

Newsletter February 2010

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How to Lose Money in a Top-Performing Fund

An article in the December 31 issue of the Wall Street Journal makes a point that many of us in the financial planning world have long suspected. It says that the CGM Focus fund was the top performing mutual fund, by far, over the past ten years, generating an annualized return of more than 18% a year since January 1, 2000.

Now here's the punchline: the average investor in this top-performing fund lost an average of 11% a year over the same ten year period.

How is it possible for investors to lose their shirts in a fund that posted outsized returns?

Most planning professionals know the fund's manager, Ken Heebner, as a swing-for-the-fences investor, somebody prone to huge runups and equally scary drops. A Chicago-based investment research firm called Morningstar--whose data is used by most financial advisors--calculated what is called the "dollar-weighted" return of the CGM Focus fund, which gives a picture of what investors in the fund actually experienced. If you had bought and held Ken Heebner's portfolio throughout the 2000s, you would indeed have received returns of 18% a year. But the fund was so up and down that investors were alternately panicked and selling out or optimistic and crowding back in.

The article says the most dramatic example came after the fund was up 80% in 2007. Investors flocked in, putting \$2.6 billion into the CGM portfolio--just in time to catch its equally-dramatic 48% drop through the end of 2008.

There have been credible studies showing that the average investor underperforms the market, and this illustrates exactly how it happens. Right after an investment generates strong returns, people tend to jump on the bandwagon--and then they experience the subsequent return to reality. When an investment is struggling, people tend to abandon it, and miss out on its recovery. Missing the upside and catching the downside, consistently, is human nature, perfectly understandable behavior. But it inevitably leads to dismal investment results--as it did for the battered, unhappy, money-losing investors in the best-performing mutual fund of the 2000s.

How Savings Beat Returns

We're hearing a lot about higher savings rates, which have risen from roughly 0% over most of the past decade to the 6-7% range since the end of 2008. Higher savings rates worry economists who want us to spend our way out of the downturn. But most financial advisors think that the return to savings habits is a terrific long-term trend.

And it illustrates a secret that financial planners and investment advisors understand all too well: investors (like you) have a lot more control than the professionals (like them) over how fast your portfolio grows. Seemingly small changes in savings rates can have far more impact on the growth of a retirement portfolio than investment returns.

Let's take a simple example. Suppose Jonathan has an income of ¥10,000,000 per year and manages to save 1% of his total income each year for 20 years--which would have made him a champion saver during the 2000s. Let's assume Jonathan's salary goes up 2% a year with the cost of living. Finally, we'll assume that he's able to earn a very generous 8% yearly return on his portfolio. (Important caveat: all return assumptions you read here are purely hypothetical and for illustration purposes only,

and should not be regarded as an indication of what we or any other advisor might achieve in the unknowable years ahead. For all we know, the markets may be more or less generous, and they will be so in unpredictable ways.)

The result? In 20 years, the portfolio would be worth ¥9,374,165.

Now let's suppose that a second person, Joanna, follows today's (much-improved) average savings rate and sets aside 7% of her income each year. Alas, Joanna experiences a less favorable investment time period, and her portfolio goes up just 4% a year--half of what Jonathan was earning.

Even so, after 20 years, Joanna's portfolio is worth ¥37,318,384--more than three times more more in retirement wealth than Jonathan's, even though Jonathan had a much higher rate of return on his portfolio.

Of course, if Joanna were to save 10% of her income--which is what most financial advisors normally recommend--and if she were to get the same rate of return as the less thrifty person with a 1% savings rate, her terminal wealth would be almost exactly TEN TIMES as much as Jonathan's.

As you know, the numbers are never this tidy, you would never earn the same return each and every year, and most of us don't receive the same salary increase from one year to the next. But the point, which can be made with much more complicated illustrations, is that, in general, savings rates matter more than rates of return, and seemingly small changes in savings habits can add up dramatically over time.

No matter what the economists tell you, the higher savings rates we're seeing today are great news for America, one of the few positive changes to come out of the Great Recession of 2008-2009.

Quarter-end, Year-end, Decade-end market report

2009 was an interesting investment year by any standard you want to apply. When it began, the global economy and international banking industries were still reeling from a free-fall in the markets that would continue on to a major low on March 9. All of the major Wall Street firms that sold toxic assets to their customers were receiving multi-billion dollar transfusions of taxpayer money, and AIG (the world's largest insurer), Fannie Mae and Freddie Mac--and, soon, General Motors--were effectively owned by the U.S. government. We would later learn that the economy had slipped into a recession over a year earlier.

