

SPECIAL REPORT

April 3, 2010

Telling You What Wall Street Doesn't Want You To Know

STRETTALKADVISORS

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ABOUT MARKET MYTHS

THESE ARE ARTICLES THAT WILL ADDRESS INVESTING STRATEGIES, UNCOVER TRUTHS ABOUT MONEY MANAGEMENT AND HELP GUIDE YOU THROUGH THE TRAPS AND PITFALLS OF PLANNING AND SAVING FOR RETIREMENT.

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Savings vs. Investing

Each week I get lots and lots of emails about whether one should contribute the maximum amount to their 401(k) plan at work, which stocks to buy that will go up, plus tons of questions about some stock or investment strategy that was recommended on television or in an article.

Our responses to these questions are generally met with disappointment, skepticism and / or downright frustration. Why, because most investors have been taught to believe that investing in stocks and mutual funds is HOW you get rich. In reality, very, very few people have ever gotten rich investing. Most wealthy people have gotten rich by saving money, living below their means, and saving more money. Wall Street doesn't want you to know this, of course, because if you begin to save money Wall Street makes less of it.

The media and Wall Street wants you to believe that investing is the secret to getting rich and all you have to do is to win at the "beat the market" game each year to do it. So, each year you dutifully sit down and calculate your return for the year to find out whether you and/or your advisor won or lost the game. Most likely....you lost.

There it is though...right there on paper...you underperformed some benchmark index and now you feel bad. The more you stare at the number; the poorer you feel. After all, since everyone else must have beat their benchmark index, they are now all richer than you....right? Then you turn on the media soapbox and the "parade of nonsense" begins about how you must move your money from here to there and do this and that to get rich. After all, CNBC has now taken on the mantra to "Make You Rich" so this must be the way to do it, right. Wrong! Think about it for a minute. If, every fund, every manager, and every stock picker were able to beat some arbitrary benchmark index, then by the very fact that they are all buying investments that are going up MORE than the benchmark index, will make the benchmark index go up. That is why 80% of all investment managers and mutual funds fail to win at the "Beat The Market" game each year.

Wall Street Wants You To Compare

Tom Dorsey of Dorsey Wright & Associates once wrote; *"Comparison is the cause of more unhappiness in the world than anything else. Perhaps it is inevitable that human beings as social animals have an urge to compare themselves with one another. Maybe it is just because we are all terminally insecure in some cosmic sense. Social comparison comes in many different guises. 'Keeping up with the Joneses,' is one well-known way.*

If your boss gave you a Mercedes as a yearly bonus, you would be thrilled—right up until you found out everyone else in the office got two cars. Then you are ticked. But really, are you deprived for getting a Mercedes? Isn't that enough? Comparison-created unhappiness and insecurity is pervasive, judging from the amount of spam touting various enlargement procedures for males and females. The basic principle seems to be that whatever we have is enough, until we see someone else who has more.

Whatever the reason, comparison in financial markets can lead to remarkably bad decisions.

Comparison in the financial arena is the main reason clients have trouble patiently sitting on their hands, letting whatever process they are comfortable with work for them. They get waylaid by some comparison along the way and lose their focus. If you tell a client that they made 12% on their account, they are very pleased. If you subsequently inform

them that “everyone else” made 14%, you have made them upset. The whole financial services industry, as it is constructed now, is predicated on making people upset so they will move their money around in a frenzy. **Money in motion creates fees and commissions.** The creation of more and more benchmarks and style boxes is nothing more than the creation of more things to COMPARE to, allowing clients to stay in a perpetual state of outrage.”

The secret to winning at the “long term” investment game is establishing an investment goal that will ensure that you reach your ultimate objective with the least amount of risk possible.

Goal Based Investing

The first thing that we do with each and every client that walks in our door is to establish their investing goals. More often than not investors have no idea what their money is supposed to be doing for them on a day to day basis. For the most part they think that if they buy stocks that those investments will ultimately go up and make them wealthy. Without a clear understanding of what their money is supposed to do for them – investors generally take on too much risk and make investing decisions based on emotions rather than a strategy.

One big contributor to this problem is that investors began marking their goals on the basis of an all equity index’s performance or some level of comparison in the traditional sense.

