Investment Philosophy

and Guiding Principles

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This paper was selected by the Academy of Financial Services for presentation to the Academy in Denver, CO on Saturday October 9, and Sunday, October 10, 2010.

The document describes the elements of my investing style and is intended to both educate and stimulate dialogue. These comments are based on my personal experience and observation. This information should not be construed to be financial advice since each individual's circumstances must be taken into consideration.

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Abstract

This paper covers topics related to financial planning and investment management. It is not a rigorous discussion of investment strategy or personal finance. The objective is to disclose Robert's perspective on subjects related to his practice, so that his audience, client or prospect, analytical or emotional, will know how he thinks.

Each portfolio is systematically designed for the client's personal circumstances and the size of the account, considering asset prices at the time of implementation. Beginning with a core and satellite strategy, Robert implements portfolios using primarily mutual funds, ETF's, stocks, and bonds. In various circumstances, other security types and asset classes can be deployed.

There are many things other than portfolio construction to consider when hiring a financial advisor, such as the type of account, fees, and other variables surrounding the nature of the relationship. Throughout the paper, Robert discusses the principles that guide his opinions on these issues.

Robert offers insight into some common investor mistakes, such as failing to rationally decide when to sell, how many advisors to employ, the judicious use of personal debt, and the key considerations when investing in leveraged companies. Finally, he shares his view of capitalism; why it works as well as its shortcomings.

About the Author

Robert Dalton Higgins received his B.A. in Economics from The University of North Carolina at Chapel Hill, in 1978. In 1980 he earned his MBA from The Babcock Graduate School of Management, at Wake Forest University, with a concentration in Finance. During the summer of 1979, he studied International Corporate Finance in London, through the Babcock program.

Robert began his career as a corporate financial analyst, with GTE Corporation, Compaq Computer Corporation, Dow Chemical and Sandoz Corporation. In 1987 Robert became a Certified Management Accountant (CMA). At Dow Chemical, Robert was Manager of Economic Planning. In 1992 he joined Sandoz in Charlotte and fulfilling a preference to live in North Carolina.

In 1994, Robert moved into financial services with Northwestern Mutual Life. At Northwestern, Robert developed his personal financial planning and investment practice, incorporating benefits and business planning. He earned the CLU (Chartered Life Underwriter) and ChFC (Chartered Financial Consultant) designations in 1998 and 2000, respectively.

By late 2000, Robert left Northwestern to help a large regional CPA firm establish its financial services practice, with 1st Global serving as broker dealer. In 2001 Robert developed his independent practice, Dalton Financial Services. He earned his CFP® designation in 2002. In 2004, Robert adopted the LPL Financial platform as a fee-based Investment Advisor Representative, under the name Dalton Financial Services.

In 2013, Robert left LPL Financial to start and operate Dalton Financial LLC, an independent, fee-only registered investment advisory firm. He provides financial planning and investment management services, as well as financial consulting. Robert served on the Investment and Financial Committees for the Board of Directors of The Aldersgate Retirement Community in Charlotte for over 10 years, through 2023. In the past, Robert served on the Board of Directors for the Financial Planning Association of Charlotte and the Hornet's Nest Girl Scouts Council. As an experienced financial analyst, he enjoys financial modeling and decision analysis. These analytical skills, coupled with his economics and management accounting background, distinguish him among financial advisors and registered representatives.

In 2010, Robert's paper "Investment Philosophy and Guiding Principles" was selected for presentation at the Academy of Financial Services in Denver, CO. The Academy encourages basic and applied research, development of curricula, and interaction between financial professionals and academicians.

Robert writes on financial topics and has been quoted in *Morningstar Advisor*, *The Charlotte Observer*, on CNBC and WSOC-TV9 in Charlotte, and in other trade journals and periodicals.

Preface

Several years ago, I planted a couple of trees in my yard; one in the front and one in back. There was a large, majestic maple tree behind a house across the street. It shaded half the yard and the large leaves turned bright yellow and orange in the fall. I discovered some saplings under the tree, small enough to transplant. The owner said I could have them.

As I dug up the first sapling, I took great care to dig deep to avoid disturbing a tap root. The last tree I transplanted was an oak, with a tap root as deep as the tree was tall. Digging deep meant I had to dig closer to the trunk, so the root ball wouldn't be so heavy I couldn't lift it. I moved the sapling, with as much dirt as I could manage. There was no tap root. I planted this tree in my front yard.

For the second tree, I revised my strategy. If maple trees don't have tap roots, perhaps their roots are shallow. This time, I dug the root ball wide and shallow, and planted it in my backyard.

A year later, both trees looked healthy. The tree in the backyard, with the wide and shallow root ball, more than doubled in height over the summer. The tree in the front yard looked healthy with dark green leaves, but it only grew perhaps an inch or so. There was no new growth.

