The MONEY MONITOR

The Monitor Group, Inc.

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Past Performance Really Is No Predictor of the Future

The statement, "Past performance does not guarantee future results," appears on all mutual fund literature. Since we see it so often, however, it is easy to ignore. Yet the disclaimer is as pertinent as ever. Simply picking funds that have been on top rarely leads to strong additional gains.

As professional investors, our firm sees new clients who come to us with some strange notions about investing. People can be naive or easily forget lessons of the past. While not relying on past performance seems like a pretty basic caveat, remembering why rear-view-mirror investing is flawed is important, and understanding a professional approach is likely to give you new insight into the benefits of working with us.

Failure To Repeat. Consider the results of a January 2007 study by Standard & Poor's analyzing mutual fund performance during the five-year period ended Dec. 31, 2006. It showed that good performers one year often fail to repeat the next year.

The study evaluated large-cap, mid-cap, and small-cap funds, measuring how well each actively-managed fund performed relative to others in its class. To gauge performance, funds were grouped into quartiles. A fund that outperformed three out of four funds in its group would rank in the top 25%, or quartile, while a fund that lagged three out of four would be in the bottom quartile.

Only 13% of large-cap funds ranked in the top two quartiles of that class for each of the five years. Just 10% of mid-cap funds and 10% of small-cap funds ranked in the top two quartiles of that class for each of the five years.

Researchers then raised the bar to see how many funds ranked in the top quartile every year for five years. A mere 3% of large-cap pulled this off. Only 2.5% of mid-cap funds and none of the small-cap funds were ranked in the top quartile every year in the five-year period studied.

Of course, just because a particular fund falls out of the top ranks occasionally doesn't make it a bad investment. But the inability of the vast majority of funds to stay on top underscores the difficulty of choosing a fund based only on its record.

A fund that has done well may have succeeded for a variety of reasons. Maybe it had a great manager, or maybe it got lucky because it happened to be operating in a particularly hospitable environment. In 1999, lots of technology funds had great records. However, investors who jumped into those funds soon wished they hadn't, after the tech-stock bubble burst. A fund's long-term record, though it can be helpful in evaluating its future prospects, is only one of numerous factors to consider when selecting funds.

Selecting Funds. One way to approach fund selection is to think of it as hiring a new employee. The fund manager we select will work for you, collecting a fee in return for trying to build the value of your investment. And while screening funds is not the same as personal

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News For Fall 2007

When was the last time you saw our "Investment Tutorial"? For some of you, it may have been recently; for others, it may be many years since you heard Lynn, Glenn, Ken or me espouse our investment philosophy. One of the key points made in that presentation is that it is a mistake to select investments or managers by focusing primarily on their recent performance. The article on this page puts an exclamation mark on this point!

There is an insurance quiz on page two. If you have not taken advantage of our Risk Assessment project, please contact Tina to set up a meeting.

The Monitor Group holds itself out as a fiduciary. Do you know what this means? Please read the article at the bottom of pages two and three, if you read nothing else. We are a fiduciary first and foremost; we put your interests first. Not many brokers, advisors or planners are willing to make this statement, and live up to it. We do, and we will.

For our clients who are business owners, the issues regardin "Transferring the Family Business" on page three are quite serious and solutions are complex. We can help navigate you through these waters.

Finally, for those of you who, like me, are north of age 50, take advantage of the "catch-up" provisions of tax-deferred retirement plans. This will not only boost your retirement savings; it will also reduce your taxes. The rules can be confusing, so give us a call if you are unsure.

Cal Brown, CFP
Vice President

Can You Pass Our Insurance IQ Test?

With insurance, what you don't know can hurt your loved ones. So here's a short quiz about the basics of different types of insurance. More than three wrong indicates that you should revisit your current policy if you have one, or that you may want to consider a risk assessment meeting in our office.

