Meeting the Needs and Addressing the Financial Goals of Private Investors

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Dear Business Times readers:

The CFA Society of Pittsburgh, in conjunction with the Pittsburgh Business Times, is proud to publish this investment supplement, “Meeting the Needs and Addressing the Financial Goals of Private Investors.” Between complex taxation issues and an increasingly volatile investment environment, individual investors face a multitude of challenges in growing, protecting, and transferring their wealth. In the following articles, written by local members of the CFA Society, we have tapped their expertise in areas as diverse as investment planning and asset allocation, market risk and return, and investing in alternative asset classes.

Founded almost fifty years ago in 1957, the CFA Society of Pittsburgh is a member of the CFA Institute, the world’s largest association of investment industry professionals. The Pittsburgh chapter has approximately 400 local members, who work in the investment industry as portfolio managers, security analysts, investment advisors, and other financial professionals.

The globally recognized Chartered Financial Analyst designation is the highest professional accomplishment in the investment industry. CFA charterholders successfully complete three levels of demanding examinations, proving extensive knowledge of financial analysis and portfolio management. Every CFA charterholder has the responsibility to uphold the highest ethical standards, a commitment that helps assure investors that their interests are protected with integrity and professional responsibility.

I hope you enjoy the supplement and find our contributors’ insights valuable. If you would like to learn more about the CFA designation or the CFA Society of Pittsburgh, please visit our Web site at www.cfainstitute.org/pittsburgh, or contact one of the board members below.

Sincerely,

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Where Would You Invest Right Now?

By Nathan Sax, CFA

Bring up investments at a social gathering and you are sure to hear people asking about, “where to invest now.” What they mean is, “what is the next hot investment?” You might hear that, “interest rates are too low for bonds to be worthwhile, commodities are the new alternative asset class, the strength in small cap stocks is at an end and large cap stocks are coming back.” Pontifications like these are not particularly relevant to the long term financial objectives of individual investors. Rather than attempting to forecast market returns, consider your personal objectives and the time frame you have to achieve those goals. Then put together an investment portfolio that is suitable in terms of your propensity for risk, your time frame, need for liquidity and diversification.

The concept of relative performance has become ingrained in people’s minds over the past 25 years or so. How does my portfolio manager or mutual fund perform against market indices? While you certainly want to select good managers, there are other investment decisions that are more likely to determine how well you do funding your retirement and other financial objectives. In that sense, an individual investor is no different than a pension plan.

Many Defined Benefit pension plans carried large surpluses into the year 2000. After the long bull market, those surpluses shrunk. Within a few years, the Funds had smaller surpluses or funding deficits. Yet, their money managers may have performed well against their market indices. So what happened?

If the Treasurer of a large corporation was looking at the company pension plan in 1999 and saw that it was 162% funded, meaning that it could lose a large portion of its market value and still be fully funded, why continue to take the same amount of risk? Yet firms all over the United States let their allocations to equities and private equities run on or remain at higher than their target levels in search of even greater gains. Decreasing these allocations to preserve full funding would have safeguarded retirees or, at least, decreased the risk of a shortfall in funding. That could have been accomplished by revisiting the original asset allocation to increase exposure to fixed income securities and reducing equity exposure.

Are your assets suited to your financial situation? If a 60-year old wants to retire in three years, would a portfolio of one-third real estate and two-thirds equities be appropriate? Should a 25-year old keep all her money in cash? Do this and, whether your managers beat the index or not, you will have a significant mismatch between your assets and liabilities. Your asset mix may not appropriate for your time horizon. Likewise, despite access to the most knowledgeable financial experts, institutions construct portfolios for their pension plans that look very much alike. Assume that a typical Fortune 100 company pension plan has 40% domestic equities, 25% domestic fixed income, 20% international equities and 15% alternative assets (private equity, real estate, hedge funds, et al). Would it make sense for institutions to hold this “typical” asset mix if they have liabilities very different from each other? It may give the CFO confidence to have a portfolio that looks just like that of Honeywell or General Electric, but that does not make it appropriate for the beneficiaries of his Company Plan.

Now let’s go back to the individual investor. Let’s say you are 40 years old. You have accumulated $300,000 in your tax deferred retirement account, and you want to retire in 25 years with $5,000,000. Your asset allocation is 40% U.S. large cap, 10% U.S. small cap, 25% fixed income, 15% international equities and 20% cash or shorter term fixed income. Your weighted average expected return on this asset mix is 7% and you are making annual contributions of $10,000. If you achieve that expected return, you will only have $2,260,000 with which to retire. Is there a way to get that expected return to the 10.8% annually you need to hit your number $5,000,000? You consider increasing your risk exposure by taking on more speculative investments. But, realistically, you know you do not have what it takes to ride out a high level of volatility.

