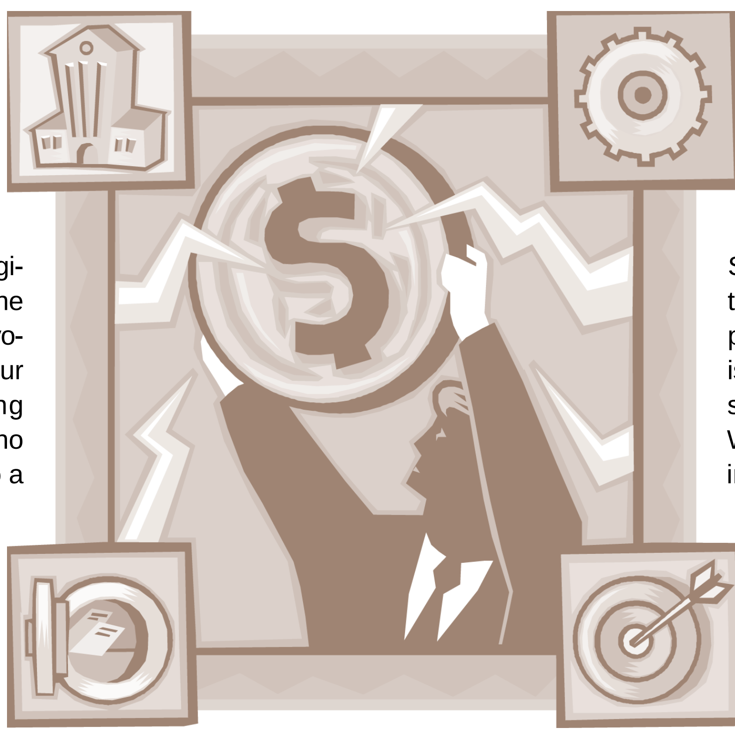
401(k) TODAY

Volume 6 Number 1 *The Latest News on Saving and Investing* First Quarter - 2003

Making Sense of Strategies

by Stephen J. Butler

The so-called “hot hands” theory of mutual fund investing holds that a winning fund has a better than 50 percent chance of beating its competitors for the next eight calendar quarters. The term itself is inflammatory and probably gets many investors in trouble. When I think of “hot hands,” one person comes to mind as the absolute personification of that term.



My friend Blair Hull, formerly of the Bay Area and now of Chicago, was once a Kaiser engineer who read the book “Beat the Dealer” and began a part-time avocation as a successful amateur blackjack player. After being physically threatened by casino management, he graduated to a career of trading options using his own computerized algorithms that contributed to enormous success and prompted a move to Chicago, the center for options trading. Over the years, he built what became Hull Trading Company, which he recently sold to Goldman Sachs for more than $500 million. In so doing, he became the largest single stockholder of that venerable investment-banking firm.

Motivated by what I know to be Blair’s “low threshold of boredom,” he is now running for the U.S. Senate from the state of Illinois. His substantial resources will enable him to be “un-bossed and unbought” on a scale unthinkable by all but a few politicians today. Those of us who have known him for years can speak for his intelligence and a wonderful temperament that will make him a breath of fresh air in Washington. For America’s sake, we should hope the citizens of Illinois agree in 2004.

For the rest of us who sometimes wish we had “hot hands” on the scale described above, there is something to be learned from a Harvard Business School doctoral thesis published in the July 1993 Journal of Finance. An analysis of 135 mutual funds showed that the winners in a previous year had a better than 50 percent chance of outperforming the losers for the next eight calendar quarters. Beyond two years, the probability withered away. This was an important study because the popular view supported by Vanguard founder John Bogle’s research suggested that the winning fund usually bombed in the following year. The latter theory explains why the American public, obsessed with buying last year’s winning fund, averaged only a 3 percent annual return through the ’90s, while the average fund earned 16 percent (according to a Morningstar survey.)

