Print

THE EDUCATED INVESTOR

Fall 2002

Cypress Asset Management

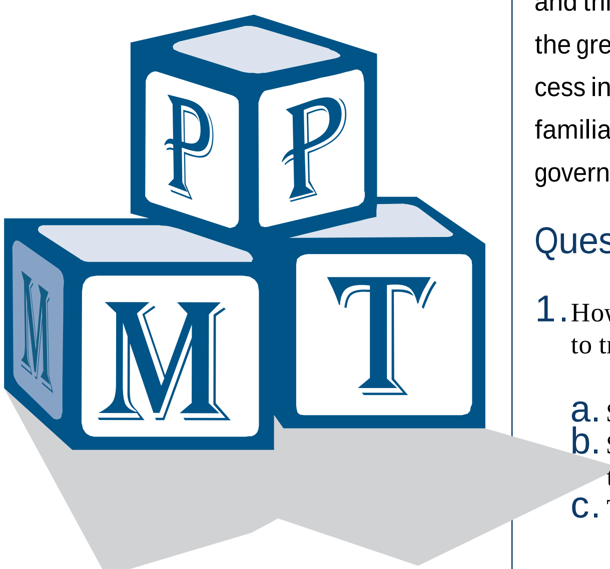
Back to the Basics

As we are in the midst of *at least* the second worst and third longest US bear market, including the Great Depression, it is as important as ever to continually revisit the basic concepts of a prudent, long-term investment approach.

During such periods, such an approach still provides the best protection for your assets, and yet at the same time can become more difficult to follow as the popular media — and your own fears — scream contradicting advice from every direction. It's time to review the basics of investing:

1. Create an investment policy … and adhere to it.
2. Incorporate passive investing to implement your policy … and continue adhering to it.
3. Incorporate the power of diversification across multiple asset classes as the key to managing the overall risk level of your portfolio ... and rebalance regularly to ensure adherence to your diversification (and related risk) objectives.
4. Seek the assistance of a qualified investment advisor. He or she can help you adhere to your investment approach.

Read on for more details.



What's Inside?

How much you set aside through thick and thin for your retirement has perhaps the greatest impact of all upon your success in meeting your objectives. How familiar are you with the latest rules governing your IRA contributions?

Questions:

1. How much can you contribute annually to traditional and Roth IRAs?

   a. $2,000 per year
   b. $3,000 in 2002, gradually increasing to $5,000 by 2008
   c. There is no limit

2. If you are 50 or older, do you have any special incentives to contribute to your IRA?

   a. Yes
   b. No

Turn to page 4 for
Investor Tester Instant Answers

The Best-Laid Plans

Whether the market is bear, bull or somewhere in between, people are people. In bull markets it is human nature to want to capitalize on whatever appears to be roaring forward the fastest, and thus we are tempted to stray from our goals. In bear markets, fear and panic can cause us to stray as far (or farther) from our best-laid plans.

As a prudent investor, you may already have taken several vital steps to establish a portfolio designed to meet your individual investment objectives:

- ▲ You have carefully considered your willingness, ability and need to accept the extra risk of equity investing in exchange for the extra compensation that studies have demonstrated can be expected from this risk.
- ▲ You have recognized that diversifying across numerous asset classes is a prudent way to reduce other types of risks that cannot be expected to offer similar compensation. Numerous studies have demonstrated that the risk of holding too many highly correlated (similar) assets — or "putting too many eggs in one basket" — is an uncompensated risk.
- ▲ Based on your risk profile, you have created a formal investment policy.
- ▲ You have planned for regular rebalancing to ensure that your portfolio adheres to your original intentions.

These are wonderful steps that already provide you with a strong defense. But they are not sufficient, because they do not combat against the very human tendency to stray from one's chosen course. In booms and busts, your discipline as an investor is under constant attack.

The current challenge is defending against bear markets. During these times, it is appropriate to revisit your risk profile:

- ▲ Your ability or need to take risk may have increased or decreased based on lifestyle changes, changes to your objectives, changes within the market, or simply the passage of time.
- ▲ You may have overestimated your willingness to take risk, and are now unable to sleep well as you watch your portfolio values drop sharply for prolonged periods.

If your ability or need to take risk has changed, a professional advisor can help you restructure your portfolio accordingly. If your willingness to accept risk is being challenged, an advisor can also help you react appropriately by adjusting your portfolio in a prudent manner rather than succumbing to a wholesale "abandon ship" flight.

