notes from the assabet

Second Quarter, 2011

Volume IX no. 2

DIY Investing

A recent study by the Spectrem Group reports that 47% of millionaires ($1 to $5 million) want to be actively involved in the day-to-day management of their assets. In other words, 53% do not. What a switch from 2009 when 69% wished to be Do-it-Yourself ("DIY") money managers. Spectrem surmises that millionaires are suffering from "investment fatigue," exhausted by the volatile path of the stock market in recent years.

Even in less tumultuous times, you might wonder, "When is it a good thing for an individual to invest his/her own assets?" Our readers won't be shocked and amazed to learn that our answer is: "rarely," but that's only because we know what's required in terms of training, tools, time and temperament.

To reduce the taint of bias, we'll argue our case by referencing the selection criteria used by boards or committees which select money managers for institutional investment portfolios. Both of us have participated in money manager searches and ongoing evaluations in an institutional setting. Institutional managers do not provide the personal life planning often offered by an advisor investing for individuals. The focus is entirely on ability to invest. Readers who DIY might test themselves against the following criteria by which institutional money managers are judged. Consider: would you hire yourself?

The firm's team of investment professionals must have strong professional qualifications and experience. A CFA is standard. The DIY investor might enjoy stock-picking and spend hours in online research during his leisure time, but it's no substitute for professional training and focus.

The investment manager needs an investment philosophy that is clearly articulated and consistently applied. Are they growth or value? Bottom-up or top-down? Active or passive? How do they select securities? A hot tip from a neighbor or even a highly researched pick would not impress, unless the stock had been chosen from a vast universe of opportunities. **The manager must be building a portfolio, not just picking individual securities.** This involves having a clear risk management process as well as defined buy and sell disciplines. Without this control, success is not replicable and periods of strong performance may amount to dumb luck.

If the candidate can verbalize and justify a clear theoretical and strategic approach, then we look to see if it is consistently applied. I recall one manager who expected to receive plaudits for three quarters of particularly strong performance. Instead, we grilled their team on why a *value* manager would outperform in a period of *growth* success. Our fear was that if they couldn't be counted on to hold to a strategy, then we could have no idea what to expect. Their lack of conviction was a black mark.

Solid investment managers are able to document performance in a multi-dimensional way, over various time periods and market environments. Performance can be compared to specific market and peer manager benchmarks. They can attribute their own performance to investment management decisions. They certainly cannot go into a board room and talk only about the last 6 months, or talk only about their big winners. *Cont'd p. 2*

Lisa Phelps & Wayne Ushman

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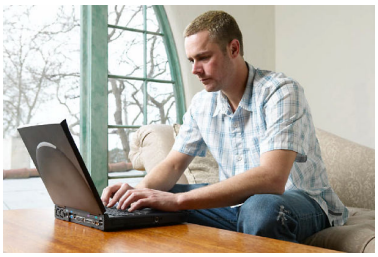
DIY investing continued

Typically, DIY investors lack the philosophic clarity that produces success. They tend to focus on individual securities, ignoring the risk structure of the portfolio. Their memories often are selective when it comes to performance. Without the strategic framework or the performance analysis, it's difficult to make effective decisions moving forward.

Organizational structures of institutional investment firms also are scrutinized. A hiring board would raise questions about stability in the case of rapid growth, a recent merger, or shifts in senior staffing. They also would study the management incentives as well as systems of accountability. The DIY investor also can be distracted from the investment process by periods of transition or personal stress, and yet there is no one to hold him accountable for his effort and results.

One factor, critical for the DIY investor but irrelevant in the institutional setting, is subjectivity. Let's face it, most of us can be quite emotional and (dare we say) "irrational" about our own money. Watching



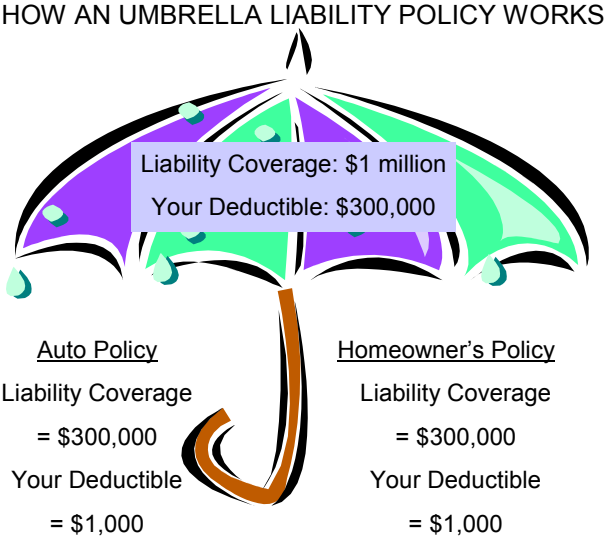
dollars disappear during a market slump is hard when you know that they were targeted for your own child's college tuition, or for your own travel in retirement, for example. Staying committed to an investment strategy becomes especially difficult when you (or your spouse) has only you to blame for poor investment results. Of all the reasons to question your ability to DIY, this is perhaps the most critical.