In most cases, especially when expected returns are not very compelling, you are better off increasing your contributions. That means saving more to accumulate shares and bonds so that, when returns do jump, you will benefit from your patience and discipline. The power of compounding is also far more powerful as you expand your investment time frame. If you start saving for retirement at 23 years of age and wait until age 70 to begin withdrawing funds from a tax deferred savings plan, you will be miles ahead of someone who started saving at age 45 and tapped this savings beginning at age 60. With an average annual return of 7% and annual contributions of $10,000, the former will have accumulated about $3.3 million while the latter will begin retirement with approximately $250,000.

An investment portfolio that lines up well with your time frame will greatly limit the risk of a shortfall in funding. Know how much risk you are willing to assume, diversify so that your assets are not overly concentrated and keep fund expenses and management fees down. Use index funds to neutralize some portion of your assets and pick your active managers carefully. Maximize your contributions and make sure you have built in a reserve for funds you will or may need in the near term. These fundamentals will stand any investor in good stead through the ever shifting vagaries of the capital markets.

Nathan Sax, CFA is the Director of Fixed Income at CIM Asset Management in Pittsburgh.
Meeting the Needs and Addressing the Financial Goals of Private Investors

The most important questions facing the retiring baby boomers is how much money is sufficient for retirement and how much can be safely withdrawn annually. In answering these questions, it is important to understand the three major financial risks that retirees face:

- market risk
- inflation risk
- mortality risk

Dealing with risk almost always involves tradeoffs. Fixed income securities have less market risk but more inflation risk. Equities have less inflation risk and more market risk characteristics. Mortality risk involves the calculation of longevity, an impossible task. In order to improve our odds that we don’t run out of money and that we are able to at least maintain the purchasing power of our retirement assets, we need to take on a reasonable amount of market risk.

This means that retirement portfolios should have some combination of equities and fixed income securities. During retirement, however, market volatility and cash outflows can have extreme consequences. Consider the example of retirees with a beginning $1 million portfolio in the first year of retirement and an outflow of $500,000 at the end of the year. In one case, the market goes up 25% in year one and down 20% in year two. In the second example the opposite occurs. Both portfolios had the same total investment return of zero over the time frame. In the second scenario with the big negative return, the portfolio value was 38% less than in scenario one at the end of the second year. (Retirees in the first example had $600,000, while scenario two retirees had only $375,000.) This is a dramatic illustration of how the sequence of returns combined with the timing of the outflow in a volatile environment can affect a portfolio.

Sometimes it is instructive to look at the past to forecast the future. A key instructive period in current economic history for retirees is the time period 1973 to 2002. Suppose you retired on 1/1/73 at age 60 with a portfolio with an initial value of $1 million. The portfolio had an allocation of 75% S&P 500 and 25% investment grade bonds. The starting withdrawal rate was 4% which equaled $33,333 per month and grew with actual inflation over the next 30 years. As shown in Table 1, after 30 years, the portfolio value was just under $1.3 million and about $3.7 million had been distributed over the 30-year period. The retiree would be 90 years old.

### TABLE 1

<table>
<thead>
<tr>
<th>Year</th>
<th>Rate of Return</th>
<th>Amount in Fund</th>
<th>Return on Investment</th>
<th>Amount Before Withdrawal</th>
<th>Amount Withdrawn</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973</td>
<td>4.75%</td>
<td>$1,000,000</td>
<td>($147,500)</td>
<td>$852,500</td>
<td>$117,460</td>
</tr>
<tr>
<td>1974</td>
<td>26.40%</td>
<td>$735,040</td>
<td>($194,051)</td>
<td>$540,990</td>
<td>$117,460</td>
</tr>
<tr>
<td>1975</td>
<td>37.26%</td>
<td>$423,530</td>
<td>$157,807</td>
<td>$581,337</td>
<td>$117,460</td>
</tr>
<tr>
<td>1976</td>
<td>23.98%</td>
<td>$463,878</td>
<td>$111,238</td>
<td>$575,126</td>
<td>$117,460</td>
</tr>
<tr>
<td>1977</td>
<td>7.25%</td>
<td>$457,656</td>
<td>($33,226)</td>
<td>$424,430</td>
<td>$117,460</td>
</tr>
<tr>
<td>1978</td>
<td>6.50%</td>
<td>$399,494</td>
<td>$19,953</td>
<td>$329,942</td>
<td>$117,460</td>
</tr>
<tr>
<td>1979</td>
<td>18.77%</td>
<td>$299,464</td>
<td>$39,316</td>
<td>$259,148</td>
<td>$117,460</td>
</tr>
<tr>
<td>1980</td>
<td>32.48%</td>
<td>$131,321</td>
<td>$42,653</td>
<td>$88,668</td>
<td>$117,460</td>
</tr>
<tr>
<td>1981</td>
<td>4.98%</td>
<td>$56,514</td>
<td>($2,814)</td>
<td>$53,700</td>
<td>$117,460</td>
</tr>
<tr>
<td>1982</td>
<td>22.09%</td>
<td>($63,760)</td>
<td>($10,085)</td>
<td>($77,844)</td>
<td>$117,460</td>
</tr>
</tbody>
</table>

