

IAP FINANCIAL ADVISOR

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Many retirees should delay taking Social Security benefits. 3

Active mutual funds come with tax cost, retirements are getting later, and more. 3

Use foreign stocks for diversification, not chasing returns. 4

Points of interest:

- Former Secretary of Defense Donald Rumsfeld's famous phrase, "unknown unknowns," pretty much describes the unforeseeable phenomena that affect the stock market.
- Studies of expert predictions show they are no better than random guesses.
- As a species we are poorly equipped to estimate probabilities and overconfident in our ability to do so.

IT IS THE 'UNKNOWN UNKNOWN'S' THAT WILL AFFECT YOUR PORTFOLIO

Among the many peculiar word constructions former Secretary of Defense Donald Rumsfeld is remembered for, there is one that applies to all forecasts of the future: the "unknown unknowns." In his words, they are "the ones we don't know we don't know."

That phrase, incidentally, was already commonly used in the Defense Department and elsewhere in its shortened version, "unk-unk."

It refers to an uncertainty that is completely unanticipated, so that it can't be factored into an analysis used to make a decision.

Unfortunately for those who participate in the investment markets, it is precisely the "unk-unks" that guide the outcomes.

Yogi Berra was right

"It's tough to make predictions, especially about the future," is an apropos saying attributed to famous baseball player and coach Yogi Berra.

Even if he wasn't the first to say that, the saying's validity stands.

Several studies of predictions by economists and security analysts have shown that their predictions—based on expert manipulation of the best available evidence—performed no better in telling us the course of events than did a simple coin flip.

As the advisors to the Tweedy, Browne mutual funds



We can't even conceive of the potential events that may affect our forecasts of the future of the economy and stock market.

noted in their recent annual report, the eminent *Financial Times* of London carried blaring headlines in the spring and early summer of 2006, predicting a dire outcome for the stock market that year.

Even as the last headlines appeared in July 2006, the market was already starting a new upswing that would lead to double digit gains for the year.

"And this is but a small sample of the volumes of advice investors have been and continue to be subjected to on a daily basis," Tweedy, Browne's managers wrote.

Another saying attributed to Berra spoke precisely to unexpected outcomes: "The future ain't what it used to be."

I underestimated

President Bush once used the malapropism "misunderestimated," a cross between misunderstood and underestimated. It is not a bad word, because it pretty accurately describes our innate limitations on estimation, which is vital to our (lack of) ability to predict.

Nassim Nicholas Taleb discussed this phenomenon in his recent book, *The Black*

WE ARE SO USED TO THE ORDINARY WE DON'T FORESEE THE UNUSUAL

Swan: The Impact of the Highly Improbable (2007, Random House). Studies of how people estimate probabilities, coupled with how confident they are of their abilities to do so, have shown “we overestimate what we know, and underestimate uncertainty, by compressing the range of possible uncertain states,” Taleb wrote.

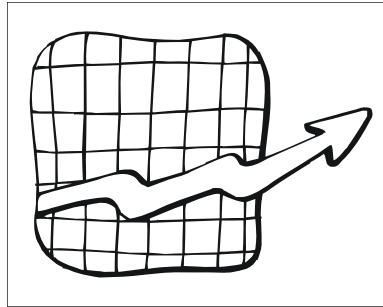
In other words, our predictive minds can't grasp the range of potential outcomes, and we almost certainly miss the rare but potential surprising or disastrous occurrences

that come along to upset our apple carts.

What didn't happen

Taleb offers another reason for our inability to predict unusual events: we are used to the familiar, the things we have experienced, and have trouble with the abstract things we have not—but could—come across.

“Randomness and uncertainty are abstractions,” he wrote. “We respect what has happened, ignoring what *could have happened.*”



Our predictions are often too narrow.

If that is the case, the best thing to do is lay off all predictions and be prepared for the best and worst at all times.

CAN YOU RESIST A CON ARTIST'S PITCH?

