

Right on the Money

Two local financial wizards weigh in on the new realities of building wealth in a market light years away from where it was five years ago.

BY TONY CARIDEO | ILLUSTRATIONS BY JANET DREW



Investing in 2005 is a Brave New World compared to the go-go days of the late 1990s. A mere five years after the stock market set all-time highs—only to plummet into a three-year long bear market—investment advisors have embraced a completely different mantra: Preserve what you have. Avoid losses. Lower your expectations. And most of all, diversify.

Charlie Maxwell has been on both sides of the roller coaster. Maxwell is a certified financial planner and co-chief investment officer for The Sage Partnership, a financial planning and asset management firm based in Edina. He asks a simple question: Do you know anybody who retired in the 1990s so they could manage their stock portfolios? Maxwell does. And over the past few years, he has seen those same people—a sizable percentage of them in their fifties—buying back businesses, once again donning a suit and tie, and trudging back to work. “In a low-return environment, you are forced to do the opposite of what you did back then,” he says.

Turn the clock back five years to 1999–2000. It was a “stock tips from shoe shine boys” environment. Lou Dobbs left the financial desk on CNN to join an Internet company, and thirty-year-old stock analysts were being paid high seven-figure bonuses for hyping technology stocks. Frank Quattrone, Wall Street’s premier investment banker—and now convicted felon—was paid more than \$120 million in a single year for managing the public offerings of high-flying technology companies, many of which are a shadow of their former selves. Even

the little guys were abandoning jobs to become “day traders,” riding the market’s hot stocks for instant profits and, eventually, devastating losses.

Maxwell also remembers the period as one during which even the most sophisticated older investors forgot time-tested principles:

■ **Diversify your investments,** because historically when one type of investment, such as stocks, loses value, others—bonds, real estate, commodities, foreign investments—typically move in the other direction.

■ **Not all stocks are created equal.** Large-company stocks sometimes outperform small stocks—and vice versa. “Value stocks” (out-of-favor companies with strong balance sheets in struggling industries) sometimes do better than the stocks of high-growth companies.

■ **Cash flow is king.** Even though your investment portfolio is throwing off 20 percent per year gains, your lifestyle needs to be closely tied to the cash you have available to spend—and that’s after leaving a healthy cushion of savings for emergencies, retirement, and things like college educations for your kids.

“The people who stuck to those time-tested investing principles—diversify your risk and put your money in a mix of small-cap and large-cap stocks, value and growth stocks, bonds, and some cash—weathered the past five years,” Maxwell says.

But not everyone did, and over the past several years Sage has initiated engagements with a steady stream of families and individuals now putting

the pieces back together. “The assignments are much more difficult,” he says, creating the need for “better planning, and maybe tougher advice” for clients.

Some of that advice: Delay the retirement party you were planning in two to five years, and forget about that new Hatteras yacht. You’re not as rich as you think.

Supporting a Lifestyle

“Many clients built lifestyles in the ‘90s that are tough to perpetuate indefinitely given the return environment we’ve had in the past five years,” Maxwell says. For example, let’s say an individual had a \$10 million portfolio, returning 20 percent in the 1990s, which was not unheard of. That’s \$400,000 per year. “We had people saying, ‘Why work?’”

Now, just the opposite advice applies. He’s telling people to spend less, work longer, and look at the harsh realities presented by the dramatic hit they took to their net worth. “We are doing very serious cash flow planning, plus a lot of (computer) simulation so that our clients understand the effects of what they are doing,” he says. “People who had been making substantial gifts to children—now, it’s not so easy to make those gifts out of cash flow.”

Consider the returns investors are realizing. The stock market was a true mixed bag in 2004. The Dow Jones Industrial Average was up a mere 5.3 percent in ‘04, but the broader S&P 500 was up 10.9 percent. The once high-flying NASDAQ, which is heavily weighted with technology

stocks, underperformed the big boys, turning in gains of just 9.1 percent for the year, and the Russell 1000 Growth Index, an index of the once-powerful large capitalization growth stocks, turned a measly 6.3 percent return.

