



Meeting the Needs *of the* Sophisticated Investor

An advertising supplement to Business First

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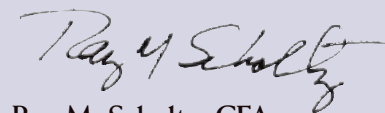
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The articles in this investment supplement address certain issues the sophisticated investor may be considering. Several of the articles have been written by some of our local members and we believe each article has relevance, given today's complicated investment landscape.

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Ray M. Scholtz, CFA
President
CFA Society of Louisville

Ray M. Scholtz, CFA
President
(502) 581-3137

Steven P. Marx, CFA
Vice President
(319) 247-6250

J. Richard Robben, CFA
Secretary
(502) 561-3246

Ben H. Thomas, CFA
Treasurer
(502) 387-1514

Jeffrey T. McGlaun, CFA
Membership Chair
(502) 560-2284

John P. Vinsel, CFA
Director
(502) 562-5298

Mark S. Mosley, CFA
Director
(502) 253-1019

Todd P. Lowe, CFA
Ex Officio
(502) 327-5660

Hedge funds

Demystifying an increasingly popular investment approach

Ben Thomas, CFA

Once upon a time, a group of friends could talk about the stock market without any of them bringing up the subject of hedge funds.

Well, times have changed and hedge funds have moved into the mainstream. In today's world, it's quite likely that you may be invested in a hedge fund, or, at the very least, know someone who has. Even investors who think they will never have a need to invest in hedge funds would be well served to learn more about them. After all, despite the growth of this industry, relatively little is understood by the average investor. Never before have the fluctuations in the market been driven more by hedge funds, and it's impacting everyone on Wall Street – including your money manager.

Growth of hedge funds

By many estimates, hedge funds account for nearly half of the daily trading volume in the markets. These lightly regulated asset managers have seen their numbers grow at a rate that would make even the most sophisticated investors pause. By most counts, there are now more than 8,000 hedge funds that manage somewhere in the neighborhood of one trillion dollars. To help put that into perspective, there are also about 8,000 traditional mutual funds. However, mutual funds assets under management are approaching seven trillion dollars.

So why have so many hedge funds sprouted up during the past decade, and why have some of the best and brightest money managers left their traditional jobs to go work for hedge funds?

The most frequent answers are money and freedom from working in a large bureaucratic environment (and usually in that order). To better understand how hedge funds differ from mutual funds and why anyone would consider investing a portion of their portfolio in a hedge fund, it's helpful to understand how hedge funds came to be.

History

Alfred Winslow Jones, a senior editor at *Fortune* magazine, is often credited with creating the first hedge fund in 1949. Jones pooled his money with the money of his friends and formed a limited partnership, which

allowed him to avoid registering with the SEC. It also gave him free reign to invest the money in any style he saw fit. Jones bought stocks that he thought were undervalued, believing that they would appreciate – just as your mutual fund manager does today.

However, he would also “short” stocks that he thought were overvalued. Shorting stocks calls for an investor to borrow stock from a broker, sell the stock at the prevailing market price, and then repurchase the shares after the price has fallen. By balancing these two investment styles, Jones could “hedge” the risk within his portfolio. The structure of the limited partnership also allowed Jones to charge his investor friends a percentage of the gains.

Today's hedge funds

Today, the term hedge fund is a bit of a misnomer. Loosely speaking, hedge fund better describes the structure of the portfolio rather than the investing style. Today's hedge funds are usually better characterized by their fee structure, which almost always pays the portfolio manager a fee based on how well the portfolio performs. The most common fee structure for hedge funds is the classic “1 and 20,” which means that an investor would pay a 1 percent annual management fee and 20 percent of the profits generated within the portfolio. For example, if you invested \$1 million in a hedge fund that returned 30 percent, you would pay \$10,000 in management fees and \$60,000 in performance fees for a net return of 23 percent. If for some reason the manager produced a negative return during the year, he would get none of the performance fee.

In contrast, the average mutual fund usually charges somewhere between

	Hedge Fund	Mutual Fund
Leverage	Can use leverage to enhance returns	Normally not permitted to use any leverage
Fees	1% of assets and 20% of profits	0.75% - 1.25% of assets
Portfolio turnover	Typically higher	Varies according to fund style, but typically lower
Regulation	Little to no regulation	Heavily regulated
Ability to short stocks	Yes	No

0.75 percent and 1.5 percent of assets under management, regardless of the performance of the portfolio. Some industry observers suggest that while this incentive fee may appear to be too generous, it does a good job of aligning the manager's incentives with the investor's goals.

What's a hedge fund manager worth?

You might be asking yourself why would someone be willing to give up 20 percent of his or her profits. The primary reason is because the investor must believe in the ability of the manager to deliver exceptional performance after adjusting for the fee. After all, investment managers should be evaluated on a net fee basis. One reason hedge fund managers tend to outperform their mutual fund competition is due to their ability to short stocks, as well as to use other financial instruments such as options.

If the overall market is down 15 percent and your mutual fund manager is down only 10 percent, that would be considered a great year. However, hedge funds are normally expected to produce positive returns no matter what the overall market does. This can usually only be achieved through the use of options, the shorting of stocks or investing in some other non-correlated asset class, such as gold or treasury bonds.

In fact, not all hedge fund managers work exclusively with stocks. Many managers prefer to trade bonds exclusively. Other popular investment styles among the hedge fund

community include more complicated convertible bond portfolios and arbitrage strategies.