If you want to be happy, the first thing you need to do is eliminate that which is making you unhappy—all of the comparisons. Clients who have learned the wisdom of “**enough**” are content. Their benchmark is not an artificial one, but one based on their own goals and risk tolerance. They are comfortable that their risk is being managed and understand the game plan for getting from **Point A** (where they are now) to **Point B** (retirement, or wherever they want to get to in the future). **They invest to obtain their goals with as little risk as possible.**

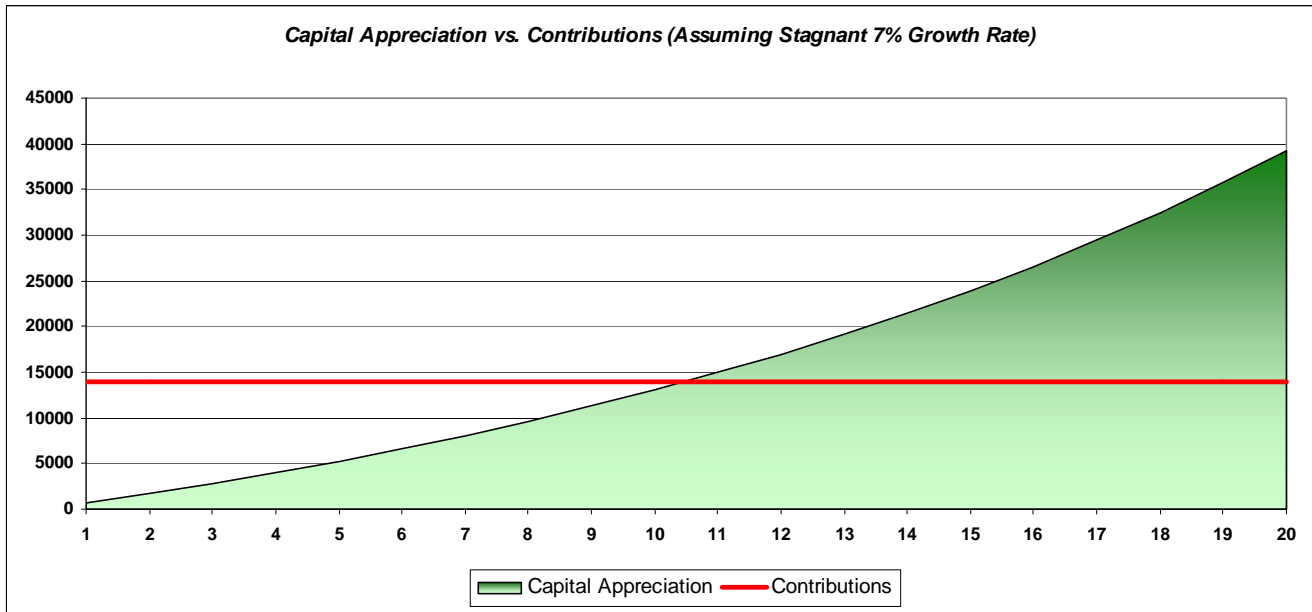
Being A Smarter Investor

Being a smarter investor begins with having a goal, backed by a discipline and wrapped in a strategy. Sound complicated? It’s not. The problem with most investors is that there is no method to their investing madness. Most people approach their investing by listening to some financial expert on television talk about a particular stock or mutual fund and how it has performed in the past, so they buy it, thinking it will continue to perform the same way for years to come. This is a deadly mistake – but more on this in a minute.

The financial markets are not casinos – they are a tool to help grow your **SAVINGS**. That’s right – the first step to becoming a successful investor is to **Save Money Like Crazy**. If you read the book “*The Millionaire Next Door*” you will find that most millionaires make their money in business and/or by **saving lots of money and living frugally**.

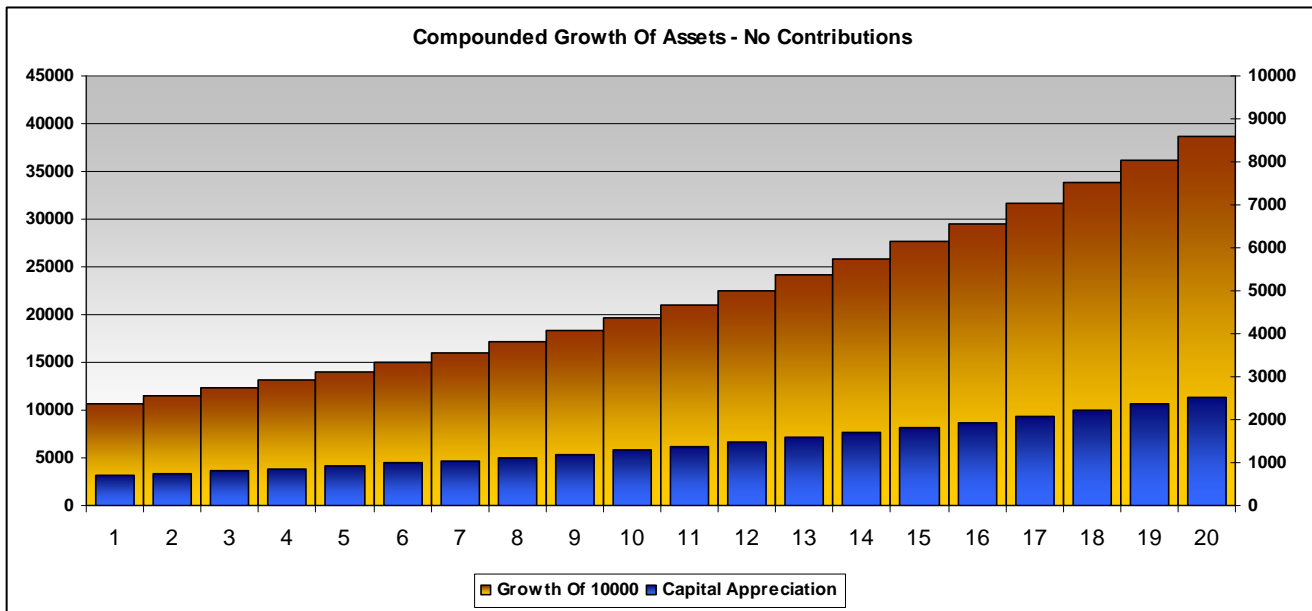
Very few make it by simply investing skills alone. Odds are that you will not be that person.

