



## INVESTMENT OUTLOOK

January 2006

We are pleased to be writing our first newsletter in almost two years. I never meant for this to be a regularly written project. Instead, I always said that I would write it only when I have something to say. And so, my friends, the good news of the day is that all the news is no longer bad.

My daughter has long accused me of being the biggest optimist she has ever known. Optimism is a frame of mind that allows one to seek out opportunities that pessimists might turn their backs on. An optimist can and should use proper caution but the distinction is best made by saying that I see the glass half full rather than half empty.

Turning to the world of investments, let's go back a few years and borrow some thoughts that I expressed in my booklet, *The Volatility Buffering Strategy*. In projecting the future performance of the stock market, I don't believe anyone would expect the market to increase in value every year. Historically, the market has declined about once every three and a half years. Because of that, a ten-year plan has to assume that three of those years will be down. A 20-year plan would assume that seven of those years would have negative results. And so, if we look back at the twenty years running from 1985 to 2004, there were only five losing years... namely 1990, 1994, 2000, 2001 and 2002. Who would have thought that three of the five bad years would come back-to-back-to-back? In spite of those three consecutive bad years, over those twenty years the Dow Jones Industrial Average (DJIA) grew by an average annual rate of 11.55% while the S&P 500 Index (S&P) averaged a 10.41% annual increase. If you had been offered a twenty-year future growth rate of 10% or 11% at the end of 1984, would you have grabbed it?

The real problem is not the growth rate or the ability to continue to achieve this level of results. The problem is "Volatility" and the inability that most people have to understand it **at an emotional level**. There is a tendency for persons who invest to keep an eagle eye on their holdings. Increases in value are wonderful but decreases are apocalyptic. I befriended a very successful private money manager in New York who handles several billion dollars for high net worth clients. His philosophy is to run safe portfolios of blue chip stocks and bonds. In reflecting upon the 2000 to 2002 period, he chuckled when he said, "There were no safe harbors." In other words, everyone went down. And in 2003 and 2004 everyone came back up. Over those two years, the DJIA bounced back up by 29% while the S&P grew by 37%. They did not take us back to where we were in December 1999, but the growth at that level was riding a boom created greatly by the Technology sector and the fear of Y2K. Retrospectively, prices were just too high at that point and we all should have sold all of our holdings. Wasn't Bernard Baruch the person who sold everything just before the 1929 crash? Ah... if we only had his vision.

If volatility is the problem we have to handle with our emotions, perhaps we need to think through a method that removes us from the controls. In my booklet, I gave you the answers. The secret to successful investing was based on three things, namely, Diversification, Professional Management and a Tax Free (or Tax Deferred) environment.

Diversification tells us not to put all of our eggs into one basket. No matter how good an investment seems, there is risk associated with concentrating one's wealth in a single investment. Thirty years ago, Lockheed was going through its bankruptcy and it was pointed out how many persons not only lost their jobs, but their savings were heavily invested in the Lockheed Employee Stock Purchase Plan and their Pension was funded by Lockheed stock. Chrysler went through the same problem, as did Enron, Lucent and a number of other companies. I have a client I met in 1999 who will remember when I told them that having almost 50% of their assets invested in Lucent was an over concentration. They responded by saying, "We will not sell any of our Lucent stock." To me, Diversification means using a large cross section of investment opportunities so that no single asset class can hurt us and that we will be participants in the gains in any class. Diversification by asset class is very important in the long run. We not only mean large, medium and small cap stocks, but Value investments as well as Growth Investments. It was the Growth investments that gave us our run in the late 1990's and collapsed beginning in 2000. Meanwhile Value funds were flat in the late 1990's but held up and showed gains over the past five years. Professional Management places the control of our buying and selling into the hands of people whose business it is to know what to do. It doesn't always work out perfectly. Will Danoff runs the Fidelity Contrafund and did so successfully for years. His philosophy was to look for the stock of good companies that had gone down for some reason, buy it, and then sell on the rebound. On average, he held his investments for six months. For years, Contrafund showed a performance history of over 20% per year for 1-year, 3-years, 5-years, 10-years, 15-years, etc. They faced a challenge as everyone did in 2000-2002. They would buy a good stock that had gone down,

but six months later, it was lower. Even the great Contrafund showed losses during those three years (“There were no safe harbors”) but Contrafund is now on its way to returning to its old successful days. More to the point, professional managers have quicker access to information, they understand better how to use the information, and they stay on top of their portfolios at all times.

