WEALTH MANAGEMENT

MADE SIMPLE

7 SIMPLE *But Not Easy* LESSONS

ON YOUR INVESTMENTS AND YOUR WEALTH

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WEALTH MANAGEMENT MADE SIMPLE

Seven Simple—But Not Easy—
Lessons on Your Investments and Your Wealth

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Wealth Management Made Simple: Seven Simple—But Not Easy—Lessons on Your Investments and Your Wealth
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Everyone Starts Somewhere

"In the long run, it's not just how much money you make that will determine your future prosperity. It's how much of that money you put to work by saving it and investing it."

—Peter Lynch, American investor, philanthropist and mutual fund manager of the Magellan Fund at Fidelity.

Can You Answer the Following Questions?

How do I set financial goals for my family…or my business?

How can I plan for an uncertain and unpredictable future?

How do my investments fit into my overall financial plan?

Could I do more to reduce what I pay in taxes?

Have I done enough to protect my wealth while I built it?

In our business, we speak with many clients and prospective clients every year. Regardless of their background, geographic location or even stage of career, they often have many of the same questions.

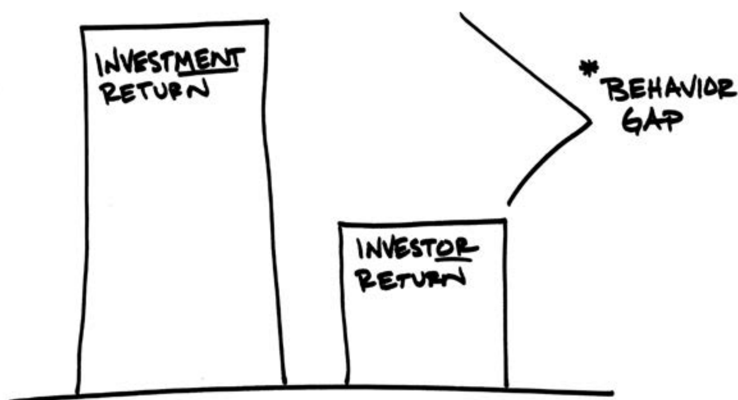
When we set out to write a book specifically on wealth management with information on planning and investing; we immediately began with the idea of creating a resource that could outline answers for the most common questions we hear from clients all the time. Virtually every question could be boiled down to the basic, underlying concern:

Am I okay now? Will I be okay in future?

We can't answer these two questions from a physical or mental perspective—but as it relates to money and finances, we will try. Money is not everything, but a recent American Psychological Association survey found that *money* is the leading cause of stress among Americans. Why are we all so stressed out about money? Because most of us are afraid that we will run out. No matter how much you have—it is a basic fear that you may lose all or a significant enough portion that would change your life for the worse.

We will attempt to answer many of your basic investing and wealth management planning questions in this book. However, the answers to these questions tend to lead to more specific questions about your *specific situation*, which is natural. When that happens, we will show you where to go next or simply how to get started. Everyone starts somewhere—and anyone can start with this book.

We are eager to share the knowledge we have gained from decades of serving individual investors and their families by focusing on what clients have asked us and found most valuable from our services.



A major portion of this book will address the gap between how *investments* do—and how *investors* do. Carl Richards drew up this simple illustration over ten years ago to show this "Behavior Gap." Little has changed since he first drew this modest picture. We will explain in detail in the following Lessons—but for now simply note—in most cases we are our own worst enemies when it comes to our investing performance. We will show you why, but we want to start with what you will not find in this book.

What You Will Not Find Here

In the interests of saving your time and being fully transparent—we feel obligated to let you know what you will *not* find in this book.

This book makes no guarantees. We do not have a quick, easy, secret strategy. We do not offer get-rich-quick lessons or an easy path to financial freedom. There is no magic algorithm or fancy high-frequency trading, or other cutting edge technology promising to deliver high performance with zero risk.

If you pick only one piece of advice to take with you from reading this book—it should be: do not trust anyone who offers easy, get-rich-quick ideas. We will show you why these promises are always misleading and usually fraudulent.

Claims of easy money play on our psychology—we fall for far-fetched claims because deep inside we want them to be true. Of course, we want easy money, high performance with low risks—who wouldn't?

But there are no free lunches. Later sections of this book will describe how and why we fall for unrealistic promises; and we will provide additional information on what specifically to look for when scouting potentially fraudulent investments.

What You Will Find Here

What we offer is a time-tested approach to wealth management, planning and investing that will help you reach your financial goals to enable you to retire on your terms and continue to live the lifestyle that you are accustomed to.

It is *simple*—but not *easy*. It requires education. It requires discipline. It requires maintenance.

