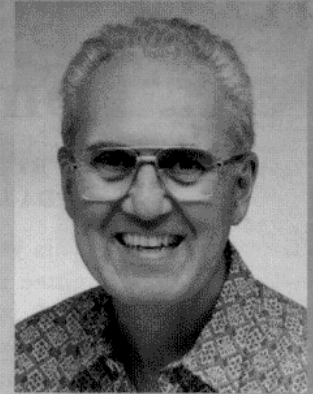


# \$mart Money Management

BY RON MILLER, DDS, AFP  
Financial Feature Section Editor



*I was honored when Dr. George Wessberg asked me to be responsible for a few articles for this edition of the HDA Journal. His only instruction was to cover something in the area of financial planning or investing. Regardless of your interest in this area, these are topics that you ignore at your own peril.*

*One area of investing that I was first exposed to in 1982, while taking the necessary academic requirements to become a Certified Financial Planner, was how to establish a Written Investment Policy. I believe it's as fundamental and important to investing as doing a proper diagnosis is to the practice of dentistry.*

*After an Investment Policy is established, the how-to of investing becomes the issue. For that I called on my friend and fellow classmate during our formal financial planning education. Robert Priske is a CFP and CPA and is located in the Kahala area. He currently manages \$50 million of pension plan investments. Most of that belongs to health care professionals. That is an awesome responsibility.*

*We both hope you gain a few insights from these articles and wish you the greatest success in this important aspect of your life.*

## Written Investment Policy In An Era Of Confidence

BY RON MILLER, DDS, AFP

How sweet it has been since 1982 for U.S. stock investors. As of December 1999, the S&P 500 has compounded at an 18.9 percent rate annually since August 1982. That percentage growth transferred to a home purchased for \$125,000 in 1982 would have brought that home's value to an incredible \$2,820,000 by December 1999. It's been very strong tailwinds indeed, making it relatively easy to achieve U.S. stock investing success for most investors these last two decades.

Will the equity markets continue to grow at that pace? It is not likely. Over the last 70 years, major market highs have occurred when dividend yield fell below 3 percent, or when the P/E ratio started rising 20 times above earnings, or when the total market value of our equity markets reached the area of 80 percent of our gross domestic product. Where are we as of April 2000? Dividend yield is slightly above 1 percent, P/E ratios are around 32 times last year's earnings and our \$17 trillion

stock market is 180 percent of our \$9.4 trillion gross domestic product. Certainly U.S. stock markets are more richly priced than at any time in the past.

A little over a decade ago, in 1989, innovation, growth, productivity, superior products, surpluses, low inflation and unemployment defined the Japanese economy. That was reflected in the Tokyo Nikkei stock market index hitting almost 40,000 that year. Nine years later, in 1998, the Nikkei Index dipped to a low of 13,000. That is the equivalent of the Dow Jones Industrial average dropping from its 11,900 high to 3,867. Could anything like that occur in the U.S.A.? I'm about 99 percent certain it will not. However, if they took a survey in Japan in 1989 to predict where the Nikkei would be at in 1998, I would guess that 99 percent of the people knowledgeable about those things would not have predicted a lower — much less a 67 percent lower — Tokyo Nikkei in 1998.

The main point is that stock market

performances are not actuarial tables that can be extrapolated from historic performance with certainty. The rewards come much more randomly than most people believe or currently expect.

But it's even worse than that. Charles Ellis said in his book *Winning The Losers Game*: "The crucial question is not simply whether long-term returns on common stocks would exceed returns on bonds or treasury bills if the investor held on through the many startling gyrations of the market. The crucial question is whether the investor will, in fact hold on. The problem is not in the market but in ourselves, our perception and our reaction to our perceptions."

We all react differently when we are losing money in the stock market and perceive that we may continue to lose even more money over time. For some, especially in a long, protracted bear market, the discovery that they have committed too much of their wealth to stocks comes too late. The emotion of concern turns to fear and then panic, which overwhelms them. They end up getting out of the bear market at what may be the worse possible time.

Regardless of all of these potential problems, historically over long periods of time, investing in equities has been the best and safest way of accumulating wealth. It's necessary though to be prepared for the times when the equity markets are not cooperating and also when they are providing more than can rationally be expected.

One of the best ways to do this is to have a written investment policy. Ideally it should be written before you begin investing in equities. Even if you are already investing, taking the time to write a well thought out investment policy may prove invaluable. Your written investment policy is something that you have the primary responsibility to participate in and develop. It can be done on your own or with the help of an investment advisor.

What will a carefully thought out written investment policy do for you? First, because it is in writing, it can be referred to at critical times. It will greatly reduce the chances that you will make irrational investment decisions when speculative euphoria or panic in the markets is most likely to overwhelm you. It will customize your investments to your risk tolerance. It gives you and your investment professional guidelines to follow before deciding on how your assets will be allocated and invested. Here are a few guidelines on how to go about writing up an investment policy:

A written investment policy must be explicit enough that "a competent stranger" would be able to manage your assets. There should be no spoken or unspoken understandings between you and your investment professional that do not appear in the written policy.

