Second Quarter 2004

Building vs. Buying Your Wealth Plan

By Terry Price

We were recently asked to address a group on the subject of wealth planning. Specifically, how can individuals take charge of a process which often seems overly technical and complicated -- with infinite choices, considerations and ever-changing tax laws? We felt some of our thoughts would be of interest to our clients.

In 1925, our founder A. M. Clifford penned the following, "An investment counselor…should place himself in a position to consider *only his client's best interests* to the exclusion of every other consideration." This has been our philosophy and we think it should be yours, too.

To that end, we encourage clients to know themselves quite well . . . their goals, their desires, their dreams, and their tolerance for risk. Too often we see advice presented which neglects the basic tenet of understanding a client's needs. The result: counsel given is often based on what an advisor has to sell you, not on who you are. Don't sacrifice or alter your needs to fit what is being offered. You must remain in control of your financial planning process, reviewing any and all decisions within the context of your overall plan. We prefer to think of this as building a portfolio to satisfy your specific needs rather than buying various investment products simply because they are offered.

If self-knowledge is the source of control in managing your wealth plan, what are the basic things investors should know about themselves before seeking potential advice? Here's a short list that should help provide a framework for your investment decisions.

Income and expenses: Know your budget quantitatively.

Experience: Be honest about your investment experience…don't get into complex investments unless you thoroughly understand them.

Tax: Understand basically how all your assets impact or potentially impact your tax obligations.

Investment horizon: Match the portfolio's purpose to the actuarial life of its beneficiaries.

Environment: What extenuating circumstances impact your investment decisions? Are there legal or socially-responsible considerations that concern you? Are you (rightly) looking at this decision in

Continued on page 2

Contents:

Building vs. Buying Your Wealth Plan
by Terry Price
Pages 1-3

Cash is Key
by Ralph Weil
Page 3-4

Planned Giving News:
Proposed Legislation
by Ken Dike
Insert pages 1-2

the context of your overall plan or (wrongly) in an isolated vacuum?

Risk tolerance: This is the "Ferrari factor." We suspect it's thrilling to drive 200 miles per hour and live to brag to your friends about it. But perhaps a Honda Civic would accomplish the same job with much less personal risk. Balancing investments to one's personal risk tolerance is very important.

Having the answers to these basic questions puts YOU in charge of the planning process. Our point here is your portfolio needs to be tailored for you by you . . . not by someone else's idea of who you are, what you should be, or what you should buy. The danger is that of being "sold" investment options which may solve one or two of your checklist items, but fall apart when measured against your plan as a whole. We'll illustrate with an example.

Let's say you are retired with a 10-15 year investment horizon and rely on supplemental income to meet your retirement budget. You are interested in maintaining the purchasing power of your portfolio for the benefit of your heirs. In our scenario, you have been presented with an opportunity to purchase a variable annuity. Variable annuities are policies which consist of several components combined into one product – traditional investments, life insurance, tax considerations, as well as lifetime income. Is this a good choice for you based on your plan?

Let's examine this question by first analyzing how variable annuities provide some of the benefits our fictional investor is looking for:

-Withdrawals (usually up to 10% annually) may be made without annuitizing your contract or incurring surrender penalties.

-Principal earnings are tax-deferred except on withdrawals made.

-The insurance portion of this fictional contract guarantees return of principal on death (unless the contract is annuitized), even if the market value is lower (note: purchasing power of principal may or may not be maintained by this guarantee as no allowance is made for inflation).

Without plugging this annuity into an overall plan, the benefits as they stand sound like a good solution for our investor. But there is often an opportunity cost when an investment decision is made, and our checklist will help us to evaluate the overall appropriateness of this choice.

Income and expenses: Let's assume the annuity contract and underlying investments will provide for your income needs. The question to be asked is, "At what cost?" The life insurance portion of an annuity's fee often runs as high as 1.25 percent annually. Investment management within the annuity usually ranges between 0.75 to 1.00 percent, typical of mutual fund investing. When all these fees are combined along with a small overall administrative fee, annuity expenses generally run between 2.0 – 2.5 percent each year. These high fees severely reduce long-term profits and undermine your ability to preserve the purchasing power of your principal.