What to expect if you invest?

First of all, only accredited investors are normally permitted to invest in an alternative investment such as a hedge fund. The SEC defines accredited investors as those people making \$200,000 per year or having a net worth of \$1 million.

Once you clear that hurdle, you can normally expect a one-year lockup period that prohibits a withdrawal of your money. This is due to the fact that investors tend to panic at the same time, forcing the manager to liquidate positions in order to meet redemptions.

Finally, don't expect full transparency from the manager regarding the purchase and selling of securities. Many managers choose to keep most of their holdings a secret from fear that other hedge funds could use this information against them.

Not for everyone

Hedge funds are not for everyone. In fact, they are not for most people. You should always consult your financial advisor if you are unsure whether it would make sense for you to invest. However, if you have the risk tolerance and can afford to allocate a small part of your portfolio towards alternative investments, hedge funds may make sense for you.

Ben Thomas, CFA, is a portfolio manager, Waycross Partners, Inc., Louisville, Kentucky.

Employee stock options

Opportunities both promising and perilous

Carroll R. Goslee, CFA, CFP

Stock options are one of the many valuable prerequisites often granted to employees of publicly held companies. Once reserved for executives, more and more companies have broadly awarded stock options to executives, key personnel and other employees, as part of their overall compensation packages. These companies offer stock options as a way to build loyalty, tie performance to compensation and recruit and reward highly qualified, dedicated employees.

Despite their many benefits, exercising your options can create several financial challenges. The exercise triggers tax consequences that will vary depending on the types of options your company grants and your individual tax situation. Understanding what kind of option you have and the financial consequences of exercising that option can be confusing. Specific questions on taxes as they relate to your individual situation should be directed to your tax advisor.

Understanding your stock options

There are two types of options: nonqualified stock options (NSOs), which are most commonly granted, and incentive stock options (ISOs). These option types differ mainly in the tax consequences to both you and the company that grants them.

Other important considerations are vesting schedules and option expiration dates. Most options are granted subject to a vesting schedule that determines when the options can be exercised. Equally important is the expiration date that specifies the time period after which the option "expires." Vesting schedules and expiration dates are important considerations in deciding how to most beneficially time your option exercises.

Nonqualified stock options

NSOs are more commonly issued and don't qualify for special tax treatment. NSOs are typically granted at the company stock price on the day the options were granted and, unlike ISOs, are taxable when exercised. You are taxed on the difference (spread) between the grant

price and the stock price on the day of exercise. Because the income will be considered compensation paid to you, it will be included on your W-2 tax form, and employment taxes will apply. If the shares are not sold, the fair market value becomes the cost basis for the shares. Any change in stock price – above or below your cost basis – will be treated as either long-term or short-term gains/losses, depending on how long you hold the shares following the exercise date.

Incentive stock options

When you exercise an ISO, you incur no compensation income – as you do when exercising an NSO. ISOs are granted at a price that at least equals the stock price on the grant date, meaning the stock's price must increase for you to benefit.

At the time you exercise your ISOs, the exercise price you pay becomes your cost basis in the stock.

Whether you sell the stock now or later, the difference between the sale price and your cost basis (exercise price) is the amount of income you take into consideration for taxes.

As long as you have held the stock received from your ISO exercise for the required holding period, the entire difference between the sale price of the stock and your cost basis is considered a long-term capital gain. If ISOs are exercised and the shares held, you will be creating exposure to the Alternative Minimum Tax (AMT), and these issues need to be reviewed with your tax advisor.

Should I exercise my options?

As you contemplate whether to exercise your stock options, you will need to consider:

- What might you gain by waiting? What are your expectations for stock price appreciation and the market in general? How will waiting affect your future tax exposure?
- How much time remains until the stock options expire? Do you need to act quickly, or do you have several months or years before your grant expires? Keep in mind that once the options expire, they have no value. This is one of the biggest mistakes optionees make – waiting too long or not properly timing the exercise to their benefit.

- Whether you intend to exercise and hold. Consider exercising NSOs and ISOs when the taxable spread is minimal to limit the tax impact. Your AMT exposure can be reduced by properly balancing the exercise of NSOs and ISOs.

- The rules of your plan. Generally, you don't have to exercise all of your options at once, however, minimums and holding periods may apply. Your plan rules will explain these details. You may want to have a professional review the unique rules and features of your company's option plan as the affect your options.

- Leaving employment. Are you planning on retiring? If so, you need to determine how departure from the company will affect you options vesting and/or expiration schedule. In many cases, you must exercise your options or lose them. However, the way in which you exercise can have a significant impact on your tax situation.

- Your current and future financial needs. Is this an opportunity to improve current cash flow or an investment for the future? Are you exercising for immediate cash or to build your investment portfolio?

- Your current and potential future tax situation. Exercising stock options has tax consequences. Will you be in the same or a higher or lower tax bracket when you are ready to exercise your options? Are you creating significant exposure to the AMT? Are you inadvertently converting capital gains opportunities to ordinary income tax liabilities?

- Your risk tolerance. Are you ready to face the market's potential ups and downs, or are you seeking a more stable investment? Is your portfolio diversified to handle risk?

- Your asset allocation. You should consider stock options are part of your equity allocation. How well balanced is your portfolio? Are you building a substantial concentrated position in your employer's stock?

Many executives inadvertently create concentrated equity positions

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The crude truth

Investment implications of rising oil prices

J. Richard Robben, CFA

As of the end of August, the price of crude oil is up over 60 percent in 2005, hovering near the \$70 per barrel mark.