It is interesting to note that if we had set the initial withdrawal rate at 5% under the same assumptions in lieu of 4%, the portfolio would have run out of money in 20 years in 1992. This retiree would be 80 years old. Another example of withdrawal rates during that same period would be to assume again that you retire at 60 on January 1, 1973, with the same retirement fund of $1 million. This time you plan to take $117,460 each year, an amount equal to a long-term equity rate of return, but you make no adjustment for inflation. The pattern of actual annual returns and remaining funds is shown in Table 2. This retiree runs out of money by the time he would be 69 years old.

The illustrations in Tables 1 and 2 should not be taken lightly. Everyone contemplating retirement must forecast variables that are unknowable in advance: age of the last-to-die spouse, inflation rate, inflation rate of products most used by seniors including health care, the economic climate and the investment return of their portfolio. The only input into the equation of which we have any control is the withdrawal rate. It makes sense to understand its sensitivity to the market movements and to wisely ration its use.

Our research indicates that an initial withdrawal rate of 3 to 4% is the only amount that provides 100% probability that you will not exhaust your savings before you die.

Kathleen S. Wright, CFA and President of Wright Associates
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Meeting the Needs and Addressing the Financial Goals of Private Investors

CFA Society of Pittsburgh

By Scott Dooley, CFA

One of the fastest growing investment products, Exchange Traded Funds better known as ETFs, has taken the financial industry by storm. ETF assets have more than tripled in the past four years, growing to over $300 billion. You can no longer read a financial magazine or watch television without coming across advertisements about these unique, index-fund like investment vehicles. If your broker hasn't talked to you about these low-cost, tax-efficient, and transparent ways to gain access to the market, it's time to start asking questions. In this article we'll cover the concept of using ETFs as the core or foundation of your portfolio and creative tax-loss harvesting strategies.

For those of you who do not know, an ETF is a basket of securities that trade as a whole on a stock exchange. An ETF tracks a specific market index, such as the S&P 500, and differs from an index mutual fund in that it trades throughout the day like a stock. ETFs cover a broad range of asset classes including large, mid, and small cap stocks, bonds, real estate, gold, and other commodities. In addition, there are a multitude of sector and international country specific ETFs available. Because they are not "actively managed" like most mutual funds, the internal costs are generally lower than many mutual funds. ETFs are also tax efficient because they generally do not generate the same volume of tax events as other types of investments.

Amid the constant confusion of investment strategies and the low probability of picking the next hot stock or mutual fund, it is prudent to build your portfolio with a solid foundation. Using a well-allocated portfolio of ETFs as the core of your investment strategy gives you this foundation.

The first step in constructing the core of your portfolio is to determine your risk tolerance; this can be done through one of the many online questionnaires available or through the help of a financial advisor. This process will help to establish your risk and return objectives. As well as the constraints: such as time horizon, taxes, and liquidity requirements.

Once the level of risk to be taken is determined, the second step is setting the asset allocation policy. This involves deciding the portfolio's exposure to the various asset classes. In other words, the process of dividing investments between large cap or small cap stocks, bonds, real estate, and cash to optimize the risk/reward tradeoff based on your specific situation and goals.

The core of a portfolio's asset allocation should be constructed in accordance with Modern Portfolio Theory and the Fama-French three-factor model, or the science of investing. Modern Portfolio Theory consists of developing the optimal portfolio through analyzing the relationship between risk and return. The Fama-French model identifies the three sources of risk that compensate the investor with premium returns: market factor, size factor, and value factor. Rather than guessing which stock or asset class will outperform, your portfolio should be allocated based on this clear and consistent philosophy using ETFs.

The third step is security selection. With over 200 ETFs available, it is necessary to have a systematic, disciplined
One of the fastest growing investment products, Exchange Traded Funds better known as ETFs, has taken the financial industry by storm.

approach to selecting which ETFs to own to fill each asset class. The selections should be made through screening the universe of ETFs. This should include reviewing the sponsor of the ETF, costs, construction methodology of the index, sector weightings, historical and expected returns, standard deviation (risk), and correlations for each ETF.

The final step is the feedback stage. This covers evaluating the performance of the portfolio to make sure your objectives are being met, as well as reviewing your risk tolerance. This should be done at least on an annual basis. The assessment should include a comparison between your portfolio and an appropriate benchmark, looking at both the return and risk as measured by standard deviation.