A couple of lessons can be learned. First, a little bit of knowledge can be dangerous. Different trees have different characteristics. Knowing about oaks doesn't mean much when dealing with maples (at least silver maples).

The second lesson is, look deeper. Whether you are moving a tree or looking for a financial advisor, it is important to know what goes on beneath the surface. This paper discusses what I think is important to know about the latter.

If you don't have the time or patience to read the rest of this paper, at least consider the wisdom in the following observations (from the section, What is Satellite Investing, and When Should You Use It? On page 9):

1. *Any investment is only worth the net present value of the cash it can pay you back.*
2. *Recognize the difference between a great company and a good value (while it is necessary to know what you own, it is not sufficient).*
3. *You only get paid for taking the risk of owning a single stock if you can buy it in the market for less than what you think it is worth.*
4. *What you pay has nothing to do with when you should sell (except for tax considerations). Especially in retirement accounts!*
5. *It is not sufficient to be right. You have to be right, and then the market has to subsequently agree with you.*
6. *As the famous economist John Maynard Keynes said, "The market can stay irrational longer than you can stay solvent."*

The Nature of Markets

Markets are fickle. They are, by virtue of human nature, counterintuitive. When things look great and growth prospects seem unlimited, prices will be high because everybody is optimistic. On the other hand, when risks are apparent and fear grips your soul, prices will be low because no one wants risky assets like stocks. Such herd behavior is consistent with human evolution. We look to others around us for validation, which reinforces our conviction that things are either safe or scary. Our wired world and mass media make more information available than we can possibly assimilate. However, information does not advance our ability to invest when it reinforces primitive instincts that work against us as investors. It is hard to make money doing what everybody else is doing.

Understanding the way we are wired can lead to a contrarian strategy. Since herd behavior leads to exaggerated swings in the market, a contrarian will note extreme moods and bet against the market. I don't think of myself as a contrarian, but there is a lot of truth to this. I prefer to lean towards an aggressive strategy when times are bad, and lean towards a conservative strategy when times are good. Risk will be greatest when prices (and price multiples) are high in an economic expansion. Conversely, risk will be lowest when times are bad, and prices are down because many have fled markets for the safety of cash. Buy risk when it is cheap; sell risk when it is high.

What is the Core and Satellite Investing Model?

As with most things financial, the elements to consider are usually not good or bad, or black and white. The best answer, or optimal combination of investments, is in the mix, or allocation.

I define the core as a traditional asset allocation model. Using the Morningstar Style Box approach, we select ETF's (exchange traded funds) or mutual funds to represent the nine boxes for our chosen U.S. Equity allocation. While the [Growth : Value] x [Large Cap : Small Cap] matrix segments the U. S. market, we also include exposure to international large and small cap, emerging markets, and perhaps real estate, commodities, fixed income (diversified by credit type, rating, duration, geography, etc.), and potentially hedge strategies.

A primary issue to address in constructing the core allocation is whether to use mutual funds, ETFs, or other vehicles such as separate accounts or individual securities. While separate accounts may substitute for mutual funds on some investment platforms, for this discussion I will restrict the choice to mutual funds or ETF's. Individual stocks will be addressed in the "satellite" part of the portfolio.

A quick review of terms might be in order. A mutual fund is a pooled investment in a basket of securities (stocks and/or bonds), managed by a fund manager that picks the stocks or securities owned by the fund. This selection process is known as active management. Mutual fund shareholders own shares of an undivided whole. The fund incurs expenses, usually expressed as a percentage of the fund assets, called the expense ratio. Expenses for most mutual funds generally range from 60 basis points (60/100 of 1%) to 1.5% or more. The expense ratio does not include the additional trading costs of the fund, which is a function of the turnover ratio of the fund.

Since all mutual fund managers own stocks in the same universe, and all stocks are owned by somebody, one could conclude that half of the mutual fund managers will do better than average, and half will do worse than average. The benchmark represents the average. That makes sense until we consider the expenses and trading costs of the active fund manager. Given that the fund manager must exceed the benchmark by more than the expenses of his fund to add value and justify his keep, it follows that fewer than half of all mutual funds can possibly beat their respective benchmark. Furthermore, an investor can do better than the average mutual fund by simply owning the benchmark.

However, indexes are theoretical concepts that cannot be owned in practice. But ETF's, designed to track indexes, are managed by computers, and have much lower expense ratios, usually ranging from .03% to .6%, with the average closer to the lower end for the ETF's I use. (Many niche ETFs with small asset bases have higher expense ratios that raise the strict numerical average.) ETF's also claim greater tax efficiency due to lower turnover and the mechanism used to create and redeem shares.

