

## IAP FINANCIAL ADVISOR

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**Points of Interest:**

- The resurgence of Japan and smaller European stock markets have pushed the U.S. market below 50% of the world's market capitalization.
- Foreign markets account for the majority of the world's population and GDP.
- World class companies are operating in former third world countries.

## U.S. INVESTORS CANNOT IGNORE THE REST OF THE WORLD'S MARKETS

Every day the headlines proclaim new evidence of economic globalization. Television sets are no longer made in the United States, U.S. manufacturers rush to move production to China, programmers in India build and maintain our software.

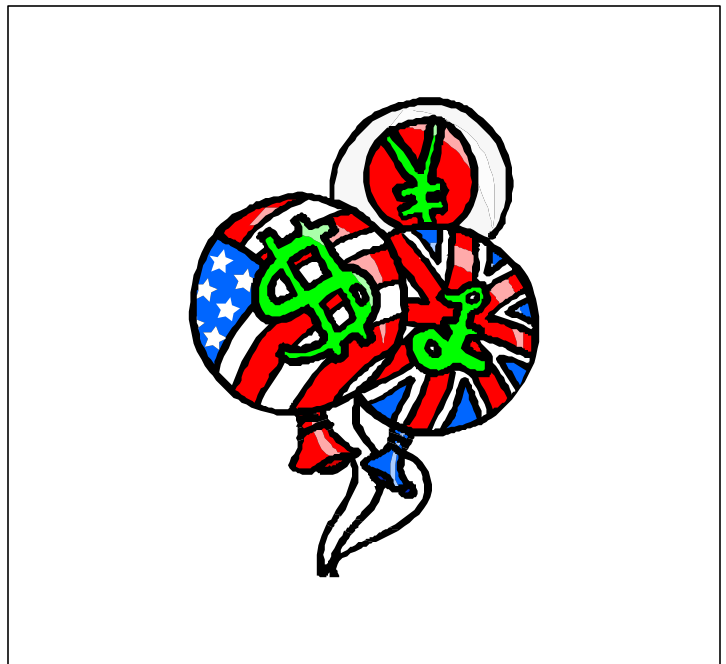
The global economic explosion has profound implications for U.S. investors: to survive, they can no longer stick to domestic stocks and bonds.

Although the U.S. stock market remains the world's biggest, its standing has declined. "The U.S. has slipped below 50% of the global equity market capitalization," says David M. Blitzer, managing director of Standard & Poor's.

The U.S. market has gotten smaller partly because Japan and some European markets have grown in recent years, he said. Japan once again is the world's second largest stock market, with a 10% share. Meanwhile, smaller European nations like Austria, Spain, Norway, and Iceland have grown, while the United Kingdom remains third largest at just under 10%.

**Don't stay at home**

Investors can no longer shop for stocks at home and ignore the rest of the world. Had they done that last year, for instance, they would have been sorry: U.S. stocks turned in a lackluster performance compared to double digit re-



The U.S. stock market has slipped below 50% of the world's stock capitalization, while Japan and a host of smaller markets are growing rapidly.

turns in other countries.

Indeed, avoidance of foreign investments means a U.S. investor gives up on 95% of the world's population and 80% of its gross domestic product.

Some big companies in developing countries are becoming dominant players in their industries: Korea's Samsung and India's InfoSys are two examples.

The growth of a middle class in Russia, China, India, and Brazil is fueling domestic demand and world trade.

And it is not just a growth story for U.S. investors: for-

eign stocks also offer diversification benefits because their economies and stock markets don't always move in sync with U.S. stocks.

**Buying foreign stocks**

The transaction and custody costs involved in foreign stock investing makes pooled investments, such as mutual funds, the vehicle of choice.

Indexed and asset class international funds are probably the best type of fund to use: they cover a range of countries and eliminate the risk of concentration in individual securities.

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## SMALLER INTERNATIONAL AND EMERGING MARKET STOCKS LEAD

(Continued from page 1)

The real benefits of international investing come to investors who venture into smaller and more exotic markets than the big industrialized countries. Smaller international stocks and developing market stocks seem to provide the most dramatic diversification benefits.