To most of us, this simply means that we are reaching deeper into our wallets in order to fill up our cars with gasoline, and then complaining about it the next morning around the coffee pot at work.

This rapid increase in the price of gasoline is of particular concern to investors. Crude oil at \$70-plus per barrel has the potential to cause widespread inflation, and ultimately send the U.S. economy into a severe recession. Investors who understand the implications of this scenario will be in much better position to protect themselves and their assets from the effects of the downturn.

... there are still ways to profit from the rise in oil prices. The simplest way is to "follow the money."

Understanding the magnitude of the problem

Before we look at the economics behind the rise in oil prices, we need to understand the staggering amount of oil that is actually used each day in the United States. Now, we all know that Texas is full of oil, and we have a big pipeline running from Alaska to the lower 48 states. So why does the U.S. need to import oil? The simple answer is consumption. Our economy consumes more oil than any other in the world. In fact, it's not even close.

In 2002, we imported approximately 10.4 million barrels of oil each day. This is over and above all of the oil that we produce domestically.

The second largest importer, Japan, imported 5.3 million barrels per day.

To put this into perspective, let's look at Saudi Arabia. Americans tend to think that the Saudis are just standing in oil. In 2002, Saudi Arabia exported 6.7 million barrels of oil each day. So, if every drop of oil that Saudi Arabia exported in 2002 went to the U.S., we would have still need to buy almost another 4 million barrels each day in order to meet our demand. The bottom line is that Americans use a lot of oil, much more in fact, than any other country on earth.

Why are gasoline prices so high?

To really understand the causes of rising gas prices, we need understand the supply and demand dynamics of the situation. The supply side is fairly easy. The majority of the world's oil output is controlled by OPEC, the Organization of Petroleum Exporting Countries. OPEC is a cartel, which means that the members act together to regulate the supply of oil. They do this in order to exert a degree of control over the price of oil, which in a free market is a function of supply and demand. The idea is that if you want to get \$25 per barrel for oil, then you only produce the amount of oil that will force the "demanders" of that oil to pay \$25 for it. The arrangement has worked very well for OPEC since its inception in 1960. But recently, the demand side of the equation has been changing, and one of the biggest forces driving that change has been the rapid economic growth of China, and other Asian economies. These economies have experienced explosive growth during the last few years, and in doing so, have become huge importers of crude oil. China's oil imports are growing at a 7.5 percent annual rate, while the number of cars in the country is growing at almost 20 percent per year.

Normal economic theory tells us that when demand increases to the point where prices rise by 60 percent, the suppliers will produce more in order to meet the demand, and that prices will then fall back to the equilibrium level. Therein lies the problem. Since OPEC is a cartel, and since the supply of oil reserves is limited, there is really no incentive for the cartel to increase production. Ultimately, an increase

in oil production wouldn't help gas prices much anyway because the U.S. is already refining as much oil into gasoline as it is capable of doing. This lack of refining capacity, coupled with increased demand from China and Asia, means that oil and gasoline are likely to be very expensive for some time to come.

Global politics are also playing a role in the rise in crude oil prices. The majority of the world's known oil reserves are in the Middle East. In fact, over half of the world's proven reserves lie in Saudi Arabia, Iraq, Kuwait, and Iran. The ever-increasing tensions in this area of the world have caused world oil markets to become very fearful of the potential for supply disruptions.

Supply uncertainty is also a problem outside the Middle East. Venezuela, with an unstable government and widespread labor strikes, has seen several disruptions to its export levels over the last few years.

Economic drag

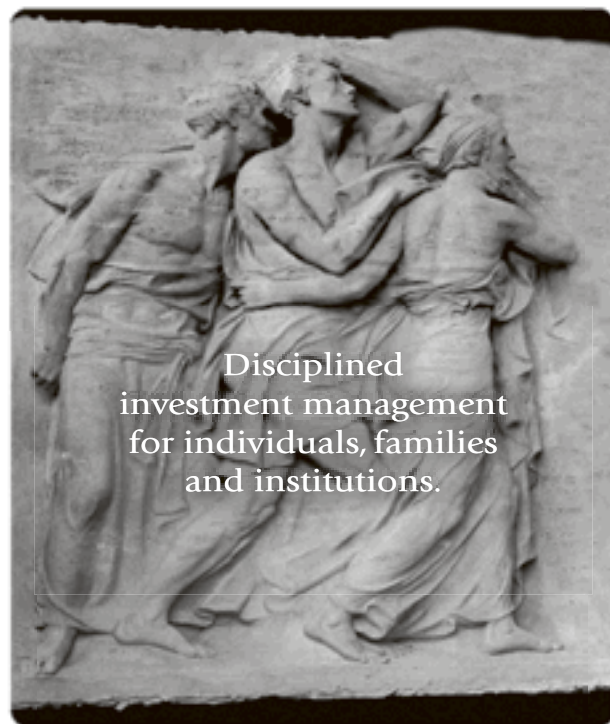
The rising cost of gasoline does two very interesting things to the economy.

First, it means that consumers have less money each month to spend on discretionary items like movies, dining, and other entertainment. Secondly, it means that businesses have to pay more for fuel, either directly in the form of gasoline for their fleets, or indirectly in the form of fuel surcharges imposed by companies like United Parcel Service, FedEx, Delta Airlines and others. Ultimately, businesses respond by passing on the increased cost to the consumer, which leads to broad-based inflation. We are already seeing this happen in the U.S., with both UPS and FedEx announcing increased fuel surcharges that went into effect Sept. 1.