The choice is not clear. The challenge is to identify fund managers that are most likely to beat their benchmark under given market and economic conditions. By analogy, if I were to go to a horse racetrack to pick horses to win, place or show, I would probably lose money. I know very little about horses and horse racing. However, I believe there are people who frequent the tracks and consistently make money by betting on horses. These people study, and know which horses run best under what conditions. They know the competition, the horse's track records, and the jockeys. They might even know the horse's lineage for four or five generations. They do their homework and can handicap horses better than the bookmaker.

My task is similar when picking a mutual fund manager. If I cannot develop conviction that a fund manager is likely to beat his benchmark, then I'll buy an ETF that fits the required allocation sector and be content to know I'll do better than most mutual fund investors.

The core portfolio is constructed according to the desired asset allocation model using building blocks of mutual funds and ETF's.

Disclosures: Principal Risk: An investment in Exchange Traded Fund (ETF), structured as a mutual fund or unit investment trust, involves the risk of losing money and should be considered as part of an overall program, not a complete investment program. An investment in ETF's involves additional risks: not diversified, the risks of price volatility, competitive industry pressure, international political and economic developments, possible trading halts, index tracking error.

Investing in mutual funds involves risk, including possible loss of principal. Investments in specialized industry sectors have additional risks, which are outlined in the prospectus.

Limitations of the Core Asset Allocation Model

The goal of most mutual fund managers is to perform slightly better than their benchmark. Such performance will probably land him in the top quartile of his peers and earn the bonus that drives his compensation. He doesn't get paid to take big risks. Indeed, an issue in the mutual fund industry is that many mutual funds have become "closet indexers". They take a large part of their funds and mirror the index, and only deviate from the index to take "beta" risk with a small portion of the fund in their highest conviction ideas.

The average equity mutual fund owns between 50 to 150 different stocks. Wouldn't you assume (hope) that a fund manager can distinguish between his best and worst ideas? Wouldn't you further suppose that he could rank his holdings from his best to his worst ideas? Did you ever wonder why he bothers putting money in companies that aren't even in his top 100 ideas?

In defense of mutual funds and their managers, there are some legitimate reasons that funds own a lot of stocks. Most investors are risk averse, and holding more stocks does help manage risk and volatility. But there are diminishing benefits to adding positions. Most volatility can be managed with a lot fewer than the usual number of holdings. Perhaps the best reason for a small position is having a real stake focuses a manager's attention. It might serve as an indication of interest.

Another issue is size. A $10 billion mutual fund would have to buy all of a $100 million company just to have 1% of the fund invested in the position. Federal law restricts a mutual fund from owning more than 10% of a company's voting, outstanding stock. For practical purposes, big mutual funds are forced to buy bigger companies to take positions that can have a material impact on the fund. So if a large fund manager's best idea is a small company, it will not help the fund even if the manager is right.

What is Satellite Investing, and When Should You Use It?

Warren Buffett does not invest in mutual funds. He buys companies. When he buys a minority position of a company, he views the investment as if he were buying the entire company. Mr. Buffett is an opportunistic investor. He observes the difference between investing and baseball like this. In baseball, if the batter takes 3 strikes, he's out. In investing, you can sit with the bat on your shoulder all day long, waiting for the "fat pitch." Perhaps it is a hanging curve ball, a little high and tight, so that if you turn on it, you can drill it into the upper deck 7 out of 10 times.

This is the objective in satellite investing. I try to use opportunistic stock selection to enhance return or income potential. We wait until we find a company that we want to own for the long term. One that the market presents at a significant discount to what we think the company is worth (intrinsic value). This is the individual investor's advantage over mutual funds. We don't have to find 100 stocks we believe are mispriced by the market. We only need 7 to 10. We never have to buy a stock just to invest. We can always allocate new money and rebalance the core portfolio.

The trade-off that keeps this methodology from having broad appeal is that investors are risk averse. Most investors prefer to minimize losses rather than maximize gains. The challenge is to find an

acceptable allocation of core to satellite. Individual stock positions add volatility. The core attempts to capture, or slightly exceed, market returns, with less risk.

My grandfather used to tell a joke about a man who prayed the same prayer for 20 years. He prayed, "Dear God, please let me win the lottery." He faithfully recited this prayer every day. Finally, after twenty years without winning, he became discouraged and changed his prayer, "Dear God, don't you hear my prayer? I've been asking for 20 years, but you have not answered my prayer." Suddenly the skies darkened. Lightning flashed, and then a voice rumbled through the hills, "Buy a ticket!"

If you want to beat the market, you must accept some risk. The key, according to Buffett, is to wait for the "fat pitch", or stock you can buy with high conviction. Peter Lynch, the famous manager of Fidelity's Magellan Fund from 1977 to 1990 coined a term for a great investment. In his classic book, One Up on Wall Street, he refers to "ten baggers". These are stocks that go up ten times more than the price paid. If you don't own some well selected stocks, you'll never see a 10-bagger. It doesn't take many to change your lifestyle.