In addition, your portfolio should be rebalanced periodically. This forces the discipline of selling high and buying low, while keeping emotions out of the process. There are various strategies to rebalancing, but this is typically done on a quarterly basis with a specific level of tolerance.

As part of the investing process, it has become increasingly vital to effectively manage the tax consequences of your portfolio. As a product, ETFs have historically been tax efficient investments. Due to the low turnover of ETFs, capital gains have rarely been distributed. They also trade on an exchange, so unlike the structure of a traditional mutual fund you will not face tax consequences from shareholder activity.

While investing in ETFs can be tax-efficient, another aspect of tax management that is often overlooked is tax loss harvesting. Tax loss harvesting with ETFs is the process of selling an ETF with a loss and purchasing a similar ETF to maintain exposure to the same asset class or market segment. This is a great addition given the significant market volatility the market has been experiencing and can be incorporated into your quarterly rebalancing process to potentially increase returns.

Scott Dooley, CFA is the Managing Partner and Chief Investment Officer for Blue Vase Capital Management in Pittsburgh.

For an investment analysis of your portfolio, Contact Scott Dooley, CFA

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The Burden for Saving is Shifting

By Mike Kauffelt, CFA

Up until about a decade ago the formula for having a comfortable retirement was fairly simple. First get a good job with a solid employer. Next, work for 30 or 40 years while paying off your mortgage and helping a kid or two through college. Then take your modest savings and combine that with your pension earned from work and your social security payments from the government and prepare to live the good life. Unfortunately this formula is quickly becoming a dream of the past as two of the important pieces in the formula above are breaking down. Private companies are eliminating or freezing their defined benefit pension plans (the ones that pay you a set percentage of your pay from your working years as long as you live) in favor of self contributing pension plans (401-k type plans where you have to contribute your dollars and make those dollars last for your lifetime). Social Security is also due to go through some drastic changes based on the projections for it to be severely under funded over the coming decades. If you are in your forties you will not likely qualify for a full benefit from Social Security until you are 67 and that age limit will probably rise closer to 70. It also seems highly likely that those future benefits will be less generous in terms of being adjusted upward over time and as a percentage of the dollars you paid into the system over your working career. I’m not a pessimist who thinks that Social Security will disappear, but I do firmly believe the benefits paid over the next several decades will be less generous in inflation adjusted dollars then the benefits received over the last few decades.

That means the current generation of workers need to save, save like they never have in their lifetime. A recent survey by a major mutual fund company revealed some startling results about the level of savings for workers in different age categories. The survey measured how much an individual had in total savings and investments excluding the value of their home. They surveyed four different age categories 25-34, 35-44, 45-54 and 55 and older. Out of all the ages surveyed over half of the investors had less than $25,000 in total savings. Even in the older age groups, which you might expect to be more prepared for retirement, 41% and 39% respectively had saved less than $25,000. Those who had saved over $250,000 for retirement in the older age groups were 16% and 19% respectively. Those hardworking savers in the last group (hopefully you are one of them) can probably think about retiring. Those in the bottom 80% plus had better plan on enjoying working because they will not be able to afford to stop.

Maybe you think the solution is to find a good financial planner or money manager (preferably one that employs some bright CFA charter holders) and have them whip your investments into shape. That is a great start, but even the best investment returns can’t make you a millionaire with less than $25,000 in savings to invest. To use an analogy with gardening, you would not expect a landscape firm to plant and grow a beautiful yard for you on your suburban half acre lot with only a handful of seeds? If we are ultimately to provide the seed for our retirement as our employers and our government provides less, we need to step up our level of savings dramatically. Unfortunately saving is like dieting, it is easy to talk about and do for a while, but hard to maintain for the long-term. The old rule of thumb was that you should save 10% of your income for your retirement. I’m telling our younger clients that they should be trying to save 20% of their income and making sure that those dollars are working hard for them over the next 20 to 30 years so they don’t have to work hard for their entire lives.

Mike Kauffelt, CFA is the President and CEO of Bill Few Associates in Pittsburgh.
Acquiring, Holding and Transferring Art

By Peter Eberhart

Whether you’re just beginning to purchase art, or have been a passionate collector for years, it’s important to understand the tax consequences inherent in acquiring, holding and transferring art. Art investments require the same careful treatment as the rest of your financial portfolio.

Can I Deduct That?

There are many costs associated with buying art other than its initial cost, including storage, display, appraisals and insurance. These costs may be deductible on your federal income tax return depending on how the IRS classifies you. Generally, artists, dealers and investors can claim these types of expenses, if they’re incurred as ordinary business expenses, or in producing income. Collectors, though, are often severely limited in these deductions. But depending on your circumstances, you may actually want to be classified as a collector to obtain other tax benefits.