If we espouse a secret; the secret is there is no *one* solution, or single strategy every person could or should implement to ensure financial success. There is no one size fits all approach. There is no easy method or benchmark that every investor can reference to determine failure or success.

The secret is; there is no secret. Crafting a plan and incorporating wealth management takes work, and we do this work every day.

Setting Expectations

A great deal of educating people on wealth management and planning starts with setting realistic and achievable expectations. We would all like to stumble upon a low-risk investment opportunity that provides high yield, but these are unicorns—at best very rare, at worst potentially illegal.

Wealth management is a long, slow process built on compounding interest, discipline and consistency. Are there opportunities out there with potential huge payoffs? Yes, but these opportunities always carry risk—risk of losing everything. With our clients, we set goals, define risk tolerance and determine expectations as soon as possible.

Investing tests your resolve and at times requires you to act against your natural instincts. Most importantly, you need to accept the fact that you will make mistakes. The world's best investors have made hundreds of mistakes. This is no different than many other professions.

Physicians are not able to cure every patient who walks into their office. Peyton Manning is a future Hall of Fame quarterback and he threw more than 250 interceptions in his NFL career. Michael Jordan missed dozens of game winning shots. A Major-League baseball player making an out in 70 percent of his plate appearances over a 15-year career will be recognized as an elite hitter.

Warren Buffett is widely regarded as one of the most successful investors of all time. Yet, as Buffett is willing to admit, even the best investors make mistakes. Buffett's legendary annual letters to

his Berkshire Hathaway shareholders tell the tales of his biggest investing mistakes. Berkshire Hathaway underperformed the S&P 500 in 2015 with the flagship BRK.A shares down 11.47 percent compared with a 0.21 percent increase in the S&P 500 (we will tell you in Lesson Four why comparing to the S&P 500 is not generally the right call, anyway). The difference in total return versus its benchmark is even more pronounced–more than 13 percentage points–since Berkshire does not pay a dividend.

What do these professionals have in common? They never dwell on mistakes, rather they learn from failure. They developed an uncanny ability to maintain a forward-looking perspective.

The same is required of wealth management. Not every call will be a home run. You will lose along the way—but if you learn from your mistakes and mitigate your risks, you will win in the long run. Like a professional athlete, you should set goals and work towards achieving what is most important. You will lose a few games—even in a championship season.

Answering the Questions on Everyone's Minds

We all have questions about money. We all worry about money. Financial conflicts touch our lives every day. What we do for our clients is try to alleviate some of the stress caused by money. We talk to people every day. We answer questions from our clients, our friends, our family like:

Do I have enough money?

What does "enough" even mean?

Will I have enough to retire when I want to?

Do I know how much money I need to live the lifestyle I want in retirement?

Can I afford to fund my children's education?

Can I afford to help take care of my parents as they get older?

Can I give more time and money to a cause I am passionate about?

When will I be able to work when I want to (rather than needing to work a fixed/full schedule)?

Our objective is simple (not easy): this book provides guidance to help answer the questions people have been asking for years. This book answers questions people ask in their 20s, 30s, 40s, 50s, 60s, 70s and even 80s.

Our firm, our team, our advisors all work with individuals to meet their specific goals by focusing on education and understanding. You are far more likely to follow a plan you understand. You are far more likely to follow and trust a plan with clear goals.

We see a significant part of our role as being teachers. We answer questions and educate our clients on all aspects of their wealth management and planning. This book is a summary of what we know. It will serve as a primer for you to get started or to better educate yourself on your own current plan.

Where to Start

We believe everyone needs to engage in *Wealth Management* to ensure they adequately plan for their financial future.

What is *Wealth Management*?

> *Wealth Management* is taking everything into account concerning your wealth. It includes investments; determining how to invest; when to invest; how much to invest; how much risk to take now—and how much risk to take later. Wealth management includes financial planning; saving and spending; taxes you must pay now—and taxes you may have to pay later. Wealth management includes protecting your assets; planning for the future with insurance and estate planning. Wealth management is having a plan in place so you have a course to stick to when you're unsure what to do during the next financial crisis (there will be another).

Having a plan is not enough—you must stay with your plan and adapt it as your life changes. We will discuss the most important components of your plan in detail, and how wealth management plays a key role in later Lessons of this book.

Our experiences have shown that the hardest part is getting started.

The following information includes Lessons we believe anyone—no matter where they happen to be in their life, and no matter how much or how little they know about investments—will find helpful.

This book is a resource guide. You can review the table of contents and see what Lessons are most interesting to you and jump right in, or you can start from the beginning.

We start with Part One: Investing 101, a valuable resource or refresher, that reviews the most common investing terms you will run into. In Lesson One we discuss basic terms, intermediate concepts and finally the more advanced items like alternatives, commodities, real estate, hedge funds and more.

