

THE PROCESS OF INVESTING



BY JOSEPH P. CURRAN

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Applied Financial Planning and Portfolio Management

By: Joseph P. Curran, CPM®, CFP®

DEDICATION

To my grandmother, Wilhelmina K. Curran

ACKNOWLEDGEMENTS

I would like to take this opportunity to thank the people who have helped and supported this book and my career. First, my wife Angela has seen me through every class, test, and job since high school: any and all success I owe to her. I would like to thank my older brother James, a friend as well as a respected investment professional who looks out for clients properly. To my children, Lainey and Will, I appreciate your support and understanding more than you know. I would like to acknowledge the rest of my family: My parents, in-laws, and grandparents have always allowed me to chart my own course.

I extend a special thanks to my business partners and co-workers, especially Cathleen. My graduate school advisors, William Butos and Ward Curran, were instrumental in my learning process and academic confidence. Eric Chatman went out of his way as a mentor to take me under his wing early in my career. I thank Dale Woodiel, the first teacher to reach out and make an effort to help me realize my potential. Last, but not least, I need to thank my clients for believing in my ability to look out for their financial planning and investment needs.

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PREFACE

The purpose of this book is to share my formula for building financial plans and managing investments. I draw from personal as well as academic and professional experiences to form a comprehensive approach. Whether reading this to understand how an advisor can help or you want to use my recipe to manage your own wealth, this book will provide insight into making the most of your financial well being. My step-by-step approach serves as a guide that will close many common gaps that investors encounter.

The objective is to make the process timeless. We will first begin by understanding where I came from and how my thoughts were formed over the years. This will lead into the practical applications for managing wealth, from getting started with investment selection, to ongoing monitoring. I believe strongly in education, process, and ethics; this book serves as my platform to document and share my method.

CHAPTER ONE



THE WONDER YEARS

My story begins in a New England neighborhood as a 6-year-old with a \$2 weekly allowance. Neighborhood kids would jump on bikes and ride into the center of town to buy candy at the local drugstore. I gained an early appreciation for budgeting by maximizing my allowance: the typical pack of candy cost 32 cents. However, if I'd saved enough over the course of the month, I'd allow myself to splurge on the 2-for-\$1 gummy bears. While young, these candy excursions motivated me and served as my first exposure to the purpose and value of money.

Jumping ahead to the ripe old age of 7-years-old, my parents sat me down with my older brother and gave us each an envelope. They said they wanted us to start saving money so we could buy things when we went to Disney World. To any child, there is no greater motivation than Disney – I was even more determined to save than I had been by gummy bears. Soon, between saving allowances, Christmas, and birthday money, I was able to build up what I considered to be a good amount of money. I would take out the envelope and sit on my bed, counting the money. I was on my way.

A few years down the line, my father brought me down to the local bank in town to open my first bank account. I vividly recall sitting at the banker's desk as we counted out every bill and coin: \$212.19! I received a little book with the account value printed on it, tangible proof of my savings. Periodically, my father would update the bank book to show me the current value of my account. It almost seemed magical. The money grew for seemingly no reason. He explained the concept of interest and I was fascinated by how the balance would increase. Keep in mind that this was the mid-1980s, when interest rates were sizable and fees were virtually nonexistent.

I was excited by any chance to earn and make money – chores around the house, yard work, even a paper route. Back then, 15 was the earliest age you could get a part-time job in Connecticut, so I started working at the local grocery store. I earned \$4.26 per hour before taxes, working three hours after school with a 15-minute break a few days a week. As a teenager, I had trouble with trying to look busy or going above and beyond without any extra incentive. It quickly became apparent that I could mow a lawn in a half an hour and make \$20. It would take many more hours to clear that bagging groceries, mopping floors, and fetching carts. So I plastered the neighborhood with flyers and landed enough clients to start my own landscaping business. Word of mouth at my grandmother's bridge club also helped, and I was well on my way.

My entrepreneurial spirit was born. Between lawns, hedge trimming, and winter snow removal, I had plenty of work to stay busy while earning money. The reward wasn't all financial, though. I learned a number of other lessons through this process as well: work ethic, client communication skills, practical landscaping skills, and what I believe to be most important – reliability. I continued the landscaping business through high school and college, illustrating that if you did a high quality job and were considerate, then the client would be happy.

One Christmas while in high school, my grandmother bought me a rather unique holiday gift – my first share of stock. It was Ford Motor Company, with the ticker symbol “F.” Ford performed very well during the early 1990s, making my grandmother's gift a great first lesson and exposure to the equity market. I would periodically check the price in the newspaper and looked forward to receiving my statements. Dividend reinvestment and spinoffs sweetened the pot and I was fascinated once again with how the investment magically grew.

Although I loved my candy, and still do to this day, I hesitate and think things through before making any purchase. That's not to say it's all about earning money, saving, and watching it grow. Money is a means to an end. There are many other components to finance, including spending wisely to maximize happiness. For the 16-year-old version of me, this meant having my own car and all of the related responsibilities and expenses. Buying guitars, drums, and musical gear was also an important way for me to spend my funds. It was – and remains – important for me to be able to afford to do and buy things that I deemed worthwhile. Looking back, there was little in the way of hobbies and activities that I missed out on due to lack of funds or time being at work for that matter. More importantly, I gained a sense of independence to make my own choices. My formula for making this happen revolved around doing a good job as a landscaper – professional, reliable, knowledgeable, and all for a fair price. It's a novel idea!

CHAPTER TWO



INFLUENTIAL EXPERIENCES THAT SHAPED THE PROCESS

When it came time to go to college and chose a major, I decided to enroll in the University of Connecticut School of Business. After my supermarket experience, my goal was always to own my own business. After three years of coursework, I had taken a number of electives in economics simply because I liked certain professors and enjoyed the subject matter. The use of money is truly a study in economics so in hindsight, it was no surprise I fell into this

course of academics. While preparing to declare a major, I realized that I'd racked up so many economics credits that I would be able to finish college a semester early if I majored in it. Decision made.

I recall feeling as though I'd spent my whole life in school and was itching to get a real job and earn money. By 1998, I had graduated and was finally able to enter the job market. Although my goal was to run my own business, I needed to make money and learn. With my savings and the \$1,000 my father gave me as a graduation gift, I was on my own. Fairly easily, I was able to find a job that looked appealing on the surface – a financial advisor for Prudential. However, this amounted to an unpaid internship to become licensed to sell insurance. Sales? Insurance sales? Selling insurance could not have seemed less appealing to the 21-year-old version of me. With a better understanding of the wide range of what qualified as “financial advising,” I wanted to hone my skills in the investment business, not the insurance business. I aspired to learn about personal finance and help people with their money. Surely there must be a better way of accomplishing this than pushing an insurance product that may or may not be appropriate for a client.

I returned to the root of where I had always received sound advice: family. My father said to look at Smith Barney, which at the time was owned by the Travelers Group, where he had worked for more than two decades. Around the same time, I had read Michael Bloomberg's book about how he started his career on the ground floor, literally, at Solomon Brothers counting securities in the back office. Smith Barney had recently acquired Solomon Brothers. Given Bloomberg's success and my father's advice, Smith Barney seemed worth looking into. While attending a seminar the company hosted, I approached the branch manager. I told him I was looking for a job and was willing to start wherever he had a need. He said he could find something for me, and my career officially started.

In my early 20s, I learned the business of finance from the ground up. I opened up new accounts, picked up mail, and made the daily drop off at the bank. I began to feel the need to move on to the next level. At 22-years-old,

I certainly wasn't ready to be an advisor for Smith Barney. However, there weren't any alternatives locally in the office. I still despised the idea of sales and having to rely on persuasion to be successful in the investment business. I wanted to be an expert and client advocate and succeed through my work ethic and knowledge. I obtained my Series 7 General Securities license, and I started my master's degree in Economics at Trinity College in Hartford. I transitioned to a new job at Cigna in 1999 where I could work directly with clients. I helped investors roll over their 401(k)s and invest money. As opposed to Smith Barney's full-service brokerage model, Cigna had a discount brokerage model similar to Charles Schwab and Fidelity. I believed this was the future; in essence, why pay for a glorified used car salesman when you could simply go to a discount brokerage and save money?

I spent the next several years at Cigna while completing graduate school, where most of my studies and research revolved around portfolio management. As the market crashed in the early 2000s, I realized the value of sound financial advice and developing relationships with clients. Most people need help with knowing what to do with their hard-earned savings, and knowledge and expertise when handling it are paramount. I headed up a program at the firm that allowed us to invest and manage client portfolios. For the people who needed special help and didn't want to make their own investment decisions, this solution allowed us to manage their assets. We set up people with solid risk profiles through a questionnaire process and managed their portfolios. We updated the investments, rebalanced, and performed quarterly calls that discussed our economic commentary and portfolio updates. It was also an opportunity for clients to ask questions regarding their accounts. This became the foundation of my approach to advising.

As the stock market continued to tank with the collapse of Enron, Internet company bankruptcies, the tech bubble, accounting scandals, and the 9/11 Attacks, I became more interested in learning about bonds and other types of fixed income securities. I involved myself in special projects with the treasurer of the bank and chief economist to incorporate my economics

background and graduate studies in fixed-income portfolio management. For a couple of years, I focused on managing client portfolios and institutional fixed-income portfolio management. I was part of a committee that priced our weekly bank CDs and used computer models to simulate what would happen to our institutional assets if interest rates increased or decreased unexpectedly. This allowed me to learn a great deal about managing bond portfolios.

Between managing client portfolios, graduate school, and the fixed-income portfolio management, I count myself fortunate to have worked with professionals who I consider among the best and the brightest. However, at a discount brokerage you are only able to take orders or manage assets for the clients, with no advice or real financial planning in between. And as an institutional bond trader or fixed-income portfolio manager, there was limited client interaction. I really enjoyed both sides of the industry – working with people and helping them with their investments. I felt there must be a way of bringing together all of my experiences.

By 2005, I was finally ready to build my own client book of business. Early in my career, I recall my uncle explaining the benefits of working with a true Registered Investment Advisory (RIA) firm. I'll return to this later on, but the premise is that only an RIA can provide true advice without a conflict of interest. No commissions or transaction costs, only a fee for advice. This is how I wanted to structure my business. There were no boutique RIA firms around hiring, and I certainly didn't have the wherewithal at that point to set up my own firm. The platform at Smith Barney would allow me to run my own book within the firm the way I saw fit with emphasis on providing a fee for advice instead of transactional commissions. I could lean on my knowledge, skills, and experience to make up for my lack of sales capabilities. That is exactly what I did. I went back to Smith Barney and began building a solid client book of business helping people with their money.

After the financial crisis, Morgan Stanley bought Smith Barney and I made a move to Merrill Lynch. Over the years, I continued my formula for helping

clients and developed more practical skills. I went through the rigorous process of becoming a Certified Financial Planner (CFP)[™] and a Certified Portfolio Manager (CPM), two designations I hold in high regard.

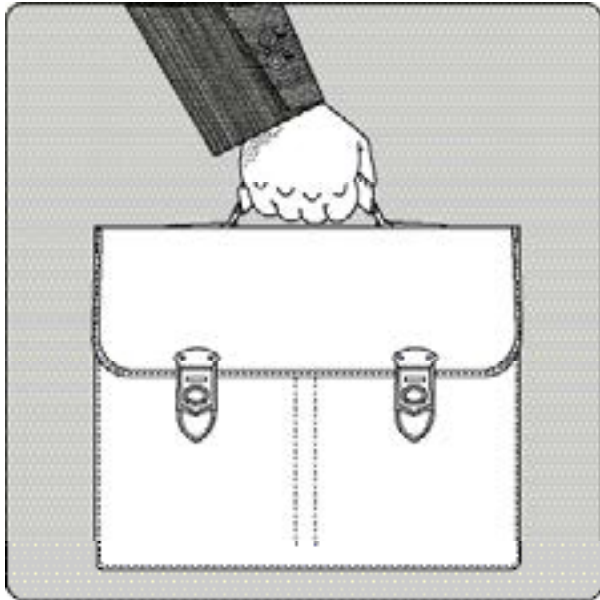
Success is earned through developing strong relationships, looking out for the client's best interest, and providing the highest level of investment advice as a true fiduciary. Even while working for other companies, I strived to structure my practice in alignment with an RIA's investment advisory, fee-based approach. This remains my formula. The importance of ethics cannot be understated in the business of helping people with their money. The most highly regarded professional designations in the investment industry, including the CFP[™], concentrate on ethics and integrity. The program emphasizes formal training and continuously holding advisors accountable. The rigorous ethics training required to maintain the CFP[™] designation has helped me reaffirm what is always most important: An advisor's core mission should be looking out for the client's best interest, and there is no reason why this would not be mutually beneficial.

Clients and interested parties can visit my website at www.processofinvesting.com for the following resources, which will be discussed in detail:

- **CONSOLIDATED PRESENTATION OF THE PROCESS**
- **FINANCIAL PLANNING PROFILE**
- **INVESTMENT PERSONALITY RISK PROFILE**
- **SAMPLE FINANCIAL PLAN**
- **SAMPLE INVESTMENT POLICY STATEMENT**
- **SAMPLE PORTFOLIO MODEL**
- **ECONOMIC & PORTFOLIO MANAGEMENT CHECKLIST**
- **QUARTERLY MARKET COMMENTARY & PORTFOLIO UPDATE NEWSLETTER**
- **SAMPLE CLIENT REVIEW INCORPORATING GOALS**

STEP ONE

CHAPTER THREE



FINANCIAL PLANNING & INVESTMENT PROFILE

Now the fun begins. To be clear, I am not taking instruction from any outside source, company, regulatory initiative or otherwise to create the ideal platform. The following process has come out of necessity to deliver the optimal client experience from beginning to end, while covering all of the angles and filling in any potential gaps. It may appear to be what every advisor should do automatically; however, I have not seen the entire process documented into the concise and holistic manner that I put forth. Although

many of the ideas I use have been formulated over time and regarded as best practices, my goal is to bring everything together into a comprehensive approach.