The consumer, already struggling with the high costs of gasoline, and now faced with higher prices for

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Retirement planning

Responsibility, risk have shifted from employer to employee

John Vinsel, CFA

When a retirement plan story makes headlines, it's generally not a good thing. Recent headlines include "U.S. Takes Over Failing United Airlines Pension Plan," "Enron Bankruptcy Threatens All Defined Contribution Plans" and "Looming Social Security Crisis Demands Action Now." Retirement plan participants understandably might feel anxious when reading these articles.

United Airlines' pension plan default, Enron's bankruptcy and the demographic dilemma faced by the Social Security program are quite different situations – yet their stories are part of a larger trend of shifting the risks of retirement finances from plan sponsors (employers or, in the case of Social Security, the federal government) to participants.

While the number of defined benefit plans dropped by half from 1980 to 1999, the total number of corporate retirement plans rose by 50 percent.

In May, a bankruptcy court approved United Airlines' termination of four pension plans and the company turned over \$7 billion to the Pension Benefit Guaranty Corporation (PBGC). The PBGC, an agency of the federal government charged with protecting the benefits of participants in corporate pension plans, will assume responsibility for paying United's retirees. Because the PBGC has a maximum payout of

\$45,600 per year per person, some United retirees will receive less than they were promised. The PBGC expects to pay about \$13.6 billion (present value) of the \$16.8 billion that retirees expected.

Traditional pensions, such as United's, are designed to pay retirees a monthly benefit according to a formula based on number of years of employment and final or average salary. Because the benefits of the plan are defined, they are known as defined benefit plans.

Since 1974, sponsors of defined benefit plans have been required to set aside cash to maintain minimum coverage for future benefits. Most defined benefit plan sponsors hire a money manager to invest the cash (assets of the plan) with the goal of providing for the payment of benefits to retirees as they come due. Because the eventual benefits depend on several unknowable factors such as future wages, inflation, and tenure of retirees, the usual risks of investing are increased by the "moving target" that is the cost of benefits. The risk may have been masked by the strong stock market returns in the 1980s and '90s (average S&P 500 return was 17.75 percent from 1980 to 1999) that allowed most pension plans to maintain adequate funding. Nevertheless, more than half of all U.S. defined benefit plans were eliminated between 1980 and 1999, according to the Employee Benefit Research Institute.

Evidence from the PBGC indicates that funding trends were good through 2000. The agency's assets minus liabilities, or its net position, rose from a deficit of \$3.8 billion in 1986 to a surplus of \$9.7 billion in fiscal 2000.

As healthy defined benefit plans terminated, pension plans covered by the PBGC were increasingly those who were less well funded and more likely to default – such as LTV Steel, Bethlehem Steel, Polaroid, US Airways, and United.

Since 2000, the PBGC has experienced a surge in defaults that have left it with a net deficit of \$23.3 billion as of fiscal 2004. This trend shows no sign of letting up as United's default will add to that deficit in 2005.

So what has happened at the companies that either terminated their defined benefit plan or never had one?

While the number of defined benefit plans dropped by half from 1980 to 1999, the total number of corporate retirement plans rose by 50 percent. Another type of retirement plan, typified by the well-known 401(k) plan, has taken the place of traditional pensions.

Enron had no defined benefit plan. Its 401(k) plan allowed employees to contribute a portion of their salary to the plan. The company contributed a match equal to half of each employee's first 6 percent of salary contribution.

The match was made with shares of Enron stock, which was restricted, or unable to be sold, by employees who were under 50 years of age. Due to the restriction against sales of matching stock, the excellent appreciation of Enron shares through the year 2000, and a high degree of confidence by some employees who bought additional Enron shares in their 401(k), over 60 percent of Enron's 401(k) assets were held in Enron stock prior to the company's 2001 bankruptcy. Compared to the nationwide average 16 percent of company stock held in 401(k) plans nationwide, the Enron plan was heavily exposed to its own stock, and participants lost a collective \$1.1 billion.

Because 401(k) plans are defined contribution plans, there is no benefit formula. Contributions are the responsibility of employees, the company, or both.

Investment responsibility is often in the hands of employees, who choose from a menu of mutual funds, or, in some defined contribution plans, the assets are invested in a single balanced fund. In the case of Enron, one segment of plan assets – the matching shares that could not be sold – was not in the control of employees. The responsibilities for contributions differ among defined contribution plans, but the risk is the employee's.

Individual Retirement Arrangements, or IRAs, are similar to defined contribution plans for individuals. Since the creation of IRAs in 1985, they have become the largest type of retirement asset, as the aggregate balance of IRAs is larger than that of defined benefit plans, defined contributions plans, or Social Security.

With an IRA, the account holder bears all risks for funding and

investments. An advisor may be hired to manage the investments of the account, or the individual may manage his or her investments alone. Regardless, the IRA has been an important factor in the shift away from defined benefit plans.

Social Security is another part of the story, as our propensity to live longer and the sheer number of participants poised to begin receiving benefits strain the program.

Social Security has functioned since its origination in 1934 as a defined benefit plan. Beneficiaries receive a monthly amount based on years of covered employment, age at time of retirement, and total covered earnings.