In the chart below, we are going to assume for the moment that the market grows by 7% each year and we are going to start with a \$10,000 dollar investment into the market through our 401(k) plan at work so we don’t have to worry about the effect of taxes. We are also going to assume that we contribute the maximum amount of \$14,000 a year to the plan.

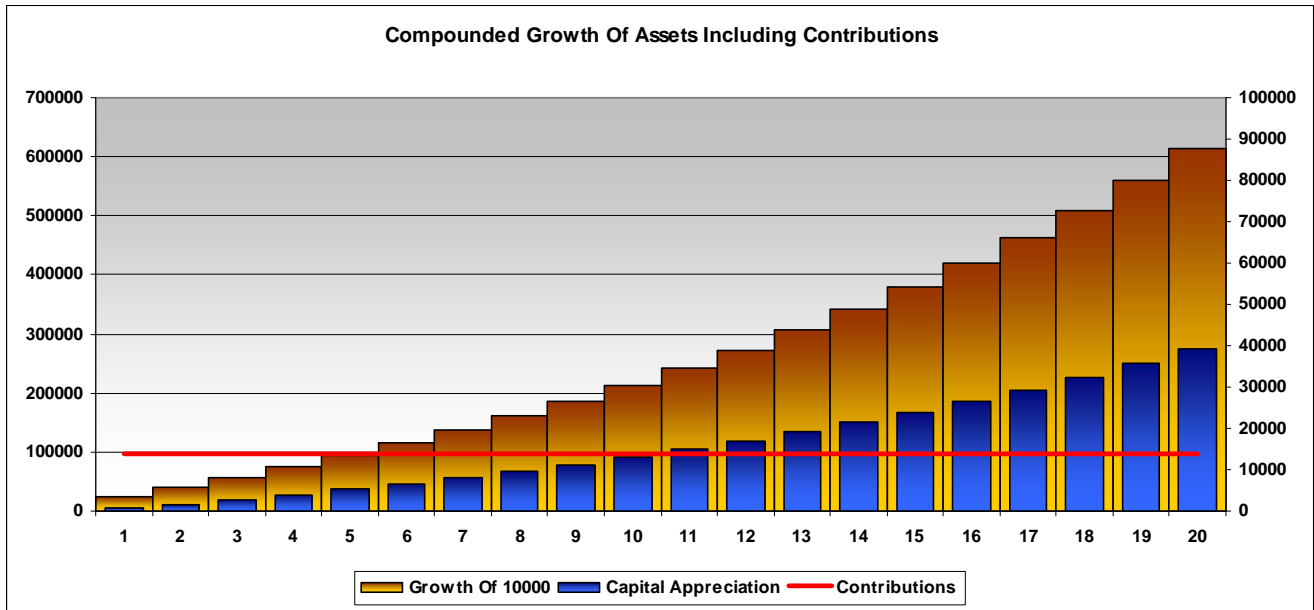


As you can see in the chart above it takes almost 11 years of saving money BEFORE the returns from our investments outpace our annual contributions. Let’s look at this in a different way.

In the chart below you will see the same idea but WITHOUT the annual contributions of \$14,000 per year. A lot of investors open accounts, buy some stocks or mutual funds, then sit back to watch it grow because they bought in for the “long term”. In our example, you will see below the value of the portfolio (gold) and the capital appreciation (blue) being compounded over our 20 year time period. As you will see the portfolio over 20 years grows from our initial 10,000 to almost \$40,000. Not too bad assuming you got a 7% return every year.



However, once you begin “watering the garden” every year with your annual contributions you can see the effect on the growth of the portfolio. The chart below shows the effect of combining capital appreciation (blue) with annual savings (red) on the total value of the investment portfolio (gold). Now our wealth goes from \$40,000 to \$600,000.