Every day, I utilize a process to ensure I am delivering and maintaining the best possible service and experience for my clients. Although everyone is entitled to that dedication, not all professionals treat their clients the same. Too often, I see people steered into products and programs on the sole basis that it pays the advisor the most. For example, some financial advisors actually try to convince themselves that an annuity should be a core component of an investor's portfolio. I believe annuities, along with structured products, insurance policies, and other proprietary offerings, are oversold because they pay the broker a higher commission. It would be interesting to see which products were actually recommended if professional fees were set level across the board. Until that is the case, some financial services professionals may have incentives to focus their training and advice on programs that may not ultimately be best for clients. Disclosing and documenting my process is useful not only for my clients and myself, but it can also serve as a tool for other advisors to utilize.

I have formed a four-step process that covers a client relationship from beginning to end. In this chapter, we will explore the first step, but the four steps are:

The 4-Step Process

- ▶ **STEP 1: GATHER PROFILE INFORMATION**
- ▶ **STEP 2: CREATE FINANCIAL PLAN & INVESTMENT POLICY STATEMENT (IPS)**
- ▶ **STEP 3: IMPLEMENTATION & INVESTMENT SELECTION**
- ▶ **STEP 4: MONITOR, REVIEW & UPDATE NEWSLETTER**

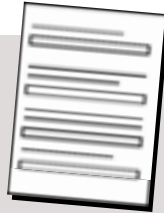
STEP 1: GATHER PROFILE INFORMATION

So, what's the scenario? We must ask the clients a series of questions to find out exactly what they are looking for. This will uncover their needs in such a way that will allow the advisor to make recommendations and manage the overall relationship. Following are the exact pieces of information for an introductory meeting to obtain a holistic profile.

Visit www.processofinvesting.com for profile PDFs.

Standard Client Information Form

As required by SEC Rule 405 (Know Your Customer Rule):



| | |
|------------------------|----------------------|
| Name | <input type="text"/> |
| Address | <input type="text"/> |
| Phone # | <input type="text"/> |
| Email | <input type="text"/> |
| Marital Status | <input type="text"/> |
| Dependents | <input type="text"/> |
| Date of Birth | <input type="text"/> |
| Social Security # | <input type="text"/> |
| Employment Information | <input type="text"/> |
| | <input type="text"/> |
| | <input type="text"/> |

| | |
|---|--|
| *Annual Income | <input type="text"/> |
| *Assets | <input type="text"/> |
| *Liabilities | <input type="text"/> |
| *Net Worth | <input type="text"/> |
| Beneficiary Information | <input type="text"/> |
| CPA | <input type="text"/> |
| Estate Attorney | <input type="text"/> |
| *Investment Experience | <input type="text"/> |
| **Investment Objective: Income, Growth, or Total Return | <input type="text"/> |
| | <input type="text"/> |
| Would you like a checkbook or debit card? | <input type="checkbox"/> <i>yes</i> <input type="checkbox"/> <i>no</i> |
| Additional Notes: | <input type="text"/> |
| | <input type="text"/> |
| | <input type="text"/> |

*More detail elaborated within the Financial Planning Profile.

**More insight obtained in the Investment Profile.

The next template delves deeper in an effort to uncover any necessary data required to create a holistic financial plan.



Financial Planning Profile

This information is required to create your financial plan.

Income Sources:

Current Income

Retirement Income

~ Pension

~ Social Security

Assets:

Banks Accounts

Investment Accounts

Retirement Accounts

Annuities

Life Insurance

Real Estate

Company Stock Options

Cars

Other Assets

Liabilities:

Mortgages

Home Equity Loans

Car Loans

Credits Cards

Installment Loans

Other Debts

Tax Considerations:

Marginal Tax Bracket

Capital Gain/Loss

Other Insurance Related Needs:

Long-Term Care

Property Casualty

Medical

Umbrella Coverage

Personal Circumstances:

Savings/Contributions

Travel

| | |
|-------------------------|--|
| Hobbies | |
| Health | |
| Education Costs/Goals | |
| Potential Expenses | |
| Inheritance | |
| Estate Planning: | |
| Will | |
| Trusts | |
| Healthcare Proxy | |
| Living Will | |
| Power of Attorney | |
| Final Expenses | |
| Personal Goals: | |
| Retirement Age | |
| Retirement Income Goal | |
| Legacy Wealth | |
| Charitable Giving | |
| Hopes | |

| | |
|-----------------------------|--|
| Concerns | |
| Target Goals | |
| Inflation Rate Expectations | |
| Budget: | |
| Monthly Expenses | |
| Emergency Funds | |
| Additional Notes: | |
| | |
| | |
| | |
| | |

A financial profile involves the client’s income sources, assets, liabilities, tax considerations as well as other insurance related needs. Other financial things to think about are personal circumstances, estate planning, personal goals, and budget needs.

To gain further insight into a particular client's risk profile we use the following Investment Profile Questionnaire. Not only will this help us gain a better understanding of an investor's personality, but it will enable us to formally establish investment objectives, risk tolerance, time horizon and income requirements. Each question has a purpose and the order is important. It is best for a client to go through the questions with the advisor to facilitate an interactive conversation. It is not ideal to blindly send the form for a client to fill out on their own.

Investment Profile Questionnaire

A series of a questions to better understand a client's investment behavior.



1. What is your prior investment experience?

(Individual Stocks, Bonds, Mutual Funds, ETFs, SMAs)

2. On a scale of 1 to 10, with 1 being the most conservative and 10 the most aggressive, where do you fall on the scale?

1 2 3 4 5 6 7 8 9 10

Scale Key: 1-3 = Preservation of capital while minimizing losses and fluctuations as much as possible. 4-7 = A balanced investment mix of growth and income with tolerance for some risk (keep in mind, when we mention income here, we are referring to investments that generate income or dividends, not literal withdrawals from the portfolio itself). 8-10 = Maximum growth of assets with corresponding tolerance for risk and fluctuations.

3. What percentage of your portfolio would you prefer to be invested in equities (stocks)?

4. If the Chairperson of the Federal Reserve announced that the economy is showing signs of a slowdown, how would you react?

- A. Would you ask to decrease your exposure and increase cash?
- B. Would you do nothing as you are a long-term investor?
- C. Would you want to increase your exposure to take advantage of a buying opportunity?

5. Which of the following best describes your investment objective?

- A. Maximum Growth
- B. Growth and Income
- C. Current Income
- D. Preservation of Capital

6. What time period will you use in evaluating the performance of this investment program?

- A. Five to 10 years
- B. Three to five years
- C. One to three years
- D. Less than one year

7. Would you prefer...(circle one of each)

- 7a. Constant Returns OR High Rewards?
- 7b. Current Income OR Capital Appreciation?
- 7c. No Down Years OR Out-Perform the Market?

8. This is you speaking here, please chose one of the following statements.

- A. I am not prepared to accept risk
- B. I am willing to experience some risk in order to exceed inflation
- C. I would like to take on additional risk to achieve higher returns while recognizing the chance of losing some portion of my money during falling markets
- D. I am willing to assume substantial risk for the opportunity to maximize returns, while recognizing the probability of losing money during falling markets

9. If you invested \$1,000,000 today and began losing money, at what point would you choose to sell and discontinue the program?

- A. \$950,000
- B. \$900,000
- C. \$850,000
- D. \$800,000
- E. You would not sell because you are a long-term investor

10. Which of the following concerns you most?

- A. Losing money over the short-term
- B. Having insufficient assets to meet your objectives
- C. Concern that the market is too high
- D. Not participating in rising markets

11. Please choose one of the following four hypothetical portfolios with a potential 1-year gain and possible 1-year loss.

- A. Up 4 percent, down 1 percent
- B. Up 8 percent, down 6 percent
- C. Up 10 percent, down 8 percent
- D. Up 20 percent, down 17 percent

12. When do you anticipate the requirement to withdraw more than 10 percent of the principle from this account?

- A. Five years or more
- B. Three to five years
- C. Two to three years
- D. Less than two years

13. Would you like to receive regular withdrawals? (Specify the exact day and tax withholding.)

- A. Monthly
- B. Quarterly
- C. Semi-annually
- D. Annually

14. Do you anticipate any extraordinary expenses?

15. Do you plan to contribute to this portfolio? At what rate?

16. How comfortable are you in the ability to achieve your financial goals?

17. How often would you like to review your investments and wealth management needs?

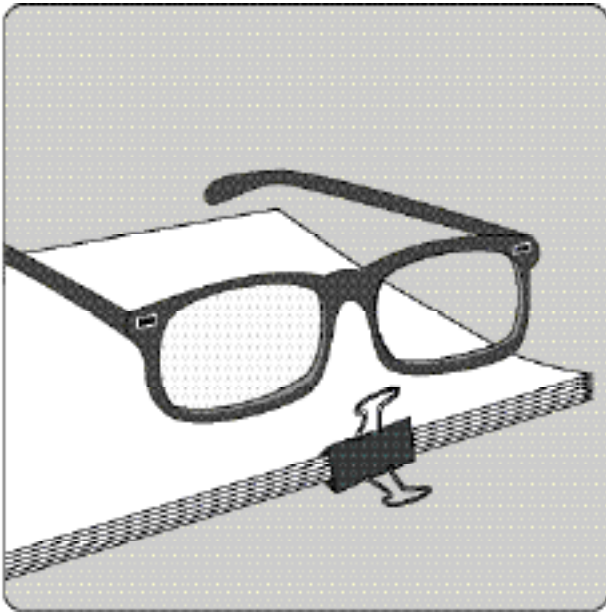
Additional Notes:

The consultative nature of the advisor should utilize the fact-finding and questionnaire process as a means for back-and-forth discussion with more listening than talking in order to really hear what is being uncovered. I quantify investors and put them on the scale of one to 10, with spouses having a separate risk target.

Gathering comprehensive and specific client information is essential before moving to Step 2 and creating the actual Financial Plan and Investment Policy Statement. The particular client's unique personality should be engrained throughout all of the findings.

STEP TWO

CHAPTER FOUR



WRITTEN FINANCIAL PLAN & INVESTMENT POLICY STATEMENT

STEP 2: CREATE FINANCIAL PLAN AND INVESTMENT POLICY STATEMENT

Now that we have all of the vital client information, we can process the data and try to make sense of the whole scenario. Every plan is unique and must be customized carefully to include the specific needs of each individual, family, or business. In essence, the number of potential outcomes

here is endless. It is not prudent to force the same cookie cutter plan when developing the proper action plan for a client. Of course, there exist basic principles necessary to build a robust presentation; however, each situation must be customized to some extent to incorporate wholly the unique personality of a particular client case.

There are a number of tools and software packages used to model certain data. Whether it is retirement income, education funding, legacy wealth, mortgages, or a variety of other tools, the output is only as good as the underlying assumptions combined with the translation of the output to integrate the information back into the client's goals. We must cover the essential needs revealed during the profile and information gathering process (Step 1).

Math rules the world, which is why the consistent answer for any financial question remains: Run the numbers. For example, clients may ask: "Should we refinance?" To determine the answer, we look at the current rates, the transaction costs involved, how long it will take to break even and how long they plan to stay in their home. Of course, the answers are not always straightforward. In many cases, we may have to run alternate scenarios and discuss potential oppositional answers. This is what makes the nature of financial advising a science and an art. The human element is really the strongest factor.

Prior to delivering any financial plan or investment proposal, we must state a number of disclaimers and disclosures. First, we base the formal plan on a series of assumptions, and the results are only as good as the data used to create them. Second, nothing is set in stone. The plan should be updated and reevaluated periodically, ideally on an annual basis. Life happens and change is inevitable. Finally, the purpose of a written plan is simply an exercise to provide insight into goals. It creates a hypothetical scenario to serve as a guide and provide a means for discussion and to document progress along the way. An action plan serves little purpose if it is simply utilized once; rather, it should serve as a solid foundation for a long-term relationship.

Even worse is when a plan is used as window dressing to disguise a financial product sales pitch.

A typical financial plan will have dozens of pages that elaborate on specific elements. Since every plan is unique, it does not make sense to include a comprehensive plan here, primarily due to the length and detail (please see the website for a sample financial plan). However, the best plans are ones that can be summarized onto a single page.

A Financial Plan

The typical key attributes are as follows:



1. Current Situation:

Assets, Liabilities & Net Worth

2. Goals:

Retirement Age, Retirement Income Target, Savings Rate & Other Goals

3. Needs Analysis:

Tax & Legal Considerations (*Wills, Trusts, Healthcare Directives & Power of Attorney Information*) and a Risk Profile

4. Assumptions:

Life Expectancy, Inflation Target, Return Assumptions, Standard Deviation Analysis & Monte Carlo Simulations

5. Retirement Income & Cash Flow Summary Forecast

6. Investment Asset Detail:

Current & Proposed Asset Allocation

7. Insurance Analysis:

Whole Life, Term Coverage & Long Term Care

8. Estate Planning Information

9. Stock Option Detail

10. Other Goals:

Education Funding, Elder Care, Travel, Hobbies, etc.

One Page Overview

There are three major ways to analyze a particular investment or client-specific goal. First, there exists fundamental analysis – the raw data and numbers. Secondly, there is technical analysis; this has to do with past information and historical movements. Third is behavioral finance, which is made up of the psychological factors that cannot be quantified

or understood due to the human element. All of the factors carry weight, especially the human element. That is what makes this process fluid and interesting, yet not a perfect science.