So how do we make sense of these conflicting ideologies? A publication I highly recommend is called The Independent Advisor, published by Daniel Wiener. It is aimed at those who invest with the Vanguard fund family and who want unbiased “out of the box” thinking as to how to gain maximum advantage from this institution. He has tracked the hot hands theory as it applies to each year’s “hot” Vanguard fund, and his results are enviable. Starting in 1981, subscribing to the theory would have generated a 3,317 percent return versus the total stock market return of 1,034 percent during the same period. Bear in mind that the average mutual fund would

(continued on page 6)

Good Help Is Hard To Find

by Stephen J. Butler

A perennial favorite of New Year's resolutions, according to various surveys, is weight loss, but a close second these days is saving more money and investing more effectively. "Where can I find good help?" is the question that echoes in the void left by major players in the financial services industry.

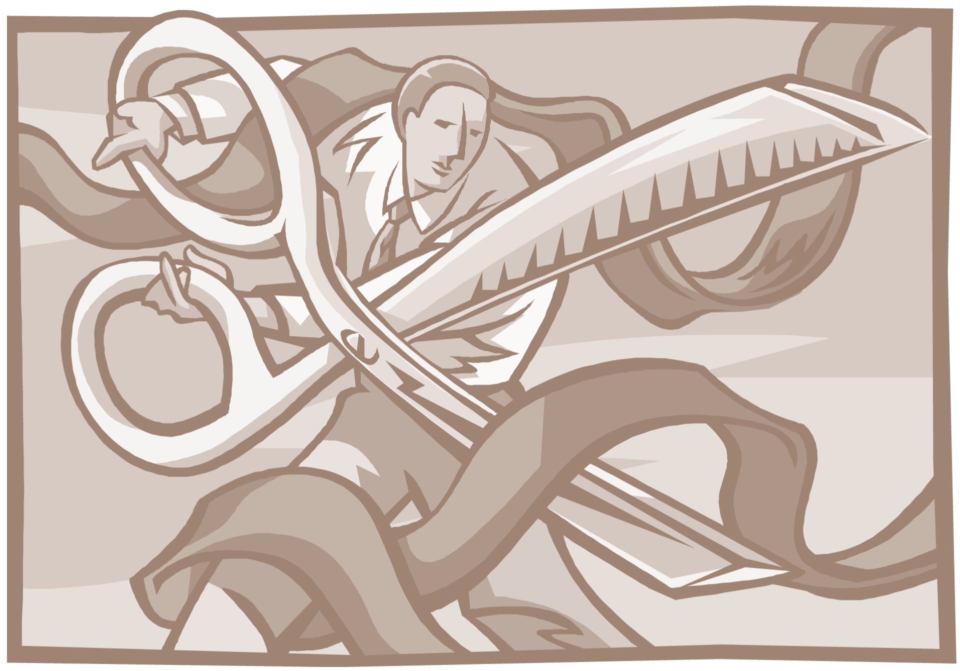
The dozen largest companies in the brokerage business have just offered to pay $1.5 billion in penalties in an effort to avoid years of litigation from angry investors. It's not clear in my mind who will receive this money. It's only clear that the industry has to pay it.

Not that long ago, one of the nation's largest brokerage firms, alone, had to pay another $1.5 billion to settle years of shareholder suits over limited partnerships that had turned sour. Lawyers presumably received a major portion of that money before the trickle-down effect benefited investors in any material way. It reminds me of the class-action suit against some dungaree seller where the lawyers received millions and the buyers each received about $5 if they bought their jeans within a specific time period. If a financial institution takes advantage of us, we can't count on the justice system to wreak vengeance and make us whole. For all practical purposes, we are alone with our money.

The first lesson is that bigger is not better. These major institutions with huge ad budgets and admittedly smart people need to be viewed with a healthy dose of skepticism. The size and national stature of a financial institution is no guarantee that the contact person we work with is giving us good advice. U.S. Trust, a venerable financial adviser for high net worth Americans (and now owned by Charles Schwab Corp.) had an especially embarrassing period back in the 1970s when, according to financial writer Andrew Tobias, it advised many of its clients to invest in what turned out to be very bad real estate deals. At the time, the company had one of the best reputations in the business.

Even Vanguard's management exhibits a touch of self-serving behavior. This unique, giant cooperative, effectively owned by its mutual fund investors, has been faulted in recent years for what some would consider to be excessive compensation coming from its so-called "Partnership Program." The latter is apparently a compensation system put in place to meet the advantage other financial institutions had in the form of stock options. Vanguard's unique ownership structure precluded stock ownership, so this "partnership" approach was adopted. In light of what has happened to stock option values in the financial services industry, it may be time for Vanguard to do some course correcting and further reduce investor expense ratios.