What’s even more important, however, are the numbers behind the numbers in that much of the gains in these indices were recorded in the fourth quarter—after the uncertainty of the election. Investors who threw up their hands prior to that had a really tough year.

Moving forward? Maxwell and many other market watchers are forecasting only modest gains in many major asset classes. Example: Sage and their investment management consulting firm, CTC



Consulting of Portland, Oregon, are forecasting returns from equities of 5–6 percent in 2005, versus 10–10.5 percent historically. The same goes with the bond market. Five years ago, bonds were yielding 6 percent or better—a decent level of income for investors who depended on those coupons. Now, many tax-exempt bonds are yielding only 3.5 to 4 percent, representing almost a 50 percent cut in income.

“We have clients who have to work a lot longer or spend a lot less,” Maxwell says. “The idea of having a balanced portfolio has really sunk in again.”

Many Unhappy Returns

In the past couple of years, Maxwell and his crew have spent a lot of time educating clients, particularly new clients, about the concept of volatility and historic returns. “In

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some instances, you are almost talking about an absence of return. Now, people think that a 3-6 percent return is pretty good.”

But many people still don't change, he says. Investors are still failing to diversify and failing to take corrective action because of taxes—namely an unwillingness to sell investments at a loss or, conversely, to take gains and pay the capital gains taxes on the profits. Another common mistake: The failure to “rebalance” by selling investments that have grown in value (thereby taking on an outsized proportion of the value of a portfolio) or in the alternative, by adding to investments that have declined in value (the old “buy low, sell high” problem).

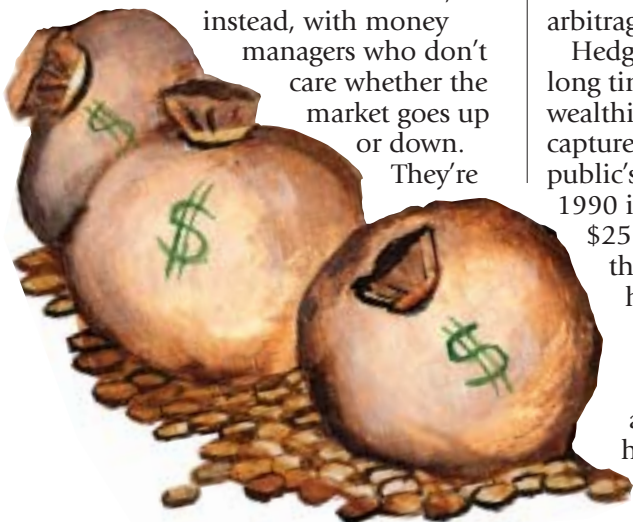
Hedging Your Bets

If nothing else, Wall Street is resourceful. In addition to the more personal issues that now face investors, they're being confronted with a whole new class of investments—hedge funds, otherwise known as “alternative investments.”

Here's the pitch: Forget about watching the overall market and depending on the “all boats rising with the tide” idea. Invest,

instead, with money managers who don't care whether the market goes up or down.

They're



so smart (or so they tell you) that they can cherry-pick only those securities that will go up—or perhaps down—resulting in what is termed an “absolute positive return,” which, translated, means a return that is blind to the daily, weekly, or yearly fluctuations of the stock or bond market.

The Tidal Wave of Alternative Investments

For the past few years, hedge funds have boomed in popularity, driven by the strong desire of investors to buck the broad market trends, as well as broadened availability and the fact that many have performed quite well.

Krista Ward has been riding the tidal wave of alternative investments. Her goal: to keep her clients from getting swamped. Ward is the managing director of Taipan Wealth Advisors, LLC, an Edina-based investment advisory firm that specializes in evaluating and recommending these funds for wealthy individuals. Ward, a registered investment advisor with both an M.B.A. and a law degree, founded Taipan in 1997 following a three-year stint as chief operating officer at Stark Investments, a convertible arbitrage hedge fund.

