The Thoughtful Investor™

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Why Don't Forecasters Get it Right?

The First Law of Economists: For every economist, there exists an equal and opposite economist.
The Second Law of Economists: They're both wrong.

One theme of investing that always fascinates is the question how highly educated, very intelligent people can consistently get the future wrong, particularly the financial future.

Economists are a favorite media source for the outlook of the economy, the markets, interest rates, the costs of government programs and much more. But in a study of forecasts made by leading researchers from 1970 to 1995, William Sherden, author of The Fortune Sellers, concluded that:

Economists' forecasting skill is about as good as guessing. Even the economists who directly or indirectly run the economy (such as the Fed, the Council of Economic Advisors and the Congressional Budget Office) had forecasting records that were worse than pure chance.

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Three Basic Steps to Become Rich (er)

Money can't buy you love and it will never solve all your problems, but it can provide you with the funds to send the kids to college, to take on your personal goals, to retire, to meet unexpected expenses and to reduce the impact of disasters. Regardless of your profession, how much you make, or your lifestyle, becoming rich, or richer, really comes down to just three key actions.

(1) Spend less than you make

It sounds simple. But far too few people take it to heart. To accumulate wealth, you have to have the funds to invest and that requires setting aside part of your income every paycheck, every month, and every year. If you are spending every penny you make, unless you are exceptionally lucky, wealth will elude you. Even small savings have the potential to grow to substantial nest eggs.

(2) Start saving early

The sooner you start setting money aside and investing it, the more time you give the miracle of compounding to go to work for you. Albert Einstein once called compounding the "*eighth wonder of the world. He who understands it, earns it … he who doesn't … pays it.*" Compounding refers to generating earnings from previous earnings. Suppose an investment earns 8% annually, and you reinvest those

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Fallacy of Average Annual Returns

There are many ways to mislead with statistics, making it hard to trust any study without asking for underlying data and methods of calculation. But one of the biggies in the investment industry is the use of Average Annual Returns. When you read a study based on Average Annual Returns, I hope it will wave a red flag once you have read the following.

Average annual returns are simple to calculate. Add the yearly returns, divide by the number of years. The implied result is that a buy-and-hold position would have achieved that return compounded over the period. But it doesn't work that way. The reason is simple math.

Suppose you were invested in a mutual fund that earned 12%, 8%, 16%, 2%, -35%, -5%, 18%, 3%, -1%, 16% over a period of 10 years. Your Average Annual Return is 3.4%. If you did indeed earn 3.4% per year, compounded over 10 years, your account should be up 40% by the end of year 10.

It's not.

The annual returns above actually resulted in a total gain of 23% in 10 years, or 2.1% compounded annually. That's a substantial difference. The reason is that it doesn't take a 35% gain to recover from a 35% loss. It takes 54%. Averages overlook the fact that you are working from a much smaller account balance once you lose money. That's a big omission.

Why Can't Forecasters Get it Right? — *continued from page 1*

- There are no economic forecasters who consistently lead the pack in forecasting accuracy.
- There are no economic ideologies that produce superior forecasts.

What is going wrong? And if some of the smartest people can't get it right, how can the more ordinary of us hope to invest successfully?

The answer is found in first accepting that "*Markets can remain irrational a lot longer than you and I can remain solvent*." Often attributed to British economist John Maynard Keynes, the first recorded use of the statement was by A. Gary Shilling in *Forbes* magazine in February 1993. What Keynes is documented as saying is *"I have reluctantly reached the conclusion that nothing is more suicidal than a rational investment policy in an irrational world."*

In 2009, then co-chief investment officers of PIMCO, Bill Gross and Mohamed El-Erian forecast a "new normal" where the U.S. economy fails to accelerate at the rate typically seen after recession, and sub-par growth remains for some time. Their expectations for the economy have proven true but their investment posture proved completely wrong.

If you accept that financial markets have an element of irrationality at times that is the natural result of merging millions of human judgments and emotions, you can (1) bet on the day rationality returns and hope you can remain solvent that long or (2) you can invest with the trend. Following the trend, which is the core of an active investment management approach, looks at what the market is doing today. If our investments are going up, we stay invested. If they are losing value and exceed our risk parameters, positions are sold or hedged.

Yes, forecasts can be important in providing a framework for risk tolerance, but in the end, what really matters is the market trend.