The number of client scenarios, planning tools, and investments can be infinite and overwhelming, leading to some of even the most important points being overlooked. This is why we provide a framework that covers the bases thoroughly, while simplifying the process and focusing on the important details. Since some of the best and most comprehensive action plans can be articulated and consolidated into one page. We've already covered the key attributes; the typical financial planning elements include:

Net Worth Analysis

Retirement Forecasts

Tax Strategies

Estate Planning

Risk Management

Investment Management



Investment Policy Statement (IPS)

While a formal IPS is simply a written plan of the client's investment needs with consideration for their risk profile, the importance of the document is paramount. Clearly documenting the investor's key requirements and critical risk factors helps set both client and advisor expectations. It will also serve as a formal guideline, especially during times of turmoil and market uncertainty. The typical IPS will include:

1. A Defined Scope and Purpose for the Specific Investor

2. Assigned Roles and Responsibilities:

Of the investor, the investment manager and third party advisors

3. Investment Allocation

4. Constraints

5. Other Relevant Factors

6. Performance Targets and Measures:

Benchmarks and index comparison matrix defined

7. Monitoring

Review, updates, rebalancing

The core of a typical Investment Policy Statement for an individual investor will focus on:

Investment Objectives

Risk Tolerance

Time Horizon

Income Requirements

Target Allocation

The CFA Institute's white paper "Elements of and Investment Policy Statement for Individual Investors" published in May 2010, expounds on the importance of a formal IPS:

Providing investment counsel to individuals requires addressing a variety of priorities and concerns in addition to addressing the absolute bottom line of investment performance. The investment strategy must be considered in the context of the client's overall financial plan, short- and long-term objectives, risk tolerance, and preferences. The potential complexity associated with taking all of these factors into account in an investment strategy requires a disciplined approach.

The investment policy statement (IPS) serves as a strategic guide to the planning and implementation of an investment program. When implemented successfully, the IPS anticipates issues related to governance of the investment program, planning for appropriate asset allocation, implementing an investment program with internal and/or external managers, monitoring the results, risk management, and appropriate reporting. The IPS also establishes accountability for the various entities that may work on behalf of an investor. Perhaps most importantly, the IPS serves as a policy guide that can offer an objective course of action to be followed during periods of market disruption when emotional or instinctive responses might otherwise motivate less prudent actions. The IPS is a highly customized document that is uniquely tailored to the preferences, attitudes, and situation of each investor.

Templates that purport to offer convenience and ease in development of an IPS almost inevitably sacrifice consideration of factors that are highly relevant to the investor. The investment professional must thoroughly understand the investor's objectives, restrictions, tolerances, and preferences to be able to develop a truly useful policy guide. "Elements of an Investment Policy Statement for Individual Investors" suggests desirable components of an IPS for a high-net-worth or individual investor. Not every element will be appropriate for every investor or every situation, and other components reflecting unique investor circumstances may be desirable for inclusion. An investor with a current IPS may choose to evaluate that IPS in relation to these elements, and those embarking on development of a new IPS may choose to consider focusing on the elements discussed here. For each

element, an example of IPS language is presented that may be relevant to an individual investor. The examples are entirely fictitious and are provided to suggest how components might be documented. For an example to reflect appropriate language for a particular investor would be an improbable coincidence. Rather, the most relevant and useful language should be developed in consultation between the investment counselor and the client.

Investment Policy Statement

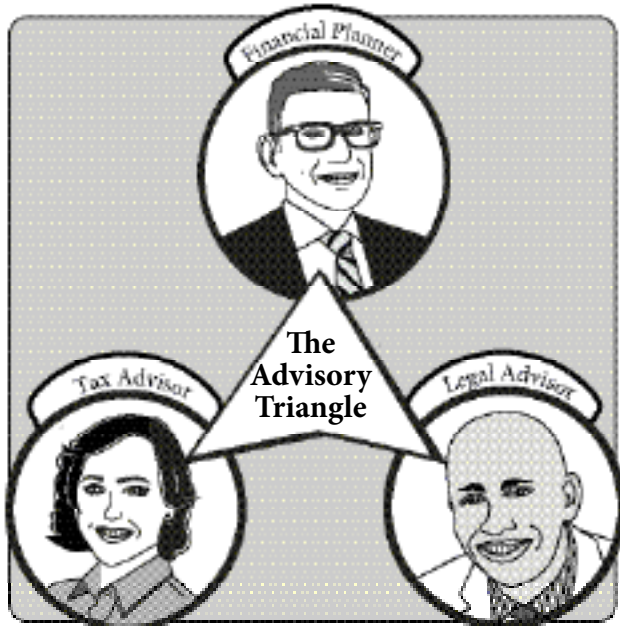
Due to current firm policy and copyright sharing, I am unable to show the actual IPS I currently use. Please see my website for an updated version. There are many examples of Investment Policy Statements online. A typical IPS will be customized, especially when it comes to institutional relationships. The actual output or formal end product should be catered to the specific needs and situation of the client.



Now that we have undergone a thorough information gathering profile, and we have documented a comprehensive financial plan and investment policy statement, we can implement the plan and invest. This assumes we have presented and fully agreed upon the course of action with the client. The presentation and discussion should be quite involved. Back-and-forth questions and elaborations can be a process in and of itself. For the purpose of this exercise, let's assume the client and advisor have common ground to move forward with the agreed-upon plan. The next step is putting it into action.

STEP THREE

CHAPTER FIVE



EXECUTING THE PLAN

STEP 3: IMPLEMENTATION AND INVESTMENT SELECTION

The real value of all of our work up to this moment is lost unless we take action. The recommended course of action begins with a list of recommendations. Typically, this will involve organizing, consolidating, and retooling the client's current scenario, with help from an "advisory triangle" and team of specialists. The extended team of specialists may include, but is

not limited to: a private banker for lending needs, an insurance specialist, a business retirement plan person, and other experts that may be helpful regarding particular investments or other client needs. The advisory triangle often consists of a financial planner, tax advisor, and legal advisor/attorney. In practice, the financial planner can oversee (even if outsourcing) the investments, insurance, and liabilities such as mortgages and lending needs. Very dedicated planners focus on the plan from inception to ongoing maintenance. They utilize their team of resources (internally or externally) to specialize more on items such as lending needs, insurance, portfolio management, and even establishing retirement plans for small businesses, among other potential financial related services.

Now that our advisory triangle and team of specialists are aligned, we can put everything together. Building upon the recommendations, we take steps to implement the plan and situate necessary items. We may need to establish new accounts, retitle old ones, or consolidate numerous retirement plans. It may be prudent to refinance or buy term insurance to protect a young family. Implementation can come in many forms to carry out important goals.

Assuming the elements of the financial plan are in place, we can now invest. Based on the IPS, we must ensure the investment portfolio minimizes risk and maximizes returns for any given investor profile. Every step of the process is important in more ways than one. It is important to cover typical key areas but also uncover parts that may be overlooked for a number of reasons. This is why we sometimes focus on particular parts of steps more than others. Yes, a clear outline of the overall process is important, but identifying common areas overlooked will provide the continuity required for a complete execution from beginning to end. The investment process substantiates everything we are trying to accomplish and, thus, should be explained in detail. Guidance, service, and an overall consultative approach all work to solidify client relationships. However, the true underlying value really comes from actual investments, whether the clients are sophisticated investors or if they don't even want to be bothered with knowing the details. Regardless, the portfolio manager has to perform when it comes to

allocating a client's hard earned money. Unfortunately, some advisors jump right to the investment step for the sake of getting paid, neglecting the other important steps that build the proper foundation. Further, this is also the area with the highest potential to be improperly executed and managed. An advisor may simply not understand an investor's goals, or the steer the investor into programs that pay the advisor the most, or the advisor may not fully understand the investment universe.

For clients looking for a financial advisor, there are some important key attributes to look for. Sadly, the majority of people who represent themselves as financial advisors have never undergone financial coursework or had any formal investment training. Interviewing a financial advisor is important, just as one might ask questions of a real estate agent or doctor.

Financial Advisor Interview:

(A checklist of a Financial Advisor)



- 1. Why is the individual in the business in the first place?**
- 2. Did they come from another industry and make a career change to make more money?**
- 3. What are their academic credentials?**
- 4. Do they have professional designations?**
- 5. How long have they been in the business?**

6. Do they have a team to support them? If so, will they assign their junior advisor to service your accounts?

7. What are their real “core values,” both professional and personal?

Financial Advisor Interview:

(Questions to ask a Financial Advisor)



- 1. What types of clients do you enjoy working with?**
- 2. What will my client experience be like if we start working together?**
- 3. How will you react if I do not agree with one of your recommendations?**
- 4. Do you have a strategy or plan if we head into another crisis in the markets?**

5. Describe a situation when you had to help a client make a difficult decision.

6. Could you explain your fees and the total costs I would incur for your services?

7. What are your career goals? (Retirement Timeline)

8. Compared to your competition or investing on my own, why do you believe you would be a good advisor for my family and me?

“Why did I earn 20 percent last year while my neighbor earned 30 percent?” The answer might be that the neighbor didn’t disclose the year prior when he lost 25 percent and the client was down less than half of that. Transparency and communication are essential.

This is really the main principle of asset allocation and decreasing volatility without losing longer-term performance. The point is that clients may be unaware or forget about previous discussions regarding portfolio makeup. Regardless, this should be discussed to make sure all parties are on the same page. If communication breaks down, the client’s risk may actually increase. Good clients bring out the best of an advisor. A mutually beneficial relationship is formed when the client and advisor are both in it for the right reasons.

Visit the CFP Board’s website to find a number of other helpful resources: www.cfp.net.

Keep in mind that there are just as many bad clients as there are bad advisors. I personally prefer to have a small number of very close relationships with good people and families who appreciate my process. I want to know the details of a particular case on a personal level, as opposed to trying to fit too many people into a cookie cutter plan or portfolio. Over the years, a good advisor will transition away from negative or bad relationships. We have resources to transfer accounts to a centralized call center or give them away to other colleagues who may be a better fit. We hold onto good clients, regardless of size or revenue. To be clear, it is important for a client to express any concern, especially if it is potentially invalid or could lead to a misunderstanding. For example, a client may ask:

CHAPTER SIX



PORTFOLIO CONSTRUCTION (PART A) TAME THE BULL PORTFOLIO THEORY

We've gone over how to form an investment strategy; now let's examine some of the theories involved in getting here. The best way to appreciate where we are heading is to understand how we arrived. My portfolio management process, while unique in its scope, involves several time-tested elements utilized by many portfolio managers on a daily basis. My program brings together a number of major strategies to maximize investor value

and make sense of the economic landscape by accounting for a number of exogenous variables that are overlooked.

One such variable is what I call El Matador, meaning something to tame the "bull." On Wall Street, the bull represents the running up of the stock market. The most common investment mistake is becoming too complacent with bull markets. Historically, we have over a 10 percent correction on average every year for the past several decades (see J.P. Morgan's "Quarterly Guide to the Markets"). People panic when markets retreat and feel comfortable investing more when markets are relatively high. This is the opposite intuition that is needed to protect assets, and why it is important to centralize portfolios with bull markets in mind. Ideally, for the sake of scalability and making sure the investments can be monitored properly, the goal is to have one portfolio that can be dissected inside and out. A portfolio manager should always be aware of all of the holdings. A major issue most advisors face is that their clients have dozens, if not hundreds, of different holdings and portfolio iterations. It is nearly impossible to keep up and advise actively when a client has a significantly different set of securities in their portfolio.

The answer is remarkably straightforward: I propose ONE PORTFOLIO! The portfolio can still be customized to include securities such as low-basis holdings, company stock, or a specific desired investment directed by the customer. But, for the most part, we can feasibly create a portfolio of all the desired equities (stocks) and all of the desired fixed income (bonds). The only question would be how much of each is appropriate for each desired level of risk. For instance, if an investor is a five on my scale of one to 10, then his or her strategic target would be 50 percent equity and 50 percent fixed income. A more conservative investor may be 30/70, respectively.

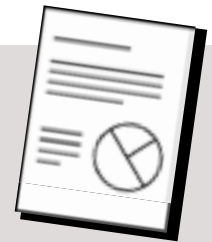
Now we will explore the different theories and ways of analyzing investments in more detail.

MODERN PORTFOLIO THEORY

Modern Portfolio Theory (MPT) is a Nobel Prize-winning theory developed in 1952 by Dr. Harry Markowitz. It's actually not modern at all, but didn't gain significant popularity until the early 1990s. MPT is a blueprint for investing based purely on statistics, math, and numbers. According to its principles, we reduce risk via diversification. That is, we optimize investment outcomes for risk taking by placing money in a wide variety of assets. This thinking delves deeper than the saying "don't put all of your eggs in one basket." MPT provides the building blocks for proper asset allocation. Depending on the risk a particular investor wants to take, there is an efficient mix of investments that can maximize return while minimizing risk as much as possible. If an investor is willing to accept fluctuation in an investment portfolio, we want to find a mix that will maximize return. Conversely, if someone has a certain investment return target, the goal of MPT is to minimize the deviation of the asset base as much as possible to accomplish the return target. Why take unnecessary risk?

A basic example of MPT would be a one stock portfolio versus a two stock portfolio. Hypothetically speaking, an investor could own one stock, Exxon Mobil (XOM), for instance. Let's say XOM averages 10 percent annually over a 5-year period. The stock may fluctuate 30 percent from year to year. One year it may be up 20 percent and the next, down 10 percent; however, over time, it averages 10 percent. If we were to add another stock to the portfolio, such as Boeing (BA), it also may average 10 percent annually. However, BA has a negative correlation to XOM. When oil prices are down, oil companies revenue decreases, but orders for planes go up due to cheaper fuel prices. Boeing may also fluctuate 30 percent per year, but not with the same correlation to XOM. Ultimately, the two stock portfolios will earn 10 percent over time while decreasing risk, for example, from 30 percent to potentially 15 percent. If we target a 10 percent return, we can temper the risk or fluctuation. This is most beneficial during down markets.