The rising markets of the '80s and '90s turned all investors into self-styled masters of the universe. It was intoxicating to get those statements in '97, '98 and '99 and see what for most of us were dramatic gains. Now, for the past three years, we have found ourselves having to duke it out with the dark side of the Force. The temptation to throw in the towel and turn to an expert — any expert — is probably greater than ever. It's in this state of mind when we can be most vulnerable.



A constructive first step is to determine the soft underbelly of our investment and savings program. Are we dealing with substandard investment results or just a lack of self-discipline that leaves us saving less than we should?

When it comes to substandard investment results, we should ignore the actual percentage loss of assets and focus on whether or not we had been adhering to basic investment rules of thumb. The markets have lost 40 percent or more overall, and the best money managers in the world are, for the most part, stuck with something close to those losses. To have known, in advance, what adviser or money manager could have helped us avoid that loss would have been impossible. My mail

(continued on page 6)

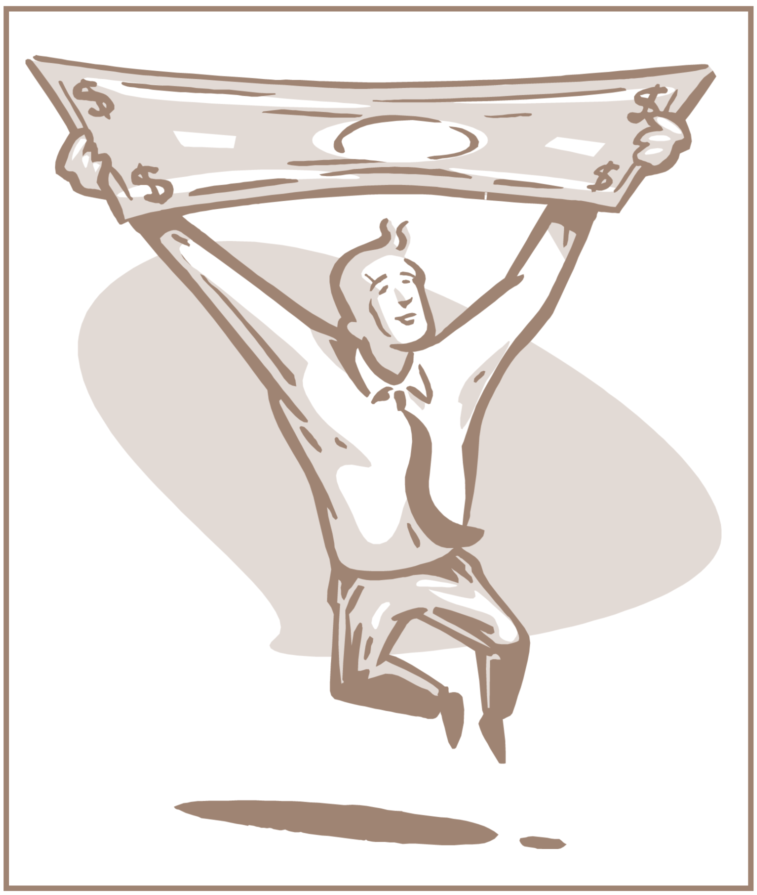
Gurus Take Look At Fundamentals

by Stephen J. Butler

Within hours of reading Warren Buffett's 2002 year-end letter to stockholders (at www.Berkshirehathaway.com), I attended a seminar conducted by Robert Kiyosaki, the author of "Rich Dad, Poor Dad." For different reasons, the two sages really impressed me, so I will offer a mixed green salad of their comments.

Buffett, of course, is the brains behind the success of Berkshire Hathaway, a company whose shares sell for $68,000 each (but you can buy the B shares for about $2,500 each). Of course, no brokerage analysts follow this iconoclastic company because brokers make no money trading a stock whose single share costs so much. It's laughable to consider a $68,000 single-share stock trade generating a commission of only $29, a typical minimum commission cost.

It's interesting that there is only one Berkshire Hathaway. If imitation is the sincerest form of flattery, why hasn't the rest of the financial services industry risen to the bait? There's grist for a Ph.D. thesis here somewhere.