To be classified as an investor you must show that you collect primarily for investment purposes. The IRS looks at the purpose for acquiring a piece, length of time it’s held, and how proceeds from a sale are used. Implicit is the notion that investors sell, or are willing to sell, the art for a profit.

Most purchasers fall under the category of collector. Collectors appreciate art and accumulate it for personal enjoyment. While expenses for acquiring and maintaining art are not deductible for collectors, they often receive favorable tax treatment when their art is sold or donated.

What Will I Pay?

The 2003 Tax Reconciliation Act excluded lowering the capital gains tax rate for collectibles, including art. Consequently, gains on sales by investors and collectors of art held more than a year are still taxed at 28%. The rationale is that art in their possession is considered a capital asset. For artists and dealers, however, the art they sell is considered inventory and typically taxed at rates up to the highest ordinary.

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In practice, the charity will also require the donor to pledge that he’ll leave the remaining fractional interests to the charity when he dies. The last thing a charity wants is to have partial ownership of a work in perpetuity with others.

Cash and A Deduction?
Another transfer technique that not only removes art from the owner’s immediate possession, but also puts money into his pocket, is to sell art to a charity at a substantially reduced price. This “bargain sale” strategy monetizes the art’s value for the taxpayer and produces an immediate charitable income tax deduction. Every bargain sale has two elements: sale and gift. The sale element calculates the taxable gain, and the gift element calculates the charitable deduction. Most charities are quite familiar with this technique and willing to explore such purchases.

Still More Cash
Another idea is funding a charitable remainder trust (CRT) with art. The idea is to allow the trustee of the tax-exempt CRT to sell the art and redeploy proceeds into a portfolio of stocks and bonds. The portfolio can pay you, or you and your spouse, an income stream for a term of years or for your lifetimes. You’d also get a charitable deduction based on your age, interest rates, and actuarial assumptions by the IRS. Since the donation fails the related use test because of assumptions by the IRS. Since the donation fails the related use test because of the immediate sale by the trust, artwork with a relatively high basis should be used for this strategy.

But if a sizable deduction is driving your decision to transfer art, a CRT may not be the vehicle for you. Timing can be another issue. Best to check with an estate planning expert to see if a CRT is right for your situation.

What About My Family?
Transferring works of art to family members is typically much easier to structure. Most transfers are made at the death of the collector, or of the surviving spouse. But collectors need to understand the effect their art will have on their estates. Valuable pieces might trigger an estate tax, which could cause a liquidity problem. If you’ve got a taxable estate and artwork appraised at more than $20,000, the IRS’s Art Advisory Panel will review your estate to see whether its value should be adjusted upwards – creating more estate tax. In 2004, the panel increased 56% of all of items they reviewed, boosting estate and gift tax values by more than $73 million.

Pete Eberhart is a senior director of wealth management at Mellon’s Private Wealth Management group in Pittsburgh.

Who are the region’s best CFOs?
Nominations are now available for the CFO of the Year Awards

The CFO of the Year Awards are given to financial professionals in the Pittsburgh region for outstanding performance in their roles as corporate financial stewards. This program provides many benefits to the region’s business community by highlighting the growing importance of financial executives in today’s corporate environment.

The awards will be presented in six categories at a gala dinner this November. Nominees are required to provide narrative answers to several questions about their personal work experience. Nominations are due July 21, 2006.

To request a nomination form or to recommend an individual for this prestigious honor, contact:

Richard Cerilli, rcerilli@bizjournals.com or 412-481-6397 or go to http://pittsburgh.bizjournals.com/pittsburgh/nomination/569 and request a nomination form.
The American court system is replete with cases of litigants who have been smart enough to make fortunes over a lifetime, but unskilled in the use of financial tools to help protect their wealth from encroachment. The estates of some of the richest people of their times, including financier J.P. Morgan and businessman Howard Hughes, were diminished by taxes and legal costs that might have been avoided with better planning and document preparation.

Without a sound financial structure in place, money is inherently at risk and, worse, can become a troublesome issue for family members. While most of us don’t generate the cash flows of a Morgan or a Hughes, more and more Americans are finding themselves quite well off. The United States was home to a record 7.5 million “millionaire” households in 2004, according to the Spectrem Group, a Chicago-based research firm. And the upward wealth trend is expected to continue. The Boston Consulting Group estimates that American households with liquid assets exceeding $20 million will grow by 3,000 families a year. The study also noted that the affluent often rely on diversified investment portfolios — including a component of hedge funds, private-equity funds and debt instruments — for managing wealth.

As fortunes bloom, family leaders have a responsibility to see that assets are managed properly for growth and distribution to beneficiaries. Prudent wealth management is particularly important for complex situations involving family-run businesses, partnerships, multiple advisors and children with special needs.