MPT takes out the guesswork for most in trying to decide which assets they should invest. This approach to risk inspects historical returns in great detail. Further, the method scrutinizes the past volatility of different asset classes and evaluates the mutual relationship between said asset classes. After the data is compiled and evaluated, investors will decide how much of the portfolio should be invested in stocks, bonds, real property, and commodities, etc. All this, however, is meaningless unless one can accurately determine (or predict) the spread between the numbers (i.e., variance), correlation, and expected return.



Modern Portfolio Theory

The following Buckets and Sectors are:

1. The Buckets (Asset Classes):

Equity (*Large Cap Growth, Large Cap Value, Mid Cap Growth, Mid Cap Value, Small Cap Growth, Small Cap Value, International, Emerging Markets*)

Fixed Income (*Short term, Intermediate, Long term, High Quality, High Yield*)

Alternative Investments (*Commodities, Hedge Fund Strategies, Private Equity*)

2. Sectors:

Healthcare, Consumer Staples, Information Technology, Consumer Discretionary, Industrials, Materials, Financials, Telecommunications, Energy, Real Estate

MPT is truly the most important stepping stone in constructing an asset allocation in the correct manner and, thus, is the basis for my pragmatic approach. Time and again, my client portfolios have benefited from the discipline of the strategy. There is an infinite amount of information available regarding the topic. I encourage the reader to investigate MPT in more detail. For example, Sharpe Ratio and Efficient Frontier are other MPT-related topics that could be further explored.

The biggest criticism of MPT is that during extreme times, many assets become correlated, diluting much of the benefits of a well-diversified asset mix. Blindly relying on MPT may leave an investor vulnerable to market forces that could possibly be avoidable. If, for example, interest rates are at an all-time low, it may not be prudent to invest in bonds that will get hurt when rates increase. A way to combat this is by overweighting and underweighting areas that may obviously be undervalued or overvalued. In addition, an approach that can incorporate investments tactically could give the portfolio manager a fighting chance to take advantage of opportunity and stay away from trouble. This leads us to the next strategy: the core/satellite approach.

CORE/SATELLITE APPROACH

The majority of performance comes from the allocation, not individual security selection. To remain consistent with our overall “top down” approach, we want to make sure the “core” of our portfolio is properly diversified and allocated in such a way it withstands the test of time. This is accomplished with MPT. Then we can identify our satellites to take advantage of additional opportunities or to stay away from potential issues. Here is where we can add value. It is very difficult to predict, time, or anticipate all possible changes in the marketplace, but our satellites will allow us a chance to increase value in an investment allocation.

The core is comprised of the major asset classes in the realm of MPT. We also keep in mind the sector weightings to maintain proper exposure. The satellites will include the increased alpha (additional performance potential) and decreased beta (limited market downside exposure). The hope is that these alpha generators will create an above-market return.

Satellites may also include commodities and real estate. A tailored core-satellite approach provides an opportunity to access the best of both worlds: better-than-average performance coupled with lower volatility.

Core-satellite investing is a strategy that captures broad market exposure (think indexes) coupled with individual financial instruments, such as more specialized stocks and bonds. The core investments are meant to be relatively passive and not actively managed. The satellite components are actively managed and meant to provide a little extra zip, or return, to the overall portfolio.

FUNDAMENTAL ANALYSIS

Portfolio managers use fundamental analysis to analyze a particular company, sector, industry, or market. It looks at the raw data and numbers, allowing for a quantitative approach. All of the accounting data from the

financial statements allow for a number of ratios and other information to be analyzed. From a broad perspective, we could say that stocks in Europe are undervalued compared to the United States due to the stock prices being lower than earnings. This may urge the manager to increase European exposure in a portfolio. When compared to its peers, if a specific company were undervalued for the same reasons, the investment would be promoted from a fundamental standpoint. Followers of fundamental analysis include Warren Buffett and Sir John Templeton, solidifying the success of this approach.

Fundamentalists believe today's stock price is reflected in what the market will do 18 months from now, based on what's happening in real time. This analysis involves looking at a company from the bottom up and figuring out the mechanics of how they operate and produce cash flow.

Fundamental analysis is the careful study of a stock to learn about its assets, liabilities, earnings, and commercial markets. This takes the form of scrutinizing every observable element of a company's operation, such as balance sheets, cash flow, and net worth statements. The analysis further examines the industry participants, marketplace potential and overall health.

Taking this information in total, the investor attempts to determine if the stock should be bought, sold, or held. If the valuation concludes appreciation, one should purchase. Conversely, if the analysis reveals price devaluation is imminent, one should sell. Mixed signals may indicate a wait and see approach, and thus hold the stock for a certain period of time. The procedure commences with a look at the complexion of each financial statement at a granular level. The following ratios help ascertain the overall health of a company:

Gross Profit Margin

P/E (Price to Earnings) Ratio

Dividend Payout Ratio

Cash Flow

ROI (Return on Investment)

Debt to Equity

Devotees to this buy-and-sell discipline are thus able to develop a quantitative value; they can then determine if a stock is cheap or expensive relative to its stock price. Many pricing models and mathematical equations can aid in the process. However, just as with technical analysis, efficient market theorists cling to the belief that one cannot outperform the market by conducting this type of data gathering. Fundamental analysis is best served when coupled with other qualitative approaches.

Remember, the numbers are only as good as their accuracy. The severe issue with Enron, Worldcom, and the gigantic banks was that they misrepresented their balance sheets. They were all able to creatively hide debt and risk "off the balance sheet." A diligent fundamental analyst will try to uncover ways of manipulation. They will try to identify "smoothing," which is an effort by accountants to increase earnings in slow times and decrease earnings in good times. Some accounting tricks are hard to uncover, and that is really one of the difficulties with simply looking at the numbers.

TECHNICAL ANALYSIS

Wall Street has an oversupply of analysts trying to predict market movement and there are two mainstays into which traders fall: either fundamental or technical when it comes to analyzing equity prices. Once at odds, these methods are used to validate one another. Many times a trade will not be made unless both are in alignment. Once vilified, technical analysis is now mainstream and is included with other types of examination of the elements or structure of a security, and as a basis for discussion or interpretation. As opposed to their fundamental brethren, technical analysts do not rely on a company's intrinsic value, but instead look at share volume and momentum and believe that past price movement predicts its future. Even traditionalists from the fundamental camp (those who look exclusively at earnings balance sheets, income, and cash flow statements) are not comfortable unless the "charts" line up with their conclusions. Technical Analysis captures two separate and distinct patterns of stock behavior: (1) reversal, which signals that a trend will do just as the name suggests, move backward; and (2) continuation, which signals that a trend will continue.

Technical analysis looks back in the past to identify patterns that could explain potential future outcomes. For instance, there is evidence that the majority of the time the markets go down toward the end of the year and go up at the beginning of the year. They call this the Santa Claus Effect or the January Effect. It could be due to investors selling at year-end to capture losses for tax purposes, and then buying back in the beginning of the new year to reclaim their exposure. Regardless of the reason, it happens more often than not and should not be ignored. Patterns have also been attributed to weekly movements. It's called the Weekend Effect. Investments tend to decrease at the end of the week and increase on Monday. Traders could explain this movement through not wanting to hold positions over the weekend due to uncertainty or pending newsworthy events. In my practice, for instance, I will typically choose to invest a new client portfolio at the end of the week versus the beginning of the week due to the Weekend Effect. That's not to say the aforementioned patterns are the only ones; in fact there are several. The most well known chart pattern of them all is the head and shoulders. It signals that the stock is going in reverse and moving against its trend. A cup and handle pattern forecasts a stock will continue in an upward direction and is a bullish sign. A bullish pattern that reverses and occurs over a long period of time is called a saucer bottom. Many patterns throughout history can be identified to try to explain what could potentially happen going forward. These are all looked at in an effort to predict the future.

My biggest takeaway from technical analysis is reversion to the mean. I believe that the markets are cyclical, and investments swing like a pendulum, back and forth, to their longer-term average. If an investment has been overvalued for an extended period of time, then it should eventually swing back, typically by overshooting to the negative territory.

Every theory or way of analyzing investments has at least some element of truth to them and should not be discounted. Some might say that the past is gone and history does not predict the future. I do not agree with that completely. All portfolio theories should at least be considered.

BEHAVIORAL FINANCE

Behavioral Finance explains the unexplained – the x-factor. Fear, greed, bubbles, herding, rationality, rules of thumb, anchoring, framing (the way a problem is stated), biases, and the Black Swan (unexplained events).

INFLUENCE OF PSYCHOLOGICAL FACTORS ON INVESTMENT DECISIONS

Economic forces cannot all be explained by clear-cut factors like government spending, tax cuts, money supply, corporate earnings, fundamental analysis, or even technical analysis. There is a human component that is missing from the puzzle.

Are markets efficient or do investors create inefficiency with their emotions? Burton Malkiel's (2003) article "The Efficient Market Hypothesis and Its Critics" defends the notion that financial markets are efficient. Malkiel provides a modern day view of the efficient market hypothesis that was widely revered in the economics community during the 1970s through the likes of Eugene Fama's 1970 article "Efficient Capital Markets." Over the years, however, critics have attacked the idea that markets are efficient, and have provided compelling evidence to disprove Fama and his followers.

Behavioral finance, the incorporation of psychology and sociology with modern day economic and financial theory, has gained recognition in the academic and professional arena as a strong contradiction to the efficient market hypothesis. Robert Shiller's (2003) article "From Efficient Markets Theory to Behavioral Finance" stands at the foreground in providing evidence of inefficiency in the financial marketplace.

The efficient market hypothesis describes an efficient market as one that is informational. To understand the hypothesis, one must assume that there are a large number of participants aimed at maximizing profit through an independent analysis of securities. Information arises in a random fashion,

and the profit-maximizing participants adjust security prices to reflect the new information. With these things in place, expected returns should reflect the risk embedded in a particular security.

The theory of modern finance evolved from the assumption that investors make rational decisions and are unbiased in their predictions about the future. Conversely, the field of behavioral finance delves into the notion that people can act irrationally and make consistent errors when forecasting the value of a security. According to Nofsinger (2002), the brain frequently processes information through shortcuts and emotional filters. Greed and fear can cause investors to overreact and underreact to information. Some further examples of psychological patterns in financial markets are: social comparison, when investors rely on the opinions of others; the greater fool theory, when an investor may buy a security at what they consider a high price because they believe someone will buy it for even more; and crowd behavior, when individuals base decisions on what the majority of others are doing rather than what may be best.

According to BlackRock's 2015 Investment Insights publication, stocks averaged over 8 percent and bonds over 5 percent from 1996 through 2015, but the average investor earned only 2.11 percent. The best explanation for this is that both investors and advisors feel comfortable buying in good times and, conversely, selling in bad times. They end up buying high and selling low.

KEYNES AND THE COMMON MAN

Behavioral finance has emerged over the past decade or so, but considerations for irrational behavior can be traced back much further. For instance, in 1935 John Maynard Keynes published his renowned General Theory of Employment Interest and Money. Chapter 12 in Keynes's General Theory emphasizes the role of the average uninformed investor. Keynes explains that individual investors have limited knowledge of certain investments they purchase. With this lack of empirical and fundamental

decisiveness, investors focus on the short term and day-to-day fluctuation creates waves of optimism and pessimism. Keynes also classifies investment professionals (experts) in the same context. Experts do not correct ignorant investors and focus on the longer term; instead, Keynes claims experts concentrate on choosing investments that are most likely to catch attention from other experts. Lacking regard for long-term yield forecasts, experts fix themselves on "what average opinion expects average opinion to be." In addition, Keynes adds that the atmosphere of the average businessman exaggerates economic disturbances. The picture painted by Keynes views the common man as too short term in thinking with speculation and with a lack of "enterprise."

BIG PLAYER THEORY

Another alternative theory explained by Koppl and Yeager (1996) is the Big Player theory, which emphasizes the influential power of "Big Players" who encourage bubbles and herding. A Big Player must be large enough in the sense that they can influence the course of economic events, relatively insensitive to profit and loss, and must use discretion in exercising market power. This approach considers influential players who affect markets through their discretionary actions and policy making to create herding which leads to dependence. The government, oligopolies, investment bankers, finance ministers, central bankers, and anyone that uses discretion over the markets while remaining fairly immune from profit and loss are all considered Big Players.

Keynes views the markets as being overly affected by the average unintelligent man. The uninformed investor has too much liquid access to investments that move in waves of optimism and pessimism. The overwhelming influence of the small, average men in concert is contradictory to the Big Player theory. In the Big Player theory, the individual investor does not directly influence markets; rather, the Big Player influences the markets and the average investor follows in a herd at the mercy of the Big Player. Koppl and Yeager's article "Big Player and Herding in Asset Markets" provides a rebuttal to Keynes's Chapter 12 of the General

Theory of Employment Interest and Money in the sense that the Big Players move the market versus ignorant individuals.

MALKIEL'S VIEW OF MARKET EFFICIENCY

Malkiel's (2003) article "The Efficient Market Hypothesis and Its Critics" confronts rebuttals of the hypothesis that markets are efficient, and attempts to tackle the arguments that pose a threat to the validity of the hypothesis. Malkiel explains an efficient market as one where "news spreads very quickly" and new information is incorporated into security prices as it arises. Under these conditions, technical analysis and fundamental analysis do not provide any insight that is not already imbedded in the price of an investment. Prices reflect all current information, so as news arises, security price changes are "random departures" from previous price movements. The concept is referred to as a "random walk." Ultimately, the official test is if investors are able to earn long-term, above-average risk adjusted returns.