If you measured yourself against these standards and came up short, yet you enjoy investing and do well at it, consider going the DIY route for a portion of your assets and letting someone with the time, the knowledge and the objectivity manage the rest.

www.cogentresearch.com/news/pressrelease 3-23-11, "Investment Manager Selection," www.Aston Asset Management.com, "Sub-Advisor Selection Process," www.calvert.com. Goetzmann & Peles, "Cognitive Dissonance and mutual fund investors," Jrnl of Financial Research 20(2)

Unless You Have Nothing to Lose

HOW AN UMBRELLA LIABILITY POLICY WORKS



You get sued. You settle fo $1 million. You pay a $1,000 deductible for the auto or homeowner's policy involved. The policy pays $299,000. Your umbrella policy kicks in because the $300,000 deductible has been met. It pays $700,000. You pay nothing.

It happened again. We're always surprised. Recently a very intelligent person with substantial assets told us that she doesn't have an umbrella policy. We opined, as we always do, that she should get one with all deliberate speed. An umbrella policy extends your protection from liability claims, not only by supplementing your auto and home liability coverage (see the illustration), but by broadening your protection from other potential threats: a clumsy handyman gets hurt on your property, a guest suffers an injury in your beach house, your perfect child gets into a scuffle at recess and injures another child, Fluffy, your Doberman, takes a chomp on the postman's leg, someone takes offense at your latest blog and sues you for slander. It could happen.

Besides providing essential coverage, umbrella insurance comes relatively cheap. Depending upon the individual situation, an average $1MM policy may cost between $150-300. Usually it's best to get it from your regular carrier. That will make a defense easier to coordinate, and the policies will have similar language. (Your carrier may require that you increase your underlying coverage.)

The umbrella policy won't cover business liabilities or intentional damages... so don't bite anyone.

Mymoneyblog.com, "Reasons we have an umbrella policy"

Newbuyer.com, "Umbrella Policy", 6/28/11 has links to several sites.

Economic and Financial Review

The second quarter was difficult. It wasn't just that the stock markets were erratic and the quarterly returns were neutral. Those things happen. The period also included events that were alarming and ominous, as if we weren't shaken enough by the earthquake and nuclear threat in Japan in March. Weather disasters continued with severe tornado activity in several states, a serious drought, and tragic flooding. The gravity of Greek sovereign debt became widely known as well as its potential impact on other European economies. Leaders on capitol hill showed few overt signs of being able to come together to raise the debt ceiling in time to avert a crisis in our own system, much less to reduce the deficit.

During the period, Americans began to understand more clearly the gravity and the cost of our high indebtedness, both on the consumer level and the government level. These situations could be unraveled over the shorter term in an environment where economic growth was accelerating and policy-makers had the option of lowering interest rates But that's not where we are. In the midst of all the alarming news, economic indicators in May through mid-June suggested a slowdown in economic improvement, even the possibility of a "double dip" recession. Stocks declined and investment dollars flowed into bonds and money markets while equity investments overweighted defensive sectors: healthcare, consumer staples and utilities. In the final week of the period, some encouraging economic data and the prospect of some relief for Greece, buoyed investor confidence. In an abrupt about-face, U.S. stocks ended the quarter with a 4-day winning streak, and the highest weekly performance in 2 years. This brought the S&P 500 Index to a quarterly performance of –0.1% while the Russell 2000 (small caps) lost –1.6%. Large-cap international stocks rose by +1.56%[1] while emerging markets stocks fell by –1.15%[2].

At the beginning of the third quarter, typically a sluggish trading period for the stock market, the investment environment remained generally fearful in spite of persistently healthy growth in corporate profits, good stock valuations and some positive manufacturing and employment data. The threat of financial chaos in Europe still loomed, as did the possibility of an oil price shock caused by political turmoil in the mideast. The impact of the end of quantitative easing was unknown. Bond yields had edged even lower, encouraging new corporate debt issuance.

As the deadline for raising the debt ceiling approached without an agreement in place, the public dialogue became increasingly alarming. Gold bulls were in heaven.

[1]MSCI EAFE Index and [2]MSCI Emerging Markets Index both www.northernfunds.com

Living in Interesting Times

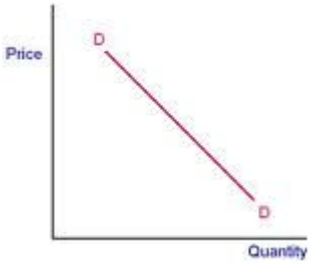
Recently, many investors have been eager to receive near zero, even negative returns on their money, just to assume safekeeping. It's a flight to quality by cautious investors, concerned about stock market volatility, the end of QE2 (the Fed's stimulative policy of "quantitative easing") and, most notably, the Eurozone credit crisis.

