IAP FINANCIAL ADVISOR

May 2005

Volume 6, Issue 3

Inside this issue

Many large stock funds are becoming "closet" index funds, but at a higher cost. *See story on page 2.*

The SEC is forcing brokers to disclose that their fee-based brokerage accounts may not always be in the clients' best interest. See *story on page 3.*

Banks and their brokerage subsidiaries get caught breaking the rules. Who uses checks anymore? *See story on page 3.*

Hedge funds are coming to the masses, but their returns may not be as advertised. *See story on page 4.*

IAP is:

Arthur J. Canter, CPA/PFS, CFP

Frederick M. Heimberg, Attorney at law

Mark D. Miclean, CPA

Inflation: Income and portfolio slayer

Investors, especially retirees living off their portfolios, spend a lot of time worrying about market volatility. The temporary ups and downs of the stock market are scary but they are truly temporary. Meanwhile, another and scarier killer, one that seems permanently embedded in our financial system, lurks about, constantly devaluing retirement incomes and portfolios.

The culprit - inflation - has become so familiar that it doesn't seem to scare us as it once did. Yet, as we come off of a period of relatively benign price increases, it is worthwhile to note that inflation should remain the key concern of anyone planning for retirement or who is already retired.

Anyone over 50 can remember 25-cent-a-gallon gasoline, 2-cent postage stamps, and new autos that cost $2,100.

> "Anyone over 50 can remember 25-cent-a-gallon gasoline and 2-cent

And they can also remember the last bout of high inflation we endured, the period 1973 through 1981, when the Consumer Price Index rose at an average annual rate of 9.2%.

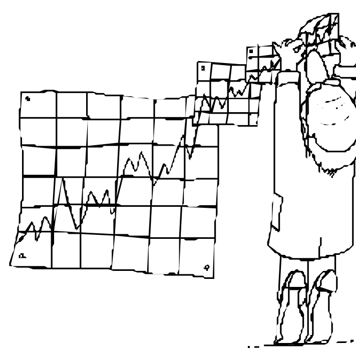
Inflation also seems to be a pretty constant phenomenon. The last calendar year in which consumer prices fell was 1954.

Inflation lately has been down but not out. The long-term average since 1926 remains at 3% through 2004. At that rate, a 65-year-old worker who retires today with an income of $50,000 a year will have the equivalent spending power of just $27,000 at age 85. It is not pleasant to contemplate a constantly declining standard of living in what are supposed to be the golden years.

The Silent Enemy

Inflation is a permanent danger that can devastate a portfolio and a retirement income:

- ⇒ *Inflation has risen in all but 10 years since 1926.*
- ⇒ *The last time inflation declined for a calendar year was 1954.*



- ⇒ *The long-term average inflation rate is 3%.*
- ⇒ *3% inflation can cut a $50,000 retirement income almost in half over 20 years.*
- ⇒ *Inflation can run much higher than average. From 1973 through 1981 consumer inflation rose at an av-*

Source: Stocks, Bonds, Bills and Inflation 2003 Yearbook

Stocks: The inflation defense

How does one prevent inflation from wrecking retirement?

The first thing to avoid is socking everything away into fixed income investments, be it the bank, money markets, government or corporate bonds.

Fixed-income investments have a lousy history of keeping ahead of inflation. During 33% of

(Continued on page 2)

IAP Financial Advisor is published quarterly by **Investment Advisory Professionals, LLC**, Registered Investment Adviser, 400 S. Dixie Hwy., Ste. 322, Boca Raton, FL 33432. (561) 391-4477.

Active mutual funds become high price indexers

Actively managed mutual funds purport to offer market-beating strategies in return for the higher cost of owning them.

That supposed advantage has disappeared for many large stock funds, according to a recent study by Morningstar Inc., an independent rating service.

The study found that the number of closet index funds has tripled over four years.

At the end of 2004 some 27.6% of large stock funds were very closely correlated with the Standard & Poor's 500 Stocks Index, the leading index of large U.S. stocks.

At the end of 2000 just 9% of large stock funds were closely correlated to the S&P 500, Morningstar said.

Back in 2000 many large stock fund managers were still concentrating their money in big high tech stocks that had dominated the market over the previous four years.

However, after being burned badly in the subsequent three-year bear market, it appears that some of those managers believe it is safer not to stray far from their benchmark index.

"It's the chicken's way out," said Kevin Fryer, whose Kansas City, Mo. company produces software that tracks correlations between funds. "Many of these fund managers got burned in 1999 and 2000, and they are risk averse."