The stereotypical victim of financial fraud is isolated, frail, and gullible.

This picture may not be so accurate; in fact, research on investment fraud indicates that the typical victim may be very like ourselves, says the National Association of Securities Dealers.

The stock market regulatory organization says fraud targets often share some or all of these traits:

- Self-reliance in decision making.
- Optimism.
- Above average financial knowledge and income.
- College education.
- Experience with a health or financial setback.
- Openness.

A variety of tactics

Scam artists are good at matching their pitches to the psychological profiles of their targets, the NASD says.

They use mailing lists

derived from consumers' innocent response to preferences, hobbies, and lifestyles. They also ask simple questions about health, family, politics, and quickly adapt their pitches to your cues.

The tactics are varied and insidious. One method, dubbed the “source credibility” tactic, claims reputable associations, special credentials, or experience to win trust.

Another, The “social consensus” tactic, lures you with the claim that other savvy investors are already in on the deal.

The “scarcity” tactic creates a false sense of urgency by claiming limited supply.

The “reciprocity” tactic offers a favor, such as a price

cut or a cheaper commission, in return for your participation.

How to fight back

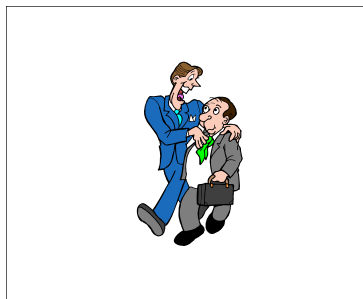
The NASD recommends immediately ending any telephone conversation involving a suspicious sales pitch, especially if the pressure is building.

Those

You can also ask the questions, finding out whether the seller is licensed and by whom, and whether the securities being sold are registered.

claims can then be checked on the Internet with the NASD, the Securities & Exchange Commission, and the North American Securities Administrators Association.

Finally, don't take action before discussing it with a family member or another trusted professional.



Financial con artists use questions to get inside of your world in order to tailor their pitches to your needs and weaknesses.

“They also ask simple questions about health, family, politics, and quickly adapt their pitches to your cues.”

SOMETIMES IT IS BETTER TO DELAY TAKING SOCIAL SECURITY BENEFITS

Some retirees—especially those who retire early—may be too quick to grab their Social Security benefits.

Many are happy to start collecting Social Security as soon as possible because they don't want to miss out on getting back some of the money they contributed over their working lifetimes.

Given that life expectancies are increasing, and that delaying receipt of Social Security increases benefits significantly, many retirees should consider waiting until full retirement age or even as late as age 70, says Laurence J. Kotlikoff, a Boston University economics professor.

The 7% solution

He notes that Social Security benefits increase in value for each year they are delayed (age 70 is the cutoff for increases). The increase is equal to 7% per year from ages 62 to 66 and 8% per year from 66 to 70, he says.

A study by the Fidelity Research Institute agrees.

For instance, a worker who is currently 55 and

makes \$75,000 a year can expect a Social Security benefit of \$15,888 at age 62.

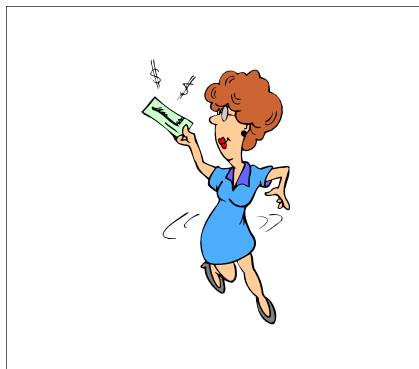
Waiting until the worker's full retirement age at 66 increases the benefit to \$21,768, and delaying until age 70 results in a \$29,436 benefit, Fidelity estimates.

If that worker lives until age 80 or beyond, he will collect more lifetime benefits by delaying his Social Security benefits to age 66 or later. If the worker dies earlier, it would have been better to collect Social Security at 62.

