WIAD Newsletter

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What I Am Thinking - Big Picture

A volatile month. In a month with broadly disappointing corporate earnings, gloomy economic data, the initiation of US military retaliation in Afghanistan, anthrax contamination in the media, postal, and legislative arenas, and the continued threat of further terrorist attacks in the US, a reasonable individual might have thought the uncertainty in the world would have caused the market to move down, or at least not move up.

Instead, with few exceptions, equity and fixed income markets around the world rallied in the month of October. While rising markets are always welcome news, I am at a loss to explain the market's global near-term resilience. Perhaps the US equity markets moved up in October in anticipation of Congress passing of a generous economic stimulus package. Perhaps all that cash raised from mutual fund tax-loss harvesting this month needed to be reinvested. Perhaps it is merely because there are more buyers than sellers. Who knows?

I think if one were to ask an institutional equity fund manager who is buying in the face of all this bleak economic data why he is buying, the manager would be hard pressed to give a thoughtful fundamentals-based answer. My point is, this is still a very confusing, emotional and volatile time in the markets and investors must have good reasons to make portfolio decisions. Buying simply because things are going up was not a good strategy in the tech bubble of 1999-2000, and it isn't now.

In uncertain times like these, it is easy to let emotions dominate investment decisions. Reacting to current events is no way to manage an investment portfolio; it is important to stay focused on things you can control like asset allocation. Long-term investors, especially at times like these, must focus on staying committed to their asset allocation plan and maintaining a disciplined portfolio rebalancing and tax-loss harvesting strategy.

Asset Allocation – The First Step

Since I started my investment advisory business earlier this year, I am struck by how many individual investors construct their portfolios. Many investors seem to buy funds and individual stocks without first determining their risk profile, investment horizon and asset allocation plan. In my opinion, the "buy first, plan later" investment strategy is like going out for a meal and eating dessert before looking at a menu and ordering. If you do this too often, you'll probably get sick.

The actual buying of individual securities and/or funds should be the last and least complicated step an investor takes in constructing a properly allocated investment portfolio. *The first step, is the formulation of an asset allocation plan*. The formulation of this plan starts by determining your risk profile and investment horizon.

Determining your risk profile and investment horizon are very personal and individual decisions. These issues should be discussed candidly and realistically with one's trusted advisors. For purposes of this discussion, I will assume the investor's risk profile is moderate and the investment horizon is long.

> *"Risk and reward are inextricably intertwined. Do not expect high returns without high risk. Do not expect safety without correspondingly low returns"*
>
> *William J. Bernstein, Author*
> *The Intelligent Asset Allocator*

Truer words have never been spoken. As this is our first discussion of asset allocation, let's keep it to the basics for this issue: domestic stocks vs. bonds. If we take the concept of risk and reward and apply it to stock and bond investing, it is fair to say that in general, stocks are riskier than bonds.

This is easy to understand if we look at the capital structure of a hypothetical company with tangible assets that has issued both stock and bonds. The stockholders are the owners of the company's assets and the bondholders are lenders to these owners of the company's assets, secured by their stock.

If the company flourishes, the bondholders merely get paid back (with interest) and the value of the stockholder's stock increases. If the company does not flourish, in the most dire of circumstances, the stockholder's stock becomes worthless and the bondholders take the tangible assets (if any remain) of the company. The bondholder's upside is limited to the interest earned on the loan and the downside is floored by the liquidation value of the company's assets. The stockholders, on the other hand, have unlimited upside as long as they pay their obligations to the bondholders and have the downside of losing their total investment if they cannot. While bondholders are taking less risk than the stockholders, the stockholders have a chance for higher returns.

In this simplistic example, we see that stocks and bonds have different risk characteristics and consequently also have different return characteristics. *Bonds are less risky than stocks because they should be*; bonds are different type of investment than stocks. It should come as no surprise that over the long-term, the historical return for bonds is less than for stocks.

In an investment portfolio it is important to have different kinds of assets. While the actual percentage mix of stock and bonds (and sub-sets of each) in an investment portfolio will vary depending on an investor's individual risk profile, a comprehensive asset allocation plan and properly diversified portfolio should have some of each.

A key concept in any discussion of portfolio risk and return is *correlation*. Diversification with asset classes with *uncorrelated* historical returns can decrease portfolio risk and increase portfolio return. We will discuss risk, return and the importance of correlation in the context of asset allocation more deeply in a future WIAD Newsletter.

What I Am Doing – TIPS and I Bonds

As we have begun to discuss in the previous section, it is prudent to have some level of fixed income in one's portfolio from an asset allocation standpoint.

That being said, if you are currently under-allocated in fixed income, you must approach any portfolio rebalancing into bonds carefully as US interest rates are at historically low levels. As you may be aware for fixed income securities, when interest rates go up, bond prices go down (and vice versa). Investing in bonds in a rising rate environment can be hazardous.

While I do not believe in market timing when it comes to asset allocation decisions, I do believe that in general, the likelihood US interest rates go up from here in the long run is greater than the chances they go down (with 2.00% Fed Funds rate and 30 year treasury bonds yielding below 5.00%, there isn't much more room to go down).