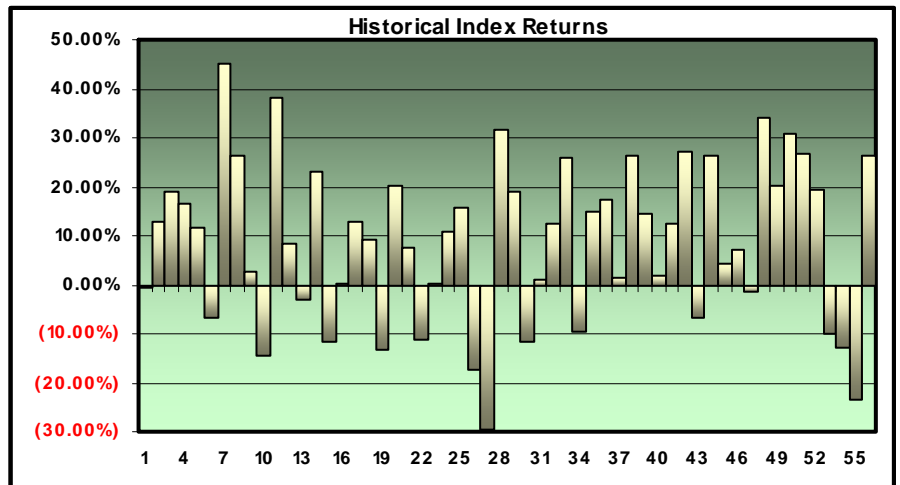
Saving money and regularly investing into a growing portfolio is THE most important factor to building wealth particularly in the early years. Over a 20 year investment period the compounded effect of growing your money at 7% a year can create enormous wealth.

Problem: Markets Don't Grow At 7% A Year

If you want to achieve the graph above DON'T invest in the stock market...buy bonds. Why, because fixed income investments WILL provide an annual return every year over a period of time. The stock market does not. The chart below shows the actual returns of the S&P 500 over the last 55 years.

The AVERAGE return of the chart to the right is 8.9% annually. The problem is that if you invested in the market over that period of time you did NOT receive 8.9% annually. As you will notice there are plenty of periods where the market took away a large amount of your savings.

The problem with chasing a benchmark index like the one in the chart to the right is that you are going to not only get the up years but the down years as well.

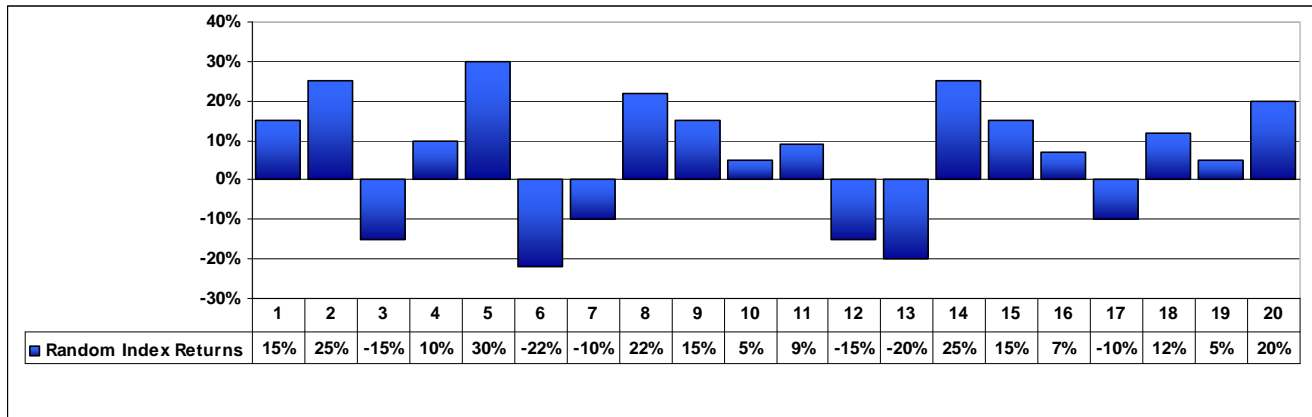


I have never met anyone who was happy when the market was down 15% and their mutual fund was down 14%. They won the "beat the market" game but still weren't happy. Bottom line: Everyone wants the up years, no one likes the down years. Reality: If you invest in the market you are going to have down years. There is a better way though.

Absolute Versus Relative Returns

I have had many discussions with clients, prospects and listeners about the idea of “**absolute returns**” in portfolio management versus “**relative returns**”. The most common response to the discussion generally begins with – “*I understood the part up to where you started speaking.*”