## **FIVE ELEMENTS OF A POLICY**

An investment policy is a dynamic document and should be modified as your personal circumstances change. It should contain a minimum of five elements:

**1. A clear statement of your financial goal.** The goal may be stated in relative terms, such as: "Obtain an annual rate of return equal to that of the S&P 500 for equity portions of the portfolio and equal to that of intermediate-term U.S. Treasury securities for the fixed-income portion of the portfolio,"

or "Provide an overall annual portfolio rate of return at least 5 percent above the level of inflation as measured by the consumer price index."

**2. A statement of those investment vehicles deemed suitable (and unsuitable) for your portfolio, and how they should be managed.** For example: "The portfolio may invest in individual common stocks, mutual funds (both closed and open ended), bonds with maturities under 15 years, loan participation funds and money market funds. At this time gold or gold stocks are not to be considered. Stocks with P/E ratios over 50 are also not to be considered."

**3. A statement of risk level acceptable to you, as well as how risk will be managed or controlled.** "The portfolio will be constructed to fluctuate no more than 50 percent of what the market does. This will be done by never having more than 50 percent of total assets in stocks. It will also be done through diversification, never having stocks with P/E ratios over 30, rota-

tion from long-term to short-term bonds under specific conditions, etc."

**4. A statement of how your assets should be roughly allocated among the suitable investment vehicles and a statement of the philosophy under which they should be managed.** For example: "The portfolio should be allocated 60 percent equity assets and 40 percent fixed assets under normal conditions. Only after at least a 30 percent stock market decline will consideration be given to allocating up to 70 percent of the portfolio to equity assets. Under no circumstances will the allocation to equity assets go beyond 70 percent equity assets or under 50 percent equity assets. The portfolio will be immediately rebalanced any time this 70 percent to 50 percent range is violated."

**5. A provision for periodic review.** For example: "Investment performance will be reviewed annually, using appropriate and objective benchmarks."

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## Written Investment Policy

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### SAMPLE INVESTMENT POLICIES

1. The expected time horizon of the first portfolio is 35 years. This policy pertains only to the assets now in the tax shelter pension plan and any future contributions made. It is expected that over the next 15 years, \$30,000 will be added to the plan annually. This pension plan will be the primary source of retirement income. The equity portion will be 75 percent and the fixed asset portion will be 25 percent. No attempt will be made to better the market averages. The entire equity portfolio will be invested in Index funds representing various market indexes. Because of their lower management fees, Vanguard index funds will be the funds of choice. The indexes will include about 25 percent in the S&P 500, 20 percent in foreign index funds, 15 percent in a small cap and 15 percent in a REITs index fund. The fixed portion will be invested in intermediate-term U.S. government bonds. No attempt will be

made to time the market and the entire equity portfolio will be fully invested at all times. Buying and holding will be the rule. The percentages allocated to the various indices will not vary by more than 10 percent of the established percentages. This policy will be reviewed every two years or when a major live change occurs.

2. The time horizon of a second portfolio is 30 years. The portfolio will have 4 percent of its funds withdrawn every year beginning in five years. No additional contributions to the portfolio will be made. Equities and fixed assets outside of the tax-sheltered portfolios are to be considered part of the asset allocation. The average split between fixed and equity assets are 60 percent equities and 40 percent fixed assets. The portfolio in general is never to go above 60 percent equity assets or below 50 percent of equity assets. The only exception would be to purchase individual quality stocks if they are selling at the low end of their range after a 25 percent-plus market correction. In that event up to a 70 percent temporary equity position will be taken. The portfolio is to be evaluated for a rebalance

on an annual basis. It is intended that the remainder of the portfolio will ultimately be passed on to our children with the funds still remaining in the tax sheltered vehicle. Large charitable contributions are expected to be made as the portfolio grows. The goal is to grow the portfolio at least 5 percent above the inflation rate over the life of the portfolio. The equity portion will be compared annually against the S&P 500 and the fixed portion annually against the long term U.S. government bond index.

Smoothing the volatility of the portfolio is a concern now and is expected to become a greater concern as time passes. The primary method to do this is by investing in a large variety of asset categories of which I have a reasonable understanding. Fixed assets can include but are not limited to: Cash, MM funds, U.S. Treasury Notes, Bills and Bonds, Convertible Bonds, Mortgage Backed Securities and Loan Participation Funds. The Equity portion will consist of: Domestic Stocks (Large Cap, Medium Cap, Small Cap and REITs). Value style of investing will be favored, however Growth and Eclectic with discounts will be considered. Mutual funds (both open end and closed end with discounts) will be considered. Foreign Stocks through both open and closed end mutual funds may be purchased. Gold related issues are not to be considered at this time. This Policy will be evaluated every two years.

### GUIDELINE FOR ALLOCATING YOUR WEALTH

Here is one last bit of advice: When deciding on how much of your wealth will be allocated to fixed assets, such as Bonds, Treasury Bills, MM funds, CDs, etc., choose on the consequences of having too little in these fixed assets. One thing about boring CDs, Bonds and Treasury Bills is the interest is predictable and can be relied upon. If you are nearing retirement, it is wise to have enough money in those types of assets to take care of your basic living expenses.

*Ron Miller, DDS, AFP successfully completed the necessary academic requirements to become a Certified Financial Planner in the early 1980s. He has also completed several courses on investing and financial planning through the College of Financial Planning in Denver, Colorado.*