My first 10-bagger was Compaq Computer Corp. In 1990 the company was in crisis. Ben Rosen, the Chairman and lead venture capitalist, fired founder and CEO Rod Canion. At issue was the strategy of whether to pursue the emerging home market for personal computers. Canion wanted to maintain the company's focus on the high end, business market. Rosen wanted to address the home market to compete with manufacturers using low end Asian components with improving quality. The stock price fell, from the mid 60's to the high teens. The market saw a company in turmoil. I saw a solid company adapting to a changing marketplace. I bought in the mid 40's, the mid 30's, and the mid 20's. I didn't have the nerve to buy again under $20.

By August 1997, my most expensive block was a 10-bagger. Meanwhile, I witnessed Compaq's price/earnings multiple more than double, while gaining the leading market share. The law of large numbers was catching up. I sold half that month. The price kept soaring. Within a couple of weeks, the stock was up another 10%. I sold the rest. The last sale turned out to be within a month of the all-time high for Compaq Computer, which subsequently struggled from increasing competition from Dell, and was acquired by Hewlett Packard in 2001.

Another 10-bagger was Ciena. There would be more if I had sold closer to the highs. But a 10-bagger can fall 50% and still be a great investment. Three to five baggers are nice, and more common. Also, there is no guarantee that I'll ever see another 10-bagger. (Update: as of 11/27/2023 there are 3 more 10 baggers in my portfolio: Apple, Microsoft and Nvidia.) Still, it is good to know that while you can lose 100% of a stock position, you can earn much more than that.

This is not to say that satellite investing should be part of every portfolio. It only makes sense for investors that can afford the greater volatility inherent in concentration.

Conservative investors might use satellite positions to capture higher dividend income, with lower expenses, than is possible with a mutual fund. Even in this situation, it is important to maintain

diversification by avoiding excess industry concentration. Many conservative, retired investors learned this lesson the hard way in the financial crisis of 2008-2009, when nearly all banks cut dividends.

While there are many good books explaining how to invest, perhaps the most important concepts are:

1. Any investment is only worth the net present value of the cash it can pay you back.
2. Recognize the difference between a great company and a good value (while it is necessary to know what you own and own what you buy, it is not sufficient).
3. You only get paid for taking the risk of owning a single stock if you can buy it in the market for less than what you think it is worth.
4. What you pay has nothing to do with when you should sell (except for tax considerations). Especially in retirement accounts!
5. It is not sufficient to be right. You must be right, and then the market has to subsequently agree with you.
6. As the famous economist John Maynard Keynes said, “The market can stay irrational longer than you can stay solvent.”

These are guiding principles I apply to portfolio construction. But there is more to investment philosophy than how to build a portfolio.

Knowing When to Sell

According to Kenny Rogers in, *The Gambler*:

You got to know when to hold ‘em, know when to fold ‘em,
Know when to walk away and know when to run.
You never count your money when you’re sittin at the table.
There’ll be time enough for countin when the dealins done.

One difference between an investor and a gambler is that a gambler will keep doing it until he loses. In the short run the market is very risky, and much like gambling. We take positions based on judgments about the probabilities of various outcomes, and the resulting expected values. But in the long run, earnings matter. Remember, any investment is only worth the present value of the cash it can give you back.

A common investor mistake is induced by the tendency of investors to anchor emotionally. Selling at a loss makes it real, in the minds of such investors. Also, they’d rather defer the pain of realizing a loss by waiting to get back to even.

The price paid for an investment is irrelevant to the sell decision, except for the secondary consideration of taxes, in non-retirement accounts. When an investor asks if he should sell because he’s doubled his money, it begs the question of whether he would buy the investment if the entire portfolio were suddenly cash.

The all-cash test is a good exercise. Pretend that when you wake up in the morning, all your investments are in cash. Now, figure out the best way to invest based on your current circumstances in today's market, without regard to past decisions that might have been made with imperfect knowledge and wisdom. Free yourself from the emotional baggage. What difference does it make what you paid for something? Isn't it more important to assess the potential returns going forward? And if the market is down, what difference do taxes make? Selling and repositioning can create tax losses to carry forward to shelter future gains.

Behavioral inertia may be tacit acknowledgement of fear of following the herd. Avoiding change seems to eliminate the risk of making a mistake. Unfortunately, either way a decision is made. Every day you do not sell, you are implicitly saying you would buy.

What are the Advantages of the Separate Account Structure?

Separate accounts are baskets of securities, usually actively managed like mutual funds, but typically with high minimums. However, with separate accounts, the investor owns the underlying securities in the basket directly, rather than as a share of an undivided whole. The separate account format offers two key advantages. Tax losses can be harvested to shelter gains, and investors do not have to worry about buying into the tax liability of unrealized gains. A mutual fund investor that buys into a fund holding stocks that have already gone up might see his shares drop in value yet have taxable gains because the fund manager sold stocks with gains.

