

Financial Perspectives

Q1 08



Contents

Avoiding Investment Pitfalls

The Importance of Diversification

The Flowering Inferno and Other Tales of Speculation

Upcoming Events

Wealth Transfer
Thursday, May 15, 2008
6:30 p.m.

Long-Term Care Insurance
Thursday, September 18, 2008
6:30 p.m.



Welcome

In this issue of Financial Perspectives, we cover major topics of interest related to investing your money. The first article, "Avoiding Investment Pitfalls," outlines common mistakes people make when deciding where to invest their money. "The Importance of Diversification" details the reasoning behind keeping a diverse portfolio. Finally, "The Flowering Inferno and Other Tales of Speculation" takes a somewhat humorous look at trends investors have been following for centuries.

If you are an SC&H Financial client, you can feel confident that our advice regarding your investments will be clear, knowledgeable, and in your best interest both short and long-term.

As always, please contact us if you have questions regarding these issues, or if we can be of any assistance.

Regards,

Greg Horning
President, SC&H Financial Advisors, Inc.
(410) 403-1512
GHorning@SCandH.com

Avoiding Investment Pitfalls

One of the biggest challenges investors face is controlling their emotions. Neither volatile geopolitics nor the global economy is as likely to defeat investors over time as their own fickle emotions. Fear and greed can lead to excessive trading and market timing at precisely the wrong times. It is always helpful to step back and examine these flaws in investor behavior to learn how to avoid them. See if you recognize any of these characteristics in yourself or in people you know:

Overconfidence

Investors are often too confident about their ability to forecast the future. Successful investing is really an acceptance of an uncertain future, so portfolios should be structured accordingly. The purpose of a multi-asset-class portfolio is to protect against what we do not know about the future.

Loss Aversion

Investors are loathe to booking losses on their portfolio positions. This reluctance leads investors to hold losing concentrated security positions while they wait for that holding to climb back to its purchase price - which can lead to even bigger losses. Instead of being loss-averse, investors should be risk-averse. A risk-averse investor would sell any concentrated position (even at a loss) and use the proceeds to diversify. This diversification makes the overall portfolio less volatile. Rebalancing is another strategy to spread risk. A risk-averse investor rebalances on a regular basis by shifting assets from the top performing asset classes to the underperforming classes. This forces an investor to sell high and buy low with a portion of his assets.

Asset Segregation

Investors tend to focus on the performance of individual holdings instead of the performance of the overall portfolio. In any given year, it is likely that one or more asset classes of a properly constructed portfolio will generate negative returns. The performance

of the portfolio as a whole - and not its individual components - is the proper mindset for achieving long-term financial goals. If every asset class in a portfolio is showing positive returns, then the chances are that the portfolio is not properly diversified.

Home Bias

Investors all over the world are inclined to favor stocks from their own markets. However, by including a mix of foreign stocks with domestic stocks, portfolio returns may be enhanced and portfolio risk reduced more so than the portfolio invested only in domestic stocks.

Employing an asset allocation strategy that includes a well-diversified portfolio may help you stay the course over the long term, regardless of short-term market aberrations caused by economic and political swings. Investment discipline and portfolio structure are key tools to help protect your current lifestyle while building for the future. Regularly review your investments with us or your financial advisor. Ask if your asset allocation is aligned with your risk tolerance and time horizon, and determine if your portfolio is fully benefiting from a diversified multi-asset-class philosophy.

The Importance of Diversification

It is a little known fact that nearly 92% of how well your investments perform is determined not by what you purchase, but rather by how your assets are allocated. In other words, the fact that you own Coke instead of Pepsi probably will not have a major impact on your portfolio's overall performance over the long run. However, if all of your investments are in large company stocks, or if you buy and sell based on emotions, chances are you are not optimizing your returns.

Asset allocation – diversifying your investments across a variety of asset classes – is an investment strategy used to reduce portfolio volatility (risk). The stock market can be jumpy and it's human nature to react hastily to drops in the Dow Jones Industrial Average or other

stock market indices. No one likes to see his or her portfolio decline in value. If we select asset classes that aren't "correlated" – that is, that do not all move in the same direction at the same time – we will still suffer a bit when the market undergoes one of its periodic market declines; but with a properly diversified portfolio our ride will be much smoother and any losses will be much less severe than a portfolio invested in only one or two asset classes. This is why a properly diversified portfolio will carry a mix of such investments as big-cap stocks, small-company shares, fixed income, international stocks, and real estate. The idea is to construct a portfolio that will deliver the greatest return at the level of risk you are willing to assume.