Much of the first quarter felt like a free-fall; here in Japan the index dropped 36%, and the world markets were awash in gloom. The S&P 500 finished the first three months of the year down 11.7%; its sixth consecutive losing quarter. Industrials were down 21.8%, financials had fallen 29.5%, and wherever you looked abroad, the news was even gloomier-- the UK off more than 48%, Germany down 50.6% in dollar terms, China and India down 34.7% and 52.3% respectively.

None of us in the financial planning community knew what was coming; the most we knew was that markets eventually rise after a hard fall, and that the rise would inevitably come earlier than anybody expected. As it turns out, we didn't have long to wait. The S&P 500 index rose 15.93% in the second quarter and 15.61% in the third, marking the best back-to-back quarterly rally in decades. High-yield corporate bond indices posted double-digit returns and outperformed Treasuries by some of the biggest margins ever recorded. International stocks rose 26.74% and 19.52%.

The gains were more subdued in the 4th quarter, but still strong. The S&P 500 gained 7.5% in the last three months of the year, posting an extraordinary 23.5% gain for the year. The Russell 3000--a close proxy to the entire U.S. stock market--was up 5.89% for the last quarter of 2009, finishing up 28.34% for the year. The Russell 1000--a proxy for large cap U.S. stocks--gained 6.98% for the quarter and 28.43% for the year. The Russell 2000 (a proxy for small cap U.S. stocks) gained 3.87% for the quarter and was up 27.17% for the year, while the Nasdaq composite finished the year up 43.9%.

Around the world, the EAFE--a broad index of large cap stocks in developed economies--finished the year up 27.75%, and the EAFE Emerging Markets index posted a startling gain of 74.14%. China's key stock index was up 80% and Brazil was up 83%. An international index of Latin American stocks ended the year up 98%. Japan's Nikkei index was up 19%. The Financial Times European index gained 25.4%.

Commodity prices were also up, with copper rising 139% for the year, silver up 48% and gold up 24.8%--the precious metal's largest gain in three decades. Oil finished the year above \$79 a barrel, up 78% in calendar 2009.

Perhaps the biggest recovery of all investments came in real estate investment trusts; the NAREIT index rose 24% in 2009, but that represents a 110% gain from the March low.

Not all investments finished the year in positive terms. A composite of Treasury bonds--the safest investments in a downturn--lost 3.5% of its value in 2009--which, when added to inflation, means a real-value loss of more than 5%. This represents the first annual loss since 1999, and only the fourth time Treasuries have lost money over a calendar year since 1978.

The question is: with all this good news in domestic and international stocks, REITs and high-yield corporate bonds, why aren't we feeling any better? For many of us, 2009 felt like we were getting some of our money back, and we didn't get all of it. By the perverse math of down and up markets, an investor who took the full brunt of the 37.31% decline in the Russell 3000 index in 2008 would have required a 59.6% return in the next year to break even.

In addition, there is unhappy evidence that most investors didn't participate in the upturn--and, therefore, didn't make ANY of their money back. In time-honored fashion, the average investor retreated from stocks after the downturn and watched the upturn from the sidelines. Statistics compiled by the Investment Company Institute show that investors across 25 developed nations (including the U.S.) had \$10.4 trillion of their wealth in stocks at the end of the second quarter of 2008. Money continued to pour out, so that by the end of the first quarter of 2009, while the rally was already underway, total stock exposure had fallen nearly in half, to \$5.9 trillion. In the U.S., much of that money went into Treasuries--just in time to catch a rare losing year in government bonds. Money market funds, meanwhile, surged \$444 billion in the fourth quarter of 2008 and another \$63 billion in the first three months of 2009--putting a significant amount of money on the sidelines just in time to miss the record stock rally.

Bigger picture, we are emerging from a historically bad decade for stock investors. If you managed to increase your wealth over the last ten years, then you deserve congratulations. A chart circulating among financial advisors shows that the Dow Jones Industrial Average was up roughly 50% in the 1900s and 1910s, up more

than 100% in the 1920s, and up more than 200% in the 1950s, 1980s and 1990s. The index rose narrowly in the 1940s and 1960s and squeaked out a gain in the 1970s.