In last month's WIAD Newsletter, I said as a result of the events on September 11th, an argument could be made that the US Treasury yield curve will steepen. As the Federal Reserve continues to calm the markets with liquidity (lending short-term), Congress will need to finance (borrowing long-term) its ambitious $100 billion economic stimulus package as well as pay for our increased military, anti-terrorist and intelligence efforts. Herein lies the recipe for a steep, positively sloped yield curve in our future. A steep, positively sloped yield curve implies higher interest rates in the future. Can inflation be far behind?

With the current low-interest rate environment and the likelihood of higher rates and the possibility of future inflation, what does a long-term investor who wants to initiate or increase a portfolio allocation to fixed income do?

I like TIPS.

Treasury Inflation-Indexed Securities (also known as TIPS) are fixed income securities issued by the US Treasury that pay a rate of interest that is determined by an inflation rate index. *These securities are designed for investors seeking to protect the purchasing power of their investment against inflation and earn a guaranteed real rate of return.* The index for measuring the inflation rate is the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U), published monthly by the Bureau of Labor Statistics (BLS).

The interest rate on TIPS remains fixed throughout the term of the security. *The return on TIPS is realized in two forms i) an inflation rate premium - the principal amount of the security is adjusted for the inflation index and is not paid until maturity, and ii) semiannual interest payments – these interest payment are based on the inflation-adjusted principal each period the interest is paid.*

At maturity, TIPS are redeemed at the *greater* of their inflation-adjusted principal or par amount at original issue. On the downside, in the event of sustained *deflation*, the amount of the semiannual interest payments and the inflation-adjusted principal of the security would decrease. *However, if at maturity the inflation-adjusted principal is less than a security's par amount, the US Treasury makes up the difference so that the inflation-adjusted principal equals the par amount. In effect, if the economy deflates, the US Government subsidizes the TIPS investor.* The best thing about TIPS is that the investor locks in a positive spread to inflation and in a worst-case scenario the investor can receive no less than par at maturity.

Interest income on TIPS, like all fixed income securities issued by the US Treasury, are taxed at the federal level but not subject to state and local taxes.

TIPS can also be bought in Savings Bond form (Series I, also known as I Bonds) that have some additional benefits. I Series US Savings Bonds are an accrual-type security, meaning that there are no semiannual interest payments; the interest earned on this security is added to the bond's principal and paid to the investor when the bond is redeemed or matures. Interest on I Bonds is also exempt from state and local income taxes and has an advantage over the TIPS as federal income taxes on I Bonds can be deferred for up to thirty years, or until redemption. Additionally, under certain circumstances, the interest on I Bonds is exempt from federal income taxes if the proceeds of the bond are used for qualified educational purposes. The US Treasury limits investors to purchasing a maximum of $30,000 of I Series US Savings Bonds each calendar year.

With interest rates as low as they are, it is difficult psychologically to initiate or add to a fixed income allocation in this market environment. If rates go lower from current levels, inflation-indexed securities and savings bonds may underperform other types of fixed income securities. However, if the yield curve steepens, which may imply increased inflation as well as higher interest rates in the future, TIPS and I Bonds may be a good alternative to add in the fixed income asset sector.

I take my inflation-indexed fixed income exposure in tax-deferred accounts using the Vanguard Inflation-Protected Securities Fund (VIPSX) and in taxable accounts using the I Series US Savings Bonds.

For more info:

TIPS: www.publicdebt.treas.gov/gsr/gsrlist.htm

I Series US Savings Bonds: www.publicdebt.treas.gov/sav/sbifaq.htm

Vanguard Inflation-Protected Securities Fund: www.vanguard.com

October Investment Results:	**October**	**Last 3 mo.**	**YTD**
NJL Equity/Income Aggregate	2.02%	-10.09%	-14.28%
S&P 500 (including dividends)	1.91%	-12.19%	-18.87%
Russell 3000 (including dividends)	2.33%	-12.20%	-18.93%
MSCI World (in US $, price only) 1	.85%	-11.82%	-22.77%

Note: The NJL Equity/Income Aggregate is a multi-cap global equity composite that is reflective of my aggregate investment portfolio's performance. The composite returns are comprised of over 98% global equities and cash and less than 2% domestic fixed income and include taxable and tax-deferred portfolios. The composite returns are unaudited and are calculated using AIMR Performance Measurement guidelines.

Summary

With all the global uncertainty and resulting market volatility, it is difficult to know what to do. As Mr. Bernstein has so eloquently stated, "*asset allocation is the only factor affecting your investments you can actually influence.* If you haven't looked at your asset allocation in a while (or do not have one), you should.

For those whose portfolios are under allocated in fixed income, TIPS and I Bonds are good alternatives in this low interest rate environment.

As you know, October 31st marked the mutual fund year-end for tax purposes. In the month of November, most mutual fund companies will start to publish estimates of the ordinary income and capital gain distributions their funds expect to make before the end of the year. It is important to use this information to determine your taxable liability from these investments and fine tune any tax loss harvesting you may have done or have to do before year end.

Nelson J. Lam
The Lam Group, Inc.
November 9, 2001

Next Month:

- More asset allocation
- Legacy Holdings

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