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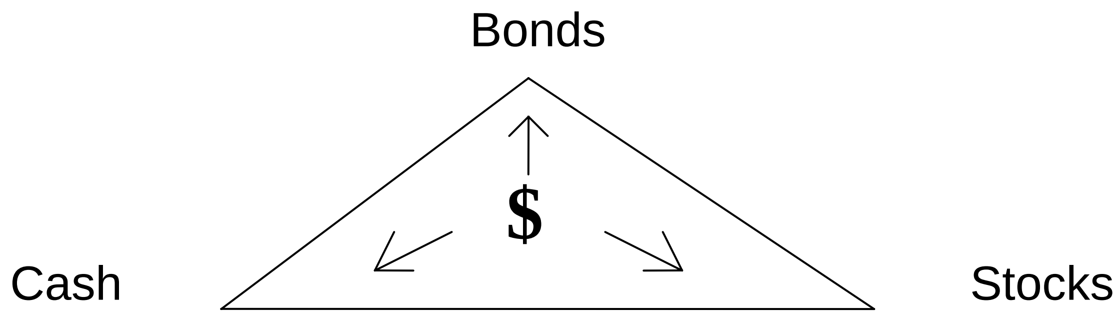
PDV *OBSERVATIONS*

The Benefits of Asset Allocation



What is asset allocation and why is it a beneficial investment strategy for investors? While there are several forms of the asset allocation strategy which differ in complexity, the simplest version of this strategy involves allocating and investing your assets among three broad asset classes: bonds, stocks and cash.

The reason asset allocation is beneficial is because each of these asset classes exhibits different investment characteristics. Each class has also outperformed the other two during different time periods. Asset allocation therefore not only offers you the potential of matching the respective investment characteristics to your individual needs, but also gives you the opportunity to capitalize on the relative strengths of the asset classes over time.

To illustrate the advantages of an asset allocation strategy more fully, let's discuss the respective investment characteristics of the different asset classes. It should be pointed out at the outset that each asset class is itself composed of numerous investment vehicles with varying characteristics. For example, a growth stock will perform differently than a cyclical stock. The following discussion focuses only on the general characteristics of each respective asset class without delving into the differences among investments within each class.

Stocks generally offer more potential for capital appreciation, but are subject to a greater risk of capital depreciation. Essentially, stocks experience greater volatility in their principal value. Annual price swings of 30% - 40% between the 52-week high and 52-week low in price for stocks are not uncommon. Also, dividend-paying stocks may legally suspend dividends at any time, and therefore the income stream generated by stocks is more unpredictable.

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Compared to stocks, **bonds generally offer less potential for capital appreciation, but are subject to less risk of capital depreciation.** Longer-term bonds, however, are subject to greater principal volatility than shorter-term bonds (but you are usually compensated for taking this risk by the higher yields associated with longer-term bonds). Barring defaults by the bond issuers, the income stream produced by bonds is much more predictable.

Over the past 70-year period, stocks have averaged about a 10% annual nominal return; bonds have averaged about a 5% annual nominal return; and cash has averaged about a 3.5% annual nominal return.

Cash has no capital appreciation potential, but is not subject to any principal volatility. Cash produces income returns that are less predictable than bonds. Income returns from cash adjust upwards or downwards relatively quickly to market conditions, while income payments from fixed-rate bonds are fixed at bond issuance and do not fluctuate.

To completely understand the utility of an asset allocation strategy, it is also necessary to examine the long-term investment records of the three asset classes. Over the past 70-year period, stocks have averaged about a 10% annual nominal return; bonds have averaged about a 5% annual nominal return; and cash has averaged about a 3.5% annual nominal return. These figures are *nominal* amounts, meaning they do not take into account the eroding effects of inflation.

Apparent from the above figures is the tradeoff between risk and potential return. The respective asset classes essentially offer a spectrum of risk/return characteristics which you can use to match your own goals and needs. The more risk you are prepared to assume as an investor, the more your assets should be allocated to stocks. You should follow a more conservative approach and allocate more to bonds and cash if you have a short investment time horizon, low tolerance for volatility in security prices, a need for income rather than asset growth or would feel uncomfortable seeing your portfolio incur "paper losses."

The above historical return figures represent average numbers over an extensive period of time, and they become increasingly meaningless as a reference as your investment time horizon shortens. Both the *absolute* and *relative* performance of the respective asset classes over any one-year period, for example, are likely to deviate substantially from these average historical figures. For instance, last year when the Federal Reserve raised short-term interest rates six times, not only did stocks and bonds achieve returns substantially below the historical figures of 10% and 5%, respectively, but cash actually outperformed the other two asset classes.

Because the *absolute* and *relative* performance of the respective asset classes can differ substantially from historical averages over shorter periods of time, **you should view asset allocation as a *dynamic* (and not static) process and make adjustments to your portfolio based on prevailing market and economic conditions.** For example, there will be times when bonds will be relatively more attractive than stocks despite bonds' average historical record of lower relative returns, and adjustments in asset allocation can be used to profit from the changing relative strengths of the asset classes over time.