Robert Kiyosaki was another story. His seminar from 6 p.m. until 10 p.m. on a Tuesday night packed the grand ballroom of San Francisco's St. Francis hotel with what looked like about 4,000 people paying between $60 and $90, depending on how close they wanted to sit. With two large-screen projections of himself so people in the back could see, he expounded for four hours on the basics of saving and investing. There was a big emphasis on real estate, of course, because the nature of this asset is that you can apply the resource of OPM (Other People's Money.) "If you save a dollar, all you have is a dollar. If you save a dollar in real estate, you have saved $10, because your first dollar allows you to borrow nine more dollars," and so on.

He did not mention that leverage can work both ways — that some downtown San Francisco buildings are now 85 percent empty and that apartment vacancies are rising, while rental income is softening. It doesn't take much to wipe out a dollar of equity in a leveraged real estate investment.

Buffett starts by pointing out that his retirement is scheduled "five years after (his) death." After talking about the specific results of the various companies owned by Berkshire Hathaway, Buffett launches into the meat of his message, offering thoughts about the stock market and economy in general.

The stock market offers virtually nothing that he is interested in buying right now. He is feeling increasingly comfortable with his current stock holdings (Coca-Cola, Gillette, H&R Block, Wells Fargo, American Express, Moody's and the Washington Post Co.) because the stock prices have come down to reasonable levels and their earnings continue to be strong. These stocks represent a purchase price over the years of $9 billion, and today they are worth $28 billion. When I think of Buffett's investment attitude, what always comes to mind is Mad Magazine's Alfred E. Newman: "What, me worry?"

Kiyosaki had some of the same message for his room full of eager listeners. He shrugged off the market "dip" and pointed out that markets go through cycles. "It just doesn't matter," was his message. I think Kiyosaki's value as a teacher of financial principles is that he focuses on the basic need to save and invest rather than getting bogged down in the specifics of analyzing investment choices. In other words, he's not a stock picker, and he's not there to teach people how to buy houses at foreclosure sales. The main message of his best-

(continued on page 5)

Which Daycare Program Produces The Greatest Tax Benefits?

by Michelle L. King

Is participating in a Daycare Reimbursement Account through a Flexible Benefit Plan better than taking the Dependent Care Tax Credit at the end of the year? Some people make their decision based on "effort". They don't like having a deduction from their paycheck and then having to get a receipt and fill out a form to get those tax-free dollars back. They would rather have normal tax amounts withheld, and receive a lump sum daycare credit at the end of the year when they file their return.

However, most people who ask this question want to know which option will produce the greatest tax benefit. This answer is not always easy to determine. There are a number of variables unique to the individual, such as tax filing status (e.g., married, single, head of household), number of dependents, earned income, tax bracket, etc. that can effect the calculation.

The answer used to be a little easier, when the maximum Daycare Tax Credit was only $4800 for the year. If you had high expenses, the Daycare Reimbursement Account through a Flexible Benefit Plan was the better choice because it had a higher maximum ($5000). Now that recent legislation has raised the maximum Daycare Tax Credit, for 2003, to $6000 ($3000 if you have only have one child who qualifies) and the Daycare Reimbursement Account has not changed ($5000 regardless of the number of qualifying children) we have to stop and think a little harder to determine which is the better choice.

Though the change in the rules governing the Dependent Care Tax Credit make it a more attractive option than before, the Daycare Reimbursement Account through a Flexible Benefit Plan will still generate the greatest tax savings for just about everyone. After looking at some hypothetical combinations, the Employee Benefits Institute of America (EBIA) has come up with a General Rule of Thumb:

If a married couple has no income other than W-2 wages, and uses the standard deduction for calculating federal income taxes, participating in a Daycare Reimbursement Account will usually produce the greatest overall tax benefits. However, there is an exception:

If W-2 income is around $35,000 to $39,000, the family only has one child (qualifying individual), and the daycare expenses for the year are $3,000 or less, the Tax Credit may produce equal or greater savings.

In this example, the tax bracket (based on the income level) is low enough that the tax savings through the Daycare Reimbursement Account would be roughly the same as the calculated Tax Credit. Since the total expenses for the year do not exceed the Tax Credit maximum, there is no incentive to use the Daycare Reimbursement Account.