Higher costs for consumers

Some of the most popular large growth funds are closet indexers, the study said.

For instance, Growth Fund of America, with $95 billion in assets, and Fidelity Magellan, with $60 billion in assets, were very closely correlated with the S&P 500 Index.

There's nothing wrong with following an index; indeed, much academic research indicates that returns on indexes often beat the returns on many actively managed funds.

However, there is a disadvantage to paying active managers' higher costs.

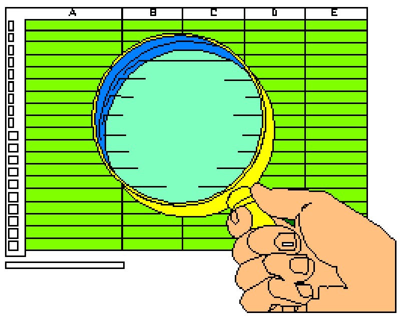
The average expense ratio of actively managed large stock funds was 1.47% of assets at the end of last year, says Lipper Inc., another mutual fund rating company.

By contrast, investors would pay management fees of less than 0.2% for the average S&P 500 Index fund. Be-

Examining Funds

A study by Morningstar shows that some active mutual funds are disguised index funds:

- ⇒ *Almost 28% of large stock funds were virtually indistinguishable from the Standard & Poor's 500 Index last year.*



- ⇒ *The number of closet index funds has grown dramatically since 2000.*
- ⇒ *The average management fees on closet index funds were seven times that of fees on index funds.*

Source: Morningstar, Inc.

Bond returns fail to keep up with inflation

(Continued from page 1)

the 20-year calendar periods from 1926 through 2004, short-term cash investments fell behind inflation. Someone who put their money in short-term cash holdings saw their buying power decline during those periods.

Longer-term bonds did not do much better. Five-year Treasury Notes fell behind inflation during 27% of those 20-year periods.

Investors in U.S. stocks did much better.

An investor who bought the stocks in the Standard & Poor's 500 Index at the start of any of those 20-year periods ended up ahead of inflation.

It should be noted that this stretch included the stunning stock market decline during the Great Depression of the 1930s, as well as the large losses experienced in the major bear markets of 1973-74 and 2000-2002.

Investors in small U.S. stocks also ended up ahead of inflation during every 20-year period, as measured by the Center for Research in Securities Prices 9-10 Index.

Take a balanced approach

No one can predict the course of inflation and investment returns in the bond and stock markets during any individual's retirement. Although stocks have a good record of keeping ahead of inflation, they are periodically subject to extended downturns. Few retirees living off of investments can afford to put everything into stocks.

Therefore a mixed portfolio of stocks and fixed-income investments seems the most reasonable approach. Investors can insulate themselves somewhat from inflation's effects on their fixed-income portfolios by including a stake in inflation-linked U.S. Treasury or Corporate Bonds.

One must still be careful when buying these, however, as prices often are bid up by anxious investors, lowering

> "Five-year Treasury Notes fell behind inflation during 27% of those 20-year periods."

Brokers vs. advisers: What's the difference?

Investors are having a lot of trouble telling the difference between stockbrokers and investment advisers.

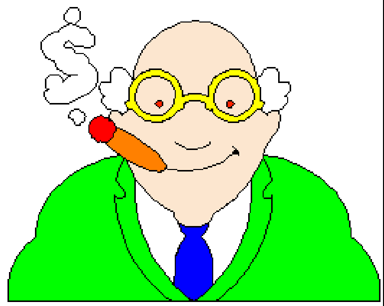
Despite the very real differences in their responsibilities toward clients, the lines between professional advisers who manage investment accounts for a fee and stockbrokers have become blurred, especially since major stock brokerages began offering look-alike fee-based accounts.

The Securities and Exchange Commission is concerned that investors are confused and has promulgated specific disclosures that brokers will have to make.

Investor Confusion

Stock brokerages have blurred the line between investment sales and investment advice:

- ⇒ *Brokers do not have the same responsibility as investment advisers to act in a client's best interests.*
- ⇒ *Big brokerages now offer fee accounts that resemble the full-advice services of investment advisers.*



Source:"Securities & Exchange Commission

The major difference between investment advisers and brokers is their responsibility to the clients.

Advisers are required to act as fiduciaries, meaning they have to put their client's interests first. This is considered a strong protection for investors, since the fiduciary has a legal duty to the client.

Brokers, on the other hand, are not bound by those rules. Their main obligation is to offer investments that are suitable to an individual client's needs.

Since it isn't always clear what is suitable, this protection is weaker. In fact, some arbitrators have ruled that brokers weren't obligated to represent a customer's best interest.