Malkiel agrees that prices are not always perfect. However, he contests that markets can still be efficient even though investors may be quite irrational. He refers to short-term momentum and "bubbles" that arise as not being able to prove superior returns for investors due to added risk and transactions costs. Anomalies also disappear once recognized by the marketplace. Any systematic way of earning excess returns will diminish soon after discovery (Schwert 2001).

Mean reversion is the idea that prices revert back to a central point. Prices overly inflate and subsequently deflate. Malkiel found this trend is not consistent over time in terms of earning above average returns, although it is consistent with an efficient market as returns revert back to the norm.

The January and Weekend Effect are challenged by Malkiel as not being predictable from one period to the next, which does not allow investors to earn superior profits. According to Malkiel, these seasonal and day-of-the-week patterns "do not appear to offer arbitrage opportunities that would enable investors to make excess risk adjusted returns."

Malkiel sees other predictable patterns as inconsistent. For example, the dividend yield strategy attempts to exploit returns by looking at a company's dividend. Shiller (1988) found evidence of this, but soon after the investment strategy proved inconsistent. The Dogs of the Dow Strategy mutual fund utilized this theory and underperformed from 1995-1999. Whatever the pattern may be that appears to provide over performance, the pattern is either traded away or includes a corresponding risk premium, according to Malkiel.

Malkiel considers fundamental analysis through valuation and measures such as the capital asset pricing model negligible. He explains this could be due to valuation not appropriately accounting for risk. An investment may provide higher than market average returns, but that may be due to inappropriate risk levels. Opponents of the efficient market hypothesis use the stock market crash of 1987 as an example. The 1987 crash would seemingly provide overwhelming evidence that investors are irrational and are overly emotional as indicated by the behavioral theorists such as Shiller. Malkiel agrees that change in the marketplace in October of 1987 was significant, but explains, "... a number of factors could rationally have changed investors' view about the proper value of the stock market." He mentions dramatic changes in the bond market and interest rate environment. He also refers to the foreign exchange market and the change in perceptions of the marketplace as a whole. Malkiel explains these "cumulative" effects as combined reasons for such a dramatic decline in the markets, which he does not necessarily consider as inefficiency. Malkiel would regard a crash as a correction in the sense that prices are adjusting to new information and perception. He contends that the market may "temporarily fail" in instances such as bubbles, but these "occasional mistakes" are facets of a flexible market system that usually does a very effective job of allocating capital to its most productive uses.

To reiterate, Malkiel's true test of market efficiency is whether investors, particularly money managers, are able to provide above-average, risk-

adjusted returns. Close to 80 percent of fund managers have not been able to outperform their corresponding benchmark index. Evidently, these numbers may be skewed on the low end due to money managers' incentive to outperform and increase risk. Also, a "survivor bias" only accounts for funds that have endured, and many underperforming funds have merged with other funds or have disappeared.

Malkiel agrees that the market can make occasional mistakes and aren't "perfectly efficient," but patterns or anomalies are short lived exceptions to the rule.

BEHAVIORAL FINANCE AND SHILLER

The emergence of behavioral finance as a formal field has evolved through the years in reaction to explain market events and inconsistencies of the efficient markets hypothesis. Robert Shiller's (2003) article "From Efficient Markets Theory to Behavioral Finance" provides an interesting opposition to Malkiel and followers of the efficient markets hypothesis. Behavioral finance is the culmination of psychology and sociology with regard for modern finance.

Excess volatility, which emerges due to "mass psychology," is a main point Shiller brings to the table. The anomalies mentioned above are viewed by Shiller to be proof that markets are not always efficient. Noise can transmit into the perceptions of investors, leading to security prices that are not linked at all to fundamentals. Shiller refers to the "feedback theory," which is considered to be a main contributor to irrational behavior leading to bubbles and the like. As an investment becomes a high performer, word of mouth pumps the price beyond what is justified, leading to an inefficient price allocation. This notion of investor behavior dates back to Keynes, his predecessors, and his followers in regards to herding and waves of emotions. Shiller gained notoriety when he published his book *Irrational Exuberance* in the beginning of 2000 before the market declined for three straight years. It

is not that Shiller was able to "time the market" per se, but he was able to see the telltale signs that investors lacked sound judgment and enterprise when investing in what they believed was a new economy.

Shiller mentions the smart money versus the ordinary investor hypothesis. The efficient market hypothesis contends that the two would cancel each other out to create efficiency. The idea is that as the uninformed individual investor buys excessively high, pumping up the price of a stock, the smart money or informed trader would be selling. Conversely, smart money buys when the individual investor sells at the bottom of the market. Shiller finds that this does not always happen in practice, if at all. Money managers or smart money actually tend to amplify the individual investor through feedback. Moreover, even if smart money successfully followed a profitable contrarian approach, they would be able to buy at lower prices and sell at higher prices compared to the individual investor. This would essentially enable smart money to outperform.

According to Shiller, the efficient market hypothesis can lead to an "incorrect interpretation of events such as stock market bubbles," but markets are not grossly inefficient in the sense that "profits should be continually available." Although the marketplace may seem fairly efficient, excess volatility and irrational behavior can and do arise.

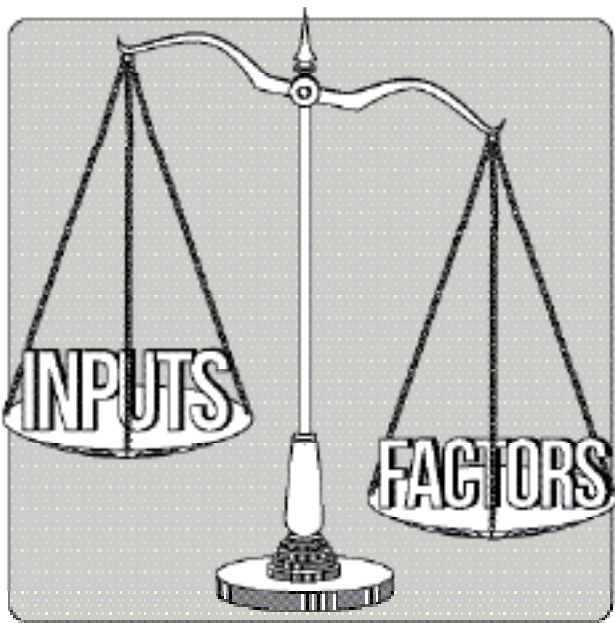
Eugene F. Fama, Robert J. Shiller, and Lars Peter Hansen shared the 2013 Nobel Prize in Economic Sciences for their findings regarding how financial markets work and the long-term predictability of assets such as how stocks are priced.

It's important to be aware of the psychological component to interest rate expectations and market behavior. With economic activity, some of the gray area is potentially caused by human emotion.

SO, WHAT'S THE POINT?

All of the preceding information regarding portfolio theory and analysis can be quite technical, but it all serves a purpose for the sake of understanding how investments and markets work. A greater understanding of major portfolio theories helps an investment manager construct and maintain a well-designed asset allocation. To create an optimal portfolio model, all of the theories and criticisms should be taken into consideration, even if solely for the sake of consideration. The financial markets are constantly changing, and it is nearly impossible to predict exactly what will happen. We can, however, equip ourselves with as much information as possible to gain a higher level of understanding.

CHAPTER SEVEN



PORTFOLIO CONSTRUCTION (PART B) INPUTS AND FACTORS

Each of the following pieces of information is considered in great detail to understand and create the investment portfolio. Similar to the review checklist detailed in a later chapter regarding a portfolio review, each item is looked at in relationship to where the data was before, where it is currently, and what that could potentially mean for the future.

Inputs And Factors Checklist:



1. Macroeconomic Factors:

Gross Domestic Product (GDP), The Fed/Monetary Policy, Interest Rates, Inflation, Exchange Rates, Commodity Prices, Employment

2. Asset Allocation Buckets:

Size and Style, Sectors, Tactical Additions

3. Political Factors:

Fiscal Policy, Laws and Regulation, New Legislation

4. Exogenous Variables

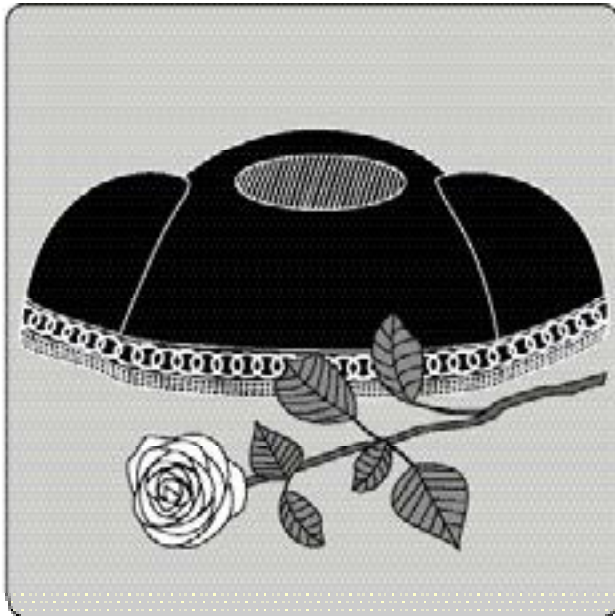
News/Current Events, Terrorist Activity, Natural Disasters, Epidemics

5. Due Diligence

Investment Selection (*Cost, Tenure, Trading Efficiency, Style Purity, Potential Conflicts*)

This information will allow us to construct an investment allocation that is planned well. The aim is to base our decisions on the data with an untainted interpretation of the information. External commentary can cause an investment manager to question decisions or make choices based on another source's opinion. At this stage, it is essential to stick to the facts and interpret the numbers and information independently.

CHAPTER EIGHT



PORTFOLIO CONSTRUCTION (PART C) EL MATADOR MODEL!

Tame the Bull with the Yield Curve! What makes this model different than any other is its ability to be actively manipulated to take advantage of opportunities and stay away from potential red flags. The portfolio that was discussed in the preceding chapters is really the middle point or ideal target. In the investment world, we call it the Strategic Allocation. When the markets move and the different buckets become misaligned, many managers

rebalance back to the strategic allocation. I do not believe systematic, blind rebalancing makes sense, even when accepting the merits of Modern Portfolio Theory in relationship to long-term investing. Rebalancing during many points in an economic cycle will cause portfolio managers to systematically keep buying stocks as they continue to lose money; and, in turn, sell the winners.

Instead, based on the several factors presented earlier during the construction of the initial allocation, I look at the inputs to make sense of why certain fundamentals and macroeconomic variables are not performing. I believe in momentum, but also reversion to the mean. For example, I can tolerate the potential run-up of a certain asset class as long as I can model and see the underlying fundamental data that supports a continuation or reversal. There may be a lag but eventually investments will revert to their long-term average.

Instead of sticking with the strategic allocation that cannot be nimble to benefit or protect an investor during certain periods, I incorporate a tactical strategy to overweight and underweight the portfolio to take advantage of opportunities and protect against potential problems. Most of these factors can be modeled but if not, we can still adjust the weightings to desired levels. For example, when gold prices are at an all-time high we remove our exposure, or at least underweight our precious metal allocation. In another example, emerging markets may be the worst performing asset class for three years in a row, but if the fundamentals (such as very low historical P/E ratios) do not support that, then we would overweight that sector. The key is to try to model the lag as best as possible, especially when it comes to policy changes. Even if the portfolio allocation updates are off, this is still light years ahead of a passive portfolio that blindly rebalances.

This same approach is also applied to the entire portfolio in relationship to overall market levels. For instance, if we are heading into a recession, the portfolio is retooled to decrease its stock market exposure and increase the overall cash position. What's this, you say? That's right, we CAN predict the

PROBABILITY of a recession and incorporate that information into the model. This portfolio protection could very well be the most profound item I can offer the reader of this book. I could write an entire book on portfolio construction and illustrate in detail the El Matador Model, while quantifying the movement with empirical analysis. For now, I must at least elaborate more on this macroeconomic forecasting to account for potential slowdowns in the future. This is all based on what is called the yield curve, or the term structure of interest rates. I have done extensive research on the yield curve. Since this is a significant part of my portfolio management technique, it requires further investigation into why it is truly the secret to success!

THE YIELD CURVE: THE EYE IN THE SKY

The ability to accurately predict future economic activity has puzzled businesses, policymakers, economists and investment professionals for several years. The one forecasting tool that has withstood the scrutiny of time has been the term structure of interest rates, or what is also referred to as the yield curve. The yield curve is the graphical representation of the interest rate yields on debt securities. Time to maturity is located on the horizontal x-axis, and yield is located on the vertical y-axis. Liquidity, risk, tax considerations, convertibility features, and any other special characteristics of the bond need to be held constant. For analytical purposes, most economists employ U.S. Treasury securities as the basis for obtaining term structure data.

Different shapes of the yield curve can forecast future economic activity. Historically, the yield curve has assumed a number of patterns throughout different periods in time. Various shapes of the curve are important and have meaning of their own. Normal, steep, flat, inverted, and humped are classifications that can be examined. Each general classification carries with it an indication and information pertaining to potential future economic activity. For example, an inverted yield curve signals economists that a downturn in the macro economy is virtually imminent. Because of its ease of use and accuracy, an inverted yield curve alone is perhaps the most powerful

economic forecasting tool available. Every single U.S. recession has been preceded by an inverted yield curve.

The yield curve, for our purposes, will serve as the “eye in the sky” to determine the overall cash position/fixed exposure in the portfolio. *Ceteris paribus*, the overall cash exposure or protective stance of the investment mix, will increase or decrease based on what the yield curve is predicting.

Once we understand the shape of the yield curve, we can apply theory surrounding the determinants of the curve. There are several theories regarding what affects the yield curve’s slope and what the slope implies. The expectations theory asserts that market participants expect interest rates to be at certain levels in the future, and that is the primary reason for the path of interest rates throughout particular maturity ranges. The liquidity preference theory implies that long-term rates will equal an average of short-term rates plus a risk premium. The segmented markets hypothesis treats different maturities separately and contests that rates will vary along the yield curve depending upon the preference in the marketplace for a particular issue. Other theories regarding slope determination implicate the role of monetary policy among a number of other factors as the cause for undulation.