Inflation bonus

An added bonus of waiting until later to begin collecting the benefit is that future cost of living increases will be calculated on the larger benefit, further increasing the lifetime income collected by the recipient, Fidelity says.

Fidelity notes that you can retire but delay taking Social Security benefits and still get the benefit of higher



Some retirees shouldn't move too quickly to collect Social Security at 62.

benefits later.

However, retirees have to evaluate the tradeoffs of potentially depleting their retirement savings while waiting to begin benefits.

One mistake many retirees make is underestimating their longevity, Kotlikoff says.

For instance, a 65 year old male's average life expectancy is 76, while a female's is 81. Average, of course, means many will live longer, and in some cases much longer.

“An added bonus of waiting until later to begin collecting the benefit is that future cost of living increases will be calculated on the larger benefit.”

TAXES HIT FUNDS, LATE RETIREMENT, & MORE

Active investment strategies among stock mutual funds have cost investors 1.4 to 2.3 percentage points in annual returns, says Lipper, a Reuters subsidiary that tracks the mutual fund industry.

Trading of stocks held by the funds led to realized capital gains that are expected to cost mutual fund investors as much as \$25 billion in income taxes this year, Lipper said.

The average turnover ratio, an indicator of how fast



funds are selling their investments, reached 93% for actively managed funds, compared to 53% for stock index funds, says fund research company Morningstar.

Later retirement

Workers have been retiring earlier and earlier since the beginning of the last century.

That trend has reversed in recent years, says the Center for Retirement Research in Boston.

It says incentives from Social Security to continue

working, worries about Social Security's future, the shift from defined to contributory pension plans, and increased longevity are behind the trend.

Investing at home

Should you invest in a home rather than the stock market? Maybe not, says Yale economist Robert Shiller.

His study of house prices and rents shows that the rate of return after inflation has been zero since 1900, with the exception of brief periods after World War II and since 2000.

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FOREIGN STOCKS OFFER REAL DIVERSIFICATION IF DONE RIGHT

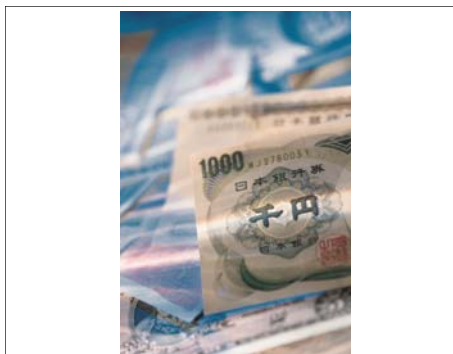
American investors have been pouring money into overseas stock markets, but their enthusiasm may be misguided.

The ability to diversify and reduce a portfolio's volatility is the most compelling reason for investing outside of the United States.

Having a portion of a portfolio in another stock market whose movements don't closely track that of the U.S. market can protect a portfolio when domestic stocks fall.

An added diversification bonus is the ability to diversify by currencies: if stocks are bought in local currencies and the dollar falls in value, the foreign investment is worth more to the U.S. investor.

Recent statistics on mutual funds indicate that American investors have been



The Japanese stock market offers real diversification to American investors.

throwing money at the hottest overseas markets, rather than those that currently offer the most diversification.

Financial Research Corp., a Boston-based company that tracks where mutual fund money is invested, found that funds investing only in European stocks got \$11 billion in new money last year, vs. just \$2.6 billion going into funds that invest in the Japanese

stock market.

Yet the correlation between most European stock markets and U.S. stocks has hit a high of over 80%.

Meanwhile, the correlation of Japanese stocks to U.S. stocks is at just 29%, meaning that Japan is much less prone to following the movements of our stock market.

Hong Kong, Singapore, and South Korea also have lower correlations to U.S. stocks than do European and Latin American markets.

Japanese stocks have not been doing as well as U.S. and European stocks, which is probably why they are not attracting as much interest. Investors looking for diversification, however, should make sure they are invested in all major markets, whether or not those markets have been doing well recently.