Meanwhile, brokerage firm ads stress their new roles as "advisers" and long-term investment planners.

The SEC's own focus groups show that consumers can't tell the difference. When asked to distinguish among brokers, investment advisers, and financial planners, investors in Baltimore and Memphis offered responses like these:

- "I don't know the difference. I mean I've got a guy that gives me advice. I don't know what he is."
- "I couldn't tell you (what the differences are). "It's probably on my monthly sheet and I couldn't tell you which one it is."
- "How could you be clear when you've got brokers calling themselves planners and planners calling themselves investment advisers? It's not clear."

The SEC told brokers that they must offer plain-English disclosures in their advertisements and brochures.

The brokers will be required to tell investors that brokerage firm interests may not be the same as the investor's interests.

Investors will be urged to "ask questions to make sure you understand your rights and our obligations." And investors will be told "we are sometimes paid

Shelf space scandal, annuity sales, & more

Major brokerages continue to get into trouble for offering preferred "shelf space" to mutual fund families that paid higher commissions to the brokerages.

In the latest cases, Banc of America Investment Securities - formerly Quick & Reilly - was fined $570,000 and Piper Jaffray & Co. was fined $275,000 by the National Association of Securities Dealers.

Both firms favored a handful of mutual fund companies, the NASD said.

"These sorts of arrangements encourage the inappropriate use of mutual fund commission dollars and have the potential to improperly influence a firm's judgment when making recommendations to their clients," said Mary L. Shapiro, NASD vice chairman.

The NASD previously fined Edward D. Jones and Morgan Stanley for similar violations.

Annuity violations

Bank sales of annuities are being scrutinized by securities regulators.

The NASD recently filed a complaint against Citizens Financial Group in Massachusetts and said that complaints about annuity sales practices have jumped by 50% over five years.

The NASD said it is looking into sales practices that involve switching senior citizens from certificates of deposit to annuities without ensuring the buyer understands the risks and possible early withdrawal penalties.

The decline of the check

Remember when you used to have to wait in the supermarket line for someone ahead of you to write a check?

Those days are declining fast as debit card use, Internet transactions and other electronic payments increase.

The Federal Reserve says that 2004 was the first year ever that credit and

IAP FINANCIAL ADVISOR

Investment Advisory Professionals, LLC
400 S. Dixie Hwy., Ste. 322
Boca Raton, FL 33432

Forwarding and return postage guaranteed
Address correction requested

First Class Mail

Here's your copy of
IAP Financial Advisor

Fashionable hedge funds don't deliver returns

Every few years an investment product catches the public's eye. Investors clamor for it and salespeople are more than happy to provide.

The problem is that such exotic products usually have already peaked at just about the time they hit the mainstream market.

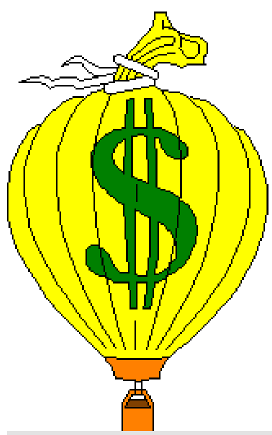
So it may be with hedge funds, those wild and highly unregulated investment vehicles that used to be available only to the very wealthy.

Over the last two years hedge funds have become widely available to middle income investors.

During that same period performance dropped sharply.

But over the same period investors would have done better by sticking their money into an average mutual fund. Hedge funds gained 3% on average in 2003 and 8% in 2004, while the average stock mutual fund gained 24% in 2003 and 8.4% last year, according to DFSB-Tremont, which publishes a hedge fund index.

Other investment professionals have argued that those hedge fund return figures are inflated.



Expectations for hedge fund returns may be inflated.

Princeton University professor Burton Malkiel says returns are inflated by "backfill bias," a phenomenon where hedge fund managers establish a fund with seed capital and report their returns later only if initial results are favorable.

This practice could add as much as five percentage points to reported returns, he says.

Also, hedge fund return reporting suffers from survivorship bias, where failing funds stop reporting their results to return databases. For instance, Long Term Capital Management, which blew up in the late 90s and lost 92% of its capital, never reported those returns.

Investors should also be wary of hedge funds because they face far fewer regulations than do more common investment vehicles such as mutual funds and individual stocks and bonds.

Mutual funds, for instance, have to state their strategies and discuss their risks openly with investors. Hedge funds do not and are likely to swing widely from one investment strategy to another. The Securities and Exchange Commission is looking at new disclosure regulations for hedge funds.