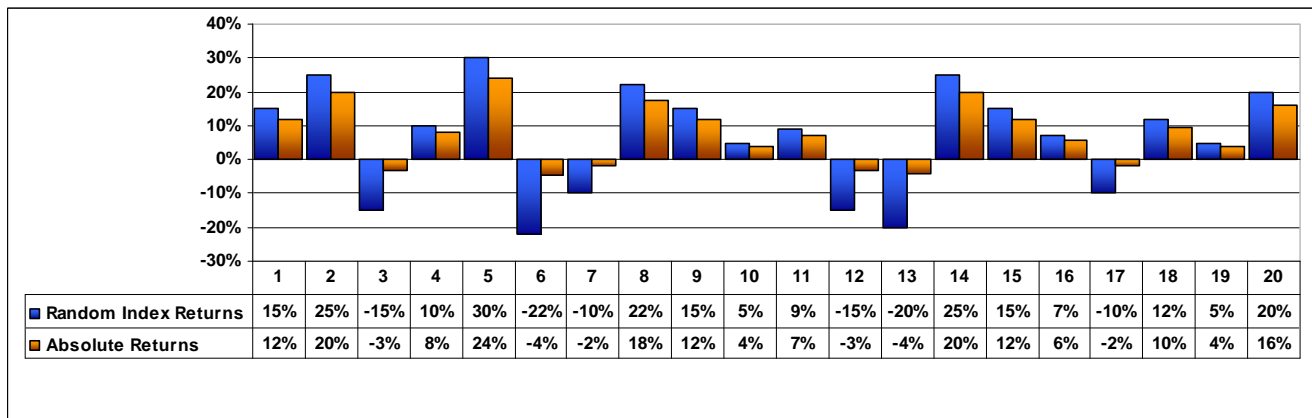
Let’s take a look at an example of what we are talking about. In the chart below we have created a **random return model** on the S&P 500 to see what the **next 20 years** might look like. As you can see there are quite a few up years and some down years too. Not too far different from what the historical example above looks like.



This is really an important concept to understand since Wall Street has trained most investors to believe that relative performance is all that matters.

Relative performance is the comparison of the returns of your portfolio to that of some benchmark index.

Absolute performance is the return of the portfolio itself on a year over year basis.



Underperforming And Loving It

What is important for you to notice here is what the **Absolute Return matrix** looks like. In this study we purposely made sure that in *every up year the absolute return matrix underperformed* the index by only capturing 80% of the upside potential. However, in down years the absolute return model outperformed by not losing as much as the index, only 20%. Were there down years in an absolute return portfolio – you bet!

The lesson we want to drive home here is the danger of following Wall Street's advice of beating some arbitrary index from one year to the next. What most investors are taught to do is to measure portfolio performance over a twelve month period – which is absolutely the worst thing you can do – it is like being on a diet and weighing yourself every day.

If you can look at a picture like the one above and see the whole future laid out in front of you it is very easy to make an investment decision that you know will underperform at times and outperform in others. However, we don't have the luxury of such foresight. Instead we are taught by Wall Street that if your manager lags in one year, or the next, then you have to move your money somewhere else. This forces you to chase performance and creates fees and commissions for Wall Street.

Slightly Better Than Average – Wins

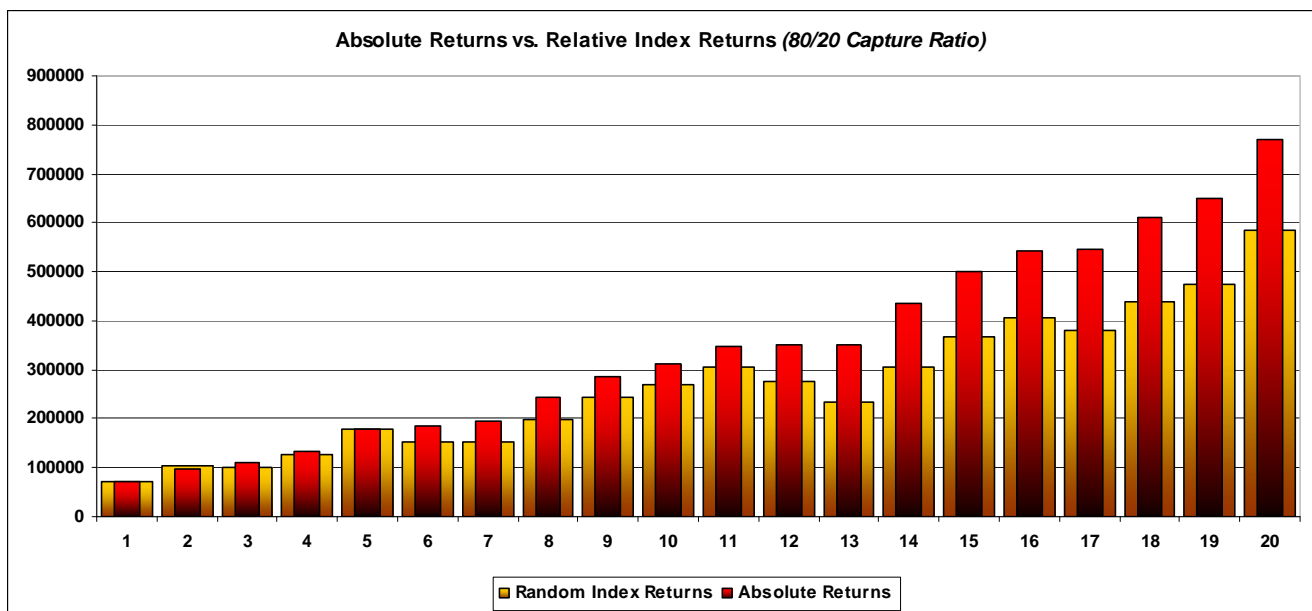
Let's look at the return matrix chart above and assume that we invested \$50000 into the Random Index Return Matrix and \$50000 into the Absolute Return Matrix.