A non-taxable or tax deferred environment permits your investments to be managed without having to give up any of your current gain for taxes. Fidelity Contrafund’s rapid portfolio turnover would drastically truncate their gains if held in a taxable environment. If you can earn 10% and are in the 30% tax bracket, your net gain of 7% doubles your money every ten years. If your account is held in a tax deferred or non-taxable environment, you don’t pay current taxes. You keep the full 10%, which doubles your money every seven years. After 20 years, the taxable environment would have doubled your money twice. \$100,000 grew to \$200,000 and then \$400,000. In a tax deferred or non-taxable environment, however, your account would have grown to almost \$800,000. If you then begin drawing income, it doesn’t take much to realize that the income on \$800,000 at any tax rate would be greater than the income on \$400,000 that would also be taxable.

A well-diversified portfolio in the hands of professional managers allows you to consider your portfolio almost on cruise control. What you need to stay on top of is whether there is any change in the management of your fund. To that extent, the oversight provided by Variable Annuity and Variable Life insurance providers makes sure that funds perform consistent with the expectations one could reasonably ask of their class. For example, in the late 1990’s, I was a participant in a deferred compensation plan over which I had little control. The sponsoring company placed all the investments with Kemper, a management company I did not particularly like. Going against my philosophy but going with the times, I put all of my money into Kemper’s Technology Fund. At the end of the year, it had gone up 109%. But in ranking the fund among all Technology funds, it was 61<sup>st</sup> among 65 such funds. The top fund had grown 450% that year and the median growth was 250%. Clearly, that fund needed to be replaced and it was. The plan was moved to Fidelity.

We’ve taken a look at the performance of the variable accounts our clients have held for almost ten years. We can give you some numbers through November 30, 2005. Using the twelve funds in the model, the One-Year growth is 14.06% compared to the DJIA’s 3.62% and the S&P’s 6.45%. Our 3-year history is a compounded 15.85% compared to the DJIA’s 6.70% and the S&P’s 10.10%. Our 5-year history is a compounded gain of 2.74% compared to the DJIA’s gain of 0.74% and the S&P’s loss of -1.02%. Not enough of the funds have 10-year histories inside our annuities but those that do give us a compound growth rate of just under 10%. We can give you these histories for your account if you ask us.

Interest rates remain low even though short-term rates have climbed from their extremely low base of two years ago. Mortgage rates are up only slightly. Employers still can’t find all the qualified people they are looking for suggesting that unemployment is not all that bad. Large corporations are reporting profits. Well-run smaller companies are doing extremely well. The news from the mid-east is better than it was a year ago in spite of the continued horrible loss of life. We like what we see and invite you to discuss it with us regarding your existing and future investments.

For those of you who simply distrust the market and feel that you’ve had it, and are frustrated by the low interest rates available on your savings accounts, don’t forget Indexed Accounts. We’ve written about them before. Indexed accounts provide you with participation in the upside of the stock market and protect you from any loss. Over the term of the contract, you simply cannot lose. You have a guaranteed minimum gain such as 1½% per year, but you pick up larger gains when the market moves up. Your gains are then locked in every year or two, depending upon the contract. Indexed accounts are not investments. They are fixed annuities in which the interest that is credited to your account is based upon the performance of the stock market. Down years have no effect on your values. This is a place to invest your “Safe Money” where you are looking for an average of 6% to 8% over a period of time.

Looking to the future, we can assist you with setting up your long-term investment strategies using a variety of investment concepts. We take you through a goal setting process that considers your opportunities and needs as well as your fears and doubts. The objective of working together using such a process is that three or five years from now it will give us a benchmark from which to determine your success. It’s one thing to recite past results. It’s quite another thing for the outcome of your investment strategy to be the result of a unique personal action plan that we created together. Please contact our office when you are ready to move ahead. I look forward to working with you.

We wish you a tremendous year for 2006.

**Paul A. Gomperz, CLU, ChFC**  
**1 – 888 - PLAN AHEAD**  
**[pgomperz@vbcorp.com](mailto:pgomperz@vbcorp.com)**  
**Visit our website at [www.vbcorp.com](http://www.vbcorp.com)**

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