Another benefit is that managers can customize an investor's portfolio, within limits, to avoid certain securities. This might be a good idea if the investor has a large position in his employer's company stock and wants to minimize overlap. An investor may also selectively reject any security they might find objectionable for personal reasons.

I think that separate accounts are oversold. In fact, the traditional tax benefit of separate accounts is a disadvantage when the market is well off its highs, since many mutual funds have loss carry forwards that can make them more tax efficient than separate accounts. While overlap and concentrated positions can be a problem for some, the issue tends to be minor given the diversification of mutual funds (and ETF's).

The greatest appeal, I'm afraid, is in elitism. Investors enjoy telling their neighbors about their exotic investment structure, one reserved for the wealthy. That's often just a marketing tool. Don't get distracted feeling special when you should be asking good questions.

When are Commodities a Useful Asset Class?

Commodity prices fluctuate as a function of supply and demand. If supply is inelastic in the short run, prices can be volatile. Prices go up when shortages occur, but higher prices attract new capital and resources. When supply comes on-stream in large chunks, prices can collapse. At the end of the day, commodities are only raw materials that go into other products. They do not, by themselves, create value. Value creation is the domain of companies (stocks). Stocks represent ownership of organizations designed to create wealth. If you want to own growth or the right to income, buy stocks and bonds. Commodities are a useful asset class to use when diversifying from equities to hedge against a correction precipitated by over valuation, or as an inflation hedge. Note that a global recession-induced correction can reduce demand for commodities; hence they might not provide the desired portfolio protection if global consumption declines.

Best Uses of Permanent Life Insurance

Cash value life insurance has a lot of moving parts, and consequently is a very flexible (and complicated) vehicle that can be used for many different purposes. However, just because it is a tool that can be configured for many purposes doesn't make it the vehicle of choice for all purposes. As mentioned previously, this is not about good or bad, it is an issue of finding the right amount for a targeted purpose; a purpose where permanent life insurance is the best vehicle. The best use in most cases, not surprisingly, is to die with it and efficiently pass assets to the next generation or a charity, potentially reducing one's estate tax liability. But if things change to the extent you need the cash value, there are tax benefits that will help offset the insurance costs over the long term, so that it can be competitive with other investments like mutual funds. One of the easiest ways to lose money is to start a permanent plan, fund the big sales commission, and then cancel the policy before realizing the long-term benefits.

When Guarantees Are Important

The market is a harsh mistress. While she can bring you great happiness, you just can't trust her to be there when you need her. There are various products designed to shift market risk from the investor to someone else, for a price. Such guarantees are like any other insurance. If you need it, or understand why you want it, it can make sense to buy it. Much like life insurance needs analysis; we first identify "the gap". The gap is the difference between what you know you have, versus what you require to fulfill your basic desires. It makes sense to insure the essentials. Also, recognize that a guarantee is only as good as the institution behind the guarantee.

Are Variable Annuities Right for You?

Have you ever driven over a tall bridge? A bridge so high that when you looked down at the little boats below, you could barely even see the people on them. Did it make you just a little nervous driving over that bridge while you looked over the edge? Did you happen to hit the guard rail while you were driving? No? Have you ever seen anyone hit a guard rail on a bridge? Any bridge? Probably not, so the guard rail isn't necessary, is it? That's good to know since those rails are expensive, and we could save a lot of money and replace old bridges faster, making them safer by leaving off the guard rails.

OK, I've spun this yarn enough to know that most people would not drive over a high bridge without guard rails. Most people prefer the emotional comfort of knowing the rails are there and are happy to incur the extra expense for the emotional benefit. Like guard rails, I do not believe most people will see an economic benefit from variable annuities. But if they will not drive across the bridge, or invest in equities, without guarantees, the cost may be worth it.

The variable annuity is a tool designed to shift investment market risk to an insurance company. Variable annuities with living benefit riders can be very complex, but the most popular designs guarantee the original principal if the guaranteed amount is taken in a series of withdrawals not exceeding a stated amount over a period of years. A common plan allows 5% for life, with qualifying age restrictions. The guaranteed amount is generally reset to a higher level, based on investment performance. Once reset, it cannot go down, and the withdrawal percentage will be applied to the higher guaranteed amount.

During the accumulation phase prior to withdrawals, the insurance company will guarantee annual increases in the guaranteed account value, for a number of years. The guaranteed contract value will increase at the greater of the guaranteed growth rate.

In the distribution phase, guaranteed increases usually cease, but the annual income can increase if market performance increases the guaranteed account value.

