the extent that we can successfully recognize these trends and use them to our benefit, we can certainly improve our year over year returns. I call this a Tactical Asset Allocation Strategy which includes re-balancing the asset allocation at key times.

Value Investing

Whether investing in mutual funds or individual stocks, I prefer an emphasis on value investing. This does not mean that "growth" investments should be ignored, however a focus on value can not only allow for substantial increases in price on the upside, but also help limit the amount of volatility as the market corrects on

the downside. "Value Investing" can be defined as the strategy of selecting stocks that trade for less than their intrinsic value. It could also be looked at as an investment style which favors "good stocks at great prices" over "great stocks at good prices". Value investing often utilizes such valuation measures as price-to-book ratio, price/earnings ratio and yield.

Risk Management

There are many forms of risk management such as overall diversification with the use of various asset classes, the ratio of equities to fixed income, and the use of long-term trending to periodically change the asset allocation. Since I prefer to use mutual funds rather than individual stocks, diversification is easy to accomplish. As a matter of fact, many of my clients who have decided on their own investment options in 401k's are frequently over-diversified.

a) Overall Diversification and the Use of Various Asset Classes

The basic asset classes that I use to diversify portfolios are Stocks (small, mid, and large cap), Real Estate (REITS), Commodities (Metals, Natural Resources), Bonds and Cash. Most experienced investors recognize the need for overall diversification, which can take place in many different ways. My rule for individual stocks is that no single stock should represent more than 5% of a given portfolio. This rule prevents what I call "single stock risk", so that an Enron, WorldCom, or PG&E debacle cannot significantly damage a portfolio. There is also the need for industry diversification. Even though energy stocks did well in 2005, we would not want our portfolios to consist of 80% energy stocks.

b) Tactical Asset Allocation Strategy

The awareness and use of long-term trending and re-balancing of the asset allocation is another form of risk management. This does not mean going to 100% equities in one cycle followed by 100% fixed income in another cycle. Some cycles may call for minor changes to the basic asset allocation while others may call for major changes. The awareness of these cycles combined with the investor profile should dictate the appropriate changes.

As we begin the new year, you might want to look over your current portfolio to see if you have considered these Investing Basics. If you have questions, please call or email and I will do my best to respond. Have a Happy New Year filled with good health and prosperity.

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