It just so happens that these are the countries with big long-range growth potential as well.

Asset class funds that invest in a representative array of stocks in each of these markets can reduce

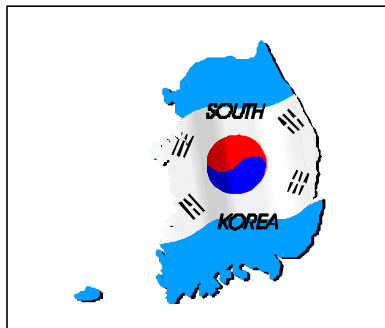
risks inherent to them.

The same reasons that domestic investors profit from using indexed and asset class funds apply to foreign investing.

In the United States it has long been shown that the average active investment manager has trouble beating the indexes.

Recent statistics show that international stock investment managers are having an increasingly difficult time beating their relevant indexes.

The *Journal of Indexes* recently reported that 61% of



South Korea has become a regional economic powerhouse.

managers failed to beat the international EAFE index in 2003, while 58% failed to beat it the following year.

## HOW TO AVOID SEVEN BIG MENTAL ERRORS

Human beings seem to come ready-equipped with cognitive biases related to their perceptual equipment and adaptations to the world throughout evolution.

Investors who want to do better in the markets and feel better about what they are doing must learn to recognize these states of mind.

Here is a summary of the major biases, with an investment lesson to be learned from each:

**Error 1: Confirmation bias** causes us to rely on first impressions and to ignore further, disconfirming evidence. The lesson is to pay attention to new information and don't stick with a losing investment just because it rewarded you at one time.

**Error 2: "Anchoring"** causes us to fixate on a starting number or fact. Forget that you bought a stock for \$45 a share. That price has no long-term significance and there is no reason it can't go

to another much higher or lower level and stay there.

**Error 3: Representative-ness** causes us to make judgments based on strong images maintained in our minds and to extrapolate based on current conditions.

Investors should realize that today's trends will not be tomorrow's and that winners may not repeat.

**Error 4: "Salience" and "availability"** also cause us to overestimate or underestimate the odds of market trends. However, markets will not go up or down forever, and investors should turn to market history for a corrective to their current optimistic—or pessimistic—feelings.

**Error 5: Overconfidence**

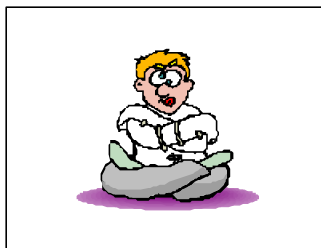
tends to make us place too much value on our own abilities. However, we can't all be above-average drivers.

Investors should question their own beliefs about whether they can profitably pick stocks or time markets.

**Error 6: Loss aversion** makes it hard to admit errors and realize an investment loss. However, it often is better to get out of a losing investment or strategy and go into a more rational, diversified portfolio.

**Error 7: The "money illusion"** causes us to rely on nominal values and ignore the effects of inflation.

All investment returns—whether it is bond interest or capital gains on stocks—should be evaluated within the framework of long-term inflation.



Emotions and mental biases can make an investor crazy.

*"Investors should realize that today's trends will not be tomorrow's and that winners may not repeat."*

## SO WHAT IF INTEREST RATES ARE RISING? BUY BONDS NOW

The last 18 months have been a difficult time for bond investors.

The Federal Reserve Board has been relentlessly raising short-term interest rates and bond investors have watched as the principal values of their bonds have fallen.

It appears the Fed hasn't finished raising rates and that puts investors in a quandary: should they buy bonds now as part of a diversified asset allocation strategy, or should they hold off until rates stabilize?

Although it is counter-intuitive, there really is no penalty for buying and holding bonds in a rising-rate environment, say two professors at Ball State University in Indiana.

"In the portfolio context, now is always the right time to own bonds, because bonds will always be part of the market portfolio," write Manoj V. Athavale and Terry L. Zivney in the *Journal of Financial Planning*.