Social Security's trust fund holds only about \$8,000 per participant, a fraction of what would be required in a private sector defined benefit plan. Steady receipts from payroll taxes have maintained Social Security's funding system thus far, but our decreasing ratio of active workers to retirees will lead to annual deficits as baby boomers retire.

Who bears the responsibilities and risks for Social Security?

In a way, each generation bears the responsibility for the generation that came before. This is much more important today and in the future than it was 50 years ago, when there were 21 workers to supply funds for each beneficiary. With only three workers per retiree today – and with that factor projected to fall – the willingness of younger workers to support their elders may be tested.

Investment responsibility today is borne by the government.

The Social Security trust fund is invested in treasury notes so the excess funds in the trust fund are lent to the government with the promise that they will be repaid as needed. Since the trust fund is quite small compared to the magnitude of the program, investment risk is slight. No matter what investment scheme is used, Social Security is currently a pay-as-you-go system.

The implications of Social Security funding may be more important to the federal government as a whole, which has seen its deficit reduced by the steady surpluses provided by Social Security. When Social Security surpluses reverse in a few years, the federal government will have to raise revenue from some other source

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Tax-efficient investing . . .

Accumulating wealth in your lifetime

Brian C. Breidenbach, CPA, PFS, CFA

Both affluent and middle-class investors can benefit by incorporating tax efficiency into their wealth accumulation and investment strategy.

Do an internet search on the topic of tax efficient investing and you are likely to be inundated with information regarding *tax-efficient* investment vehicles, such as mutual funds, exchange traded funds (ETFs), separately managed accounts (SMAs), municipal bonds and others.

Although these investment vehicles can play a part in tax-efficient investing, the key to a successful investment strategy is to realize tax efficiency is part of the investment process, not a product.

The tax-efficiency process is a balance between mitigating or lessening the tax bite while avoiding the tax tail wagging the investment decision dog.

Tax efficiency is a complex issue. Unfortunately, there are many myths and oversimplifications that investors utilize without analyzing the merits and effects on their portfolios.

Two common myths

Myth #1: Investors who use a passive strategy or index funds, believe they have tax efficiency by de facto.

In a study published by Andrew Berkin and Jia Ye in the July/August 2003 Financial Analysts Journal, the authors state: "Our findings show that no matter what market environment occurs in the future, managing a portfolio in a tax-efficient manner gives substantially better after-tax performance than a simple index fund, both before and after liquidation of the portfolio."

Myth #2: A Kentucky resident solely utilizing Kentucky municipal bonds for fixed income investing is likely to believe they have maximized their tax efficiency via tax-free interest at the federal and state levels.

These municipal bond investors may fail to realize that Kentucky municipal bonds' total return (income return plus capital return) as a whole have been consistently sub par relative to the national municipal bond average. Because of this return differential, Kentucky investors could increase aftertax returns by utilizing taxable and/or non-Kentucky municipal fixed income instruments.

Additionally, municipal bond investors chasing higher coupon rates could be hit with AMT (Alternative

Minimum Tax), which can further hinder portfolio tax efficiency.

Implementing a two-pronged process

For an investor to incorporate a tax-efficiency process into their wealth accumulation and portfolio investment strategy, he or she must implement a two-pronged process: *financial planning* (a big-picture view) and *portfolio policy* (a detailed view).

Financial planning process issues can include:

- What taxes are you trying to minimize/mitigate: income, capital gains, or estate taxes?
- Use of separately managed accounts.
- Priority of funding a 401k, IRA, Roth IRA or taxable account.
- Defining the goals your assets represent: retirement, estate, philanthropic, etc.
- Segmenting less tax-efficient assets into tax deferred accounts.

Portfolio policy issues are usually addressed in an Investment Policy Statement (IPS) and can include:

- Use of FIFO (highest-in-first-out) cost basis.
- Tax loss harvesting while avoiding wash sale rules.
- Individual security and investment vehicle selection.
- After-tax portfolio/benchmark comparisons.
- Rebalancing policies.

Using this two-pronged approach can help prevent you from making common investor mistakes such as:

- Failing to fund 401k, especially when a matching contribution is available – effectively giving up "free" money.
- Failing to fund a non-deductible IRA. Just because you do not get to deduct the IRA, it still has substantial tax-deferral benefits, plus the non-deductible part carries as a cost basis for your IRA.
- Holding a tax deferred annuity in an IRA account. This is the "Animal House" version of double secret tax protection.
- Holding a mortgage with the ability to pay it off. Having a mortgage deduction feels like tax savings, but many times this is the equivalent of spending a dollar to save fifty cents on taxes; it's a net loss.

• Failing to retain cost basis documentation. Documentation is your weapon against the IRS.