1. Term life insurance:
- **a.** Generally offers year-by-year protection
- **b**. Has no cash build-up component
- **c.** Offers lower annual premiums than cash-value policies
- **d.** All of the above

2. Umbrella insurance:
- **a.** Protects against damage caused by storms
- **b.** Comes with your homeowners policy
- **c.** Covers liability for your businesses
- **d.** Is extra home and auto liability coverage

3. Term insurance prices are:
- **a**. Near an all-time low
- **b**. Near an all-time high
- **c.** About the same as five years ago
- **d.** Tied to stock market performance

4. Paying for life insurance in semi-annual installments:
- **a.** Often means paying unpaid premium balances at about the interest rate on a credit card debt
- **b.** Is usually less expensive than making a single annual payment
- **c.** Does not affect the total cost of your insurance
- **d.** Is not permitted under federal insurance law

5. Disability insurance:
- **a.** Is almost always provided by employers
- **b.** Is cheaper to buy than ever
- **c.** Has become harder to qualify for in recent years
- **d.** Has been much easier to qualify for in recent years

6. Business owners who buy long-term care insurance policies:
- **a.** Are almost never entitled to a deduction on the expense
- **b.** Can qualify for a tax deduction
- **c.** Must buy LTC policies for all of the company's employees
- **d.** Only individuals, not business owners, can buy LTC policies

7. If you're in your late 50s or early 60s and have had a life insurance policy for 15 years:
- **a.** The death benefit is probably zero if you die at your job
- **b.** The policy is probably much cheaper than any similar policy you can buy now
- **c.** You may be able to get a cheaper policy now if you're a non-smoker in good health
- **d.** None of the above

8. A second-to-die life insurance policy:
- **a.** Can ensure heirs inherit a specific amount of money
- **b.** Can ensure estate taxes are paid after parents die
- **c.** Is best considered a last resort to be used only after exhausting all other ways to reduce estate tax
- **d.** All of the above

9. Policies combining life insurance with long-term care insurance:
- **a.** Are likely to cost more than buying a term and LTC policy separately
- **b.** Are likely to offer big savings over purchasing separate policies
- **c.** Were recently cleared for sale by federal insurance regulators
- **d.** Cannot be purchased by those over age 65

10. A cash-value life insurance policy:
- **a.** Could be a whole life or universal life policy
- **b.** Gives you an investment account
- **c.** Stays in effect as long as you pay your premiums
- **d.** All of the above

Answers: 1.d, 2.d, 3.a, 4.a, 5.c, 6. b, 7.c, 8.d, 9. a, 10. d

When Your Financial Advisor Accepts The Role Of Fiduciary,

In the world of financial advisors there are myriad labels, certifications, registrations, and other terms that tend to be meaningful only to industry insiders. But one distinction could be crucial: An advisor bound by contract or law to serve as a "fiduciary" is obligated to act solely in your best interest. That's different from others who may seem to work for you but in fact owe primary allegiance to the companies that pay them.

With other professionals, such as lawyers and CPAs, there's typically a fiduciary responsibility that requires them to act in clients' best interests. But for financial advisors, fiduciary status is not yet standardized or guaranteed. So while you may think your stockbroker offers unbiased advice, he or she is probably receiving a commission for selling you products. To complicate matters, even a fee-based advisor who charges for advice may not be acting solely in your interest.

Not surprisingly, there's widespread confusion among consumers on this point. According to a recent survey by a major financial services firm:

- More than half of the investors interviewed believed both stockbrokers and Registered Investment Advisors (RIAs) have an obligation to act in the client's best interests.
- Three out of four investors didn't realize that only independent RIAs have a fiduciary duty to their clients.

RIAs must inform clients of potential conflicts of interest, and they're legally obligated to act as a fiduciary. They have a fiduciary duty to act in their clients' interest at all times. Stockbrokers don't have the same obligation. Brokers must make recommendations that are suitable but are not required to adhere to the higher standard of care—to always do what's in your best interest—as a fiduciary.

