IAP FINANCIAL ADVISOR

Aug 2005

Volume 6, Issue 4

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Hedge funds: There's no free lunch

Ever since the big bear market of 2000-02 individual investors have been leery of the stock market.

Still reeling from big losses, and battered by scary headlines about the dollar's decline, rising interest rates, and trade and budget deficits, they have flocked to "alternative" investments that promise big returns not tied to the stock market.

Hedge funds have been the big beneficiaries. These lightly regulated investment pools engage in a variety of strategies from currency speculation to shorting stocks to other forms of speculation. They promise to make money in both up and down markets.

The reality may be a little different than the promise. Reports in recent weeks of hedge funds closing due to poor returns and lack of investment opportunities illustrates that there is no risk-free lunch when investing.

In mid-June a $1.7 billion hedge fund, Marin Capital Partners, announced it would close and return its investors' money.

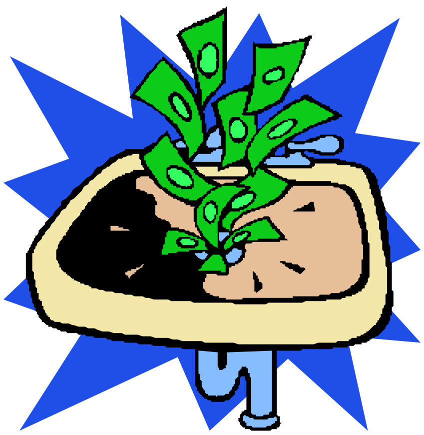
> "The translation is as follows: 'We can't make money in this market.'"

Marin said it was closing "due to a lack of suitable investment opportunities in the current market environment, and in our view an unfavorable risk/ reward situation in the relative value strategies we trade." The translation is as follows: "We can't make money in this market."

Strong Headwinds

Hedge funds promise high returns with low risk, but reality may not match expectations:

- ⇒ *Index comparisons show that the average stock mutual fund handily beat the average hedge fund in 2003 and 2004.*



- ⇒ *Several large hedge funds are closing due to poor returns and lack of investment opportunities.*
- ⇒ *Hedge fund expenses are high: many charge 2% annual asset fees and keep 20% of each investor's profit.*

Marin is not alone. Less than a week after its announcement, another hedge fund, Bailey Coates Asset Management, said it had lost 25% of its investors' money this year and would close.

The London-based company said it had made bad bets on U.S. and European stocks. The fund managed $1.3 billion at its height but was worth only $500 million when the announcement was made. On the same day a third hedge fund, Aman Capital Management of Singapore, said it was returning $240 million to its investors.

Their experiences are not unique this year. *The Wall Street Journal* reported in its story on Marin Capital's closing: "Many of the biggest,

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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.

Investors who want to prosper think long term

"Live long and prosper," Leonard Nimoy's character Spock, from the original *Star Trek,* liked to say.

Investors - especially the media-bombarded impatient types of today - should take that adage to heart, perhaps substituting the word "invest" for the word "long."

In an era of second-by-second market updates readily available on cable TV and the Internet, investors seem to be having trouble with the concept of long term investing.

One major cable station starts out its morning financial coverage with a segment called "Trade of the Day." Investors check their account balances daily, even hourly, online.

Is this any way to make money? Clearly not: the markets can fluctuate widely and violently day-to-day and week-to-week. These fluctuations, however, mean nothing in the long term and tell you very little about the future.

A smart investor shouldn't worry about tomorrow's account balance or how much he or she is likely to make or lose this year. Instead, equity investors should be pumping every dollar possible into the market so that 15 or 20 years from now he or she can have bragging rights over the ensuing profits.

It doesn't matter that the Dow Jones Industrial Average started 2005 at 10,783 and that it is below that level now.

What matters for a long-term investor is that the Dow was at 1,198 at the start of 1985. Wouldn't you have liked to have invested then and seen your money grow by 800%?

A smart investor is focused on 2025, not 2005. Where could the Dow be by then?

Roger Ibbotson, a Yale professor and respected investment researcher, has predicted that the Dow would be over 100,000 in 20 years. Back in 1973, when the Dow was only 850, Ibbotson predicted the Dow would hit 10,000 in 1999. The Dow closed above 10,000 for the first time in March 1999.