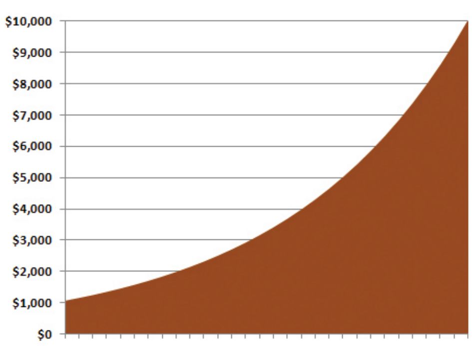
The world economies are in new territory. We have never had as much central bank intervention or government deficits. Economies have never been as interwoven throughout the world. We don't know what will happen in the financial markets in the next month, six months or six years. But we do have the tools and strategies to invest in what is working today. If it changes, we change along with the trend. ""Don't fight the tape," is an old Wall Street adage dating back to the days of ticker tape machines, but it still holds true.

Q: Why did God create economists?
A: In order to make weather forecasters look good.

Three Basic Steps to Become Rich (er) — *continued from page 1*

earnings each year. Each year, you earn 8% on your original investment **and** the earnings you reinvested. At first your account grows relatively slowly, but over time it picks up speed until the rate of growth can look like this:

Growth of $1,000 over 30 Years Compounded at 8% Annually



Disclaimer: This is a hypothetical example. There can be no guarantee that an investment will earn 8% annually for the period shown. All investments have the potential for loss as well as gain.

(3) Invest, but manage your risks

To put your money to work for you, it needs to be invested. But there are very, very few things that you can afford to invest in and walk away, coming back years later to see if your savings have grown. The only way you will know what those investments are is hindsight.

Among the risks your savings face are:

- **Inflation risk** – There is always the risk that rising inflation will erode the value of your savings and they will only buy a fraction of their current value in the future. Most investment plans assume a 3% annual rate of inflation, but there have been periods in the past when inflation was much higher.
- **Market risk** – A sector, national or worldwide market decline could adversely impact the value of your investments. Bear markets, for example, have occurred on average once every five years and erased an average 30% of the market's value.
- **Default, or individual investment risk** – This is the risk that a company or government entity underlying the investment runs into financial trouble and is unable to repay debts or declares bankruptcy.
- **Mortality risk** – Die too soon or live too long and you may miss the benefits of your investment or outlive your savings.

As the value of your savings increase, professional management makes more sense, and ideally should more than pay for itself in terms of a better long-term outcome. This is where we come in. Our job is to help our clients become wealthy. We welcome the opportunity to review your financial progress with you and to assist others. If you are happy with our services, we appreciate your referrals. And, if at any time you have concerns, we want to know. Call today and let's set an appointment to review your account.

Managing the Tax Bite with a Roth IRA

There's nothing like tax season to make us very aware of the impact taxes have on our take home pay and earnings. When you are retired and withdrawing funds from retirement accounts, that tax bite can look even bigger. It's not like a paycheck, where the money was withdrawn before you ever saw it.

One tool you do have to control the tax bite in retirement is a Roth IRA. Among the advantages of this retirement account structure are:

1) No federal taxes on earnings when withdrawn.
2) Contributions are after-tax. While you cannot deduct Roth contributions, there are circumstances in which you can withdraw them prior to retirement without adding to your taxable income.
3) You can make contributions to a Roth IRA until you die.
4) You don't have to take minimum distributions.
5) Non-spouse heirs have to take distributions from an inherited Roth, but they can stretch them out over five years, or their lifetime, continuing free of federal taxes.

To contribute to a Roth IRA, you must have employment compensation, and there are income limits. In 2014, the limit for single filers is income up to $114,000 for a full contribution ($5,500 or $6,500 over age 50); $114,000 to $129,000 for partial contributions. For joint filers, the 2014 limit is income up to $181,000 for a full contribution; $181,000 to $191,000 for a partial contribution.

If your income is over these limits, you can still take advantage of a Roth IRA's tax advantages by converting money from an existing retirement account such as a traditional IRA. You must pay income taxes on the conversion amount; however, there are no penalties for early withdrawal as long as all the funds roll over into the Roth IRA. Taxes need to be paid from funds outside the IRA. If you expect income tax rates to be higher in the future, it can make a lot of sense to pay taxes now and then let your account compound tax free. Or maybe you want to leave your retirement assets to the next generation.

If a Roth IRA sounds like a good tax and estate tool for you, please call and let's go over your options and what your potential tax liability might be if you need to convert.