When a client is interested in engaging PDV to manage his or her assets, we initially develop a financial profile for the client. We then design an asset allocation strategy that is consistent with the profile. After the initial allocation is determined, we continue to monitor the relative attractiveness of the respective asset classes based on market and economic conditions, and would make allocation adjustments when warranted.

Variable Annuities (Part I)

Variable annuities ("VA's) have become very popular in recent years. Any time a financial product gains a wide following, a contrarian question to ask is whether such popularity is well deserved or just the result of hype and salesmanship.

This is the first of a two-part article on VA's. In Part I of this article, we will examine the basics and benefits regarding VA's. In the next issue of ***Observations***, we will explore the disadvantages of investing in VA's and suggest ways to critically evaluate these financial products.

VA's are insurance products with an investment component. When you buy a VA, you are entering into a contract with an insurance company. You pay certain premiums, a portion of which is retained by the insurance company for its benefit. The remainder is invested at your discretion among what are commonly known as "subaccounts", which are essentially mutual funds set up specifically for the VA's.

You have the option to select the maturity date (also known as "annuity date") of the contract, at which time you have various options to have the value of the VA paid to you and other beneficiaries. During the period prior to the annuity date (known as the accumulation phase), the premiums you pay (less any amounts deducted by the insurance company) are invested in the subaccounts. Whether the invested amounts will grow depends on the performance of the underlying mutual funds. The money invested in the subaccounts is segregated from the assets of the insurance company and not subject to the claims of its creditors. The financial condition of the insurance company underwriting the VA is therefore less important, since its failure should not result in the loss of whatever value has been built up in the subaccounts (though the financial failure of the insurance company could impact its ability to pay the death benefit described below).

While the specific requirements and benefits will differ among VA's, as a generalization there are certain common benefits that all VA's offer. **The most important benefit is that any returns derived from investment in the underlying mutual funds are *not* taxed until the amounts are withdrawn.** This means all income and capital gains accumulate on a tax-deferred basis, and you can switch between mutual funds in the subaccounts without triggering any taxes.

> Before you run out and buy a variable annuity, you need to be aware that variable annuities often involve costs and expenses that overwhelm the benefits promoted by those selling variable annuities.

Further, while some VA's restrict the amount you can invest in the subaccounts, the **restrictions are usually considerably more liberal than those relating to 401(k) plans, profit-sharing plans, Keogh's and IRA's.** Therefore you are generally able, through the use of VA's, to shelter more of your money from taxes.

Also, unlike IRA's (which currently mandate distributions to commence after the account holder turns 70 1/2 years old), many **VA's allow you to leave your money in the subaccounts accumulating tax-deferred for a longer time without being required to withdraw it.**

Moreover, the insurance company will pay a death benefit if you die during the accumulation phase. The death benefit is *not* the same as life insurance, and usually equals the greater of the amount you have invested (less withdrawals and any applicable premium taxes) or the aggregate value of your subaccounts.

VA's can be very lucrative for those selling them. While the benefits described above are of unquestionable value, you need to weigh the disadvantages of VA's against their advantages.

Before you run out and buy a VA, you need to be aware that VA's often involve costs and expenses that overwhelm the benefits promoted by those selling VA's. Ironically, while one of the biggest benefits of VA's lies in their tax-deferred feature, VA's also produce some *adverse* tax consequences. Unfortunately, sometimes these disadvantages are not adequately discussed with the prospective VA buyer.

In the next issue of ***Observations***, we will discuss the disadvantages of VA's in more detail, and offer ways of critically evaluating these increasingly popular financial products.

A Primer on Mutual Funds

Mutual funds have experienced explosive growth in recent years, as an increasing number of investors have poured their investment dollars into such funds. **Mutual funds are essentially investment companies that pool the funds of their shareholders for investment, and can be set up as either "open-end" or "closed-end" companies.** The less common closed-end variety will be discussed in a future article. This article discusses open-end mutual funds.

When you buy a mutual fund, you are in fact buying shares of the fund. An open-end mutual fund continually issues additional shares for anyone who is interested in investing in the fund. The fund also is prepared to buy back shares from any investor who wants to redeem (sell) his or her investment at what is known as the net asset value ("NAV") per share. Per share NAV is simply the net value of the investments held by the mutual fund divided by the number of outstanding fund shares.

The types of investments held by different mutual funds can vary widely. **Bond mutual funds** invest in fixed-income securities, while **stock mutual funds** invest in equities. **Balanced mutual funds** invest in both stocks and bonds, as do **asset allocation funds**. While most mutual funds are diversified, investing in a wide variety of securities, others may be non-diversified. Non-diversified funds concentrate their investments narrowly. For example, a non-diversified stock fund may concentrate on buying only stock of biotechnology companies.

The types of investments targeted and the investment philosophy and strategy followed by a particular mutual fund are described in the prospectus. You should not commit funds to any fund until you have read the prospectus. This is easier said than done. Unfortunately, prospectuses are often written in legalese and generalities, making them unintelligible or simply boring and tedious to read.