Ibbotson has predicted a median return of 11.6% per year for the big stocks that make up the Dow and that prediction underlies his forecast of a Dow above 100,000 by 2025.

What if returns are less? A 6% average annual return over the next 20 years will still boost the Dow to nearly 35,000 by 2025. That low return would still triple an investor's capital.

The lesson: ignore today's market movements, put your money to work,

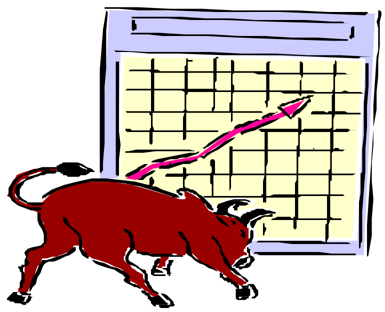
The 20-Year Plan

Investors should ignore daily market movements and focus on results 20 years down the road:

⇒ *20 years ago the Dow Jones Industrial Average stood at 1,198. At the beginning of this year it was at 10,783.*

⇒ *One forecast places the Dow above 100,000 by 2025.*

⇒ *Even a modest 6% annual return would push the Dow to nearly*



Sources: Ibbotson Associates, Dow Jones & Co.

Hedge fund returns have been below par

(Continued from page 1)

best-known funds have done a poor job, whatever the market, whatever the strategy. Even strategies aimed at limiting volatility have produced big losses this year."

It also reported that two of the largest hedge fund companies, Vega Asset Management and GLG Partners "are nursing big losses at funds they manage."

This hasn't stopped the big brokerage houses from pushing hedge funds to middle-class investors. Many now offer "funds of hedge funds" that allow investors with modest amounts to buy a pool of hedge funds.

Whether they are buying something that will give them decent returns with low volatility is another story.

First, they face a big expense drag. The average hedge fund operates by the "two-and-20" rule, charging a 2% annual fee on assets under management and keeping 20% of any profits earned.

Compare that to an average stock mutual fund, whose expense charge hovers around 1%, or to an indexed fund with expenses of 0.2% or less.

Also, they rely on the unproven claim that their particular hedge fund manager has a unique strategy and the skills necessary to implement it so that he or she can earn money even when others are losing it.

> "They rely on the unproven claim that their particular hedge fund manager has a unique strategy."

On average they don't seem to excel. DFSB-Tremont, which publishes hedge fund returns, estimates that the average hedge fund gained just 3% in 2003 and 8% in 2004. The stock market - and the average stock mutual fund - handily beat those returns.

In the end, simpler may be better. A portfolio of diversified, low-cost mutual funds is a better bet for long-term profits with lower volatility.

How 'confirmation bias' clouds your judgment

(Editor's note: This is the first in a series on cognitive errors and emotional biases that hinder investment success)

First impressions count, but, unfortunately for many investors, they may count too much.

The human tendency to rely on first impressions and stick with them despite later evidence to the contrary has been dubbed "confirmation bias" by cognitive researchers.

It is a form of mental shortcut that allows us to make decisions when faced with a lot of information.

However, it also may force us to rely on the wrong information and to ignore good information that may help us later.

Many psychological experiments have identified confirmation bias as being widely held.

They found that as soon as someone develops a preference they would filter new information in a way to support that preference. New information that contradicts the preference will be ignored or discounted.

Dangerous Preferences

We have a tendency to develop an initial preference and to stick with it despite contradictory information:

⇒ *"Confirmation bias" has been identified by cognitive researchers as a common human tendency.*

⇒ *Once a first impression is formed, additional information is filtered to confirm the impression.*

⇒ *New information that contradicts the first impression is ig-*

They also found that once someone has developed a feeling about something it becomes much harder to overcome the bias created by that feeling.

Marketers and advertisers use this bias as the cornerstone of selling: if they can make a positive first impression, they are more likely to make a sale.

How does this affect investors?

Suppose you buy a stock for whatever reason - a tip, research you have done, or you just like the company's products.

Immediately the stock starts going up and has a great run for six months.