The human element is also a critical component to the term structure of interest rates. It is helpful to investigate behavioral and psychological factors to provide insight into intangible dynamics that affect the term structure of interest rates and the economy as a whole. Behavioral factors play a role in affecting market forces. Psychological aspects addressed by Keynes, Malkiel, Shiller, and others help to consider the human component of analytics.

An easy-to-use probit model will be presented to allow for recession probability forecasting that can be quantified in a matter of minutes. Econometric analysis can be limited, but overwhelming evidence that the yield curve is able to forecast economic trends cannot be ignored (Dueker 1997).

Being able to put yield curve information to use is essential not only for policymakers, but private industry as well. Modeling the yield curve and assessing potential future interest rate risk is continually becoming a critical focus in the financial industry. Risk modeling is expected to become the next trend among the academic community. We can incorporate this powerful tool in the management of our investment portfolios.

Although impossible to predict markets with complete accuracy, there are lessons in history that inevitably repeat themselves. We can't always time things perfectly; however, the yield curve gives us a greater chance and more supporting evidence than any other predictive tool when it comes to forecasting future economic activity.

PREDICTIVE POWER OF THE YIELD CURVE

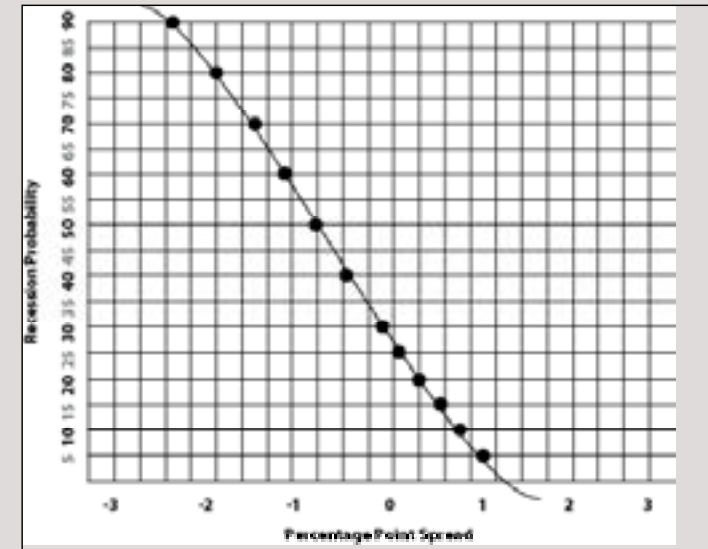
Besides the ability to easily determine if a yield curve has inverted, quantifying the predictive power of the curve is very helpful. Yield spread may be narrow or wide, and the curves slope may be inverted or steep. Historically, the term structure of interest rates supplies economists with signals for future economic activity.

Probit Model

Estrella and Mishkin (1996) refer to a probit model that enables them to empirically predict the probability of a recession. Their analysis is straight forward, easy to use, and simple to understand. Estrella and Mishkin concentrate on the spread between the 10-year Treasury note and the three-month Treasury bill as a predictor of recessions in the United States. Their findings indicate that the probit model outperforms other economic indicators two to six quarters ahead.



The probit model estimates recession probabilities in terms of the three-month Treasury bill and 10-year Treasury note spread.
*(Estrella and Mishkin, 1996, p. 2)



According to the model, if the yield spread between the three-month Treasury bill and the 10-year Treasury note is 0.02, the probability of recession four quarters in the future is 25 percent. A negative point spread implies an inverted curve, which ultimately predicts a recession within the next 12 months. As the spread narrows, the probability increases. In the first two quarters of 2003, the yield spread remained well over two percentage points, which predicts an insignificant probability of a recession in the next four quarters.

Dueker (1997) performed research on Estrella and Mishkin's findings. Dueker substantiates their findings and elaborates by stating that the "yield

curve is the single most powerful predictor of recessions” (p. 42). He adds that his analysis concludes, “empirically, it appears that the yield curve slope, lagged nine months, is the best recession predictor” (p. 44).

The predictive power of the yield curve is convincing regarding the ability to forecast recessions, but the ability to predict future growth is a different proposition. The inverted yield curve and the narrowed yield spread are more accurate in predicting economic downturns than steep curves or wide spreads are in determining future economic growth. Relatively steep yield curves have been present prior to economic expansion. Whether it is easy money that stimulates the economy due to businesses borrowing at lower rates, the market’s expectation of future inflation and or growth, or a combination of a number of other factors; it is detrimental to completely ignore the shape of the yield curve preceding economic expansion. A number of models have been utilized in determining future growth.

UNDERSTANDING THE YIELD CURVE — REAL WORLD BANKING, ASSET/ LIABILITY MANAGEMENT (ALM), AND INTEREST RATE RISK

If you recall, ALM and institutional fixed-income portfolio management, which includes risk management, was a big part of my academic research and professional experience. Fixed income and the bond portion of a portfolio, in my opinion, require a certain level of knowledge to execute proper investment exposure in a particular client’s portfolio.

Risk management is an effort employed by banks that allows them to better understand potential uncertainties. A bank’s liabilities are in the form of products that are owned by their customers. They can exist as demand deposits, checking accounts, savings accounts, certificates of deposit (CDs), and a number of other instruments. Assets of a bank are comprised of money obtained through liabilities; which, in turn, are reinvested into other vehicles or investments. The idea is to take the liabilities and reinvest them into higher paying instruments and create a spread, which allows the

bank to realize profitability. The management of a bank’s assets in regards to its liabilities is the formal definition of asset/liability management. Bank managers assess potential asset/liability risk in terms of interest rate “what if” scenarios. This can further be explained as interest rate risk management.

Although banks have been managing risk for hundreds of years, asset/ liability management initially began in the early 1970s. The severely volatile interest rate movements in the late 1970s, which continued throughout the 1980s, have spawned asset/liability management into what it is known as today (Fabozzi 1996).

In the mid 1990s, intermediaries such as the Office of Thrift Supervision and the Basle Committee have taken shape and provided extensive guidance for the management of interest rate risk. With the help of financial institutions, academics, examiners, and regulatory organizations, asset/liability management is wide spread and a key component of managing a modern day bank.

A formal definition of interest rate risk is useful in order to better understand what regulators and portfolio managers are faced with. Basle (1997) defines interest rate risk as “the exposure of a bank’s financial condition to adverse movements in interest rates” (p. 6). Thrift bulletin 13a (1998) indicates “the term ‘interest rate risk’ refers to the vulnerability of an institution’s financial condition to movements in interest rates” (p. 2). Reilly (2003) explains “interest rate risk is the uncertainty of returns on an investment due to possible changes in interest rates overtime” (p. G-8). Mishkin (2003) points out that interest rate risk is “the riskiness of earnings and returns on bank assets that results from interest rate changes” (p. 220). Mishkin’s definition should be extended to incorporate liabilities as well. Finally, Fabozzi (2002) defines interest rate risk as “the risk that a depository institution will misjudge future interest rates and take positions with regard to borrowing and lending that may create a negative spread when rates change” (p. 636). The purpose of this exercise is to expose the varying definitions and become familiar with what different regulators, portfolio

managers, and academics suggest when they refer to “interest rate risk.” For our purposes, the most inclusive definition is Fabozzi’s, which incorporates yield spread. Also note that the definitions do not contradict one another and are all insightful in terms of summarizing risk management.

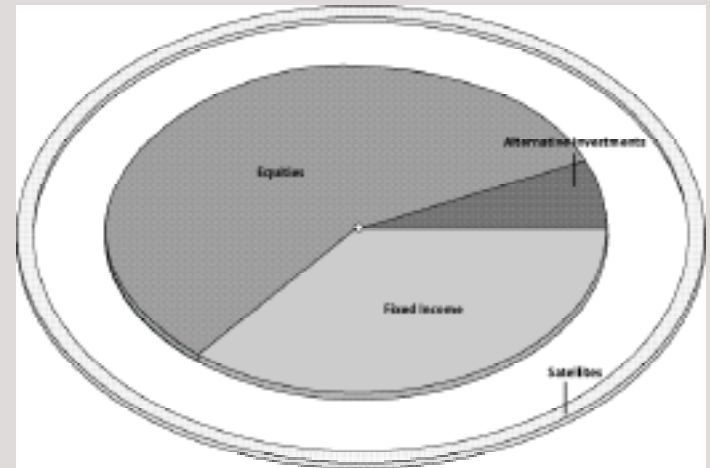
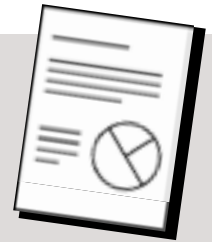
Understanding interest rate risk is inherent in the management of a bank’s assets and liabilities. Assessing risk is not only imperative to remain solvent, but is equally necessary in enabling a bank to realize profitability through strategizing in potential interest rate environments. According to the Basle Committee (1997):

Changes in interest rates affect a bank’s earnings by changing its net interest income and the level of the interest sensitive income and operating expenses. Changes in interest rates also affect the underlying value of the bank’s assets, liabilities, and off-balance sheet instruments because the present value of future cash flows (and in some cases, the cash flows themselves) change when interest rates change (p. 6).

Interest rate changes can create a ripple effect throughout a financial institution that can potentially generate positive or negative changes in unlikely areas of the institution. A firm grasp on the full impact of a given rate change will enable superior results for risk managers.

Moderate Growth Portfolio Model #6

After incorporating all of our analysis, we can bring it all together to show you a portfolio example. In this example, the core is 80 percent of the overall portfolio and the satellites make up the other 20 percent.

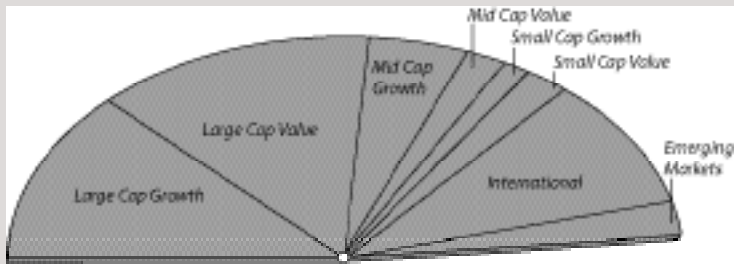


Sample Portfolio Model #6 Breakdown

Each bucket is broken down into various sectors that are illustrated below.

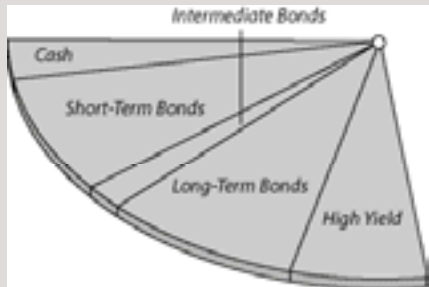
Equities:

| | | | |
|------------------|-----|------------------|----|
| Large Cap Growth | 10% | Small Cap Growth | 2% |
| Large Cap Value | 11% | Small Cap Value | 3% |
| Mid Cap Growth | 5% | International | 9% |
| Mid Cap Value | 3% | Emerging Markets | 3% |



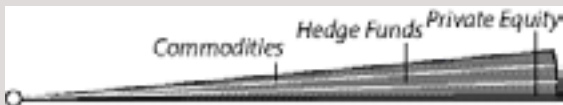
Fixed Income:

| | | | |
|--------------------|----|-----------------|----|
| Cash | 3% | Long-Term Bonds | 8% |
| Short-Term Bonds | 9% | High Yield | 6% |
| Intermediate Bonds | 2% | | |



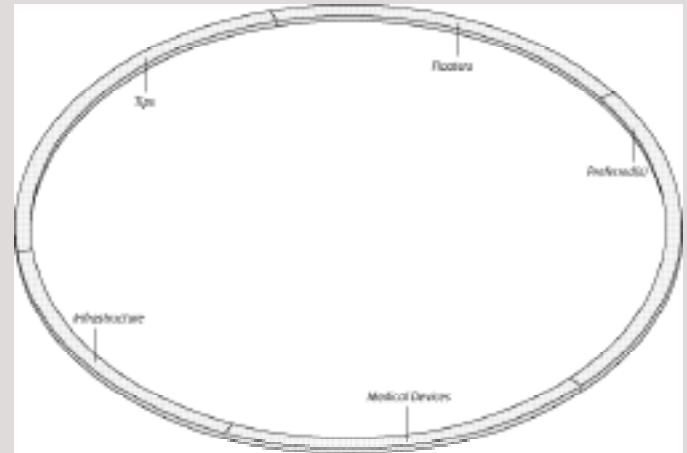
Alternative Investments:

| | | | |
|-------------|----|----------------|----|
| Commodities | 2% | Private Equity | 2% |
| Hedge Funds | 2% | | |



Satellites:

| | | | |
|--------------|----|-----------------|----|
| Tips | 4% | Medical Devices | 4% |
| Floater(s) | 4% | Infrastructure | 4% |
| Preferred(s) | 4% | | |



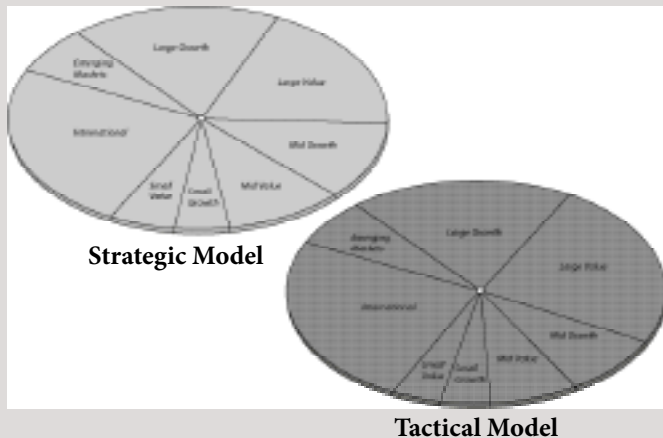
Large Cap Growth and Value are broken down into the following sectors; Healthcare, Consumer Staples, Information Technology, Consumer Discretionary, Industrials, Materials, Financials, Telecommunications, Energy and Real Estate. Municipal bonds will be used for investors in higher tax brackets.