What's the price? Many of these guarantees are purchased with a "living benefit" rider, with annual expenses that are deducted from the non-guaranteed account value. Total expenses (administrative, investment expenses and riders) are often around 3%. That's a steep price, but it might allow an investor to have peace of mind and participate in equity markets. Such investors, as Mark Twain said, are "more concerned about return of their principal than return on their principal."

Another drawback of many variable annuities is lack of liquidity and long surrender periods. Fortunately, more companies are making their products available through investment advisors on a no-load basis. For risk adverse investors, the higher fees can be worth the promise of protected principal, lifetime income (potentially increasing), and ownership of the account value (as opposed to annuitization, where the insurance company controls the asset).

How much of a portfolio to allocate to such guaranteed products is best determined by estimating how much insurance is needed, or how much income will be required, to fill the gap between living expenses and income provided by other sources including social security and pensions.

Disclosures: Riders are additional guarantee options that are available to an annuity or life insurance contract holder. While some riders are part of an existing contract, many others may carry additional fees, charges and restrictions, and the policyholder should review their contract carefully before purchasing. Guarantees are based on the claims paying ability of the issuing insurance company.

Variable annuities are long-term, tax-deferred investment vehicles designed for retirement purposes and contain both an investment and insurance component. They are sold only by prospectus. Guarantees are based on the claims paying ability of the issuer. Withdrawals made before age 59 ½ are subject to 10% IRS penalty tax and surrender charges may apply. Gains from tax-deferred investments are taxable as ordinary income upon withdrawal. The investment returns and principal value of the available sub-account portfolios will fluctuate so that the value of an investor's unit, when redeemed, may be worth more or less than their original value.

Evaluating Corporate Debt

In the financial world, you can use debt to spend money you don't have but expect to earn. Companies you might invest in do the same. You can either buy the bonds (debt) they issue, or you can buy the stock (the future earnings). But what if you buy the stock of a company that has issued a lot of bonds? Leveraged companies can increase their return on equity by using borrowed money. The downside is they have an additional fixed cost; the interest to service the debt they carry. They need more sales to breakeven. If a company's cash flow falls below breakeven, then the risk of bankruptcy is greater.

A "value" company with predictable cash flow can more reliably employ a higher debt/equity ratio. A growth company with a lot of debt can be very risky. In evaluating growth companies, I prefer little or no debt, so they can be flexible while managing their way through the challenges of growth. As companies become more established, they can then employ debt to magnify returns to shareholders. I want financial leverage option to be an arrow in the quiver rather than spent ammunition.

Debt is not a red flag in and of itself. I focus on "Net Debt", to take balance sheet cash into consideration. If a company has more cash than debt, the debt is less worrisome. When debt is a concern, I will search the company's 10k and review every incidence that the word "debt" appears. I want to know the cost of the debt and when it comes due, so I can judge the company's chances of rolling it over or repaying it on favorable terms. You can't go bankrupt if you don't have debt.

How Operating Leverage Affects a Company's Earnings

I mentioned that financial leverage increases a company's breakeven point by adding fixed costs. Another important consideration regarding operating leverage is that it considers the other costs of running a business. A company with a 10% net profit margin earns $10 of profit for each $100 of sales. Further, suppose that the company's variable costs (direct costs including materials and labor) are $.50 per $1.00 of sales. The gross profit margin is 50%. If sales decline by 10%, profits decline 50%. A relatively small change in sales has a much greater impact on earnings. See what big swings in earnings can do to the stock market during recessions! There can be wide variations in our valuation assumptions during times of maximum fear and uncertainty.

During profit crunches, companies reduce costs. They cut staff, consolidate operations, and generally get lean. With a lower cost structure, they have better operating leverage. Even if they have the same variable costs or degree of operating leverage, the lower fixed cost reduces breakeven, generating larger profits on lower sales than before. Companies will not add costs after a recession until they reach capacity constraints. This is one reason why unemployment is considered a lagging indicator.

What is the Difference between Brokerage and Advisory?

In the brokerage arena, compensation is based on commissions. Advisory account compensation is usually a fee based on a percentage of assets. The following discussion will highlight more of the key differences.

Commissions are transaction based. Transaction based compensation involves inherent conflicts of interest. No one expects a salesman to spend as much effort explaining why a transaction shouldn't occur, as to why it should. After all, he only gets paid if the transaction occurs. This is not to imply dishonesty among brokers, but the level of objectivity is greater in the advisory world.

Not all products pay the same commissions, and some do not pay commissions at all. There are some very good no-load mutual funds, but brokers generally do not recommend no-load mutual funds in brokerage accounts. No-load funds do not pay commissions. For stocks and ETF's, a somewhat arbitrary commission is tacked on the transaction. The broker has an incentive to change the position to get paid again.