Experience: For most people, annuities seem difficult to understand – because they are. Are you buying insurance, an investment, a tax shelter, or just what are they? And what of the investments? Who makes the investment decisions? How do they relate to your overall asset allocation? It is our strong recommendation that anyone considering the purchase of an annuity should seek the expert advice of a disinterested, third party. We are happy to provide referrals for this service to our clients.

Tax: As tax-deferred investments, they probably make no sense in IRAs or retirement accounts which are already tax-deferred. But if held outside a qualified retirement plan, annuity distributions are taxed as ordinary income on non-annuitized contracts (annuitized contracts are taxed on a different basis). By contrast, individuals only pay 15 percent on long-term capital appreciation from stock investments as well as their dividends – less than half the rate payable on ordinary income. Also important to understand is that unlike common stocks, annuities do not get a step-up in basis upon your death. When naming your beneficiaries to receive the balance remaining on your annuity contract at your death, know this portion of their inheritance may be fully taxable.

Your investment horizon: Most annuities carry surrender charges if they are terminated earlier than 10-12 years after purchase. Some of those surrender charges can be as high as 9 percent, severely limiting alternatives once a policy has been purchased. This can affect portfolio changes and good judgment in the future, should your circumstances or time horizon be altered.

Risk tolerance: Potentially higher costs and higher taxes, limited liquidity, and a complicated product make it difficult to justify the stability often promoted with these investments without a specific need for guaranteed income.

In this instance, this specific variable annuity seems to fall short when held up against our client's overall plan checklist. We do not dispute annuities sometimes provide an appropriate investment choice. Indeed, there are so many permutations of benefits and constraints for annuity contracts, that each situation must be analyzed for its unique characteristics. For our purposes here, we have artificially simplified the decision making process to make a basic point: know yourself and your plan before purchasing investment products.

So as we continue to counsel with our clients, we encourage them to keep us informed as to changes in their circumstances. As we hope we've illustrated, each client's understanding of their personal circumstance is important in helping us "build" a proper portfolio to meet specific needs within an overall plan rather than simply buying "interesting" products out of context. This thinking pioneered by A. M. Clifford is also underscored in the modern text of the current Uniform Prudent Investor Act," . . . investment and management decisions respecting individual assets and courses of actions must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the [investor]." Years later, we still like the way it sounds.

We wish to thank Tom Meehan of the Executive Benefits Group for his assistance with this article.

Cash is Key

By Ralph Weil

Over the years our clients have heard us discuss the importance of cash flow in evaluating companies in our portfolios. We would like to take this opportunity to explain why we use this approach and give a brief summary of the benefits.

One significant reason we find relying on reported earnings problematic is the fact that accounting rules may legally be applied differently from corporation to corporation, even within the same industry, which makes comparing companies for investment purposes almost impossible. If a company has changed accounting policies over the years, comparing one year to the next can also present a problem. In contrast, an emphasis on cash flow allows us to review a company's long term record and helps us understand how a company finances its operations. Cash flow gives us a consistent benchmark that creates a level playing field on which we can make comparative judgments over time and from company to company. After all is said and done, there is either enough cash in the till to pay the bills and/or reinvest in the company, or there isn't.

Before including a stock in a client's portfolio, we analyze its valuation, meaning that we determine whether we think it is a good buy or not based on several criteria. Traditional measures of valuation focus on *earnings* growth, *earnings* per share, *earnings* return on equity or *earnings* return on capital employed. At Clifford Associates, we start with cash flow, instead of the traditional earnings, and end up with Economic Margin (EM) as a key component of our valuation process. To put it

Continued on page 4

"Cash is Key" continued from page3

Principals:

Maye Albanez, CFA

David Andrew

Peter Boyle, CFA

Ken Dike, Esq., CPA

Jim Fox

Terry Price

Ralph Weil, CFA

Bruce White

Randy Zaharia, CFA

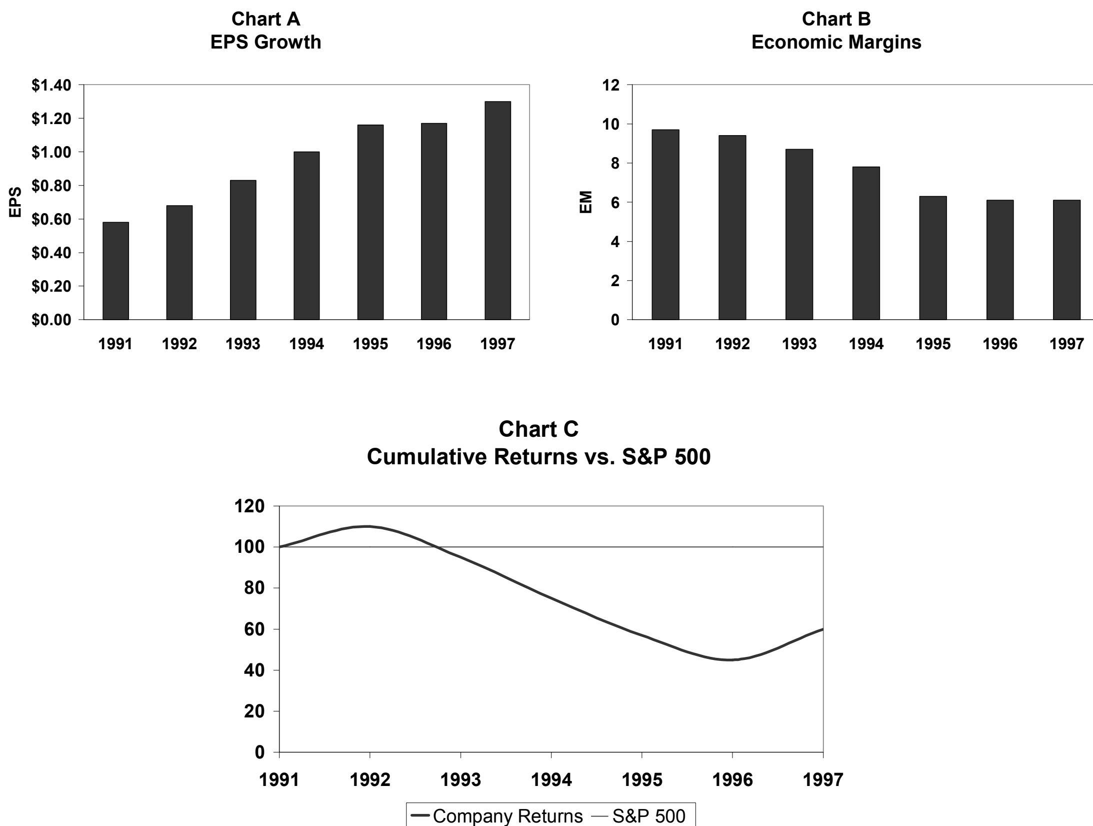
Offices:

Pasadena,
California
(626) 792-2228

Huntington Beach,
California
(714) 846-2851

Evergreen,
Colorado
(720) 746-1244

simply, Economic Margin is the difference between the cash return on investing in a company and the cost of financing the company. For example, if a company finances through stocks and bonds $1 million at 4% and invests it in company assets which produce a return of 6%, the EM for the company is 2%. We like what EM tells us about a company's ability to generate wealth, and we like that we can compare this data from corporation to corporation, across industries, regardless of accounting practices.



Source of Charts: Applied Finance Group

Above is an example of an actual company's stock performance during the 1991-1997 time period. As indicated by Chart A, this was a period of rising earnings per share for the company (doubling from less than .60¢ to over $1.20). However, Economic Margins declined over that same time period due to overinvestment by the company during the mid-1990s, as shown on Chart B. As illustrated in Chart C, the decline in Economic Margins strongly correlates with the performance of the stock price relative to the market as a whole, even though earnings per share were increasing over the same time frame. In this example, as in our daily fundamental analysis of companies, earnings per share proved to be a poor indicator of future growth, while a study of cash flow and resulting Economic Margin told a much different and truer story.