Moderate Growth Portfolio Model Comparison

The following is another example of a portfolio with a side-by-side comparison of the Strategic allocation (long-term target) versus the updated Tactical portfolio that considers the current market environment.



| Strategic Allocation Equities: | Tactical Allocation Equities: |
|--------------------------------|-------------------------------|
| Large Cap Growth 20% | Large Cap Growth 22% |
| Large Cap Value 20% | Large Cap Value 24% |
| Mid Cap Growth 10% | Mid Cap Growth 8% |
| Mid Cap Value 10% | Mid Cap Value 9% |
| Small Cap Growth 5% | Small Cap Growth 5% |
| Small Cap Value 5% | Small Cap Value 5% |
| International 25% | International 23% |
| Emerging Markets 5% | Emerging Markets 4% |

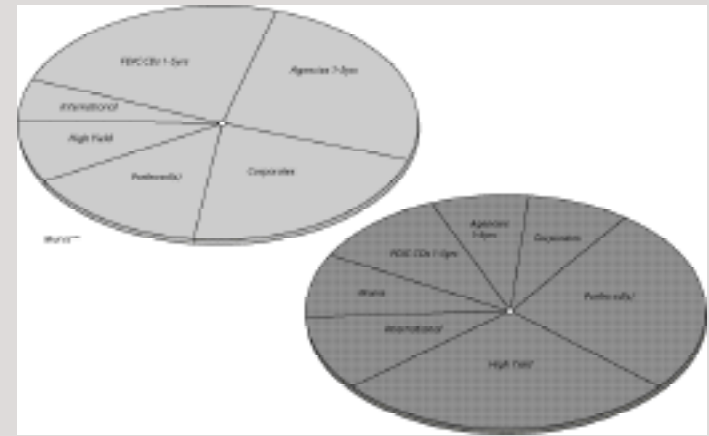


Strategic Allocation Fixed Income:

| | |
|-----------------|-----|
| FDIC CDs 1-5yrs | 25% |
| Agencies 1-5yrs | 25% |
| Corporates | 20% |
| Preferred(s) | 15% |
| High Yield | 10% |
| International | 5% |
| Munis ** | |

Tactical Allocation Fixed Income:

| | |
|-----------------|-----|
| FDIC CDs 1-5yrs | 10% |
| Agencies 1-5yrs | 10% |
| Corporates | 10% |
| Preferred(s) | 25% |
| High Yield | 25% |
| International | 10% |
| Munis | 10% |



Tactical Model

*Ladder vs. Barbell

**Tax Status

*Ladder vs. Barbell

**Tax Status

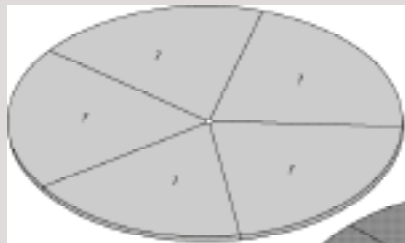
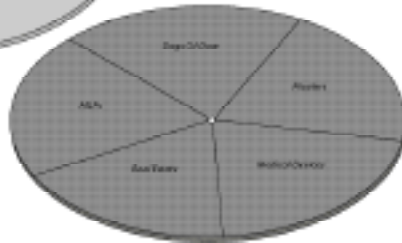
Depending on interest rates, we will use a Ladder approach or a Barbell approach. The use of municipality bonds will be mostly influenced by a particular investor's tax status.

Strategic Allocation Satellite:

| | |
|---|-----|
| ? | 25% |
| ? | 25% |
| ? | 25% |
| ? | 25% |
| ? | 25% |

Tactical Allocation Satellite:

| | |
|------------------------|-----|
| <i>Dogs of Dow</i> | 25% |
| <i>Floater</i> | 25% |
| <i>Medical Devices</i> | 25% |
| <i>Real Estate</i> | 25% |
| <i>MLPs</i> | 25% |

**Strategic Model****Tactical Model**

In the preceding example, you should see the assets are divided into three major categories: equity, fixed income, and satellite, each equaling 100 percent. The idea is to isolate each category in an effort to clearly identify the target versus desired and timely adjustments. From this basis, we can then create or retool models based on investor risk. This ties into the one portfolio idea presented earlier. For instance, a moderate growth portfolio target (six out of 10) based on the current economic environment may call for 60 percent equities and 40 bonds. Now we can simply update the model accordingly. To be clear, it's not about being totally in or out of the market. We make slight adjustments to calibrate the overall mix.

TOP DOWN VS. BOTTOM UP

If you haven't noticed, the product choice to fill the buckets should be the last step. According to Ibbotson 1986, over 90 percent of performance is due to allocation and not individual stock selection. For the most part, low-cost Exchange Traded Funds (ETFs) should be used for liquidity, low fees, tax efficiency, and style purity. Some areas do require more care. For instance, bonds would be best if the individual paper was held, or at least placed in a Separately Managed Account (SMA) to protect against forced selling. If rates go the wrong way, you can hold the bond to maturity. If you are in a mutual fund or ETF, not only will the price go down on paper, you may be forced to realize an unrecoverable loss because other investors liquidate and make you realize the loss. If you hold the individual bond, you can hold to maturity and get your money back. For the Large Cap buckets, individual large Blue Chip Stocks would be used to create the Large Cap Growth and Value portion of the allocation, divided by sector and coupled with respective ETFs.

Our overall approach to this whole process is defined as a "top down approach." We find out what the investor is looking for from his or her risk and goal perspective. We look at the broad economy. We look at the different sectors and defined types of investments and then, ultimately, invest in certain securities with our eyes wide open. The very last step in the individual investment is the stock or bond selection.

In many ways, this last step can be the most exciting for the client or even the advisor. It's human nature to be impatient, wanting to get right to the point. The old fashioned "stockbroker" is the philosophical opposite of an investment advisor. Brokers would start their days trying to find investors with cash available. They may craft a story about what should be sold in an investment account. They would then pitch the story of the day from the squawk box. A stockbroker will buy investments for a client over time based on what may have been appealing according to the merits of that individual security. If brokers are successful, they will be able to convince many people

into buying the stocks they are pushing. Wonderful stories sell stocks. The problem is that they (usually) skip all of the previous steps that previously discussed. Is the investment too risky for the client? More importantly, does the investment make sense in the grand scheme of the client's overall portfolio? If you only get paid to move stocks or bonds, then it makes sense to concentrate solely on pushing the sale. In reality, I have witnessed too many instances where a client's hard earned money is invested in a portfolio that doesn't align with the ultimate goal. As an example, an investor may have half of his money in energy companies. If that sector fails, which it does periodically, the client is subject to undue risk. For the same amount of potential return, why take on more risk if it is not necessary? It doesn't make sense.

Unfortunately, it doesn't matter to some brokers, and clients simply don't consider the ramifications. I saw this during the tech bubble when people only wanted technology related stocks. The NASDAQ (the index that tracks technology related companies) lost over 60 percent of its value during the tech bubble. 2015 was the energy crisis, and in recent history there was a financial crisis, real estate bubble, and a biotech debacle, just to name a few. This is why it is important to make sure a particular portfolio is well diversified and not overly concentrated in a particular stock or sector. I see this mistake too often, and it is completely avoidable. It is statistically proven that for the same amount of expected return, you can significantly reduce your risk. Why increase portfolio fluctuations for no reason? Maximize returns and minimize risk.

We can pick great stocks and bonds based on the same premise as a stockbroker vetting a sale, but we need to make sure it fits into our allocation. Again, the majority of performance comes from asset allocation and not individual security selection. You can have your favorite stocks, just please make sure you are otherwise well balanced. Take a top down approach versus a bottom up approach to avoid unnecessary risk. This will reaffirm that the individual investments make sense in the grand scheme of your entire scenario.

SOCIALLY RESPONSIBLE INVESTING

Socially Responsible Investing (SRI), also known as Impact Investing, has become increasingly popular and can definitely be incorporated into the overall financial plan. The whole process that has been laid out would be followed the same way except during the step of picking the specific investments, we can take an extra initiative to add or subtract securities based on the merits of their SRI qualifications. The financial planning profile, investment risk profile, portfolio allocation constructions, and review process would all be the same. We would simply take extra measures to incorporate the SRI solution when picking the specific investments that create the investment portfolio.

Socially Responsible Investing is all about the screen. A portfolio can be filtered to include (or not include) specific elements based on a series of parameters. Specific companies could be filtered out because they do not align with the investor's moral compass. Reasons could include: animal testing, firearms, environmental damage, child labor, alcohol and tobacco, or a number of other criteria. Conversely, companies can be filtered if they engage in social justice, environmental sustainability, community involvement and clean energy.

A socially responsible investment is ONLY as good as the screen. Take a close look behind the curtain. I come across many SRI portfolios that include stocks or bonds of firms that one would not think should be there. A mutual fund I once looked at claimed to be an SRI, but held one company that was known for using child labor, another company that does significant animal testing, and an energy company that was responsible for an environmental disaster. Just because something claims to be an SRI doesn't mean it will provide what you expect from a social perspective. You need to be aware of the strategy's screening criteria.

When I first started building portfolios under the SRI framework about 15 years ago, I would explain to clients that they could expect to give up about

1 percent in performance. Looking back, this may have been due to a couple of factors, one being the lack of options and good availability of securities and funds to choose from to create a proper target allocation. Another reason may have been due to inflated operating expenses offered by fund managers at the time. Maybe prevailing governmental initiatives at the time supported big oil, military, and corporations that didn't fit the profile. This is no longer the case. I do not believe an investor has to give up returns, per se, to have a portfolio with a conscience. Perhaps there has been enough of a social shift where businesses can actually prosper while doing societal good. Regardless of the underlying reasons, an investor can enjoy the benefits of a socially conscious investment portfolio while not having to sacrifice overall performance and growth.

STEP FOUR

CHAPTER NINE



ONGOING MONITORING AND REVIEW

STEP 4: MONITOR, REVIEW, AND UPDATE THE PLAN

The preceding chapters, albeit technical, were necessary to arrive at the final step. It's best to go forward with the knowledge of where we've been. Every quarter, I go back to the drawing board and gather data to see where we are compared to where we were and where we are possibly going. This part is mostly data based and I try to close myself off from any outside opinions or speculative commentary. I want to see the numbers and raw information without any influence or bias. Once all of my data is gathered, I write my

quarterly commentary and present changes to the core to overweight and underweight certain areas. I then make additions or subtractions from the satellites to update the portfolios. This one formal research effort allows me to deliver a consistent message for all clients and their associated allocation models.

INVESTMENT COMMITTEE

An investment group or firm should have a formal investment committee that gathers systematically to bring together all of the data, research, and information that is essential for a proper economic update. This update can be documented in a newsletter that goes out to clients indicating timely updates relevant to changes in the investment allocations.

The same information that is analyzed during the Portfolio Construction - Inputs & Factors section is reevaluated to make updated portfolio adjustments that incorporate changes in the overall environment. The following checklist is scrutinized and serves as a basis for review during the Investment Committee Board Meeting.

Economic & Portfolio Management Review Checklist:

1. Macroeconomic Factors:

Gross Domestic Product (GDP)

| | | | |
|----------------------|----------------------|----------------------|----------------------|
| <input type="text"/> | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Prior YE | Last Qtr. | Current Qtr. | Forecast |

The Fed/Monetary Policy

| | | | |
|----------------------|----------------------|----------------------|----------------------|
| <input type="text"/> | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Prior YE | Last Qtr. | Current Qtr. | Forecast |



Interest Rates

| | | | |
|----------------------|----------------------|----------------------|----------------------|
| <input type="text"/> | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Prior YE | Last Qtr. | Current Qtr. | Forecast |

Inflation

| | | | |
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Commodity Prices

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2. Asset Allocation Buckets:

Size and Style

Sectors

Tactical Additions

3. Political Factors:

Fiscal Policy, Laws and Regulation, New Legislation

4. Exogenous Variables

News/Current Events, Terrorist Activity, Natural Disasters, Epidemics

5. Due Diligence

Investment Selection (Cost, Tenure, Trading Efficiency, Style Purity, Potential Conflicts)

QUARTERLY ECONOMIC COMMENTARY AND PORTFOLIO UPDATE NEWSLETTER

A formal economic and portfolio commentary/newsletter allows for a consistent message that can be used as a reference to update investment positions. This information is also used to deliver the quarterly WebEx conference call available to clients and the public.

2013 Q1 Economic Update:

(The following is an example report)



1. **The Fed should remain on hold through 2013**
2. **2yr Treasury:** (0.26 percent) expected to inch closer to 0.50 percent
3. **10yr Treasury:** (1.91 percent) should be closer to 2.25 percent by year-end
4. **Inflation:** Core CPI should increase but stay near 2 percent
5. **Unemployment:** 7.7 percent now and should slightly improve
6. **GDP growth:** 2 percent average growth is expected
7. **Oil:** \$92 now – shale revolution should moderate prices below \$100
8. **Gold:** \$1,650 now – the year should end below this level
9. **Euro/Dollar:** (\$130) should be flat or appreciate slightly as Europe strengthens
10. **S&P 500:** (1420) 1550
 - ~ Policy Risks
 - ~ P/Es – Staples vs. Technology
 - ~ European issues
 - ~ Recent market gains increase the odds of a pullback close to all-time-high

2013 Q1 ECONOMIC COMMENTARY

Averting the fiscal cliff was a good first step toward bureaucratic compromise. However, short-term noise and lack of a “grand deal” will create volatility in the markets over the next few months. Ineffective policy makers will create a bumpy ride, but over the course of 2013 core economic fundamentals should prevail. Last minute mini deals are most likely. In addition, there are many key indicators pointing to broad based growth. A recession is not likely at this point.