Such action would "confirm" your decision. What if negative information started coming in, such as critical analyst reports, an accounting scandal, or a decline in your stock's industry?

For investors already confirmed in their beliefs in the stock, the new information most likely would be discounted: they would continue holding the stock because it was "good."

Sound outrageous? Then consider the millions of investors who stuck with Internet and communications stocks from the late 1990s through the bear market.

Many saw gigantic leaps in value in 1998 and 1999, only to see the stocks go into a freefall in the 2000-02 bear. Unfortunately, their early good experiences clouded their judgment and they couldn't bring themselves to sell their stocks.

Many held on until their stocks

Social Security, Amex is fined, & more

As the debate over Social Security's future continues, future retirees should know how important the program is to many workers who retire.

A recent study by the non-profit Employee Benefit Research Institute shows that Social Security is the largest single source of income for those over 65.

Social Security accounts for almost 42% of the average retiree's income.

Another 21% of income is derived from pensions, 22% from earnings, 14% from income from investment assets, and the rest from other sources.

Meanwhile, the poorest 20% of the population rely on Social Security for 91% of their income.

Amex settles charges

American Express Financial Advisors has reached a $7.4 million settlement with New Hampshire, which had charged the company with selling "cookie cutter (financial) plans heavily laden with American Express mutual funds."

The state had discovered during branch audits that accounts were loaded with Amex funds; later it obtained e-mails showing that agents had been pressured by regional management to sell Amex funds rather than those of non-related fund companies.

Analysts get it wrong again

Stock analysts at major investment houses were told to clean up their acts after the scandals of a few years ago.

They still aren't doing a better job, according to a study by Zacks Investment Research for *The Wall Street Journal*.

The newspaper recently reported that stocks subject to "sell" recommendations by analysts have performed better than stocks the analysts recommended for purchase.

Experts attributed the phenomenon to late calls by analysts, who reluctantly issue sell recommendations after bad news hits companies. At that point, the bad news is already out and the stocks are often primed to recover.

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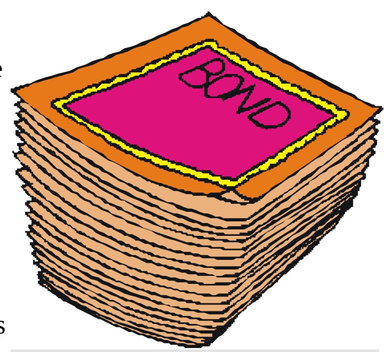
U. S. Savings Bonds are no longer a great deal

Once again the U.S. Treasury has changed the Savings Bond program and, once again, the changes make them less attractive.

Hundreds of millions of dollars continue to pour into the decidedly old-fashioned Series EE Savings Bond.

For many years now the rates on EE Bonds have been adjusted every six months based on the recent rates for other Treasury Securities. When owners cashed in the bonds they received an average of all the six-month rates declared during their ownership period.

This method ensured that bond owners would not get stuck with a low rate during a period of rising interest rates.



Series EE Savings Bonds are losing their ability to keep up with rising Rates.

However, rising interest rates may have scared the Treasury. The benchmark rate for EE bonds hit 3.94% at the end of April.

In May it announced that it was switching to a fixed rate system for EE bonds. Anyone who buys an EE bond between May and October of this year will get a fixed rate of 3.5% for 20 years; a separate rate will be announced for the remaining 10-year life of the bond.

The change effectively puts EE bond owners back on a par with buyers of traditional Treasury T-Bills, notes, and bonds: they will have to take the chance when buying their EE bond that its rate will stay competitive for many years.

However, unlike holders of other Treasury securities or of corporate bonds, EE bond owners will not find it so easy to sell their bonds if the rates are no longer attractive.

Buyers must hold the EE bond for one year before cashing it in; if they cash it in before five years are up they pay a three-month interest penalty.

Those who like Savings Bonds should consider an alternative: the I Bond, which earns a fixed interest rate plus an added bonus rate to make up for inflation.

Currently the I Bond fixed rate is 1.2%, while the inflation premium is 3.6%, giving the bonds a 4.8% interest rate.

Mandatory one-year holding period and early redemption