Aside from building a portfolio containing a blend of assets, it is important to allocate your holdings based on your own personal objectives, investment time horizon, and risk tolerance. A 20-year-old college student has more time to recover from market reversals and can afford to be more aggressive than his grandfather who plans to retire in five years. The grandfather would probably select a conservative portfolio consisting of 60% of fixed income and cash, along with a smattering of the other asset classes. His grandson might opt to hold only 20% of fixed income and cash and also be more aggressive in the other asset classes, including growth stocks.

Likewise, two individuals who are the same age might have different perspectives on investing. One might enjoy taking a bit more risk to see more return, while the other might become upset at the slightest dip in the market. When we meet to discuss your investments, we review your holdings and plans from your perspective. By doing this, we can work to design an asset-allocation-plan that is unique to your own needs and desires.

Once we have created that asset allocation, we can then choose stocks, bonds, mutual funds and other investments that best fit the allocation plan. Once the portfolio is properly invested, we will monitor each investment's results compared to their specific benchmarks and periodically rebalance among the asset classes. This is done by cutting back on the positions

that have increased in value and buying more of the positions that have not done so well (selling high and buying low). As your goals change, we will adjust your target allocations. Over the long run, if you stick to your asset allocation and ride through the rough times, you will be much more likely to achieve your financial goals.

The Flowering Inferno and Other Tales of Speculation

From 1634 to 1637, all of The Netherlands found itself under a spell. But it wasn't diamonds or gold that left the Dutch feeling mesmerized – it was tulip bulbs.

This pretty flower that many of us grow in our gardens started out as a status symbol and evolved into a measure of wealth and object of obsession for thousands. The tulip bulbs were difficult to obtain and the prices skyrocketed (at one point doubling almost every day), as everyone wanted "a piece of the action." Before long, people were buying futures in tulips, options markets opened up and "Tulip Mania," as it's now known, became the entire business of Holland.

But it could not last. Tulip Madness, or Tulpewoerde, reached its inevitable, frenzied peak. Prices stalled, then skidded, and then dropped into a full-fledged freefall – leaving the Dutch economy in a shambles and demonstrating, for the first time, the ruinous effects of manic speculation.

In the early 18th century, with Tulip Mania a fading memory, Merrie Olde England fell under the spell of the South Sea Bubble – the world's first story stock.

Like Holland before it, the England of the time was ripe for a speculative mania. As a growing world power, England was prosperous, and fortunes were being made in construction or transportation. Protecting its far-flung empire was expensive, so national debt was soaring. However personal savings were climbing, too. Unfortunately, there were few stocks available for all that money to chase

The success of the Hudson Bay Co. led to the creation of the South Sea Co., chartered to exploit the expected riches of the New World. South Sea had no sales or no earnings, but the romance of that New World represented that fabled once-in-a-lifetime shot at quick riches. The stock languished initially, but when the British government began pushing the shares, South Sea stock took off like the rocket's red glare. Margin purchases were introduced, so "investors" could buy the shares by putting only 5% down.

The stock, which had debuted at 100 pounds sterling per share, had dropped to 55 before its march northward began. With some helpful manipulation by the Crown, the shares hit par, then 130, and then 300 – on their way to 1,000.

Fanned by the easy access to credit, the speculative mood spread like a virus, spawning the creation of dozens of "bubble" companies, many of which had no real businesses to speak of. It was all too much for investors to support. When the shares collapsed, even Sir Isaac Newton got nicked. And he certainly should have understood that what goes up, must come down.

In more recent years, most of us felt the sting of the dot-com collapse. And we've only just started to feel the pinch of a housing bubble that was inflated by the subprime mortgages that also caused the housing market's collapse.

Market manias have been part of the investing picture for centuries. When a particular area of the economy is doing well, all investors want to be part of the action.

It doesn't matter if they understand the investment. In the midst of a market mania, when "everyone" is making huge profits without even trying, many investors give in to the temptation to join in.

The problem is – as the great Newton himself discovered the hard way – what goes up must eventually come down. Everything runs in cycles and investors have no way of knowing when the top has been reached. And as demand goes up, so do prices. Before long, investors are paying far more than a fair price to be in on the latest trend – and they're happy to do so. Unfortunately, when these bubble investments sour – as they eventually must – there is that much further to fall.

Investors have no way of knowing what the next great investment will be. Chances are good that by the time most people get in on it, it will be close to the end of the cycle and they won't reap the big benefits about which they have been hearing and reading.

That's not to say we should ignore all market trends. However, with a well-diversified portfolio, we will be positioned to profit from these manias in a disciplined way. By rebalancing back to our targets when an asset class gets out of balance, we will enjoy the thrill of the ride, but will take profits off the table well before the peak is reached. Granted, those profits will be smaller than those who brag about their success with the latest investment fad, but we will be back within a normal range, and maybe out of the investment long before the investment collapses in price.