Only the Great Depression-era 1930s and our recent decade of the 2000s delivered negative stock performance. Meanwhile, on December 31, the S&P 500 index closed out its first decade ever with a total return loss--which means a loss even with dividends reinvested.

So perhaps this is a time to count our blessings. The recession that began two years ago is officially ended, and the TARP program officially ended its existence in the final months of last year. Your investments were not dangerously concentrated in one asset or security--the reason why Bill Gates reportedly lost \$7 billion in 2009. We can all be pleased that we weren't fully-invested in Citigroup, which fell 50.7% for the year, or the Royal Bank of Scotland, which lost 40.9%.

Or we could envy the greed that still seems to be rampant among those Wall Street firms whose reckless actions brought the markets and the economy to their knees. Brokerage house bonuses and stock options haven't yet been paid out for 2009, but a survey by eFinancialCareers.com found that most brokerage professionals are expecting higher compensation for their 2009 labors than they received in 2008.

To put this in perspective, in 2008, the top 100 executives at the 20 largest banks that received Troubled Asset Relief Program (TARP) infusions from the taxpayers--including Goldman Sachs, JPMorgan Chase and Bank of America--received an AVERAGE total one-year compensation of \$13.8 million. More than a third of the brokerage executives, traders and top salespeople who expect bonuses to be higher this time around said it would be due to 2008's abnormally low bonus payments.

A cynical attendee at a recent financial planning conference hit the nail squarely on the head when he observed that "Terrible investment advice, and bad performance, don't come cheap."

What's ahead? With so many surprises over the past two years, professional soothsayers and prognosticators are being unusually cautious this time around. Normally, the year after a recession brings a hard and fast recovery, with GDP growth in the 6-8% range over the following 12 months. But a recent survey of economists by the Bloomberg organization found a consensus expectation of just 2.3% growth in U.S. economic activity, largely because the deleveraging process--paying back debts on the federal, state, local, corporate and personal balance sheets--may continue for into the

future. Fortunately, if this continues, it will lead to a thriftier, financially healthier economy--eventually.

Of course, those predictions are merely guesses, as are anything you hear about investment returns during the next year. There are positive and negative surprises in our future, changes that will help or hurt. But generally, over time, the positive influences always tend to outweigh the negative ones, which is why we don't still live in caves or drive mules to work, and why the Dow is not still hovering around 43, as it did in the early 1930s. We don't know what the future brings, but it's a good guess that the trauma of 2008, and the first decade of the millennium, will be remembered as unusual detours in the longer-term upward march of the markets.

Good Company?

We're all hearing a lot about U.S. budget deficits, which are high by historical standards. According to figures compiled on the web site www.usGovernmentSpending.com, the projected deficit in 2010--8.54% of U.S. GDP (a measure of total economic output in the country) has been exceeded only four times in U.S. history: 1918 (11.88%), 1919 (16.86%), 1942 (12.04%), 1943 (28.05%), 1944 (22.35%), and 1945 (24.06%). A more normal figure is in the 2% to 5% range, although there were four recent years--1998 through 2001--when the government balance sheet showed a surplus. (The government also managed surpluses in 1969, 1960, 1956-57 and 1951-52.)

The size of the deficit is worrisome to economists. But an article in the January 14 issue of The Economist magazine says that we may have gotten through the recent banking meltdown fairly inexpensively. Previous systemic banking crises have, on average, cost 13% of GDP to resolve, according to the International Monetary Fund. But because the U.S. government offered its assistance in the form of loans (which were mostly paid back with interest by the big investment banks) and stock (which may appreciate in value), the final cost is now projected to be somewhere around \$90 billion--almost all explained by losing investments in General Motors, Chrysler and AIG, and by subsidies to homeowners to help modify their mortgages. A proposed

special tax on large investment banks could further reduce the cost to practically zero, and the Federal Reserve and the FDIC both made money on loan and bank-bond guarantees. The article cautions that a fair accounting would include the \$111 billion capital infusion into Fannie Mae and Freddie Mac, which brings the total bailout cost to something less than 2% of GDP.