Advisory accounts decouple compensation and commissions, so the advisor can be more objective about investment choices. It improves the alignment of the advisor's and the investor's interests. Conflicts can still exist, however. If a client consults an advisor that is compensated as a percent of assets under management, about withdrawing assets to pay a debt or buy real estate, then the advisor has a conflict.

Law	Securities and Exchange Act of 1934	Investment Advisors Act of 1940
Regulator	FINRA	SEC and States
What's Regulated	Regulates Sale of Product	Regulates Advisors
Compensation	Commissions Based on Transactions	Fees (Usually Asset Based)
Accountability	Suitability Standard	Fiduciary Standard
Registration	Series 6, 7	Series 65 and 63 or 66
Transparency	Disclosed in Prospectus, compensation paid by Investment Company or Broker Dealer to Advisor from client funds	Disclosed by invoice directly to client and paid directly to advisor

FINRA and the SEC - How Do Their Regulatory Standards Differ?

An often overlooked, but significant distinction between advisory and brokerage accounts is the legal relationship between advisor and client. FINRA is a corporation that acts as Wall Street's self-regulating body. FINRA requires brokers to ensure their clients are getting suitable investments. The SEC, under the standards of the Investment Advisors Act of 1940, goes further, requiring a fiduciary obligation to put the client's interest first. That's a higher standard than suitability. The double standard is currently part of the financial reform debate.

A Guideline for Advisory Fees

Any fee is too much in the absence of value received. Advisory clients receive a quarterly performance statement that shows the performance of their portfolio, net of all expenses. It usually groups investment positions by asset class, and reports benchmark performance for each asset class, and a selected blended benchmark for the portfolio. The quarterly report is my report card.

A guideline fee schedule is available upon request. Generally, the advisory fee is 1% from $500,000 to $1,000,000. It can be lower for more than $1 million and higher for less than $500,000. Separate account fees include the manager's expenses, and are typically 50 to 70 bps higher, since the advisory and investment manager fees are combined.

Value-Added Services for Advisory Accounts

All advisory accounts receive quarterly performance reporting. For accounts greater than $500,000, the fee includes comprehensive financial planning, including retirement, college, estate, insurance, portfolio analysis and optimization.

Other value-added services may include:

- Educational Client Workshops
- Quarterly/Semi Annual Client Reviews
- 401(k) Asset Allocation Assistance
- Company Stock Option Analysis
- Qualified Plan Beneficiary planning

What Can Financial Planning Do for You?

Financial planning is the process of comparing your resources to your goals, to understand how you are doing and your likelihood of success in achieving those goals. Sometimes adjustments to goals, savings, or strategies are required. Sometimes things are OK. If issues exist, the plan can be altered to incorporate recommended changes to get the client on track. A good planner will help identify your blind spots.

But first and foremost, please recognize that a financial planner can't fix your problems for you. Because it all ultimately boils down to an exercise in delayed gratification, you must prioritize. By focusing on long term important goals, we can make better decisions in our daily lives and change behaviors that might interfere with long term success.

Sometimes a planner can suggest strategies to achieve multiple objectives more efficiently, or reconcile goals that seem at odds, such as providing charitable benefits without disinheriting children.

The Financial Planning Association has an online directory of financial planners at http://www.fpaforfinancialplanning.org/PlannerSearch/PlannerSearch.aspx.

Most financial planning is derived from the following four maxims:

- Develop a written plan
- Spend less than you make
- Avoid debt when practical
- Maintain liquidity with an emergency fund

Client Deliverables and Advisor Responsibilities

The quarterly review is a time for attribution analysis to understand why a position has performed well or not. If the process is working, clients should buy-in to the portfolio construction. Good and open communication is important. Clients have an obligation to ask questions. Unasked questions can become concerns, and concerns can become problems. Clients have a responsibility to be involved rather than second guess. Client satisfaction is a function of the ratio of results to expectations.

How Many Advisors Should You Have?

There can only be one advisor. Just as there can only be one quarterback calling the signals if a team is to function as a unit, you can't have a unified investment strategy with multiple advisors managing different sleeves of the portfolio. This defeats the purpose of having an advisor. Hiring multiple managers is like not having one, and just picking mutual funds. In either case, no one is looking at the big picture. Who decides which account to pull assets from to fund a distribution strategy? If the idea is to foster competition among advisors, where is the discipline to manage an asset allocation strategy, or keep them from taking excessive risk in response to the element of competition? Hiring multiple managers puts the client in control of something he probably intended to delegate. As an alternative, why not give the assets to one manager, and hire a second on retainer if you want another opinion? Then both advisors would be somewhat accountable.

Choosing an Investment Advisor or Financial Planner

The SEC has recommended guidelines for consumers choosing a financial or investment advisor. The following link will connect to an article on the Securities and Exchange Commission's website, "Investment Advisors: What You Need to Know before Choosing One", http://www.sec.gov/investor/pubs/invadvisers.htm.