Most of you would be told after the first year that you need to move your money to another manager because he underperformed the index. Same in year two. However, in year three you are feeling pretty good but in every up year you lag – so you chase another fund that beat the pants of the index that year.

However, when we extend the absolute return model out twenty years you will see that not only did you beat the benchmark index you did it with less volatility and more sleep.

The problem with Relative performance is that while you are happy in up years because you are beating some index, in the years the index went down 20%, and you were down 19%, however, WallStreet says you should be happy because you still beat the index. Right? I haven't personally met anyone who was happy with that, were you?

Learn to love what is enough.



In the chart above you can see that over time investing in an absolute return portfolio will more than beat the average market return with less risk and volatility. Why? By not losing your principal investment in down years it is possible to

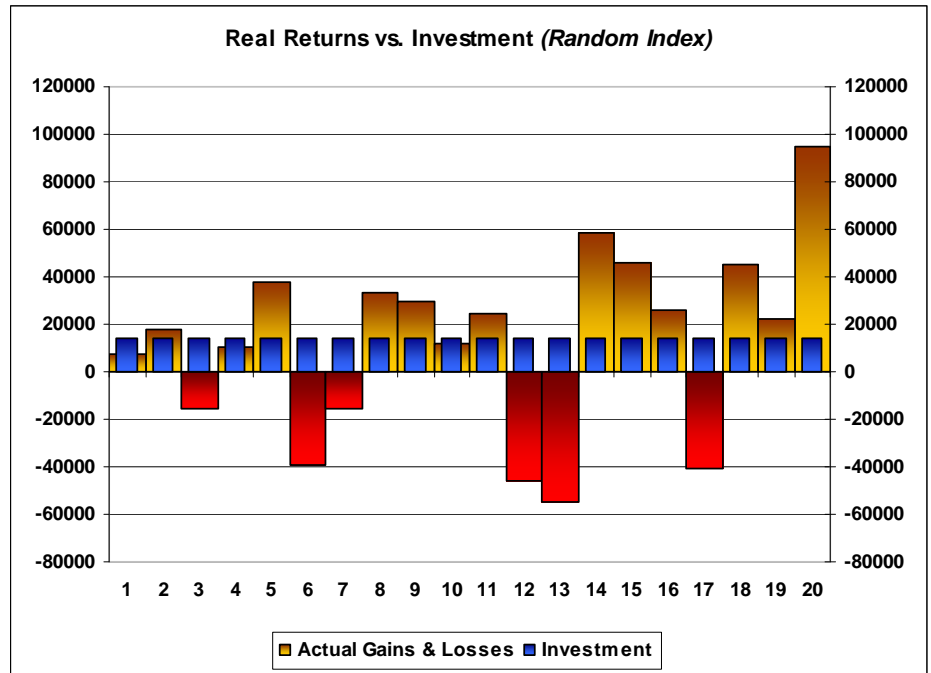
actually utilize the power of compounding returns. The problem with market benchmarking, and the one thing that all financial advisors won't tell you, is that when there are back to back losing years in the market – you compound losses.

Saving vs. Investment

Let's go back to our savings scenario above but instead of getting 7% compounded annually let's look at what would have actually happened to your money over a 20 year period using our Random and Absolute Return index models.

In the chart to the right you will see our annual contributions of \$14,000 per year (blue) and our capital appreciation (gold) or loss (red) for each year in relation to our Random Index model.

What is important here is that there are years where our annual contributions are the only advance that our portfolio would have made and particularly during the early years our savings rate is exceeding our capital appreciation thereby compounding our wealth effect.