Of course, the U.S. government is also spending money to pull the country out of recession. However, almost unnoticed in the deficit debate is the fact that almost all other countries around the world are also running up deficits--for the same purpose. A chart (below), taken from figures in the January 23 issue of *The Economist* (page 90) ranks the world's economies according to their 2009 deficits as a percentage of GDP. The chart also includes a second figure, which shows the current account deficit--basically the difference between the value of imports and exports. A negative number means that the country is spending more than it takes in; a positive number (as in China) means the country is taking in an excess of capital. Here we can see the relative ranking of the US and Japan. Not surprisingly, Japan is running a trade surplus (column 2); but somewhat surprisingly (to me, anyway) is that the US budget is a greater percentage of GDP than is Japan's budget to its GDP.

You see two things here: first, that the U.S. deficit is higher than the global average, but not unusual and certainly not the worst--and it's probable that a higher percentage of its deficit will go toward jobs growth than countries which handled their banking crises less thriftily. And second, you see that even countries that are running a surplus are still spending more than they generate in taxes in an effort to avoid a second dip from the Great Recession. Except for Norway and Saudi Arabia, virtually everybody is following the same course to bring global economic growth and prosperity in 2010 and beyond. Let's hope it works.

See below for chart.

Country	Budget Balance as % of GDP 2009	Trade Balance as % of GDP 2009
Britain	-14.2	-1.9
Greece	-13.0	-12.2
Spain	-11.8	-5.7
United States	-10.0	-3.0
France	-8.4	-2.0
India	-8.0	-0.7
Malaysia	-7.7	+15.9
Venezuela	-7.6	-2.1
Japan	-7.4	+2.7
Russia	-7.2	+3.8
Egypt	-6.9	-1.7
Czech Republic	-6.4	-1.9
Turkey	-6.3	-2.3
Belgium	-6.0	-0.9
South Africa	-6.0	-5.3
Thailand	-5.6	+6.6
Pakistan	-5.2	-1.4
Italy	-5.1	-2.9
Netherlands	-5.1	+5.4
Taiwan	-5.1	+8.8
Austria	-4.8	+0.9
Israel	-4.6	+2.4
Hungary	-4.0	-2.6
South Korea	-4.0	+5.2
Australia	-3.9	-3.7
China	-3.8	+6.3
Chile	-3.8	+1.4
Canada	-3.2	-2.7
Brazil	-3.2	-1.0
Germany	-3.2	+4.2
Mexico	-2.9	-0.6
Colombia	-2.8	-2.6
Denmark	-2.8	+2.4
Sweden	-2.5	+7.4
Poland	-2.3	-0.6
Indonesia	-1.5	+2.0
Argentina	-1.3	+3.7
Singapore	-1.1	+12.7
Switzerland	-0.4	+7.7
Saudi Arabia	+0.7	+3.0
Norway	+7.9	+15.9

Roth-IRA Conversion Conundrum

All of a sudden, it seems like everybody in the financial planning world is talking about Roth IRAs and Roth conversions. In fact, an article in Financial Planning magazine--one of my top 5 "go to" trade magazines --recently proclaimed 2010 "The Year of the Roth."

What's the big deal? Roth IRAs are interesting to professionals for several reasons. With traditional IRAs (and qualified plans like 401(k)s) (though not with a Japanese 401(k) – be careful here), the money goes in untaxed, and you pay ordinary income taxes whenever you take money out of the account--which might be years in the future. The Roth reverses this; your contribution is made with after-tax dollars, but then there's no tax whenever the money is distributed. If you believe, as many financial professionals do, that tax rates are going to go up in the future, then paying taxes now and eliminating future taxes provides a net gain.

It could get better. Having money in a Roth account gives you a lot more control over your tax bracket in retirement. For instance, you might take out just enough from your IRA distributions to fill the 15% bracket, and then take the rest of your living expenses out of your taxable accounts and Roth. Another version of this kind of planning might help higher-income retirees avoid the brackets where Social Security income is taxed.

Another interesting thing about Roths is that, unlike traditional IRAs, they don't have any minimum distribution requirements once you turn age 70 1/2. So long as the money remains in the account, both Roths and traditional IRAs give you the benefits of tax deferral, which eliminates a significant drag on the growth of your money. If you can afford to keep your money in the Roth account, and take retirement income from other sources, then the deferral can go on longer.