Hedge funds have been around a long time as havens for the wealthiest investors, but they haven't captured the broader investing public's imagination until recently. In 1990 investors had allocated about \$25 billion to hedge funds. Over the past two to three years, however, the number of hedge funds has mushroomed to more than 7,000 funds with an estimated \$1 trillion in assets. Minimum investments have come down to as little as \$25,000; indeed, hedge

funds are being sold through banks and trust departments.

Hedge funds are private, largely unregulated pools of capital with managers who try to make money for their clients no matter which direction the overall market is heading.

Sound too good to be true? Maybe. Nevertheless, many of these funds have performed very well—augmented by their freewheeling style.

Generally, hedge fund managers can both buy long and sell short. In other words, they can own a stock or a bond outright, or they can “short” the stock by entering into a transaction that allows them to profit if the price of the security goes down. Such “market neutral” tactics hinge on the manager's ability to select specific securities rather than benefit from the general direction of the market.

Hedge funds come in all sizes and span the “risk-reward” spectrum. For her clients, Ward distinguishes among no fewer than eighteen available strategies, ranging from “long/short equity market neutral,” “merger arbitrage,” and “convertible arbitrage” at the low end of the risk spectrum, to “managed futures,”



First person:

CHARLIE MAXWELL

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WHY YOU SHOULD DIVERSIFY AND REBALANCE

Greater returns are achieved by combining diversification with rebalancing—redistributing assets annually by spreading them equally among asset classes.

Previous year's best-performing index	\$373,558
Diversifying	\$442,957
Diversifying and Rebalancing	\$444,117

All three scenarios assume an annual investment of \$10,000. *Data Source: Lipper, Inc.

worst-performing funds drop out of the index because they fail, leaving only those that are doing well enough to maintain their asset base.

Where do hedge funds fit in an investor's portfolio? Ward says that it

"emerging markets," and "global/macro markets" at the high end.

Hedge fund fees can be stiff. Most funds charge a standard management fee that ranges from 1 percent to as much as 3 percent of assets (not cheap to begin with, plus a performance fee of some percentage—10 to 30 percent—of any return). "Very few hedge funds have a 'hurdle rate,' which is some minimum rate that

depends on the investor and his or her level of sophistication, goals, tolerance for risk, and time horizon. Time horizon is particularly important for older investors.

Even though, at age fifty-five, many people have twenty to thirty more years to live, their employment activities and income needs often change much sooner than that. Whether someone puts 10 percent or

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they guarantee before shaving off their performance bonus," Ward says.

With so much money—much of it from aging baby boomers—flooding into these funds, the returns they report are already beginning to show strains. Advisors are starting to notice that the assets that are popular with hedge funds are becoming more efficiently priced, reducing the opportunity for the big home run. And how good are those returns really? How accurate, for instance, is the pricing of the funds themselves? Ward notes that the price of the underlying securities in some funds is often virtually impossible to determine—so how can the indices reflect the true value of the underlying funds? Finally, such indices aren't necessarily complete because of "survivorship bias"—the

90 percent of their money into such funds, Ward notes that "hedge funds are extremely tax-inefficient. We highly suggest that people use them for tax-deferred retirement accounts. You can also wrap a hedge fund into a life insurance policy. A private placement is a type of variable life insurance offered only to accredited investors." This is especially sound advice for



First person:

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investors age fifty-five plus, since many of them are at their peak earning years and, hence, their highest tax bracket.

Also, don't count on getting your money out anytime soon. Many hedge funds allow only quarterly withdrawals; indeed some only allow withdrawals once a year. Says Ward, with a large dash of understatement: "Due diligence on choosing hedge funds is very important."

But due diligence—care, diversification, and a level head—is a requirement for any smart investment, especially in this Brave New World of lower expectations.

NOW!

Tony Carideo is president of The Carideo Group. His column "Portfolio Positions" appears in Twin Cities Business Monthly.