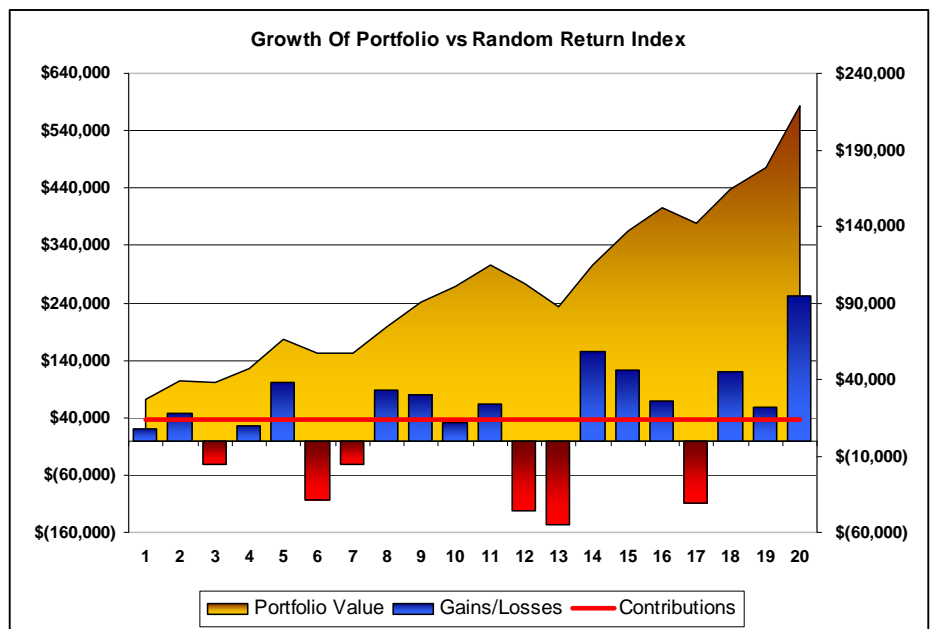


So, what would have been our net effect on the portfolio utilizing a “beat the benchmark” approach? Take a look at the chart on the next page.

Not bad. Our initial investment grew from a meek and mild \$50,000 to almost \$600,000.

However, again notice that during quite a few years the majority of the gains to the portfolio came from what we SAVED and not from what was EARNED.

Also, notice the reduction in value that occurred in the down years of our index. Our portfolio declined substantially not only reducing our value but also wiping out the net effect of our annual contributions.



Absolutely Better

When we apply this same approach utilizing our absolute return model the differences become much more pronounced.

When using our absolute return approach we reduce our draw down years substantially from a loss of almost \$60,000 to a loss of only about \$15,000.

In the 13th year of our example for instance that would have netted an additional \$45,000 in our portfolio by just not losing that much in a bad market year.

Not only do we begin to outperform on the downside but also on the upside. Remember that capital appreciation is a function of the percentage gain on investments times the value of the investments.

Therefore, since we have been losing less in earlier years our dollar appreciation in the value of our portfolio begins to exceed that of our Random Return Index model. For example notice in year 20 that the capital appreciation returned to the portfolio in our Absolute Return model was in excess of \$100,000 versus about \$90,000 in the Random Return model EVEN THOUGH the Absolute Return model only achieved 80% of the Random Index Model's return that year.

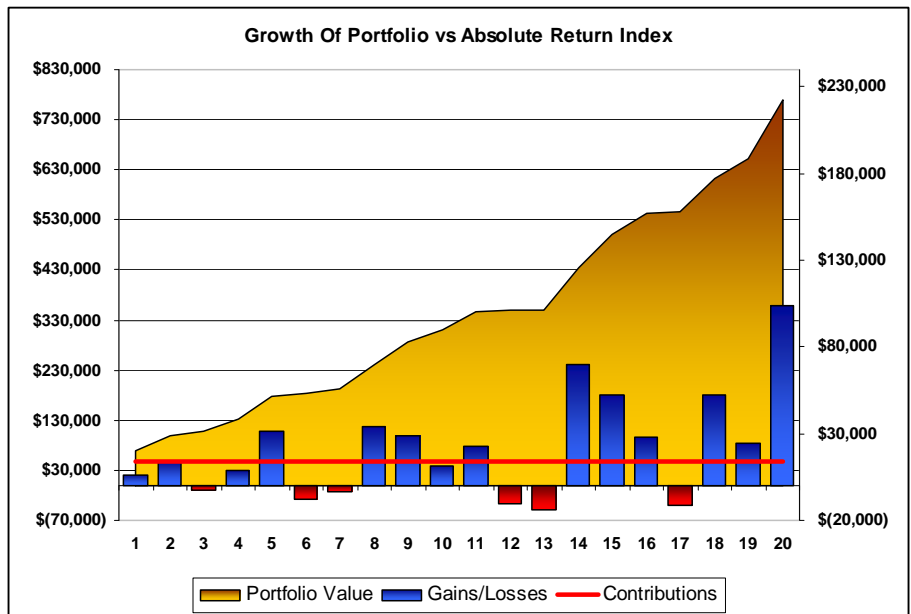
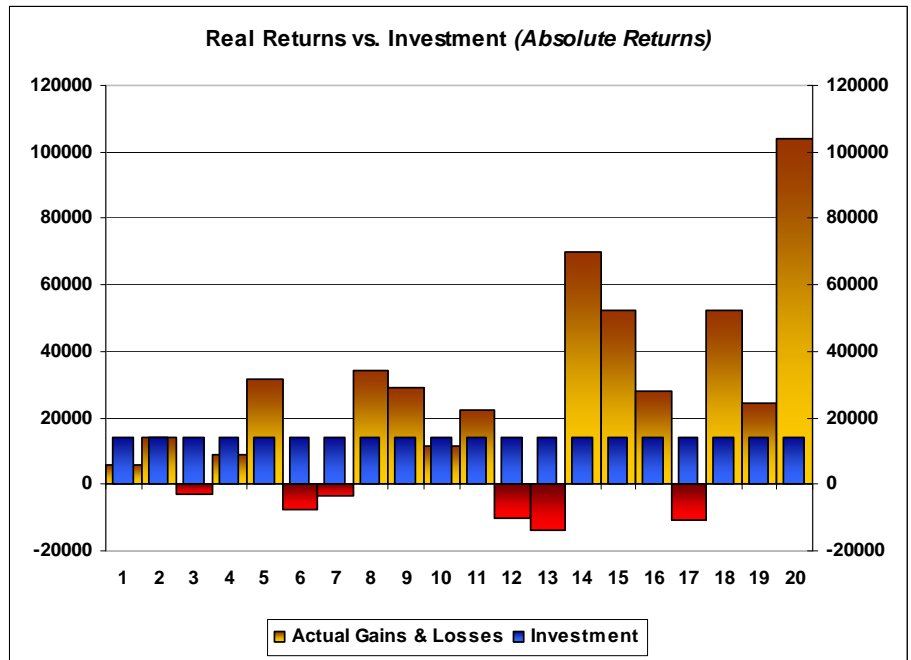
I understand that this can be somewhat confusing but the simple matter of fact is that the less you lose when the markets are declining the more money you can make when the markets are rising.