One reason that the Daycare Reimbursement Account still produces the greatest tax benefits even for most taxpayers earning less than $43,000 is that payroll deductions for the Daycare Reimbursement Account reduce a taxpayer's earned income, which actually results in an increase in most taxpayers' Earned Income Credit (EIC). However, taxpayers with earned incomes of $12,000 to $15,000, or less, who elect to have pre-tax payroll deductions will experience a decrease in their EIC, not an increase.

Another reason, for those of you in a higher tax bracket, the Daycare Reimbursement Accounts work so well is because the payroll deductions reduce your W-2 taxable income. Therefore, this salary reduction option could drop you into a lower tax bracket, resulting in your remaining income being taxed at a slightly lower rate.

If your not sure how all of this applies to your situation, Pension Dynamics Corporation is happy provide you with a couple of worksheets to help you with the calculations. The worksheets (2 of them) are fairly straight forward, and the process should give you a clearer picture of what your tax savings would look like with each option. Please,feel free to contact us by phone at (925) 299-8088, or by e-mail at flex@pensiondynamics.com to request the worksheets. If, after completing the worksheets, you are still not sure which option is most beneficial for you, you may want to consult with your tax advisor. ■

Strategies... *(from page 1)*

have done even worse, falling well short of the total stock market return.

Wiener claims that the theory works in a Vanguard setting because these funds have very little “style drift.” The purpose dose of “hot hands” theory probably makes sense within a fund category. If we know we want to have a portion of our money in an overseas fund, for example, it should probably be a fund that has beaten its competitors. The same would be true for the quality of, say, our large-cap growth fund selection. In this respect, we should all be looking at our Janus funds (who doesn’t own at least some) in the light of how that company’s top management has changed dramatically in recent years. There could be a hotter hand for each category in which it fields a fund. Ideally, each investment type and style represented in our balanced portfolio could probably benefit from participation by the “hottest hand” of each fund type.

All of this takes time and energy. We are paddling upstream against our basic psychological makeup, which incorporates the “status quo bias.” In other words, we’re too busy, too lazy, or scared to death to make an active investment decision. This is why many of us should use financial planners regardless of how much they cost.

For leadership by example, one of the most stunning exhibitions of hot hands came in 1987 at the very bottom of the October crash. To this day, economists have not identified a reason for exactly why the market crashed. However, they have identified a single event that marked the very bottom of the market. The Wall Street Journal, several years later, identified the bottom as the moment when “an unidentified trader” walked onto the floor of a silent Chicago options exchange floor and submitted an order to buy. That trader was “Mr. Hot Hands” himself, Blair Hull. The question for us is, “Did he buy options in the stock that had performed the best in the previous year?” ■

Gurus... *(from page 3)*

selling book is to realize that accumulating assets is the path to wealth and that we spend money in a lot of ways that stand in the way of accumulating assets.

He points out that a residence is a liability and that a bigger, more expensive house is a bigger liability. It should not be confused with an income-producing asset (as so many of us are tempted to do). That is good information for someone to think about here in Northern California, where house prices are three times the national average. Anyone who thinks this isn’t a housing “bubble” should recall how they were feeling when the stock market reached its high in 2000.

Buffett does offer a specific hint about how we might apply new investment dollars today. He suggests junk bonds and points out that he has increased his investment sixfold in this vehicle. I have written several columns now on junk bonds and junk bond mutual funds, because I think they offer some risk but have the offsetting advantage of immediate gratification, with yields in the 9 percent range. (For those interested, all 200 of my past columns can be accessed at www.pensiondynamics.com by clicking on the box that says “This Week’s 401(k) News.”)

The two gurus, then, offer similar forms of home-spun investment knowledge. Kiyosaki is heavier in the platitude department and is easy and entertaining to listen to. I think that everyone had at least some valuable “take-aways” from his seminar. Buffett is just the smartest investor on the planet, as far as I can determine, so anything he writes or says is worth some careful attention. Gurus of any stripe earn that designation by sharing knowledge effectively. ■

PWBA
Has A New Name

The Department of Labor has announced that the Pension and Welfare Benefits Administration (PWBA) as been renamed. As of February 3, 2003 the new name is the Employee Benefits Security Administration (EBSA). This name change is intended to more clearly communicate the agency’s mission, which is to protect private sector employee benefits.