The Federal Reserve is building a creative balance sheet as they inject liquidity into the system buying long-term treasuries and Mortgage Backed Securities. Monetary policy will remain loose through 2013, with a keen eye on fiscal policy progress on Capitol Hill. The Fed will have no intention to raise interest rates until unemployment nears 6 percent and inflation accelerates. When rates are eventually changed, the Fed will be transparent and the markets will have time to prepare.

Many key economic drivers are in place to support stock market gains in 2013. This includes a stronger banking system, low interest rates, low inflation, housing market resilience, moderate oil prices, excess corporate cash, a strong dollar, and solid GDP growth. Any temporary issues created in Washington should be viewed as an entry point into risk assets. The Global economy is on the rebound as well, with Emerging Markets comprising 50 percent of Global GDP. This number is expected to only grow over time.

Recalibrating back to our neutral Strategic Allocation can summarize portfolio recommendations for Q1 2013. Previously, we were overweight domestic Large Caps and underweight International/Emerging Markets. Disciplined asset allocation is the theme for 2013. The closer we get to the all-time-high in the stock market, which we are close to, the higher the chance for a pullback. Given political risk and technical levels of equities, concerned investors can maintain consumer staples and hedge expected volatility. However, timing the fluctuations will be nearly impossible. The opportunity cost for not owning equities and risk assets will be far too great

in the latter portion of this year. In general, dividends and interest earning investments are still in favor especially due to excess cash on corporate balance sheets. Fixed income is not expected to earn much this year due to historically low interest rates. The risk of rising rates, although not likely, needs to be hedged. It is very important to diversify fixed income, keep duration short, and maintain exposure to floating rate bonds. Finally, limiting commodity exposure this year should reduce drag on portfolios, as inflation fear is low.

Please visit the website for an updated economic commentary newsletter.

INDIVIDUAL CLIENT REVIEW

When reviewing a client's situation, it is important to uncover any life changes and, if necessary, recalibrate the plan. The aim is to ensure each client is situated properly every quarter. Plan ahead and stay on track now, so as to not let anything fall by the wayside. As changes may transpire, we won't have to backtrack. Procrastination never ends well. It's a recipe for disaster. An advisor's personal workflow and client relationship will be best served when all needs are met as soon as possible. Set expectations and follow up diligently to get things done, on-time, to avoid mistakes.

While reviewing a certain client's account(s), there are specific elements that are typically covered. Listing of accounts and their titles, overall asset allocation, detailed sector exposure, performance, and individual holdings are all typically discussed in detail. Again, every client situation is different, so many of the qualitative aspects of a review can vary significantly based on the scenario. Needs and goals must be considered throughout the review process. Many parts of the conversation with the client may be casual and subjective compared to being pragmatic. A two-way dialogue with feedback is essential.

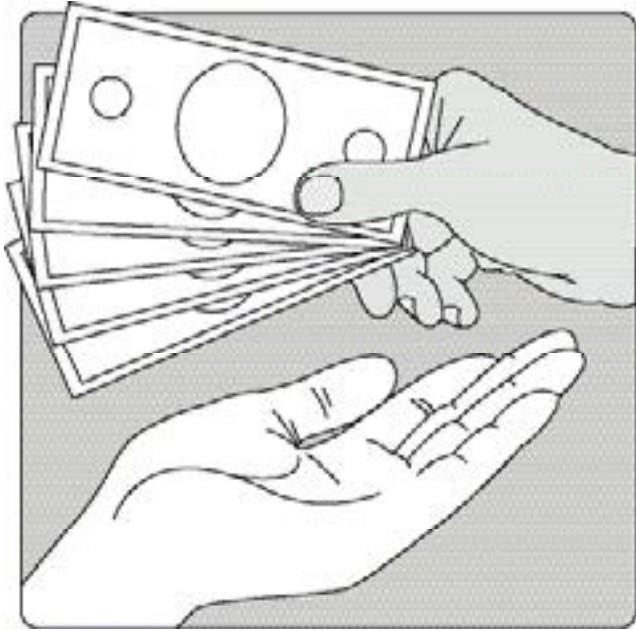
The review step of the process is perhaps the most appreciated by my clientele. It reinforces that they are not sent out to pasture. If customers know they will be reviewing their accounts every quarter, they'll likely limit

the number of random inquiries related to day-to-day, short-lived news events. Most clients won't unexpectedly call wondering what an account is doing if there is a scheduled review forthcoming. This step ensures that we are all working together diligently to move forward as life happens. Visit the website for a sample portfolio review incorporating goals.

ADVISORY COUNCIL

Feedback is essential to ensure that we, as advisors, are doing our best and that we continually refine our skills and services. Periodically, a group of clients, investment professionals, and other interested parties gather to share ideas that will help our investment advisor practice deliver services in a better way. The advisory council's aim is to uncover how we can do a better job as financial professionals for the sake of the client. Feedback from our advisory council meetings helps push our practice to the next level in providing the best service possible for our clientele. We always want to improve and make our customers happy. This is really the point of the advisory council and the periodic client review.

CHAPTER TEN



THE COST OF INVESTING

The Glass-Steagall Act (GSA) primarily defined the landscape of our modern financial system. After the fallout of the stock market crash in 1929, the GSA brought regulation in 1933 to separate investment and commercial banking to eliminate “improper banking activities.” Conflicts of interest and incentives to take inappropriate risks were the target of the legislation to prevent another Great Depression. In 1999 Congress with the Gramm-Leach-Bliley Act repealed the GSA. There were many forces at play that led to this. Most notable were the efforts of Sandy Weill, the Chief Executive and Chairman of the Travelers Group. He wished to merge with Citicorp to

form Citigroup. The wall separating banking and brokerage was taken down to allow for the merger to take place.

Prior to 1999, there was a clearly defined role for different types of financial services professionals. A banker was clearly a banker, as such focused their services for clients on lending and time deposits. If someone needed a mortgage, it was necessary to visit the local banker to undergo the application process. The GSA limited the banker from offering investment or brokerage products to customers. Conversely, if a person were looking to invest, they would have to go to an investment firm to buy stocks or bonds. There was also a clear line drawn for insurance agents who provided their services, which were limited to focusing on insurance and risk management needs. The different types of financial services professionals were highly specialized with clearly defined roles and responsibilities.

After 1999, the lines became blurred and someone masquerading as a “financial advisor” could have been a traditional stockbroker, banker, or insurance salesman in disguise. I suppose there are pros and cons to what different financial advisors and firms can offer clients, but it seems difficult to be everything to everyone while still doing a thorough job. A true financial planner should be able to be a generalist and know the particulars of a client’s needs. However, the execution of the products and services should really be left to the specialists. For example, I may be able to analyze a client’s need for a mortgage, but walking them through the administrative process is inefficient. That should be the role of a specialized team member or referral partner at a mortgage firm that you can rely on.

Traditionally, a banker would get paid a salary with bonus incentives. When a customer gets a mortgage or a banking product such as a CD, the costs and fees are built into the pricing. If the customer is quoted a rate for a savings account, for example, the rate is net of the internal costs. There may be other closing costs or annual fees, but historically the pricing included fees.

The same held true for insurance agents and the way the insurance company made money. Products sold included expenses built into the contract. The insurance salesperson typically made their living by earning commissions for products sold.

The old fashioned stock broker would usually get a transactional commission for buying or selling a stock, bond, or mutual fund for a client. Mutual funds could charge a load up-front, level, or back-end load if a client sold before a certain time frame.

In most of these cases, it was very difficult for clients or investors to fully know or see the total costs associated with buying a particular product or service for that matter. Throughout this whole time frame, before and after Gramm-Leach-Bliley Act in 1999, an advisor working under the Investment Advisor Act of 1940 was able to get compensated for their advice, not on transactional commission for a product. If you think about it, this puts the financial professional on the “same side of the table” as the clients and, consequently, takes away conflicts of interest while eliminating the potential for hidden expenses.

It should be no secret that financial professionals get paid for what they do. It should also be clear that hidden fees bring a hidden agenda that may not be in the best interest of a client. Transparency is vital to ensure a client relationship is managed appropriately.

From the beginning of my career, I have stressed the importance of a transparent fee type of relationship. This is called fee-based or fee-only. A fee-only is exactly how it sounds. A client only pays a fee to the advisor for their advice, guidance, or service. What are typical costs? As of 2019, a reasonable flat fee for a full comprehensive financial plan may be around \$2,500. An hourly charge could average \$250 per hour. A million dollar portfolio asset value would ideally call for a 1.25 percent annual fee. These

explicit charges would ensure that what recommendations are being made would be viewed by the advisor to be the “best fit” for a certain client scenario.

Some advisors deliver more value than others, and a client should be cost conscious. Of course people want to save. An investor could “do it themselves” or shop for the lowest price. I am very frugal personally, and always try to save money when possible. In fact, the easiest way to increase performance and net return is to reduce fees. With that said, it would be ill advised to cut corners here. The best professionals who are in demand require these fees for their expertise. Beware of advisors who charge less, really. Will they cut corners? Are they desperate for business? Are they worth their advice?

On the other hand, there are many clients that are so used to the old fashioned transactional model, that they simply can't grasp the idea of paying an advisory fee. It should be evident that the advisory fee relationship is the most beneficial and cost effective. The problem is that for years, some investors thought they weren't paying fees. Even if I show a client that they were paying total hidden fees of \$20,000 for their portfolio, they still aren't comfortable paying an explicit \$10,000 for their \$1 million portfolio. Some people unfortunately allow a broker to charge twice as much simply because they don't see the fees. I prefer to always take the high road when dealing with my clients. I believe in the law of reciprocity and it is that truism that allows me to have faith in what I do.

When I started my career, only a fraction of the industry provided fee related advice. Now, the majority is moving in this direction. There are a number of reasons for this shift. First, the general public is becoming more ware of how finances work. Second, the financial crisis and market volatility have exposed many of the inner workings of the investment industry. Lastly, regulation has forced the shift. The new ruling by the Department of Labor (DOL) now dictates that investment professionals act as a true fiduciary in the best interest of their clients. This is best acted out through a fee

relationship for advice. This last point is still up for debate by some, but is clear that transactional commissions are not appropriate and an advisory-based fee is necessary. My view has been and will continue to be consistent with this message, no matter what new laws or administrations allow. My goal is that my process and ideology should be timeless and hold true.

If there is one take away, it is that every investor should ask questions and find out if there is any hidden agenda or ulterior motive from the financial advisor relationship. All too often, I see people's money not being handled the best way possible. Even a financial plan can come in many shapes and forms. Many plans can essentially be a disguise for an insurance sales pitch or some other product that is being pushed. There are possible reasons for this. For instance, the financial person may simply not know more than what product they are offering. The way to remedy this is to avoid firms that offer proprietary products. It is in such firms' best interest to only push what they are offering. Most firms have eliminated this conflict, but it still exists, especially with insurance companies and discount brokerages. It may be difficult for a financial advisor to offer advice if they simply do not have the knowledge or tools to do better.

That's not to say I am entirely against annuities; I simply think they are oversold. There are, however, two scenarios in which they do make sense. The first I call a "financial diet." This is when a client insists they don't need to take withdrawals or money out, but they see the money and can't help but take it out. The annuity locks up the funds, providing an extra layer of protection limiting access to money. A monthly payout could force the client to not overspend. The second case in which an annuity is a viable option is for people who want to have their cake and eat it too. Such a person is likely to express the desire for growth without a tolerance for losing money. An annuity can provide an extra guarantee while staying invested in a diversified portfolio. In both cases, the annuity will have extra fees for their income benefits and guarantees. In many cases, the fees can be well over 2 percent more than a normal investment portfolio. Hence, the advisor gets paid more for this form of insurance product.

Other financial advisors may steer people into certain mutual funds because they pay the advisor more. Closed-end funds, Unit Investment Trusts, and Structured Products are oversold due to their lofty payouts to the advisor. A general rule should be that if you don't understand it, don't buy it. In the words of Warren Buffett: "Never invest in a business you cannot understand." Your financial plan, investment portfolio, and relationship with a professional should all make sense and feel right.

A complete financial relationship will incorporate the financial planner, investment manager, tax advisor, legal advisor, insurance specialist, and banker for lending. Some larger firms, and even boutique smaller firms may be able to provide all of these capabilities in house. In practice, most of these professionals are separated and provide a good checks-and-balance system for the client. Keep the financial planning/investment advisor separate from your tax person, legal person, insurance person, and mortgage or lending professional. A CPA has no business providing investment advice. I have never seen an instance where the client was getting all needs met proficiently when the services are combined. Again, the conflict of interest and lack of knowledge play a significant role to the detriment of the client's overall well being. Service providers need to work closely together to ensure the needs of a customer are being met, but they should not compete or overlap.

CONCLUDING REMARKS

Money should be viewed as a means to an end. After all, a common definition of economics is the allocation of scarce resources over an unlimited demand. Think about it. There are many things we desire or think we need, but it certainly does not account for the most important things in life. You can't line a casket with dollar bills. The use of money efficiently will maximize your ability to afford the things that accommodate your desired lifestyle. We do not want to waste our resources in an irresponsible manner. For example, it's far more responsible for a family to purchase an economical vehicle that also affords other things than an expensive car that drains assets. Regardless, there are ways to be smart with your personal finances. Please

don't deprive yourself or your family of what is important simply because of bad financial choices. I propose that money should be used to maximize happiness.

Life is more important, make the most of it!

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