• Failing to itemize investment advisory fees. When you are able to



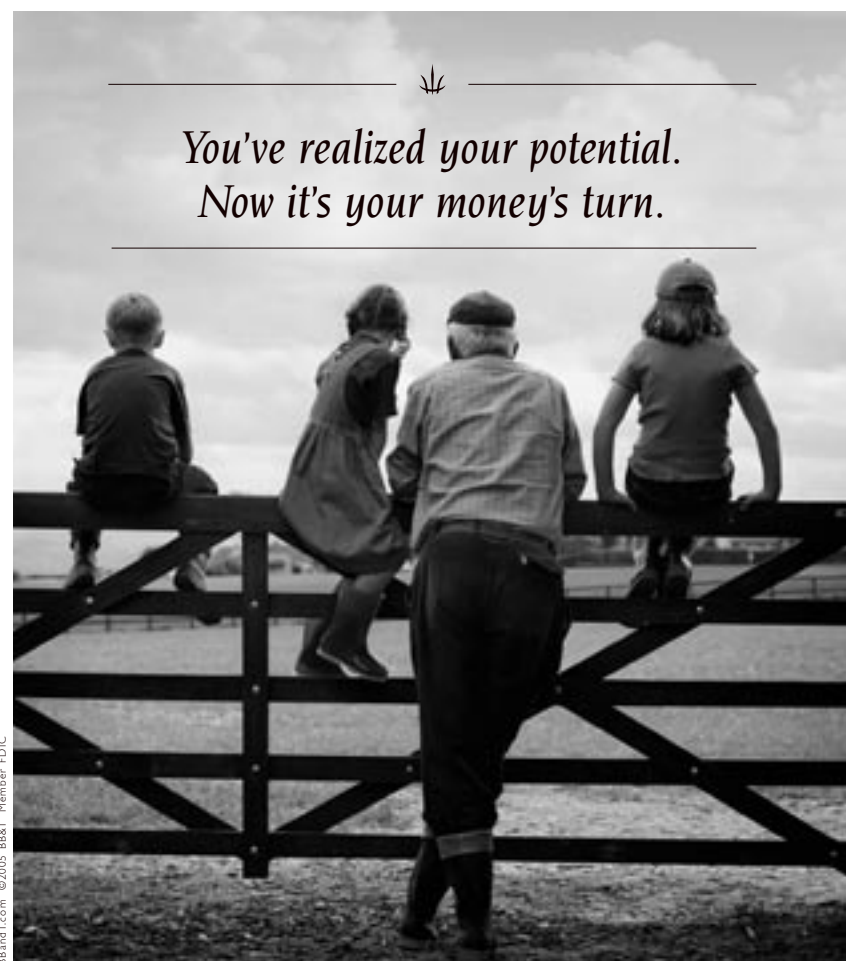
but do not itemize your investment advisory fees you are likely overpaying the government.

• Stock option planning. This area is ripe with planning fumbles and overpayments in taxes.

Making tax efficiency part of your investing process can further increase your wealth accumulation and

portfolio growth. Due to complexity, you should consider seeking out the assistance of a qualified professional before you begin the process.

Brian C. Breidenbach, CPA, PFS, CFA, is the managing principal, Breidenbach Capital Consulting, LLC, Louisville, Kentucky.



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Equity management

An invitation to mediocrity



Donald F. Kobler

I would like to question three popular portfolio concepts: rebalancing, broad diversification and growth-versus-value.

First, the idea of **periodic equity rebalancing**. This involves cutting back the stocks that have advanced beyond some policy guidepost (let's say 10 percent of a portfolio) and reinvesting in or adding to a stock that has underperformed – or buying a new name.

I equate periodic equity rebalancing to something said by Warren Buffett – “cutting the flowers and watering the weeds.” There is risk involved in letting the flowers get large but the Dow Jones Averages and the S&P 500 make very few changes. Both have beaten a majority of money managers over a long period of time – managers who are paid for this underperformance.

I have a hunch that the culprit is investment policy rather than stock selection. Rebalancing is a popular buzz word around today. I think it's

an open invitation to mediocrity.

Second, I question **diversification** – or what is more accurately described as *excessive diversification*.

For accounts of \$5 million, I see no reason to own more than 20 to 25 stocks or 4 to 5 percent in each. How many companies can one follow? Besides if you want 75 to 100 names, you can buy a mutual fund. Their fees are reasonably comparable to those of separate account managers, and their records, for the most part, are satisfactory. But if you want to manage individual accounts, discard the idea of a large number of names. Adequate diversification can be obtained with a more manageable number.

Third, conventional equity managers fall into two main groups: value and growth. This has never made a great deal of sense to me. We all are seeking both at a good price. This merges **growth and value**.

Let me raise the issue by using our own community's Brown-Forman

Corporation. In 1992 (that's as far back as my current chart goes), it was selling at about \$14 and earning 95 cents or at a price/earnings ratio of 15X. Today, it is at \$56 and earned \$2.52 in its latest fiscal year or at 22X.

The business is substantially the same as it was 13 years ago – whiskey, wine and other spirits. It would have been called a “value” stock then. Today it is in the “growth” column.

The Dow Jones Industrial Average was about 3300 then and earning \$160, thus selling a little over 20X.

Today Brown-Forman is selling at about the same percentage *premium* to the market as was its percentage *discount* 13 years ago. Yet the business is substantially unchanged.

It hasn't switched to making tires; it still produces alcoholic spirits. How can the same company be a “value” stock at one point in time and a “growth” stock at another? I submit that value and growth are really one and the same – defined in today's terms mainly for *marketing* purposes.

Finally, let me summarize by suggesting that investment managers should be skeptical of popularity.

Rebalancing, broad diversification, and the separate styles of growth-versus-value, constitute popular themes today. The crowd is usually wrong. At a football game, I don't know why anyone would try to get a hot dog or go to the bathroom at halftime because you can't do either without a crowd.

Most investors are smart enough. They understand the principles of investing; many are CFAs. However, I think that based on the long-term record of professional money management, there is room for improvement.

As Peter Drucker said, “Nothing is less productive than to make more efficient what should not be done at all.”

Donald F. Kobler is senior executive, J.J.B. Hilliard, W.L. Lyons, Inc., Louisville, Kentucky.

