

Winter 2001

THE INDEPENDENT ADVISOR

Quarterly Client Newsletter

How to React in a Down Market--Reassess Your Risk Tolerance

How many of you are currently reassessing your risk tolerance? If you're like most investors, you are concluding that you want less technology in your portfolio. Why is this happening? Behavioral economists, as I've written in this newsletter previously, believe that, when things are going well, investors become overly confident. That happened to a lot of investors from 1995 through 1999, when abnormal returns on stocks brought investors almost 20% per year on average.

The year 2000, however, was sobering for investors. Most ended the year with small losses, if they were diversified; larger losses, if they held mostly growth and technology/Internet stocks.

So just as investors tended to overestimate their risk tolerance and be overly confident during the bull market, now they are starting to over-react in the other direction and selling when they shouldn't in a down market. The continuing decline in global stock markets indicates that many stocks have

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been priced too highly to sustain their price-to-earnings ratios. It also could indicate that many investors are selling stocks at the worst possible time. Everyone knows that in an ideal world, you should buy low and sell high. But now we're starting to see the exact opposite happen. When investors jumped on the growth/tech bandwagon in recent years, they bought too high, and now they're selling too low, instead of hanging in there--the worst of both worlds.

So what lessons are to be learned from this? The obvious one is that diversification still works. During the past five years, pundits were declaring, "this time it's different—it's the new economy" and investors should devote the bulk of their investment dollars to technology. Also, they said, another thing that is different is that the ups and downs of the business cycle would no longer prevail; technology would buoy the markets to ever higher prices.

Diversification looked stodgy and unimaginative, as did the "old economy." But over the last 12 months, investors who had spread their bets among large and small stocks, as well as growth and value,

"...investors who spread their bets among large and small stocks, as well as growth and value, did better..."

came out even or slightly ahead while those who invested heavily in technology and disregarded the fundamentals, have done very poorly.

Another lesson is that upside volatility does matter. Those who had invested in little-known tech and Internet stocks and saw them skyrocket to amazing heights, felt bold and confident, under the belief that technology was going to lead the market indefinitely. But now we see that stocks with the potential to rise that high, so quickly, always have the potential to fall just as fast. And keep in mind a bit of market arithmetic that is sobering: your technology holdings that have dropped perhaps 50% will require not a 50% increase to get back to breakeven, but a 100% increase.

Initial Public Offerings (IPOs)--The Way to Get Rich?

During 1999 and early 2000, there were plenty of "moon shots," i.e. companies that went public, issuing stock for the first time, and skyrocketing up in price. Take VA Linux Systems as an example: it went public in December of 1999 at \$30 a share and soared 698% its first day to \$239.25. Where is the company now? It closed yesterday at \$4.06.

The Wall Street Journal this week published statistics about recent IPOs, showing in retrospect what a dicey game they can be. Many people think it's the way to quick riches, but perhaps only for favored investors in a bull market. They are able to buy in on the first day, and then sell at a profit soon thereafter. But those days may be gone, now that earnings matter and the bull is in retreat.

Of the IPOs that occurred from October 1999 through March 2000, the average stock is now down 40% from the offering price. As one investor put it, "it was flaky, that's what it was. No one had any idea what these stupid companies were. But you threw your money in." Obviously, once again in retrospect, that's not the best way to invest your hard-earned savings.

Over longer holding periods, according to Jay Ritter, a finance professor, the average return of IPO stocks tends to be slightly lower than those of established companies. It may seem more glamorous to take a bet on an IPO, but my advice is to stick to seasoned companies, with a history of earnings and solid fundamentals that can be researched to ensure suitability for your portfolio.

Important Changes Regarding Distribution Rules on All Tax-Deferred Accounts

The IRS has announced an important and sweeping set of changes regarding distribution regulations on virtually all tax-deferred accounts such as IRAs and 401(k)s. These rules can be utilized this year, so it's vital for everyone who is age 70 ½ or older to check into the changes, prior to requesting your RMD (required minimum distribution) this year. Most all of the new rules are investor-favorable, believe it or not (something unusual for the IRS!). For instance, under most circumstances you won't have to withdraw as much from your tax-deferred accounts this year and in future years, meaning that more of the money can continue to compound tax-deferred longer. So check with your tax accountant or financial advisor about the impact on you.

Here is a summary of some of the effects of the new RMD rules. They:

- Streamline and standardize the way lifetime minimum distributions are determined
- Simplify post-death payouts of account balances to beneficiaries
- Change the time by which a beneficiary of the account must be named
- Clarify the treatment of trusts as account beneficiaries



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 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 is a member of the Financial Planning Association and the National Association of Personal Financial Advisors (NAPFA).

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