Take Stock of Your Resources

If you are among the rising wave of affluent families, ask yourself if you’ve done all you can to help protect the assets you’ve worked a lifetime to accrue. When evaluating your financial status, consider the following basic areas to help keep you moving in the right direction.

Risk Management

Financial risk cannot be avoided, but it can be managed through a sound asset allocation strategy designed to withstand the ups and downs of the investment market. The skillful use of insurance can also help protect family members, business assets and employees.

Trust and Estate Administration

With an estimated $10-$20 trillion expected to be passed down to heirs over the coming decade, a customized trust arrangement that takes advantage of aspects of Delaware law may help prolong family legacies.

Private Banking

Access to instant liquidity is often overlooked. A resourceful private banker can help provide immediate credit at favorable terms for funding multiple mortgages on residential and commercial properties, loans for aircraft and yachts and specialized business arrangements.

Financial and Estate Planning

The law and your life circumstances evolve over time. You want to work with a knowledgeable professional who will consult with your personal attorney, accountant and tax advisor before making decisions. You want a reputable money manager who has the expertise to regularly review your cash flow needs and suggest strategies to strengthen your portfolio’s position.

Philanthropic Services

In addition to potential tax benefits, a well-run philanthropic program can perpetuate a heartfelt expression of personal values that helps strengthen the familial bonds between parents, children and grandchildren. You may wish to discuss with your legal advisor a number of charitable trust structures available to help grantors create long-lasting legacies.

John A. Martin, CFA is the Senior Vice President and Market Director for Hawthorne, a member of PNC Financial Services Group.
“Values-Based” Investing

By Thomas M. Franks, CFA

When I tell my colleagues that I promote “values-based” investing, they frequently think I’m referring to traditional “value-style” investing, à la Warren Buffett. Although I do favor value-oriented investing and think Warren Buffett is a great investor, I have to explain that I mean something else. What I mean is that I can help clients achieve something beyond financial returns, by incorporating their nonfinancial, “core values” in their investment decisions.

Historically, this type of investing has been referred to as “socially-responsible investing” (SRI), which started in the 1920’s, but has evolved and developed significantly in the last several decades. Variations of socially responsible investing now include ethical, moral, Biblical, Islamic, and sustainable investing. Rather than explain each of these terms separately, let’s just say that they are all investing approaches that go beyond the usual investing goal of achieving the “highest return with the lowest risk”.

SRI and all the values-based variations now represent a substantial part of the investing business. According to a 2005 report by the Social Investment Forum, an industry organization that promotes social investing and tracks investments on a two-year cycle, total SRI funds grew to $2.3 trillion in 2005, and represented about 9.4% of U.S. managed investments. This is an increase of 6% from 2003 and a long climb from its beginnings at $200 Million in 1972. During the last ten years (1995-2005) SRI investments grew 4% faster than the entire universe of managed assets in the United States.

Socially-responsible investing has traditionally focused on avoiding securities of companies which are considered “bad-actors” for one reason or another. The Vietnam War caused some pacifist investors to avoid investing in defense companies, which they felt helped to prolong the war. Environmental activists, such as the Sierra Club, pushed for divestment of companies that had poor environmental records—and thus “green funds” were born.

Religious groups pressured affiliated organizations to divest any holdings in “sin-stocks”—companies that profited from tobacco, alcohol, gambling, pornography, or abortion. Today, some Christian groups sponsor “Biblically” or morally-responsible funds that avoid these investment types and generally adhere to the teachings in the good book. Catholic groups sponsor “Catholic Values” funds and Islamic groups sponsor funds that follow Islamic or Shariah law.

Some values-based investors are content to invest in a way that is consistent with their beliefs. However, I think most values-based investors also want to impact the behavior of corporations through the leverage of their investments. For example, in the late 1980’s, South Africa was pressured to end its policy of apartheid through trade sanctions by major western countries. This caused activist investors to divest securities of any company that had business operations in South Africa and therefore, explicitly or implicitly was supporting an “evil” regime. A similar effort is now underway by major US institutional investors to pressure companies operating in Sudan to help stop the violence in the Darfur region.

One common concern expressed about values-based investing is that it’s good for the soul, but for not the bottom lines of companies or investors. (In fact, sometimes the effort to manage a company for more than profit is referred to as a “double bottom line”.) Opponents argue that it is difficult enough to run a company to provide strong returns to shareholders. To them, satisfying a long list of other “stake-holders” (employees, communities, suppliers, etc.) seems like too much to ask of a profit-oriented enterprise.

However, this concern about performance has been studied over the years and some researchers have concluded that this concern is not valid. A 2004 study by Marc Orlitzky, Frank Schmidt and Sara Rynes showed that companies that adopt corporate social responsibility practices actually do better. The study concluded “there is a positive association between corporate social performance and financial performance across industries and across study contexts.” The study authors note that this link “varies (from highly positive to modestly positive) because of contingencies, such as reputation effects, market measures of financial performance, or corporate social performance disclosures.”