Alas, the Roth account will still be subject to estate taxes, and your heirs (not your spouse) will have to take required distributions each year once they inherit your Roth

account. But they won't have to pay taxes on the distributions they receive--a nice additional gift for your children or grandchildren. *Further caution is required if your spouse and/or other beneficiaries are Japanese or any other non-US Citizens – the US is concerned about capital flight, so passing wealth to non-US Citizens is a little more complicated.*

In the past, the only people who could set up a Roth IRA were those with less than \$100,000 in taxable income, which eliminated a lot of the taxpayers who would benefit the most from all these features. But now, as of January 1, anybody can open up a Roth IRA. Most of the conversation in professional circles is about Roth conversions; that is, converting the money in your IRA to a Roth or taking a rollover distribution from a company retirement plan directly into a new Roth that you set up.

Should you do this? Unfortunately, that's a complicated question, since any money moving from a traditional retirement account to a Roth requires you to pay taxes on the money in the traditional account. Some of that can be deferred; with any conversion that takes place in 2010, the tax obligation can be split between the 2011 and 2012 tax returns, which represents a (very) short-term loan from the IRS. So professional advisors are looking at individual situations, looking for portfolio losses that can be used to offset the tax burden, projecting tax brackets over the next three years and a host of other issues, including how long each person will have the money in the Roth account, and where the money to pay the taxes will come from. (If you have to pay the taxes out of the IRA, then you lose the value of future deferral--not good.)

Another issue is: Do we trust Congress to keep its promise not to tax Roth distributions in the future? Few of us ever expected to pay taxes on Social Security payments.

Fortunately, the law allows for partial Roth conversions--moving some of the money over, rather than all of it--and also lets you reverse the conversion (professionals call it a recharacterization) any time before October 15 of the year after the conversion. All of this means that the conversion decision, and the amount to convert, will probably be different for you than it is for the person next door, whose decision will be different from the family down the street.

Meanwhile, you have to wonder how alert are the people who write our tax laws. Under the current rules, single persons earning more than \$105,000, and joint filers over \$167,000, are sternly prohibited from making a full contribution to their Roth account. If you earn more than \$120,000 (single) or \$177,000 (joint), you're forbidden to make them at all.

But... People in these income brackets are perfectly free to make a traditional IRA contribution--and the law says they can immediately turn around and convert the money into a Roth account. Does that make sense to you?

A Financial Planning Idea

An interesting financial planning idea that is making the rounds these days is also one of the simplest: a letter to yourself. More specifically, a letter from your future self to you, today.

Say What? Imagine yourself in five years, assuming everything has gone more or less as you hope it will. You're healthy, in good financial health and--well, you know your hopes much better than I do. The point is that the You-In-The-Future is writing a letter of thanks to the You-Today. Future You might thank Today You for exercising regularly, because Future You is fit and looks good. Future You might thank you for being thrifty and watching your budget, because in that future date, you're on track to retire comfortably--or you may even BE retired.

Future You might thank you for taking the time to smell the roses along the way, for maintaining close relationships with friends and family, for spending a little more time accomplishing goals (Writing a book? Starting a side business? Traveling to see relatives or other parts of Asia or the world?) instead of unproductive downtime in front of the TV.

Whatever it is, you are thanking yourself for taking these actions, and be specific about what you did. Then look over the letter, and know that these are all things which you will thank yourself for someday, make a commitment to do them, and save the letter.

Every week or two, take the letter out and take another look at it. Are you on course? Are you earning the thanks that Future You gave you?

The point here is that you want your future life to be as good as it can be--as full of fulfillment and happiness, joy and prosperity as possible, and your actions between now and then will--or will not--make that happen. The letter to yourself is a fantastically powerful reminder you that you're really counting on yourself to take care of yourself in the future.

Meanwhile, in between the times you spend with the letter, you can get to know a variety of Future Selves (You-Next-Week, You-Next-Year, You-Five-Years-In-The-Future), and begin to ask these future versions of you about decisions you make now. How much of the money you earn should be given to your future self for retirement? What would you, a week from now, like to have cleared off your desk? Would you like to have learned a new skill by this time next year? (I won't mention the Sisyphean task of trying to master kanji) Are there things which are hard to do now, but which you will wish you had done? Chances are, you know what that person who will be you would really like you to be doing now, which lets you navigate through the complexities of your life with very clear vision.

And if you can do THAT, you'll be one of very few in a world where most of us are muddling through our days. You could be one of the few who arrives in the future with no regrets about how you spent the precious, irreplaceable hours of your life.
