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The Sound Investor Series #77

Odds & Ends
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One of the odd things about investing is the difficulty of figuring out exactly how you are doing and this ends up causing all sorts of problems. In this predicament, investors end up oddly not knowing if they are doing a good job or not. The result - many investors don't know if they should stick with their current strategy or take a new direction.

On the surface, complicated performance questions make it look like financial professionals are trying to make mountains out of molehills. Isn't it simple - if you make money - it's good and if you lose money - it's bad? At the end of the day that's right, but how do investors grade performance half way through a 10 or 20 year investment program? The important issue for most of us is - am I on the right course?

Making or losing money during the past calendar year is usually not the best way to measure progress. Stocks are one of the best long term investments, but they are volatile and fall in some periods. Selling your stock portfolio only because it falls during one year is not a good idea.

On the other hand, making a lot of money in a particular year doesn't necessarily mean you have the correct long-term investments. What risks are you taking to get those returns? Part of running a good portfolio is controlling risk.

Financial advisers and services, like Morningstar, try to help investors understand how mutual funds perform versus benchmarks and this is helpful. Now Morningstar is adding an additional benchmarking measure called "investor returns" and that is what prompted this discussion.

As explained on Morningstar's website "investor returns (also known as dollar-weighted returns) measure how the typical investor in a fund fared over various time periods, incorporating the impact of cash inflows and outflows from all investors' purchases and sales. If investors bought a fund after it had posted big gains and sold at a low ebb, investor returns will be lower than the fund's total returns. If investors bought and sold at more opportune times, however, investor returns will be higher than the fund's total returns."

For example, over the last 10 years, large-cap growth funds returned 5.9 percent a year. However, investors in these funds only made 2.9 percent a year because they "chase performance" by buying funds after they do well and selling them after a fall.

I am not sure if “investor returns” information really helps people identify better funds. Performance-chasing by investors is not a reflection of a fund manager’s skill or the attractiveness of the sector. I understand Morningstar is trying to help investors, but this particular statistic seems like an odd way to get there.

Speaking of odd advice, did you see Jonathan Pond on Public Television’s fundraiser earlier this week? Mr. Pond is the author of “You Can Do It! The Boomer’s Guide to a Great Retirement” and most of his advice is O.K. But when he said 80 percent of Boomers are in good shape for retirement, what was he thinking? My only guess is that it is hard to get people to send a donation if you tell them they are in deep trouble and better save more!

Speaking of charities, this is the time of year many of us make contributions. About three months ago I discussed a provision in the Pension Protection Act of 2006 that could help some donors give more to their charities and in case you missed it here are some of the major points.

The Act allows people 70 1/2 or older to donate money directly from their IRA to a qualified charity and never be taxed on the distribution. For the most part, if you itemize your deductions there is little or no benefit from this rule. However, if like two-thirds of Americans, you do not itemize your deductions this can offer a significant benefit to your charity.

For example, say you have a marginal tax rate of 15 percent and don’t itemize - you take \$1,000 out of your IRA to give to charity, you must first pay taxes of \$150 and only have \$850 left to donate. The law now allows you to directly donate the entire \$1,000 without being taxed. This increases your giving by almost 18 percent.

One very important point is that the donation must go directly from your IRA to the charity. If it passes through your hands it will be taxed. Donations are limited to \$100,000 a year and at the current time this provision is only in effect for 2006 & 2007. Importantly, these donations also count toward your required minimum distribution.

Like most Americans I think charitable giving is very important. If I can help anyone with questions about these types of contributions, please feel free to call me - no charge.

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