Another good resource is the FINRA Brokercheck website. Use this to see if a commission-based broker has complaints or violations, http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/index.htm. If you are seeking a fee-only financial advisor, they will not be registered with FINRA and will not be found on Brokercheck. Instead, fee-only advisors are regulated by the SEC or states and can be researched through www.adviserinfo.sec.gov.

There are other online registries and directories that purport to showcase "5 Star Advisors" and such. The Paladin Registry is one such site. The pitch is that they vet the advisor and make a full profile of the advisor's practices available. I subscribed to the Paladin Registry for a couple of years. In principle, full disclosure of one's business practices is a good idea. However, I had to pay $175/month to be listed in the registry. Isn't that paid advertising? This is like the conflict of interest that separates advisory accounts from brokerage accounts. The Paladin Registry is getting paid to promote the advisor; it is not working for you. You get what ***you*** pay for.

If the Paladin Registry's model were objective, and provided a valuable service, the Registry should charge a fee to those who want it. When advisors pay, the public only sees advisors that "pay to play". I have chosen not to participate in this scheme, but I will be glad to share the same information I used to list on the Paladin Registry.

Perhaps a better resource is the Financial Planning Association's Planner Search tool, available at http://www.fpaforfinancialplanning.org/PlannerSearch/PlannerSearch.aspx. While an advisor must be a member of the Financial Planning Association to be listed, membership in one's professional association is not a bad idea. The FPA advocates professionalism in financial planning with its own Code of Ethics and Standard of Care (available on the FPA Planner Search website). The FPA also advocates the CFP® certification, which establishes the fiduciary standard of care under the Code of Ethics for CFP® Certificants. The CFP® Board also has a directory of CFP® certificants on letsmakeaplan.org.

A Word on Personal Debt

Debt is like most any other vice. In moderation it can enhance your lifestyle. In excess, it can destroy your life.

I have a simple philosophy towards personal debt. Pay cash for anything you do not expect to appreciate in value. And then, only finance what you can afford to make payments on in your worst nightmare. If you can't afford to pay cash, that could be nature's way of telling you cannot afford it. Buy something cheaper. Live within your means. Borrowing only increases the cost of something you already cannot afford. An exception would be one's first car to get to work for a first job to start earning a living. Borrowing to buy a home is not an exception. Remember, we expect real estate to appreciate over the

long term, despite the housing crash of 2008, so a mortgage is okay. But the real estate crash illustrates what happens when leverage becomes excessive. You must be able to service the debt in bad times. Moderation is important. Buying low also helps.

Custody, Compliance and Technology

In the post - Madoff world, it is easy to recognize the value of having a 3rd party custodian hold client assets. You don't want an advisor printing, potentially fake, statements. I use Pershing LLC as my primary custodian and clearing firm. Secondary custodians I use include Schwab and Altruist. Pershing LLC is a subsidiary of Bank of New York/Mellon. I access Pershing through Shareholders Service Group (SSG). SSG provides access to Pershing's trading platform and facilitates access to other back-office services on favorable terms. SSG prints monthly statements for clients, eliminating the possibility that I could misrepresent account activity in the way Madoff did. Bernie owned the broker dealer that printed his clients' statements, and that was a problem.

A Word on Capitalism

I am a capitalist because I believe private individuals make better decisions about how to spend their money than government bureaucrats. I also believe that people should benefit proportionally to their contribution to society. Capitalism is not perfect, but it is better than the alternatives we've tried so far. While capitalism is prone to excesses, it is also self-healing. When a recession strikes and businesses become less profitable, owners have incentives to make operations more efficient, rationalize or sell, to maximize return on their invested capital. This process often involves layoffs with the associated human toll. Herein lies the dilemma. In theory, capitalism maximizes the efficient allocation of resources in society, but without much compassion for the individual. No one is for poverty, but welfare has the potential to destroy motivation. Socialism overrides property rights to equalize the allocation of resources. The difference, I think, is the incentives. People work harder when it is to their benefit. This is not to say that we should allow laid-off people to starve in the streets. Again, it is a question of balance.

We need a modest amount of socialism to provide for a common defense, other public services, and some degree of a welfare safety net. What is the right balance? That's a matter of debate.

The key is that capitalism involves greed, generating excesses that create the business cycle. Recessions invariably follow growth spurts. Growth periods are historically longer than recessions. I plan for these, by leaning toward aggressive when times are bad, and vice versa. I believe the business cycle is a function of human nature, and the downside of the personal freedom we enjoy as a capitalist society.

Conclusion

I hope that I have given you some insight into the ideas that guide my investment process. I have not discussed real estate or fixed products such as CD's, bonds, preferred stock, fixed annuities since they are generally easier to understand by their mathematical nature. I omitted discussion of structured notes and managed futures due to their esoteric applications.

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