GUEST EDITORIAL

Alternative minimum tax

Surprise! There can be a stealth tax on municipal bonds

Mary Dennis Jones, CFA

Individuals invest in municipal bonds to avoid federal taxes and, often, state taxes on interest earned. These investors accept a lower interest rate on municipal bonds, which is generally slightly higher than after-tax yields on similar taxable bonds, depending on their marginal tax bracket. Many investors are learning a surprising truth that all municipal bonds (and bond funds) do not deliver tax-exempt income.

An additional tax called the Alternative Minimum Tax (AMT) enacted in 1969 may cause municipal bond interest to become taxable, frequently at a higher rate than your marginal tax rate. It causes taxpayers to calculate tax liability twice: first, under the regular code, and second, under the AMT rules. Tax liability is the higher of the regular tax or the alternative minimum tax figure.

To avoid paying taxes on municipal bond income, investors need to be careful. Bonds subject to AMT often pay a yield differential of up to .25 percent that many investors find attractive.

The AMT was enacted to ensure that high-income individuals could not avoid paying income taxes due to the aggressive use of deductions. The AMT rules disallow many deductions and exemptions and include additional

income items such as some tax-exempt interest to figure AMT taxable income. The rules are very complex and it is advisable to employ a CPA or popular tax preparation software to perform this alternate tax calculation.

Municipal bond interest can be included as taxable income under the AMT rules if it is earned on a

"qualified private activity bond." These are bonds issued by municipalities to finance activities that have a private business use that also benefits the public. Qualified private activity bonds include single-family housing, student loan, airport, utility facilities, solid-waste disposal, and industrial revenue bonds. These are defined by

IRS regulation.

Income earned on private activity municipals is tax exempt under the regular tax code and is only included as taxable income under the AMT rules. This municipal interest income is added to wages and other taxable income in the alternative tax

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Investment implications of rising oil prices

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everything from bread to DVDs, cuts back even further on discretionary spending, while at the same time seeks wage increases in order to meet these new prices. It is worth noting that the consumer is responsible for two-thirds of the economic activity in the United States, so a healthy economy is not possible without a solid consumer base. In the worst-case-scenario, the U.S. is plunged into what became known in the 1970s as "Stagflation," which is an economy that is stagnant in terms of growth, but also is experiencing increasing levels of inflation.

Capitalize on chaos

So how can an investor capitalize on the rise in oil prices? Even if you don't believe the stagflation idea, there are still ways to profit from the rise in oil prices. The simplest way is to "follow the money."

Who benefits from \$70 per barrel of oil? First and foremost, the answer is OPEC. The problem is that it is difficult to invest in many of the larger OPEC nations. The answer is to look for non-OPEC countries that are net exporters of oil. Russia, Norway, Mexico, and Canada are the four largest non-OPEC exporters of crude oil. In order to make a profitable

investment in these countries, investors need to understand the ownership structure of the entities exporting the oil from these countries. If the oil is owned and exported by the government, then sovereign bonds issued by that nation may be a good bet. If the oil is owned and exported by a company in the one of these nations, then stock in that company might be the best play. Investors need to be cautious when investing in equity of foreign firms however. Many countries have laws limiting investment by foreigners, and in some case while you may be allowed to purchase securities, there may be limitations on the sale of these securities, or on taking your profits out of the country.

On the other hand, if you do buy into the idea that rising gasoline prices will lead to a recession in the U.S., then you have even more ways to profit from this view.

In addition to following the money, you also have the opportunity to express your views via sector selection in the U.S. equity and bond markets. If, as we propose, consumers are cutting back on their purchases of discretionary goods, then you can decrease your investments in consumer cyclical companies like retailers, restaurants, and hotels, and instead invest in non-cyclicals like super markets, health care, and pharmaceuticals.

Investors should also pay close attention to the energy sector. To date, demand for gasoline has been fairly inelastic (up 1 percent year-over-year as of August) – meaning that as the price of gasoline has increased consumers have not lowered their demand for it. Common sense tells us, however, that there must be a price at which gasoline becomes so expensive

that consumers will start to use less. If you as an investor can determine what that price is, then you should sell refiners like Chevron-Texaco, British Petroleum, and Shell. If you believe that rising fuel costs are placing a large burden on business, particularly businesses that rely heavily on the transportation of goods around the country, then you might avoid freight haulers, transportation companies, airlines, and the like.

If you prefer to invest in bonds, then U.S. Treasury Inflation Protected securities, or TIPS, are an excellent way to invest in a rising inflation view.

Winners and losers

In the grand scheme of things, we are all consumers, so in the end, we all lose when the price of oil goes up. The real winners are the entities, be they governments or corporations, that own the oil being consumed.

We can, however, ease the pain of being a loser by making wise investments in the winners, and by understanding the ramifications of rising oil prices on the U.S. economy and markets.

Whether you believe in the possibility of a gasoline-induced recession or not, it is hard to deny that consumers are paying an ever increasing portion of their wages on fuel, and that with careful study, investors can profit from the consumers pain.

There are a myriad of ways to capitalize on an economy that is under growing pressure from rising fuel costs. Our job as investors is to choose a way that fits within our individual tolerance for risk.

J. Richard Robben, CFA, is a senior portfolio manager, Invesco Worldwide Fixed Income, Louisville, Kentucky.

Retirement planning

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in order to repay the loans being made today from the Social Security surpluses.

There has been movement to convert Social Security to a defined contribution program, whereby individuals would have a separate account over which they would have some investment authority. As with other defined contribution plans, some of the responsibility and all of the risk would be assumed by each participant.

