

Fall 2001

THE INDEPENDENT ADVISOR

Quarterly Client Newsletter

Note from the Advisor:

My deepest sympathies go out to any of you whose family or friends have been affected by the unthinkable events of September 11th. It's hard to imagine the world going back to normal, especially when we see pictures of the World Trade Center devastation every evening on the news. It's a changed world now, perhaps forever, and I just hope that some inroads can be made in the next few months and years to bring peace to the world.

While it is difficult to shake these recent events, now we all have to get back to our everyday lives. And part of that for me is to help my clients understand how a crisis like the current one and others affect investing decisions.

What Should Investors Do In These Extraordinary Times?

Prior to the terrible attacks of September 11th, many market observers were predicting that the stock markets were within a few months of a bottom. In terms of earnings projections for corporations, 2002 at least, was beginning to look like its second half would be positive. Now in the post-WTC attack era, everyone is telling us it's a "whole new ballgame." And it may be. The airline and hotel industries have been brought to a halt, and companies are accelerating the layoffs that were already beginning to occur prior to September. Investors are filled with apprehension about the future and anxiety about their investments. What should investors do in these extraordinary times?

That depends largely on your time frame; if you don't need most of your investment money for 5 or 10 years or more, you should consider yourself a long-term investor. If you need the money sooner, you must make sure your

portfolio has enough liquidity, i.e. investments you can sell without worrying about loss of principal (examples are short-term bond funds, money market mutual funds and certificates of deposit held to maturity).

Assuming you're a long-term investor, the first thing to do is control your fear. Many people have a gut reaction to run away from such a turbulent market as we're now having. As a result, for instance, hundreds of millions of 401(k) retirement dollars have recently been shifted from stock mutual funds to bonds and/or cash. Such a move locks in your losses, as

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well as puts you in a position of having to decide when you're going to get back into stocks. As I've written about in previous newsletters, market timing is dicey at best; hardly anyone gets it right. So most people who get on the sidelines end up losing out on the next couple of market surges.

At this point, you might be saying: "Well, this is a market I just don't want to be in, at least not as heavily as I'm now invested." That's fine. What the market may be telling you is that your risk tolerance is probably lower than your current asset allocation mix reflects. If you're having a hard time sleeping at night because of worries about the stock market, chances are you need more bonds and cash and less stocks. But if you're sleeping OK, then you just need to call your financial advisor before you make a hasty, and probably costly, decision.

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Dollar-Cost Averaging Works

What else should investors be doing in a bear market? Are you ready for this answer? It's "buy, don't sell." This gets back to the "Pay Yourself First" rule. What this means is that a key to successful investing is to determine a reasonable amount for monthly investing, let's say \$500, and then stick to it. The best way to stick to it is to establish an "automatic investment plan" or AIP. Most mutual funds and fund supermarkets (e.g. Schwab, Fidelity) will gladly set you up with an AIP, resulting in the \$500 being transferred out of your checking account electronically every month and into your investment account. Then it's put to work in mutual funds of your choosing.

"...the wisest thing to be doing now is buying regularly. What you must keep telling yourself is that history has shown us that even in periods of great crisis, stock market investments have never disappeared down to zero value and will eventually recover."

Why buy at such a time? The answer is simple: the share price is lower. We all know that you're supposed to buy low and sell high, but for some psychological reason, people tend to do the exact opposite. Some investors (not my clients, of course!) panic and sell when market conditions are rough and prices are at a low ebb. Further, such investors tend to hold off on buying in uncomfortable markets, preferring to wait until prices rise and conditions look rosy. The trouble with that approach is that bargains are left on the table until mass psychology causes many investors to jump on the bandwagon and buy when prices are high. Sound familiar? It's exactly what happened in the late 1990's with the technology and Internet frenzy. We now know what that "bandwagon effect" led to: a market bubble that burst in March of 2000. We're still feeling the adverse effects of such investor behavior.

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When you buy regularly in an automatic investment plan, the result is called dollar-cost averaging. Its efficacy has been proven through diverse market conditions in the past. Consider why: if you're investing that \$500 a month in February of 2000, when your mutual fund of choice is selling at \$50, you buy 10 shares. Over the next 19 months, if you were to continue regular buying, almost every month, you would be buying more cheaply. This last month, September 2001, you might have been buying at \$30, meaning that your \$500 bought not 10 shares, but instead 16.667 shares. Conversely, when prices are high again (hopefully, sometime in 2002) you might only be buying say 8 shares with your \$500. So the overall effect of dollar-cost averaging is that you effectively lower your average share price.

Lowering your average share price will then allow you to recover from a bear market more quickly than if, for instance, you had bought a lump sum just once back in early 2000. Why? Because the lump sum purchase would be obviously at a higher share price than the average of monthly buying. That means it will take you considerably longer to reach break-even with a lump-sum purchase.

So even if it might feel terribly uncomfortable to do so, the wisest thing to be doing now is to purchase more investments, not less, and buy them on a regular basis. What you must keep telling yourself is that history has shown us that even in periods of great crisis, stock market investments have never disappeared down to zero value. And as long as the market ultimately recovers before you need the money, this strategy has worked successfully.



ABOUT THE ADVISOR...

Christopher Kuehne is an independent, fee-only, Certified Financial Planner (CFP) and Registered Investment Advisor. He has worked in the financial services industry for 18 1/2 years in various capacities, including 12 1/2 years on Wall Street as a Vice President at Merrill Lynch and Bankers Trust Company. Mr. Kuehne has an M.S. in Economics from Carnegie-Mellon University, is a member of the Financial Planning Association (FPA) and the National Association of Personal Financial Advisors (NAPFA).