Predators at the Mailbox

2014 Tax Adjustment Notice

Penalty for Illegal Use

Final Notification

Ballot Enclosed, Do Not Destroy

Final Cautionary Warning!!

This delivery has been computer coded. Recipient has been asked to verify receipt of this letter by return mail.

Senate Bill 1 will destroy America

The mailboxes of senior citizens are being targeted daily with dramatic appeals, deceptive and coercive language and threats to their livelihoods. And with each comes the request for money, often stated more as a demand. The reason for the appeals is simple. They work.

And the targeting is very easy. An online direct mail list quickly provides contact information for the prime target — over age 70; widowed, divorced or single; homeowner; head of household; assets over $250,000, etc. Victims can be targeted by religion, ethnicity, hobbies, and, of course, geographic area.

Overselling, misrepresenting and selling unneeded or even inappropriate insurance products are common elder frauds. There are also fraudulent repair services, bills for services or products the individual never received, political issue campaigns, mortgage refinancing offers, sweepstakes, charitable requests, and more.

Political issue mailings based on sensationalized claims and misrepresentation insist the individual's help and money is needed to save America, Social Security, Medicare, their estate from taxes, the list goes on. Mailings may offer fraudulent products promising increased cognitive function, anti-cancer properties, and so on.

Even individuals who have been financially astute all their lives become victims. Recent studies suggest that the reason may be related to changes in the brain as one grows older. According to a study in the *Proceedings in the National Academy of Sciences*[1], seniors tend to miss visual cues that someone is untrustworthy, and their brains don't send out as many panic signals that trouble is imminent.

Seniors also make ideal victims because they are less likely to report a fraud. They may not realize they are a victim or are ashamed of having been scammed. Many are afraid that if they report the problem their financial independence will be taken away, or they may just not know how or where to report the problem. When they do report a problem, they often make poor witnesses due to uncertain memory and perception issues.

It is important that individuals with elderly parents and the elderly themselves understand the volume of mail targeting this vulnerable population. If you find yourself in this situation or have family members who are facing a flood of money-seeking mail, help sorting the chaff from real mail may be needed.

1 Castle, Elizabeth, et al. Neural and behavioral bases of age differences in perceptions of trust. *Proceedings of the National Academy of Sciences*. Published online December 3, 2012, www.pnas.org/cgi/doi/10.1073/pnas.1218518109.

LEGACY
INVESTMENT STRATEGIES

Safeguarding Your Credit and Investments

It seems like there is a new announcement every other day from a retailer, bank, employer or data company saying their computer systems have been hacked and consumer information stolen. There may be no way to know whether or not your information was among the lost data, but there are some steps you can take to protect yourself.

1) Check your monthly statements!

Don't just throw them in a drawer or set them aside. Review your credit card, bank, and investment statements as soon as they come in and look for any transactions you do not recognize. Check bills to make certain the amounts are reasonable. Small transactions matter. "Pinging" an account for a few cents is one way hackers verify that the account is active. If you find a red flag, contact your credit card company, bank or custodian immediately. It's always better to safe than sorry later.

2) If you believe the security of an account has been compromised, close it and open a new account.

There is no reason to leave your funds or credit rating at risk if you suspect your account has been hacked.

3) Set electronic alerts.

Go into your account settings at your credit card company, bank, investment firm, etc. and set email, text or phone alerts that let you know if any unusual transactions take place, such as large charge amounts you don't recognize, or withdrawals. Make certain you receive notification of any changes in your account, such as changes in address and contact information.

4) Reduce your credit limits or available balances.

If you are unlikely to need to make $50,000 in purchases on your credit card, request that your credit limit be reduced. Don't have excessive funds in debit card accounts. Make it more difficult for a thief to take advantage of your good credit standing or available cash.

5) Change your PINs and passwords on a regular basis.

There are good guidelines available on what makes a better password. Reference those guidelines when you set PINs and passwords. And make certain written records of your account access codes are protected.

6) Use a fraud monitoring service if free.

Often companies will offer one-year of free credit monitoring following the loss of data. If you opt to take advantage of the offer, make certain it comes from the company and is not fraudulent (adding insult to injury). Remember, the monitoring companies often offer these one-year deals to the companies who lost your data for no cost, anticipating that you will renew for years to come.

Just remember you cannot entrust your security to others. In today's world, you have to take an active role in safeguarding your financial accounts and your information.