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PDV *OBSERVATIONS*

Staffing Additions at PDV Financial Management

We would like to share some exciting news about PDV Financial Management. As we approach the 8th anniversary of PDV's founding, we are most gratified by and grateful for the extraordinary business growth we have experienced over the years. Due to the trust, support and loyalty of our wonderful clients, assets under PDV's management are at record levels and growing. As measured by assets under management, PDV is now considered by the Securities Exchange Commission to be among the larger investment advisory firms in the country. Client satisfaction appears high, as many clients have either consolidated accounts previously managed elsewhere with us or sent us referrals, or both, during the past few years. We greatly appreciate the support!

A long time ago, we decided PDV could not be all things to all people. There are some potential clients who would not be a good match for us. On the other hand, we are always pleased to be of service to those who have the interest and patience to seek long-term wealth accumulation through value investing. PDV's investment results, which have been highly satisfactory, both over time and through the recent market cycle of the past few years, have, we think, made our clients' commitment to our value-oriented investment style very worthwhile.

If you can think of anyone who might benefit from our investment services, we would be most pleased to hear from you. Our investment minimum continues to be $250,000 for now, though we're contemplating increasing this amount.

To accommodate and service the tremendous growth of our business, we're excited to announce that Ms. Deborah Lee, a co-founder of PDV Financial Management, has re-joined our firm. Debbie graduated from Cal Poly Pomona with honors and obtained her Masters Degree from Purdue University. For the past four years, she served as the Senior Portfolio Analyst at AMI Asset Management, in charge of that firm's "back-office" operations. She also conducted investment research and analysis for AMI. She has her investment license, having passed the Series 65 "Uniform Investment Adviser Law Examination."

At PDV, Debbie will serve as the Senior Financial Advisor, helping with investment research and analysis, and providing various financial planning services, such as consultation on 529 Education Savings Plans. With her expertise, we will also be able to broaden the scope of financial planning services that we provide.

Ms. Cynthia Medeiros will continue to serve as Senior Portfolio Specialist, in charge of helping clients with operational and administrative issues relating to client accounts, providing assistance on Schwab-related matters and generating portfolio data to support investment decisions.

Mr. Che Lee will continue to research, analyze and monitor promising undervalued investments and manage client portfolios to the same extent as before.

We look forward to continue working hard to help our clients reach their financial goals!

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Rethinking the Need for Professional Management of 401(k) Accounts

In our experience, while many people will not hesitate to hire investment professionals to help manage their assets outside of company retirement plans (e.g. taxable accounts and IRA's), they are more reluctant to see the need for professional management of their company sponsored retirement plan assets, such as those in 401(k) accounts. This is unfortunate, as the assets built up in these types of accounts over time will in many cases make up the bulk of a person's retirement assets. In this article, we will offer some thoughts about why people have this attitude and how holding onto these views may be hazardous to their long-term financial security at retirement.

The explosive popularity of defined contribution plans, such as 401(k) plans, during the 1990's was due to several factors: 1) employers' desire to shift the burden of making investment decisions to employees; 2) employers' desire to reduce their cost in funding retirement plans, giving employees only limited or no matching contributions, and letting employees finance their savings through payroll deductions; 3) employees' ready acceptance of these plans in lieu of the traditional "defined benefit" pension plans, because their contributions enjoy tax advantages and the ability to make investment decisions with respect to their retirement assets gave them a sense of empowerment and control; and 4) the bull market that prevailed during much of the 1990's made most plan participants feel like investment geniuses as losses were few, infrequent and short-lived.

These plans made just about everyone happy, until the tech bubble burst in March 2000, dragging the rest of the market into one of the nastiest bear markets since 1973-74. Slowly, millions of investors with the bulk of their retirement assets tied up in 401(k) plans started seeing their accounts actually lose value, month after month. Then came Enron and its well-publicized woes, a significant part of which related to how its many innocent, hard-working employees stood by helplessly, as their life-savings represented by Enron stock trapped inside their 401(k) accounts were decimated. Suddenly, just about every person with money invested in 401(k) accounts started questioning the wisdom of keeping money in these types of accounts.

As the Enron fiasco unfolded, demands for answers and satisfaction erupted. The politicians went into grand-standing overdrive. The recent legislation aimed at mitigating some of the short-comings with 401(k) plan accounts creates new problems for every one that it solves. People relying on the government to solve all their 401(k) plan account related problems will be sorely disappointed.

When we take a step back and analyze the wisdom and value of defined contribution plans, it becomes apparent that the model only works ***if both employer and employee are capable of making good investment decisions***. This is a tall order. Because of cost considerations, most employers elect to offer a limited menu of investment options from which to choose and among which retirement savings can be allocated and re-allocated. How well employers put this pre-screened, limited menu of investment options together essentially caps the return potential of employee savings invested among these options. In other words, if an employer, while well-intentioned but lacking in expertise, were to put nothing but poor options into the plan, every single participant in the plan will be destined for poor returns and/or losses.

Exactly how well do employers perform in this regard? The news on this is not good. Here at PDV, we have analyzed many 401(k) and other defined contribution plans for our clients over the years. Our conclusion is that employers generally do a poor job putting together a menu of appropriate and diversified investment choices for their employees. We think there are a number of reasons for this.