The move toward values-based investing has been accelerated by the rash of corporate scandals and stock “blow-ups” in recent years, as represented by Enron. More attention is now being paid to a firm’s governance, code of ethics, business reputation, and other measures beyond profitability. Mark Anson CFA, formerly the Chief Investment Officer of CalPERS, the nation’s largest public pension fund has said that “Good governance leads to good operations and better investment returns—the two are firmly linked”.

How can you find a values-based investment that suits you and your portfolio? One easy place to start is with an internet search. Socialinvest.org (Social Investment Forum’s site) and Socialfunds.com are two websites which contain an abundance of information on funds and advisors. In the past, this investing approach was only performed by smaller, niche companies. However, now even large companies, such as Vanguard, offer socially-responsible funds in order to have a more comprehensive product line.

There is a wide variety of vehicles available, with varying risk levels, for the small or large values-based investor. The most common vehicles are mutual funds. The typical values-based fund is oriented toward equities, but there are also bond funds, money funds, and balanced funds from which to choose. A more recently-available option is exchange-traded funds (ETFs), such as the KLD Social Index Fund. Finally, private equity funds, hedge-funds, and even venture-capital funds are available for those looking for higher returns and who are not very risk averse. If you are a high net worth investor or institution, you may also seek out a separate accounts adviser who could help build a portfolio to suit you.

It is easier than ever to incorporate your values into your investments, so why not do so? You can achieve good returns in your portfolio, help to improve corporate behavior, and make a difference in the world!

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Meeting the Needs and Addressing the Financial Goals of Private Investors

By Daniel P. Crawford, CFA

With traditional investments like stocks and bonds expected to experience mid to high single-digit returns over the next several years, today's investors are looking for higher portfolio returns. Some of the more industrious are turning to alternative investments like hedge funds and private equity and expecting these higher-risk options to yield returns higher than the stock, bond, or real estate markets.

Adding to this interest in these investments are media reports like those reminding us that Harvard and Yale's endowment funds have historically experienced above-average returns. This is a result of having 30 percent of their assets invested in alternative investments, which have performed extremely well.

A focus on high returns, coupled with media exposure, has resulted in a flood of money flowing into these asset classes. Traditionally, hedge funds and private equity funds were the domain of high net worth individuals and large institutions. They were reserved for high net worth investors with annual incomes of more than $200,000 and investable assets greater than $1 million (excluding residential real estate). Because these securities are not registered with the Securities and Exchange Commission (SEC), they have always held a certain mystique, even though they have existed for more than 30 or 40 years. Today, we are seeing hedge funds offered to individual investors for as little as $25,000. A significantly lowered bar has allowed retail investors to participate in an asset class that was once reserved for high net worth or sophisticated institutional investors.

The hedge fund market has grown to about $1.5 trillion dollars in 2005 (compared to $1.1 trillion in 2004). Accordingly, hedge fund managers are assuming increased risk to generate additional returns. However, returns are becoming increasingly more like traditional asset classes. For example, the CS/Tremont Hedge Fund index for the 10-year period from February 1996 to January 2006 averaged 10.87 percent annually versus 8.99 percent annually for the S&P 500. Once hedge fund fees are factored in, the funds themselves most likely under-performed the S&P 500 over this time period.

With hedge funds, investors must be cognizant about a lack of liquidity and transparency, tax inefficiencies, and unique fee structure associated with these investments. If possible, investors should hold these in qualified plans based on the high volume of trading with which hedge funds get involved -- and the short-term, taxable gains that can result. Be aware that hedge funds may have a relatively high fee structure. It is common practice for most hedge funds to take twenty percent of the profits and a two percent annual management fee before the investor is paid. However, strong performance results and the benefits of increased portfolio diversification may justify these fees.

Investors can take advantage of these hedge fund opportunities. Hiring a trusted advisor to facilitate the investment process is prudent because of the sophisticated nature of these investments (tax considerations, lack of liquidity, etc.). Given the different types of hedge fund strategies, a "fund of funds" approach may be desirable since it may own up to 12 different hedge funds that are pooled together to achieve greater diversification. This presents less risk than the hedge fund whose manager is focused on a single strategy. To find the best approach, investors need to work with someone that can perform the due diligence and analysis to create a recommended hedge fund strategy.

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Avoiding the Perils of Concentrated Positions

By Donald M. Belt, CFA® and Brian J. Koble

Most investors do not anticipate the problems that can arise from owning concentrated positions in company stock. The costs of too much exposure to a single company can be quite significant not only in terms of market value, but also in relation to personal goals and lifestyle.