The new toll free phone number for participant assistance is 1-866-444-EBSA (3272), and the web site is www.dol.gov/ebsa.

Benefits = What % of Total Compensation?

by Michelle L. King

It seems that costs for employee benefits have surged to their highest level ever recorded. According to the U.S. Chamber of Commerce, employee benefits comprised an average of 39% of employers’ payroll costs in 2001.

The number one culprit? No surprise here…it was health care benefits, which totaled 11% of compensation for the average employee.

Paid time off accounted for the second-largest share of benefits cost, averaging about 10% of payroll costs. This was followed by retirement benefit costs, which accounted for an average of 8%.

Good Help... *(from page 4)*

is full of these investment newsletter people who have claimed to have "timed the market," but according to Mark Hulbert, who tracks their long-term performance, most have had dismal records over the years.

After having lost almost 40 percent over the past three years, the market as a whole is now on a par with its long-term 10 percent average rate of return. In other words, we could draw a line of hypothetical performance illustrating a rise of an even 10 percent per year and then compare it with an equivalent line reflecting actual market performance. These two lines today, thanks to the plummet, are reasonably close. Warren Buffett, in a Fortune magazine interview about a year ago, talked about an expectation of 7 percent per year for the next 10 years. But that was before the market dropped an additional 15 percent last summer. Depending upon which of many divining rods we want to use, you can find many reasons for why the market over the long term continues to offer one of the best opportunities for patient money.

When it comes to finding advice, decide first what the problem is. A visit to a fee-based financial planner is a good place to start if you feel you have lost your financial bearings and need help revisiting your overall goals. The advantage of hiring a professional planner is that he or she will hold your feet to the fire and make sure that you plan your work and work your plan. Next, the Web sites of every mutual fund company offer financial planning programs that will help you get on the right track. One of the most user-friendly independent resources is offered at www.torridtech.com.

With regard to second guessing the market, it's important to avoid the temptation to try. Just look at the current downturn as an opportunity to increase a broad selection of diversified investments at bargain prices. For sport, a bit of second-guessing can't do much harm. In this respect, small and mid-cap mutual funds (or stocks) have historically performed better as economies come out of recessions. Meanwhile, high-yield bond funds at their currently depressed prices perform more like stock funds than bond funds. While we wait for the rest of our holdings to recover, a little money in a junk bond fund can offer some immediate gratification in the form of high current yields.

Little by little, the average person can learn once, and some inevitable mistakes along the way can cost money. However, gaining the knowledge ourselves can be far more valuable in the long run than being held hostage by financial institutions dispensing advice. The past few years may appear to have cost us some money, but in the end it has been part of a great learning experience, and markets, over time, are forgiving.

CONFESSION: Finally, I was overwhelmed by reader correspondence after last week's gas tax proposal, and it is only fair to confess that I own two four-wheel drive vehicles, a motorcycle and a boat. Like "Mr. Toad," I have no self-discipline when it comes to enjoying combustion engines. Only a gas tax will save me from myself. ■

Cool Stuff

by Lindsy Golden

Indexes

Prime Rate – 4.25%

Fixed Mortgage

30 Year – 5.56%
15 Year – 4.96%

Home Equity Loan

6.55%

New Car, 48 Month Loan

5.95%

One Year CD

1.89%

Internet Sites

www.socialfunds.com
The largest personal finance site devoted to socially responsible investing.

www.taxfoundation.org
Non-partisan, non-profit organization that provides information on tax policy, tax rates and collections, and the economics of taxation.

__401(k) Today__ is published by Pension Dynamics Corporation on a quarterly basis. All articles are written by Stephen J. Butler, Michelle L. King and Lindsy Golden.

To read more articles about saving and investing, please visit our web site at __www.pensiondynamics.com__ and click on __This Week's 401(k) News__.

These weekly articles by Steve Butler are published by the Knight Ridder newspapers and appear in the Contra Costa Times as well as other major newspapers in that national chain. An archive of all past articles are also available at __This Week's 401(k) News__ on the PDC web site.

Newsletter design and website maintenance by Lauri Nicolosi.