First, many plans are over-weighted in company stock. Employers have many reasons to make

matching contributions with their own stock, rather than in cash. The tax advantages are substantial, and the stock ends up in "friendly hands," which tends to mitigate stock price volatility and help fend off unwanted hostile bids. When employers put time restrictions on how quickly employees can dispose of such stock (which happened with Enron), they become involuntarily subjected to an over-concentration of their retirement assets in their company's stock. Should employers get into operational or financial trouble, employees risk losing their jobs at the same time that their retirement assets are getting decimated.

Second, 401(k) plans are often over-loaded with an inadequately diversified group of popular funds. Many employers make decisions on what investment options to include in their 401(k) plans through the rear-view mirror. They like to do what's popular at the time, and include the mutual fund options that have been "working" in the recent past. Rarely are they in the position or do they have the expertise to evaluate what contributed to the funds' recent success, and more importantly, whether the strong returns of these mutual fund options are likely to be sustainable through the next full market cycle or over time. Employees undoubtedly exacerbate this problem by lobbying their employers to include popular options which neighbors, friends, relatives and the media have been promoting. When it comes to money, the pressure "to keep up with the Joneses" is intense indeed.

Many employers' preference for recently popular mutual fund options for their plans also have to do with perceived legal liability. They opt for conventional market wisdom and popular fund options as their defense (as in, " we did what everyone else was doing at the time, so how can our employees blame us?") Often, these options are the very ones likely to go into a tailspin after an unsustainable rise. After enduring poor performance and hearing complaints from employees, employers will finally respond by eliminating those options from their plans and switching to what might be "working better" at the time, thereby possibly starting another cycle of rear-view mirror decision-making.

Employers also get comfort from hiring the biggest mutual fund companies to manage the investment options within their 401(k) plans. Unfortunately notwithstanding all the marketing hype, size does not equate to quality when it comes to money management. No single mutual fund company has a monopoly on investment wisdom. Plans that offer investment options from only one single mutual fund company will especially be lacking in some way. Moreover, because companies are constantly courted by the most visible and largest mutual fund companies, taking the path of least resistance by doing the conventional thing and giving them the business is considered the "safe" thing to do from a legal liability point of view.

It is not surprising that most employers don't offer a menu of best-of-breed mutual funds similar to those which you might be able to access outside of a company retirement account, because the cost and administrative headache to deal with that many mutual fund companies would be prohibitive. But using a single mutual fund company or very few companies to provide mutual fund options means that there may be too many investment options either in the same category or employing the same investment style, and not enough in others. The menu of available investment options, under these circumstances, would end up duplicative in part and inadequately diversified. We have observed this problem with many of the plans that we have analyzed over the years.

Anecdotal evidence suggests that employees have generally not done a particularly good job making investment decisions with respect to their 401(k) plans either. They generally seem to fall short primarily in two areas: asset allocation to arrive at the proper overall risk level and selection of the individual mutual fund options to implement this asset allocation. Even if the initial decisions in these areas are satisfactory, the dynamics of market conditions require that these decisions be adjusted over time, a task that few

employees have the time, interest or knowledge to pursue.

There is no reason that an employee's job of making investment decisions inside of a 401(k) plan account should be any easier than those relating to non-retirement assets. In fact, it may be more difficult because the employee's freedom to choose among the best investments is constrained by the employer's initial decisions as to what funds to include on the plan "menu." Sometimes, it is just as important for an employee to decide what to ***avoid*** among the pre-selected investment options, as what to invest in. If an employee is uncomfortable making investment decisions outside of a retirement plan without involving an investment advisor, why would an employee feel comfortable making such decisions on his/her own inside a 401(k) account?

The solution to the 401(k) plan situation is to have fully informed and educated employees making appropriate investment decisions. However, employers are traditionally loathed to give too much specific education to their employees, for fear of liability for having unduly influenced their employees' investment decisions. While the Department of Labor responsible for enforcing ERISA has granted some leeway in this regard recently, it is unclear whether a sufficient number of employees will invest the time and effort to take advantage of the extra education.

As is hopefully apparent from the foregoing discussion, the model of the 401(k) plan is commendable in theory, but breaks down in practice because of the less-than optimal decisions made by employers and employees alike. At its extreme, the combination of 1) poor pre-screening of fund options by employers (who are lobbied heavily by large, but often less than stellar, mutual fund companies) and 2) employees being lulled into a false sense of comfort that choosing among a pre-selected menu of investment options offered by their well-intentioned employer is easier than managing their non-retirement assets, can lead to destruction of retirement wealth over time.

Given that the assets building up in your 401(k) account(s) over time will likely form a large part of your retirement assets, it is important that you do something to protect yourselves. If you are not comfortable or have no interest managing your non-retirement assets outside of company retirement plans, you should likewise consider whether to engage an investment advisor to help manage what will likely become a big part of your retirement assets trapped inside 401(k) plans. The fact that there are in most cases only a limited number of investment options does not make your investment decisions any easier, or eliminate the need for making good investment selections or avoiding poor ones, especially in light of how poorly employers generally put together the investment "menus."

Here at PDV, we would be pleased to hear from you if you are interested in having us help analyze and manage your 401(k) plan assets. Thank you very much.

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