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Storm Surge

My wife Eileen and I watched quite a few people being rescued by lifeguards down by the Pacific this holiday weekend just past. Almost everyone has experienced the terrifying emotional transition from joyfully splashing around to being swept off balance and sucked out to sea by a large breaker.

This got me thinking of the cold water that washed over inexperienced investors during the last quarter. In late April I'd begun hearing congratulatory comments from a few clients about how quickly their accounts were growing. A long time friend, not noted for his investment acumen, was doing some bragging about his big market gains. So it was not too surprising that Mr. Market, like King Neptune, chose a moment of giddy excitement to remind everyone who's boss. Quite a few investors, especially those using leverage or too exposed to over-loved sectors, recently felt the terror of watching their net worth wash out to sea in a very short time.

As of this writing, US equities markets have recovered from much of the late Spring carnage, although commodities and emerging market securities remain well below their recent highs. Energy stocks, too, are well below their late 2005 highs despite near record prices for oil.

According to the July 1, 2006 issue of The Wall Street Journal, "The Dow industrials wound up giving back half of the year's gains. The average finished Friday at 11150.22, up 40.90 points, or 0.37%, for the quarter and up 4% for 2006. The volatile NASDAQ Composite Index, dominated by technology stocks, had been up more than 7% for the year at its high on April 19. It gave up all those gains and finished Friday at 2172.09, down 7.17% for the quarter and down 1.5% for the year. The Standard & Poor's 500-stock index finished June at 1270.20, down 1.9% for the quarter but still up 1.8% for 2006."

Having just reviewed client performance, I'm pleased to report that a composite of discretionary client accounts were generally unchanged for the quarter and up about 4% for the first six months of this year. On average, our client's accounts matched or out performed the most quoted US equities indexes.

Of note, we tested the percentage change in value of a random sample of client accounts at the recent US stock market peak and the nadir of the May-June sell off. The sell off represented an 8%-10% correction, depending on the index you choose to follow. Our client accounts only gave back about 4-5%. This resilience is consistent with our performance goals (see our web site www.trustedfinancial.com). Still, short term performance is not the proper way to judge the capabilities of a money manager, which is why we invite interested parties to examine our long term performance

Certified Financial Planner™

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record, also posted at our web site.

Still, it is the frightening experience of rapid, unexpected losses that can drive an investor to exit lucrative long term investment opportunities forever, in the same way that many who've been caught in a rip tide, often as children, refuse to ever enter the ocean again. This is why we at Trusted Financial offer what we believe to be a secure life jacket to our clients. We cannot guarantee that a wave will not wash over your head from time to time, but with proper flotation in the form of diverse investments, we expect you will pop back to the surface in short order.

Eleven Rules for Financial Freedom

This is adapted from a recent column appearing in the Wall Street Journal.

1. **It's hard to cut back.**

   As your salary has climbed, your standard of living likely also has risen. You probably eat out more and purchase pricier cars, and you might have traded up to a bigger home.

   Within reason, there's nothing wrong with this. Constantly deferring gratification isn't a great strategy for getting the most out of life. Still, there is a price to be paid for this ever-rising standard of living. As your lifestyle grows more costly, it becomes more difficult to retire, because you need a bigger nest egg to sustain your standard of living. Sure, to make retirement affordable, you could slash your expenses. But once you get used to a certain standard of living, it's extraordinarily difficult to cut back.

2. **You'll never be satisfied.**

   Instead of cutting back, most people constantly strive to raise their standard of living. They are forever aiming for the better car, the bigger house or the larger paycheck, only to become quickly dissatisfied once they get what they want. Academics refer to this as "hedonic adaptation" or the "hedonic treadmill." As the thrill fades from our latest promotion or purchase, we start hankering after something else -- and so the cycle goes on.

   You might want to go see the movie "Peaceful Warrior" for some perspective on this craving for more.

3. **Borrowing has to be repaid.**

   This might seem obvious. Yet I wonder what people think as they rack up huge credit-card balances, take out auto loans and borrow against their homes' value. How exactly do they plan to repay all this money? Or do they intend to bequeath these debts to heirs?

4. **Fancy cars and expensive clothes aren't a sign of wealth.**

   Rather, they are a sign that somebody once had money or chose to borrow it. The money has since been spent, and the folks are poorer for it.

5. **Your family could prove to be your greatest liability.**

   You are no doubt well aware of the expense of raising children and putting them through college. Often, however, family costs don't end there. If your adult children or your retired parents get into financial trouble, you'll probably end up bailing them out.

   The lesson: Teach your children to save diligently and invest intelligently before they leave home, and don't be coy about talking to your parents about their finances.

6. **Investors face three enemies.**

   Their names are inflation, taxes and investment costs. Indeed, once you factor in these three financial hits, you may find your portfolio isn't making any money.

   Let's say you buy a mutual fund that owns bonds yielding 5%. If the fund charges 1% in annual expenses, your yield will be 4%. If you are in the 25% tax bracket, Uncle Sam will take a quarter of that yield, leaving you with 3%. What if inflation comes in at 3%? Put it this way: At least the tax man and your fund manager made money.

7. Adding risky investments can lower risk.

This may seem counterintuitive, but it works: Consider sprinkling in "non-correlating" assets like gold stocks, commodities funds, real estate investment trusts and foreign bonds. Yes, they can be wildly erratic performers. But by adding investments that often gain when mainstream investments are suffering, adding them to an investment mix can actually lower the portfolio's overall risk level.

8. Diversification is a mixed bag.

By diversifying broadly, you reduce risk and ensure you will always have a little money in the market's hottest sectors.

But inevitably, if you hold a diversified portfolio, some of your investments will badly lag behind the market averages each year. Find that disturbing? The investments that struggle this year may salvage your portfolio's performance in the years that follow.

A corollary to this strategy – **don't over diversify**. Many people own too many mutual funds, index funds and predictable individual stock holdings (remember when everyone loved Microsoft?). This may mean that your portfolio merely follows the major indexes on their roller coaster ride without giving you any special benefits.

9. Not all risk is Obvious

When times are good and everyone seems to be making money in the hot sector of the day (real estate, oil and gas, biotech companies) it is easy to forget how quickly things can go sour when "the crowd" changes sentiment. Research the way an investment you are considering performed in the last couple of bear markets and ask yourself, "if I had purchased at the last top, and held on to the last bottom, how much money would I have lost on paper... and could I stand to have that happen now?"

10. Change is costly.

When you sell one investment and buy another, there is no guarantee you will boost your returns. But the change will almost always cost you. To be sure, if you buy and sell no-load mutual funds inside a retirement account, the trade will be cost- and tax-free. But with most other transactions, there's likely to be a fee or tax involved, and possibly both, so think long and hard before you make that next trade. We've written previously about Warren Buffet's 20 punch card rule, and it's worth repeating: invest as if you only are allowed 20 investments in your entire life. Bring the same degree of cautious consideration to each potential investment as if you have only a few chances to get it right. Don't waste money and opportunity chasing every hot idea that comes your way, or jumping in and out of the market based on current events and conflicting predictions.

11. Your best investment strategy is saving.

Even if you're brilliant at picking stocks and funds, you won't pile up a whole lot of dollars unless you have a decent amount invested in the market. The bottom line: If you want to be a successful investor, you first need to be a committed saver.