Transferring The Family Business

If it were easy to hand off a business to the next generation, more than just one in three would successfully complete the trip. As it is, many factors contribute to a high mortality rate for family companies. Estate and gift taxes take a toll, and so do family conflicts about who will take over, how to compensate heirs who don't work in the business, and how to keep the company safe from divorcing spouses and creditors who want a piece of the action. A well-thought-out plan can head off many problems, but what works for one family may be wrong for another.

Gift and estate taxes kill many family firms. Though the first $2 million of an individual's estate is currently shielded from estate taxes, inheritors of a company worth, say, $4 million, might owe almost $2 million in taxes, and coming up with the cash often means selling assets or the business itself. Meanwhile, giving away a business before death could trigger punishing gift taxes that kick in after you've used up a $1 million lifetime gift-tax exclusion.

The simplest solution is to transfer ownership of a company gradually, or to fund a trust that helps reduce taxes. There's an annual gift-tax exemption that permits tax-free gifts of as much as $12,000 to an unlimited number of recipients. Such relatively small gifts add up over many years, particularly if you take advantage of techniques the IRS allows for discounting a gift's value. But a gradual transfer requires a sound succession plan and the right business structure.

You may want to begin plotting your exit from a business years before you leave. An early start lets you groom your successors and choose a business entity

that serves your ends. It also gives you a chance to see who among your heirs is interested in working in the business and perhaps one day taking the helm. Meanwhile, you can consider how to structure your estate to provide fair compensation to heirs who choose a different career.

You won't be able to transfer your business piecemeal if it's organized as a sole proprietorship, which must change hands all at once. Shares in most other business entities—so-called C and S corporations, limited liability companies (LLCs), and limited partnerships (LPs)—can be broken out and given away a few at a time, and you may be able to retain management control even when you become a minority shareholder. Moreover, if children can't sell their stakes, the IRS considers the shares to be worth less than their full market value—so that, say, an $18,000 piece of your business that you give to your daughter might count as a gift-tax-exempt transfer of $12,000. But you'll need an entity that passes muster with an increasingly wary IRS. Owners who want to transfer value but keep management control must be particularly careful.

Various trusts can help reduce gift and estate taxes, deal with control issues, and shield personal assets from creditors. For example, you could sell the company to a grantor trust created for your heirs. You'd get an IOU, and the business would gradually pay for the shares transferred into it. Or you could set up a grantor retained annuity trust, or GRAT. If the company gains value at a rate exceeding an interest rate set by the IRS, you could end up with a major break on gift and estate taxes.

Regardless of how your business is constituted, and however you decide to hand it off to your heirs, you need a formal buy-sell agreement spelling out what happens if you die unexpectedly or simply choose to walk away from the company. Such an agreement obligates partners or heirs to purchase your share according to a specified formula, and it's typically funded with life insurance on you and other owners—likely the heirs to whom you've begun to transfer ownership. If you die, surviving owners get the proceeds and can buy back your stake.

Almost all of these strategies require an accurate fix on what your business is worth, and that means periodic assessments by a professional business appraiser. We can help you find one and work with you on a succession plan that reflects the make-up and goals of your family and business. ●

You Have A Foundation For Trust

The distinction between an advisor who is a fiduciary and one who is not could be critical when weighing an advisor's recommendations. There may be a hidden agenda—for example, if an advisor is receiving better commissions for selling you one mutual fund instead of another.

Rules recently clarified by the Securities & Exchange Commission permit brokers to give you investment advice on a fee basis and not act as a fiduciary. In these instances, a broker can only give you advice about one or two issues—such as your retirement plan or investing. If a broker wishes to give you comprehensive financial advice that spans insurance, taxation, college planning and estate planning as well as investing and retirement planning, the broker must accept his or her role as a fiduciary to you. He must disclose that he will begin giving you advice as a fiduciary and then tell you when he has stopped acting as a fiduciary and reverted back to his role as your stockbroker.

Working with someone who is a fiduciary like the Monitor Group doesn't guarantee you'll profit from the advisor's recommendations. But it does give you a greater assurance that you're both sitting on the same side of the table.●

Time To Catch Up On Retirement Savings?