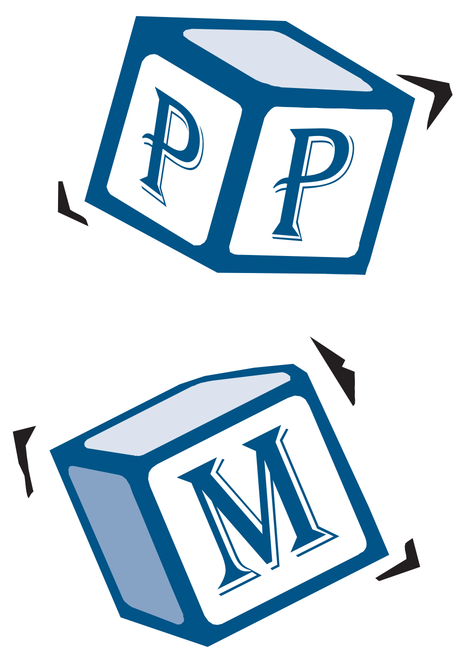
An important defense against bear-market panic is to heed the long-term historical evidence indicating that, what has gone down has always eventually come back up (and continued to climb).

History further indicates that, while numerous investors tend to sell during market lows, they have *not* been rewarded for doing so. For example, Salomon Brothers Chief Strategist Tobias M. Levkovich analyzed the returns of the S&P 500 Index in the year beginning one month after each of the four largest redemptions by mutual fund investors (based on net percentage withdrawals). If investors had been justified in their panic sales, then returns during the following year would have been poor. Levkovich instead found that the average annual gain for the S&P 500 following these four panic attacks was 19.25 percent.[1]

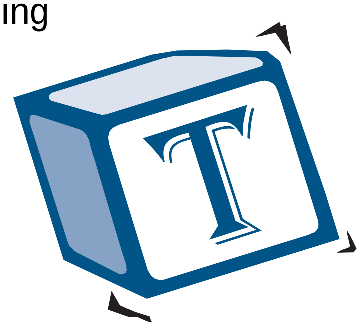
The current bear market has again led to one of the largest redemptions in history — $52.4 billion in July.[2] Only time will tell whether those placing large redemptions will be punished or rewarded. But, with history as our best guide, we expect that investors who have abandoned their long-term objectives will fare the worst. This is particularly likely given that many of today's panicking investors are likely the same ones who were participating in the huge net purchases made during the March 2000 market peak. Thus they are already at the disadvantage of having bought high and sold low.

In short, those who ignore the noise, adhere to their coherent long-term investment strategy and regularly rebalance to maintain effective diversification are taking the best stance to emerge victorious.

[1] *Business Week*, September 23, 2002.
[2] Ibid.



It's (Still) Time for Passive Investing



A series recently posted by financial columnist Beverly Goodman on TheStreet.com included three articles contrasting active versus passive investing.[1] In active investing, one attempts to beat the market through stock-picking and timing techniques; with a passive approach, one seeks to capture the highest risk-adjusted returns by incorporating asset allocation, cost management and tax management.

Goodman explains, "Passive portfolios are structured to take advantage of academic theory rather than manager bravado." She adds, "The value-added that active managers bring — even in this 'stock-picker's' market — is small to none."

Goodman may be among the more recent columnists to promote the logic of passively managed portfolios, but she is certainly not alone in her wisdom. A movement away from active and toward passive management began in the mid-1970s with the creation of the first index fund. It picked up momentum in the 1980s from an unexpected source: the arrival of high-speed computers. Their ability to process massive data gave financial economists the new ability to fully analyze the performance of active managers.

The data was consistent and compelling: Managers who sought to deliver above-market returns by picking individual stocks or timing market fluctuations ("active" managers) were consistently under-performing their benchmarks. In the 1990s, the Nobel Prize in Economics was awarded to financial economists Harry M. Markowitz, Merton Miller, and William F. Sharpe for their contributions to the body of work known as Modern Portfolio Theory (MPT). The major tenet of this theory is that markets are efficient at pricing securities — at least efficient enough to make active management non- or even counterproductive after the expenses incurred in the effort. As Goodman states, "Thinking you can consistently beat the market — bear or bull — is where the real folly lies."

Armed with the collective academic evidence, investors began to adopt passive investing. In 1992 the American Law Institute rewrote the Prudent Investor Rule, incorporating MPT into its definition of prudent investing for those with fiduciary responsibility. Since then, most state legislatures have passed legislation that adopts MPT as the standard by which fiduciaries invest funds.