However, that may be poor consolation to the buyer

who sees his bonds decline in value the minute the Fed raises rates.

Over time, however, that temporary decline will be erased, the authors argue.

### Pure expectations

First, the "pure expectations" hypothesis has long argued that today's interest rates are an unbiased predictor of future interest rates and returns. An investor who buys bonds now and collects interest will do as well as an investor who keeps his money short term temporarily and buys bonds later, Athavale and Zivney argue.

A second hypothesis about the bond market argues that investing today, even when rates are rising, will result in higher returns over time.

The "alternative liquidity premium" hypothesis argues that investors get an extra return, known as the "liquidity premium," for taking the chance and investing now. If they wait to buy later they will



Investors who wait to buy bonds may miss out on a liquidity premium.

lose that premium.

The assumption is that the bond market as a whole anticipates upcoming changes in interest rates and incorporates those anticipations into current bond prices and yields, they note.

Thus, an investor who believes he has insight the bond market doesn't have would not invest now. Those who trust to efficient markets should take the plunge now and stop worrying about short-term fluctuations.

*"There really is no penalty for buying and holding bonds in a rising-rate environment."*

## A PRICEY IRA, MERRILL IS FINED, & MORE

Tax preparation service H&R Block has gotten into hot water with New York's attorney general over allegedly excessive fees on IRA accounts sold to clients.

The state charged Block with putting low-income customers into its proprietary IRA, which charged fees higher than the interest paid on the accounts.

State Attorney General Eliot Spitzer said Block's clients were "virtually guaran-



teed to lose money on the IRAs." Block defended its product, saying it offered an "effective" savings vehicle for savers with moderate incomes.

### Merrill gets nabbed

Merrill Lynch will pay a \$5 million fine for letting its brokers put clients in inappropriate mutual funds in exchange for company-paid dinners and concerts.

The National Association of Securities Dealers said the firm switched many small customers away from their individual brokers to "call

centers" manned by inexperienced representatives. The company illegally used non-cash compensation to reward reps who sold high-cost funds to clients, the NASD charged.

### Market highs are elusive

U.S. stocks have recovered strongly over the last three years but remain below levels reached in early 2000, just before a bear market began.

The S&P 500 Index, over 1300 this spring, is up 67% from its low point in 2002, but remains 200 plus points, or about 15%, below its 2000 high point.

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## ALAN GREENSPAN'S LEGACY OFFERS A LESSON TO INVESTORS

The remarkable 18-year tenure of Federal Reserve Chairman Alan Greenspan has come to an end. Investors can learn a thing or two from Greenspan's successes.

Perhaps the biggest revelation about the key to his success is this: there was no single key.

Greenspan was not ruled by a single idea or theory. He was able to avoid dogmatic theories in an uncertain and changing world.

He has called himself a follower of the 18th century thinker Thomas Bayes, who studied how to make decisions when key factors that determine the outcome are unknown.

Greenspan says he makes decisions based on not one probable outcome, but on a range of possible



What seemed like a private crystal ball was really Greenspan's knack for remaining unbiased.

outcomes. This ability fueled his emphasis on risk management, that is, his ability to deliberately risk making small mistakes while avoiding big blowups.

Such intellectual elasticity may have helped Greenspan avoid a bout of deflation in the United States back in 2003. Rather than risk a disastrous slide into declining prices, he kept interest rates

artificially low, all the while knowing that it could result in some inflation down the line. As he told Congress that year, "We know how to deal with inflation." Deflation, on the other hand, would be difficult to solve.

Investors who think they have doped out the economy and the markets should heed Greenspan.

"Uncertainty is not just an important feature of the monetary policy landscape; it is the defining characteristic of that landscape," he said in a 2003 speech.

Greenspan didn't rely on his own and other's forecasts. He once said that one of the very few "knowns" is that a company's inventory can't go below zero. That fact is "probably the full state of my knowledge about how to make a forecast," he said in 2004.