On June 23, Assabet Advisors joined this cautious crowd when Wayne moved the bulk of money market assets held in client accounts to a U.S. Treasury Money Market Fund. He was concerned that U.S. money market funds could be at risk from the Greek/Euro sovereign debt crisis even without direct exposure. Because of the Federal Reserve's zero interest rate policy, money market funds have had to hunt for yield. They've found it in the short term debt of European banks, among Greece's biggest creditors. In mid-June, Moody's put three large French banks on notice for a possible downgrade because of their potential exposure to a Greek default.

Given the wide and dramatic press coverage of the situation, money market investors might be concerned about the safety of their funds and participate in a run. We weren't convinced that our clients' money market assets were at risk. In the past few years, new regulations have sought to improve the short term liquidity of money market funds as well as shorten the overall maturity of their holdings. Yet transferring the assets to the Treasury fund had no apparent downside but for the tedium of the process. With interest rates near zero on all money market accounts, there was no significant sacrifice in yield and credit risk was improved. Therefore, why not be prudent?

The irony of this logic is that should the our federal spending break through the debt ceiling in August before a new ceiling is in place, the U.S. would hardly appear a safe haven. This is an unlikely eventuality, but points out why an advisor has to remain vigilant.

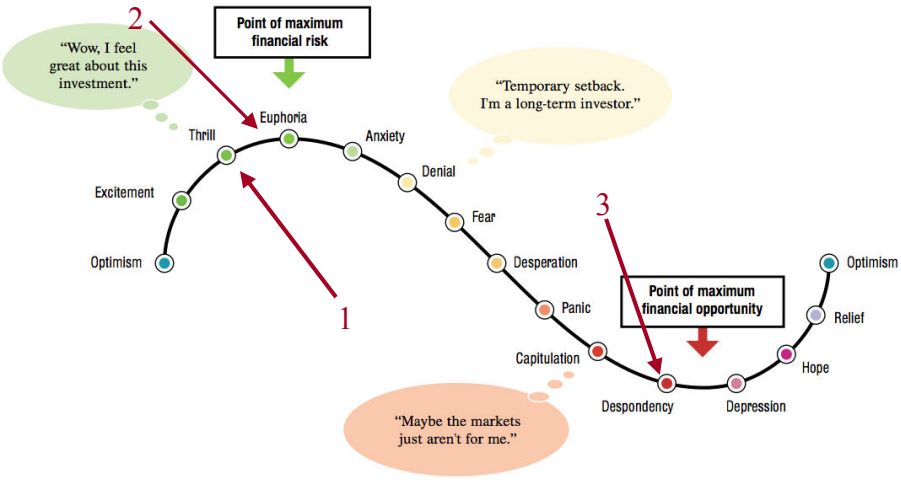
Reversing the Demand Curve



Remember the demand curve from elementary economics? Basically, it is the graphic description of something we know from common sense: as a price falls, the demand for the product goes up. People love a sale. With a new technology, prices may start too high to garner a lot of buyers. The mid-1970s price of (VHS) VCRs, for example, at over $2,000, was too high to attract many early-adopters. As the price level succumbed to competition, demand increased and VCRs became common in American homes. Demand started to wane only when DVD made video more or less obsolete. I bought my last VCR about 7 years ago for less than $60.00. The decision to buy a VCR went from: "$2,000?! What do we need one of those for?!" to "If we're getting a new TV for the study, better grab a VCR to go with it."

Practice often departs from theory, of course. It's interesting to consider where the demand curve doesn't hold: when excitement over a new highly-touted product overcomes price sensitivity. The price may be at a peak, but demand is frantic. Customers lined up in 25 degree weather waiting for the doors to open at 5 am so they could get the Xbox or Nintendo Wii. First generation Cabbage Patch dolls excited a similar fervor when they became available for "adoption" back in the mid-80s. This past February, it was hard to find parking near a Verizon store when the new I-phone went on sale. In these cases, the demand curve was beaten by aggressive marketing, and, in some cases by parental devotion.

There's another realm in which the demand curve is reversed for a large number of people: **investing**. Some investors have a firm discipline. But many others move through rotations of optimism and pessimism, generally lagging the turns in the market. When stock prices are low and just beginning to rise, they remain in a pessimistic mode. They don't perceive stocks as a good-product-on-sale, they see a bad product. Once prices have risen for a while, they begin to be more optimistic and some of them will buy (1). Late in a stock market cycle, when prices have been rising consistently, they have the confidence to dive in (2). Thus, the investor's conservatism causes them to invest near the point of greatest risk: the market peak. Later on, that same lack of confidence, amplified by inertia, causes the investors to exit the market late in the cycle, again at the point of greatest risk (3).



When it comes to cars, carpets or carrots, etc., we generally follow the demand curve and buy when prices are low. We never say, "new cars are getting really pricey. I'd better buy one!" The average investor, however, defies the demand curve and buys high, sells low.

Chart source: Westcore Funds, Denver Investment Advisers, 1998