Institutional investors have also clearly taken notice. Examples abound in *Pensions and Investments* (P&I), a leading newspaper covering institutional investing, demonstrating passive investing continues to win new adherents:

- P&I covered **Phillip Morris'** August 1999 transition from active to passive strategies for its $2 billion employee benefit plan. (August 9, 1999)
- In June 2000, P&I reported CIO John R. Krimmel's announcement that the **State Universities Retirement System of Illinois** had "decided to chuck [active investing] and go with indexing." Krimmel explained, "After 18 years, net of fees, we've done just about the index. … If you can't win, why play the game?" (June 26, 2000)
- As recently as September 2002, **Exxon Mobil's** $14 billion 401(k) plan joined the ranks of those that have adopted almost exclusive use of passively managed funds. Stating that they felt the passive approach was "a better deal" for employees, an Exxon representative noted, "We believe the index funds, on average, will outperform active funds because of fees." A memo to employees added, "Even if active managers outperform the market in one year, there is no indication of what will happen in future years." (September 16, 2002)

We applaud firms and individuals who implement a passive investment approach for all or most of their investments. While it is not the only step to success, it represents significant movement in the proper direction … and it makes the rest of the steps easier to accomplish. Despite the many Wall Street temptations that cause individual investors to stray from their investment course, the good news is that the long-term benefits of a passive approach continue to become more widely studied and recognized with every market twist and turn. It is never too late for any investor to apply lessons hard learned during the past few years by adopting a passive investment approach moving forward.

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[1] Refer to "The Value of a Good Education" on Page 4 for details on how to access Goodman's columns.

The Value of a Good Education

"Education is what you get when you read the fine print. Experience is what you get when you don't."[1]

Following are several suggested resources to help you remain an Educated Investor and avoid as many unpleasant experiences as possible in today's challenging investment environment:

Read a Good Book

In the last issue, we mentioned Larry Swedroe's latest book, *Rational Investing in Irrational Times*. Another recommended read is the recently published *The Four Pillars of Investing* by William Bernstein. Both books explain well how the markets work, and thus the logic of a passive investment approach.

Visit an Interesting Web Site

Dimensional Fund Advisors (DFA) recently upgraded its public site with more information and resources. DFA's "building block" mutual fund family is available to investors via professional financial advisors to help them implement passive investing: http://www.dfaus.com

Read a Good News Column

As described in "It's (Still) Time for Passive Investing" on page 3, Bev Goodman recently wrote an excellent series of articles for TheStreet.com:

- ▲ Active Mismanagement: The Case for Index Funds: www.thestreet.com/_tscs/funds/mutualfundmondaybg/10036923.html/
- ▲ Passive Management: It's Not an Oxymoron: www.thestreet.com/_tscs/funds/mutualfundmondaybg/10038215.html/
- ▲ The Best Fund Family You've Never Heard Of: www.thestreet.com/_tscs/funds/mutualfundmondaybg/10038756.html

Listen to National Public Radio

Tune into the following radio show, which aired on St. Louis NPR affiliate KWMU-FM, August 21, 2002, and featured a discussion about passive investing: www.kwmu.org/Programs/Slota/Archives/020821.html

[1] We saw this pithy quote attributed to numerous individuals, ranging from former SEC Chairman Art Levitt to folksinger Pete Seeger. Broadway playwright Wilson Mizner seems to have been the first to say it, sometime prior to 1933. Whatever its true origin, it's quoted often because it has rung so true across so many generations.

Instant Answer
(from page 1)

1. With the Economic Growth and Tax Relief Reconciliation Act of 2001, Congress modified IRA contributions from an allowable $2,000 per year to (b) $3,000 in 2002, gradually increasing to $5,000 by 2008, with periodic cost-of-living adjustments thereafter.

2. The same Reconciliation Act also provided that (a) Yes, taxpayers aged 50 or older could begin making catch-up contributions in 2002. Despite the change, according to a September 13 2002 *Wall Street Journal* column, "Only a fraction of those who can use these 'catch up' provisions have done so."

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- ▲ Fee-only investment management
- ▲ A disciplined investment strategy
- ▲ Access to institutional no-load passive asset class funds
- ▲ Fixed income expertise
- ▲ An academic Nobel Prize-winning investment approach
- ▲ Continued access to academic research
- ▲ A tax-efficient focus, with valuable tax and estate-planning ideas
- ▲ Risk tolerance assessment
- ▲ Periodic portfolio rebalancing
- ▲ Regular communications and state-of-the-art reporting
- ▲ MOST IMPORTANT ... A TRUSTED ADVISOR RELATIONSHIP

CYPRESS ASSET MANAGEMENT
1 N. Seventh St. Pekin, IL 61554
P 309-347-2440
F 309-347-7705
web www.cypram.com