As our retired population grows in number, the importance of adequate funding grows with it. In the last two

decades, corporations have shifted retirement plans from defined benefit plans to defined contribution plans, effectively shifting the risks from employers to employees.

As individuals become increasingly in charge of their retirement plan, it is vital that they be equipped with information about retirement finances, education so the information can be understood, and investments that are affordable, obtainable and understandable.

John Vinsel, CFA, is vice president and manager, Fifth Third Bank's Institutional Client Group, Louisville, Kentucky.

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Alternative minimum tax can affect municipal bonds

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calculation. Therefore, an investor with a significant amount of income from private activity bonds could have additional income under the AMT rules.

What other things can contribute to being subject to the alternative minimum tax?

- A high number of personal exemptions.

- High state and local tax deductions.
- Miscellaneous itemized deductions that exceed 2 percent of adjusted gross income, including investment expenses, legal fees and unreimbursed employee expenses.
- Exercising a large incentive stock options grant, which causes additional income under the AMT rules.
- Large long-term capital gains that can reduce or eliminate the AMT exemption.

An increasing number of taxpayers find themselves paying the AMT each year because it is not indexed for inflation like the regular tax code and marginal tax rates have declined. The AMT impacted fewer than 1 percent of taxpayers prior to 2000.

According to the U.S. Treasury Department, the AMT will impact an estimated 20 percent of taxpayers in 2010. The middle class will be hit the hardest. More than 90 percent of Americans with incomes between \$100,000 and \$500,000 will be levied this tax by 2010, with married couples having a higher likelihood. In this range, much of the income is taxed at 25 percent or less while AMT rates start at 26 percent and increase to 28 percent.

To avoid paying taxes on municipal bond income, investors need to be careful. Bonds subject to AMT often pay a yield differential of up to .25 percent that many investors find attractive.

However, it is not nearly enough to make up for the AMT liability incurred, if an investor becomes subject to the tax. Since most

municipals are not subject to AMT, it is relatively easy to find investments that are fully tax-exempt.

Bond funds frequently invest in AMT securities to enhance their yields. The SEC requires a minimum of 80 percent of income to be exempt from taxes for a fund to call itself "tax-exempt." Often much of the other 20 percent is invested in bonds subject to AMT and sometimes, fully taxable bonds. If a municipal fund does not have "tax-exempt" in its name, there is no limit on the amount of AMT or regular taxable income. High-yield municipal funds often hold a lot of bonds subject to AMT as well.

Since the AMT has complex rules, the way it impacts bond investors will vary widely depending on individual circumstances. Financial advisors and CPAs can determine whether municipal bonds or bond funds earn taxable or AMT subject income.

Investors should consult a professional to learn if they will be impacted.

Mary Dennis Jones, CFA, is a senior vice president, Atlas Brown Advisors, Inc., Louisville, Kentucky.

Employee stock options

Continued from page 4

through option exercises, stock purchase plans, retirement plans, and stock grants. More than 15 percent of a single stock in a portfolio would usually be considered a concentrated equity position. This "too many eggs in one basket" syndrome adds unnecessary risk. There are many ways to reduce this risk – some of which do not have to involve the sale of your company stock. Alternatives you may consider when managing your concentrated equity position include:

- Gradually selling & repositioning
- Borrowing against your stock
- Option-based alternatives
- Exchange funds
- Charitable techniques
- Combining strategies

Finally, there are very well-defined rules, set by the Securities and Exchange Commission (SEC) and your company's trading policy, that

govern trading in your company stock, particularly if you are considered an "insider." You must be aware of these rules and factor them into your option exercise strategy.

As you can see this is a highly technical and complex area. The opportunities associated with employee stock options can be significant, but so can the dangers. As you develop a strategy for exercising your options, make sure you include your financial consultant, along with your team of tax and legal advisors. This team of professions can help evaluate the varying cash requirements, tax consequences, and risks associated with exercising your options.

Carroll R. Goslee, CFA, CFP, is a registered representative and an executive planning consultant, A.G. Edwards & Sons, Inc., Louisville, Kentucky, member SIPC.

Retirement responsibilities

Elizabeth S. Peabody

Investors may be interested in the recently issued joint statement from the Securities & Exchange Commission (SEC) and the Department of Labor (DOL) relative to the responsibilities of retirement plan consultants.

Although these two governing bodies have differing and distinct charges, their duties overlap when monitoring retirement plans.

The impetus of the statement was a study that found conflicts of interest in the retirement plan consulting community and that consultant qualifications may not be adequate under our current laws that govern pensions and 401(k)s.

Two acts of Congress are the foundation for establishing responsibilities as it relates to overseeing retirement plans.

They are the Investment Advisers

Act of 1940, enforced by the SEC, and the Employee Retirement Income Security Act (ERISA).

The Investment Advisers Act of 1940 defines a fiduciary, and addresses her responsibilities. A fiduciary, according to the Act, manages assets and administers the plan as a "prudent expert" would. This includes determining a plan's investment objectives, allocating assets, selecting money managers, and tracking the performance of assets. A fiduciary is to provide objective, disinterested advice, and to disclose any conflicts of interest.

ERISA addresses the role of a fiduciary relative to managing and administering retirement plans.

For more detailed information about the recent joint statement, visit the SEC Web site at www.sec.gov.

Elizabeth S. Peabody is president, Stegner Investment Associates, Louisville, Kentucky.



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