Consider the example of Jim and Betsy of Rochester, New York. Jim is a 62 year-old chemical engineer working in research and development for Eastman Kodak. Until recently, the couple had expected Jim’s association with Kodak to provide for their financial future. After all, the Kodak brand was an American icon. The company’s history dated back to 1878, and its success and financial well-being were devastated by Kodak’s late 1990’s decision to exit the photography market and its subsequent move toward digital printing and medical imaging, and away from traditional film and digital photography market.

By 2003, Jim’s division had become the lion’s share of Jim & Betsy’s investment assets. In 1993, at the age of 50, Jim considered his retirement options but chose to work until age 60, at which time he and his wife would enjoy a long and worry-free retirement.

…but Often Go Awry

Kodak’s problems -- and Jim’s -- came only gradually. In early 1997, the company was facing stiff competition from Japanese film maker Fuji; profit margins were hurting. Kodak’s stock price had fallen from the high $90’s in March to the low $70’s by summer. Jim didn’t flinch, though. He had worked at Kodak for thirty years and felt the stock would rebound strongly. In his eyes, the couple’s ten-year plan was on target.

Unfortunately, he never envisioned Kodak’s fall from grace over the course of the next several years. The company’s hesitation toward the digital photography market proved to be a tremendous mistake, as a technological revolution swept the globe. By 2003, Jim’s planned retirement date, Kodak was suffering through layoffs and debt downgrades while its stock price languished at $20. In addition, Kodak had announced plans to shift its focus toward digital printing and medical imaging, and away from traditional film products – Jim’s division.

The Consequences of Inaction

The impact on Jim’s retirement plans and financial well-being were devastating. He had never taken meaningful steps to diversify his two most important financial assets – investments and earnings power. His stock options were essentially worthless while his 401(k) and personal assets had taken a big hit as a result of Kodak’s struggles. Ultimately, Jim had to prolong his retirement date even as his position was under constant threat of elimination. Once confident and optimistic about retirement, Jim and Betsy now face an uncertain future.

The unfortunate story of Jim and Betsy is repeated regularly in corporate America today. Numerous investors face a similar and potentially perilous financial situation involving concentrated positions. While it is common for such positions to have been built on attractive historical returns, it is future performance and risk of loss that is most critical. Similar to Jim’s optimism toward Kodak, most investors are swayed heavily by past results and are frequently overconfident that an investment which has treated them so well in the past will continue to do so in the future.

Potential Solutions

Several strategies are available to individual investors exposed to the risks of concentrated positions. Many of these strategies can be used alone or in conjunction with one another to achieve better diversification and reduce risk of loss. The following outlines common strategies that can be employed.

Sell Shares of Common Stock – Sometimes the simplest strategies are the most effective. The sale of common stock can be implemented immediately or systematically over time at predetermined time intervals or price levels. With long-term capital gains tax rates at 15% today, this simple approach can be very effective.

Eliminate Exposure within the 401(k) Plan – Most 401(k) plans today provide sufficient investment options for adequate diversification. Eliminating exposure within the 401(k) can be completed without tax consequences and help preserve retirement assets.

Net Unrealized Appreciation Strategy (NUA) – Assets in your retirement plan accumulate on a tax deferred basis. Once you start taking distributions, ordinary income taxes are applied to the current market value of the assets distributed. If you use a Net Unrealized Appreciation Strategy, you may be able to defer paying tax or pay a capital gains tax rather than the ordinary income rate on your lump-sum distribution.

Exercise Incentive or Non-qualified Stock Options – Many employees today have exposure to their company’s common stock through Incentive or Non-qualified Stock Options. A key characteristic of options is leverage, whereby small changes in a stock’s price can result in large swings in option value. As a result it is important to prioritize the exercise of employee stock options.

Gifting Strategies – Gifting techniques can be used to meet philanthropic goals, reduce income and estate tax obligations, and provide cash flow streams to meet future needs. Numerous strategies exist that combine simple annual gifting techniques with more advanced strategies incorporating irrevocable trusts, charitable trusts, family limited partnerships, and other trusts designed to meet specific objectives.

Options Strategies – Numerous option strategies are available such as protective puts, covered calls, and collars. A covered call strategy can be implemented through the sale of call options on a portion of the concentrated position. Doing so provides the opportunity to receive current income that cushions against downside price changes. In a protective put strategy, an investor can eliminate downside risk beyond a certain level by purchasing put options. Finally, option-based collars involve the simultaneous purchase of put options and sale of call options on the underlying stock. The options eliminate the potential for loss below the put price and the opportunity for gains above the call price.

In a world where information moves instantaneously, technology innovation is rampant, competitors can emerge from down the street or around the world, and financial market impact is swift, the urgency to address the risks of a concentrated position is great, particularly if your financial goals could be undermined by a decline in its price.

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