If you are age 50 or older and still working, Congress gave you a golden savings opportunity when it adopted the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Since this provision of the tax code is still relatively new and only affects the over-50 crowd, it is often overlooked. But it is significant.

EGTRRA lets older workers kick in several thousand dollars extra each year to "catch up" on retirement saving. If you're in your early 50s and have another decade or more to save for retirement, this can compound into a significant sum. Though companies don't have to permit catch-up savings in their retirement plans, and some were slow to get with the program, most corporate plans have now fallen into line.

For 401(k), 403(b), and eligible government 457 retirement plans, EGTRRA has steadily lifted the ceiling for the amount of pre-tax money you're allowed to put away. The maximum is now $15,500. Beyond that, there could be additional increases, indexed to inflation, though the 2001 tax law is scheduled to expire after 2010 unless Congress moves to extend it.

Meanwhile, if you're at least 50, your company may let you make an additional catch-up contribution of $5,000. If you're a business owner, you can squirrel away 25% of your income , up to $45,000 — and then make a $5,000 catch-up contribution.

Because older workers are more likely to be at the high end of the salary spectrum, some retirement plan administrators initially worried that allowing catch-up contributions would cause their plans to fail non-discrimination tests. These tests limit contributions by a company's higher-paid employees if lower-paid workers don't invest enough in the company plan. But in a recent ruling, the IRS exempted catch-up contributions from non-discrimination tests. That also means that if you're an executive who is subject to non-discrimination rules and are normally limited to, say, an $8,000 annual contribution, you can still put in that extra $5,000, assuming your company lets workers play catch-up. Nine out of 10 large companies now do, according to a recent survey by consulting firm Hewitt Associates.

How much difference can catch-up contributions make? Suppose you're 50 and make a contribution of $15,000 this year and add in the $5,000 catch-up. For simplicity's sake, let's assume your company doesn't match your contributions, EGTTRA is extended, and you sock away that same $20,000 each year for 15 years. If you earn a 7% return, your 401(k) balance would be $659,039.26 at age 65 and $1,054,288.25 at age 70. Without the extra $5,000 you'd have just $540,961.39 in 15 years and $856,893.69 in 20 years. If you're a little behind on your retirement savings plan, that kind of impact is hard to ignore. ●

Past Performance

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interviews with managers, exploring a manager's areas of specialization, track record, and investment style is informative. Some other factors we consider include:

- Whether the fund manager deviated from the fund's strategy—for example, if it's a government bond fund, does the manager sometimes buy riskier high-yield bonds or growth stocks to boost returns? How much of the fund's portfolio was involved?
- How much money is flowing into the fund? Often, funds get popular after they've been successful. But a flood of new money can overwhelm a manager and cause performance to drag.
- How has the manager responded when the fund's investments are out of favor? Has he managed to eke out a positive return even during tough times? Or is his style to stay fully invested? This could affect your asset allocation and needs to be anticipated.
- Other factors to consider include the fund's expense ratio, tax efficiency, trading history, the team surrounding the fund manager, and the fund company's reputation.

Past performance is a factor in the selection process, but primarily as a tool for evaluating the manager. Consistent returns, for example, could indicate a steady management style that does not chase fads. Rather than considering returns alone, it helps to compare the fund's track record with an appropriate benchmark. How did the fund performance stack up against an index of large-company stocks, for instance?

Some fund selection can also be influenced by economic factors or the prospects of a particular industry sector. This could lead to market timing, which has been shown by many studies to be ineffective and risky. The Monitor Group believes in staying fully invested across carefully selected and monitored broad asset classes discounting both the use of sector funds and the inefficiencies of market timing.

The bottom line is that a fund's past performance doesn't ensure returns in the future. A manager's track record, consistency, methodology, and experience must be considered, but these factors are only part of the equation. Fund selection needs to give consideration to your personal needs, tax situation, and other assets you own. If you would like a refresher on The Monitor Group's Investment Philosophy, just let us know so at your next review meeting, we can discuss it.

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