Let's take a final look at our portfolio value using the Absolute Return model and what the next effect was on the ending value of our portfolio even though we underperformed EVERY single up year by 20%.

The growth of our portfolio has now gone from about \$600,000 when benchmarking to an our Random Return model to about \$740,000 using our absolute return approach.

The bottom line is this. If you want to win at the long term investing game Financial Resource Corporation sums it up best; *"For those who are not satisfied with simply beating the average over any given period,*

consider this: if an investor can consistently achieve slightly better than average returns each year over a 10-15 year period, then cumulatively over the full period they are likely to do better than roughly 80% or more of their peers.



They may never have discovered a fund that ranked #1 over a subsequent one or three year period. That 'failure,' however, is more than offset by their having avoided options that dramatically under-performed. Avoiding short-term under-performance is the key to long-term out-performance.

There are no magic short-cut solutions, and we urge our readers to abandon the illusive and ultimately counterproductive search for them. For those who are willing to restrain their short-term passions, embrace the virtue of being only slightly better than average, and wait for the benefits of this approach to compound into something much better...the "long term" investment game will work for you.

Three Keys To The Smarter Investor

Know What You Can Save & Invest – this is key, the biggest key to your ability to become wealthy is through the accumulation of savings. Knowing how much you can religiously save each month without fail is paramount to the "Smarter Investor" plan.

Have A Goal – knowing what your end goal is, makes it possible to construct a strategy to achieve that goal. The two main variables to any long term investment plan is (1) the amount of money being contributed each month and; (2) the length of time to obtain the goal. Once these two variables are known quantities we can now derive the third and most crucial component of the equation – the required annual return.

Develop A Strategy To Meet The Required Return – the required annual return is where 99% of all long term investors fail. Not knowing the required annual return to meet your long term investment objectives leaves you blindly investing in a variety of assets that most likely will not perform as expected. More importantly, since most investors do not know the required return necessary they generally wind up taking on too much risk which ultimately leads to bad investment decisions caused by emotional swings due to market volatility.

STREETALK ADVISORS

What makes us different?

It's really pretty simple. We believe that managing risk is the key to long term success. Conserve the principal and the rest will take care of itself.

Risk = Loss

Seems like a simple concept – yet most people take way too much risk in their portfolio which is fine as long as the market goes up. The problem comes when it doesn't.

Managed Risk = Returns

By applying some simple risk management to a portfolio of assets the potential for large draw downs of capital is reduced thereby allowing the portfolio to accumulate returns over time.

Total Return Investing

We believe that portfolio should be designed for more than just capital appreciation. There are times when markets do not rise. During those periods we want income from dividends and interest to be supporting the portfolio.

If you are ready for something different the you are ready for common sense approach to investing.

Get Started Today

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Lance Roberts
Director of Fundamental & Economic Analysis

Michael Smith
Director of Alternative Investments

Hope Edick
Compliance

Jean Casagrande
Streetwork Insurance

Office Location:
One CityCentre
800 W Sam Houston Pkwy N
Suite 410
Houston, TX 77024

Tel: 281-822-8800

Web Sites:
www.streetworkadvisors.com

Email: (For More Information)
Streetwork@streetworklive.com

For Appointments Contact
Kim Standing kim@streetworkadvisors.com

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