The advantages of mutual funds are numerous. **You can achieve a diversified portfolio that is professionally managed with a relatively small investment**, since many mutual funds have minimum investment requirements of $1,000 or less. Also, pooling investor resources means that you can benefit from **lower commissions** resulting from the greater negotiating power of the fund. You will also enjoy **high liquidity**, as you are able to sell shares back to the fund at any time, often with only one phone call. Mutual funds also facilitate the **reinvestment of the investment income and capital gains** distributed by the fund into additional fund shares regardless of the size of any such distribution. Finally, most funds offer the convenience of **automatic investment programs**, arranging for periodic transfers of amounts directly out of your bank account, for example, to the fund for investment.

Despite these benefits, however, there are some considerations you should bear in mind. The foremost of these is probably **transaction costs** that are sometimes levied at the time of purchase (**front-end sales load**) or at the time of sale (**back-end or deferred sales load**) and/or **redemption charges**. These charges are to compensate those who are selling, marketing and giving advice regarding the funds. Front-end sales loads can amount to as much as 6-7% of the amount of your investment. So unless you plan to invest in the mutual fund for a long enough period for the sales load to be amortized over time, the sales charge can be a significant drag on potential returns. Back-end sales loads typically decline 1% each year you remain in the fund, and eventually disappear altogether. But back-end loads are frequently accompanied by what are commonly known as 12b-1 distribution fees which get levied annually against the assets of the fund, and reduce your return.

Front-end sales load can amount to as much as 6-7% of the amount of your investment.

Because your returns are dragged down by the above costs, what are commonly known as **"no-load' funds** have become increasingly popular. The true "no-load" funds do not charge any front-end or back-end sales load, redemption charges or 12b-1 fees.

In addition to the transaction costs involved, you should also evaluate the fund based on performance, investment style and objective, and tax and operating expense efficiency. When evaluating style and objective, you should make sure that the fund matches your investment needs. For example, if you have a long-term investment time horizon and a desire for capital appreciation/growth rather than a need for income, then you should select a stock mutual fund that concentrates on growth stocks paying little or no dividends. Once a fund that matches your situation is selected, judge its performance by comparing it to other funds that have similar objectives and assume similar risks.

Also, mutual funds differ in how much taxable distributions they generate. Those which engage in frequent buy/sell activity (ie. those with high portfolio turnover) will tend to generate more taxable capital gain distributions. Also, bond funds will tend to generate more taxable income than stock funds. The more tax-inefficient funds should be reserved for your tax-deferred accounts, such as an IRA account.

Finally, while past investment returns are not necessarily indicative of future performance, the historical operating expenses for a fund tend to be a fairly accurate reflection of the range of future expenses. Since expenses drag down potential returns, you need to make sure the expenses are reasonable for the type of fund involved.

PDV Offers Assistance in Managing Portfolios Through Mutual Funds

PDV currently assists clients in managing their portfolios through the use of mutual funds. First, we spend time with the client upfront constructing a financial profile. The profile consists of client responses to a financial questionnaire developed by PDV, describing the financial situation and goals, risk tolerance level and investment time horizon of the client. An asset allocation strategy is then designed for the client based on the profile.

For larger portfolios (those valued at $100,000 or over), we would implement the asset allocation strategy by selecting individual securities. For smaller portfolios (those valued at under $100,000), we would implement the asset allocation strategy by selecting mutual funds to achieve necessary diversification. **Since there are now more mutual funds (over 7,000 at last count) than stocks listed on the New York and American Stock Exchanges, selecting appropriate mutual funds is increasing challenging.**

We analyze mutual funds to make sure they possess the characteristics that match the financial profile of each client. We also evaluate factors such as tax and operating expense efficiency, transaction cost structure, income versus capital growth orientation, investment objective, style, philosophy and performance records. We then continue to monitor all these factors on an ***ongoing*** basis following purchase, and would make any necessary adjustments (including sales) if warranted.

Unlike brokers or others who sell mutual funds, we do not earn any commissions from our recommendation or selection of mutual funds. Our fee is based on the value of your portfolio. Our fee will only grow if the funds we select for you do well and the value of your portfolio grows. Also, because we favor no-load funds, we generally select funds that will not levy upfront sales charges. Load-funds deduct these charges upfront from your investment in a lump sum to compensate brokers and/or other sales people regardless of how the funds subsequently perform.

In contrast, the current fee for PDV's services in managing portfolios through the use of mutual funds is at the annual rate of 0.8%. So, buying a load-fund from a broker with let's say a 6% upfront lump-sum sales charge for what often turns out to be a *one-time* fund recommendation could potentially pay for over 7 years of PDV's ***ongoing*** management services. (This comparison is only approximate since the load is a lump-sum fixed amount while the amount of the annual fee for PDV's services will vary based on the performance of the client's portfolio over time).

Please call us if you are interested in having PDV manage your assets through mutual funds. We will be happy to explain in more detail how we can add value to your investments.