In the next Lesson, we provide a history lesson on the U.S. markets—to illustrate how history has shaped and continues to shape the field. We provide summaries about market performance over the last century to provide a historic perspective on investing over a long term. We review concepts for investing in up, down and sideways markets. We take a deep dive into diversification and how to view long-term and short-term strategies.

In Part Two: How Do I Find the Right Advisor (or Do I Even Need an Advisor)?—we provide two Lessons detailing how it may be beneficial for you to work with the right trusted advisor, or team of advisors, to benefit you more in the long run than going alone. We show how professional advice can help mitigate the risks associated with personal cognitive biases that often trip individual investors—pros and amateurs alike. We discuss many of the most common pitfalls that affect investor returns and we review many common outdated procedures and/or concepts you can avoid to better position yourself for success. We provide a deep dive into the importance of seeking out objective investment advice from trusted sources. We start out by laying out the most common options for professional investment guidance. We review how to choose an advisor by educating you on how certain advisors differ from others.

Part Three: Wealth Management Strategy and Your Financial Plan, includes instructions on wealth management and investing strategies. You will find helpful information on how to manage

your wealth strategically and how to adopt a winning mindset that can help you avoid the most common investing mistakes. The final Lesson provides detailed information on how to build and maintain your plan for investing success.

We review where to start, how to maintain, develop, and implement a wealth management plan that suits your needs. We include all the elements—and how having a good plan in place can alleviate fear, panic and stress. To go along with our discussion on transparency—we do not offer a perfect plan. There is no such thing as a perfect plan—and you will learn why.

We trust this book will be a helpful resource for you and we thank you in advance for taking time out of your busy schedule to read our work. We strongly believe everyone will get something out of this book. If nothing else, you will have armed yourself with information on where to start…or how to review your current plan to determine if you are on the right track.

Your next steps will be simple…but not easy. Good luck.

PART I

Investing 101

"Learning never exhausts the mind."

—Leonardo da Vinci

We strongly believe that thoughtful engagement in your wealth management starts with education—you must learn about basic investment terms and options.

If you think about retirement savings as a game—simply planning to budget and save money would be akin to checkers. If you actively engage in wealth management, you step up from checkers to chess.

In this Lesson, we will provide you a quick education by defining and explaining some of the basic pieces that make up investing and wealth management. Our goal is to lay out the most common concepts, provide a brief definition and describe why an investor would consider it—and potentially most important, why they would not.

For some of you, some of the terms may be new—for others, it will be helpful to review what you already know. In the long run, this can also be useful to you as a quick and easy to reference guide.

LESSON ONE

Learn Investment Terminology

"Know what you own, and know why you own it."

—Peter Lynch, American investor, philanthropist
and mutual fund manager of the Magellan Fund at Fidelity.

As Mr. Lynch states above—learning about *what* is in your investment portfolio is important. Equally important is learning the *why*. The following information is provided to help you with some of the basic, intermediate and more complex pieces that make up most investment portfolios. We describe what it is; how it is structured; and why you might consider utilizing the product, and finally why it may not work for everyone.

Stocks

When we think of investing, usually the thing to come to mind first is a stock, which can also be called an "equity"—but how often do we revisit what a stock actually is? Remind yourself now:

What are they? A type of security providing investors with ownership in a corporation.

How are they structured? Publicly-traded stocks trade on an exchange, and each corporation has a limited number of shares available for purchase. Basic forces of supply and demand influence the perceived value of a company, particularly over short periods of time. Analysts will use sophisticated financial modeling tools to determine a fair long term valuation for a company, and ultimately the stock. A prevalent component of stock valuation is to determine the present value of future estimated cash flows. Clearly this requires making assumptions of growth rates, and can include a variety of tools beyond the scope of this chapter.

Why would an investor purchase? Stocks offer investors the greatest potential for growth over long periods of time.

Why would an investor avoid? Investing in stocks comes with a high level of risk. Investors are much more likely to lose all or a portion of their investment in a single company. The risk of investing in stocks can be reduced through diversification (owning many stocks, across different industries), however investors do need to be prepared to experience large swings in the value of their stock investments. Many individuals lack the risk tolerance to handle the emotional roller coaster of stock ownership.

Bonds

Generally, the safe haven for the risk-averse investor is the bond. You probably remember that bonds are safer than stocks, but you may not remember much else. Take a minute to review.

What are they? A debt security, commonly issued by a municipality or corporation, which will pay investors a fixed rate of interest for a defined period of time. The investor will have their principal returned by the lender, once the bond has matured.

How are they structured? Interest from the bond will be taxed as ordinary income if lent to a corporation. Municipalities may qualify to issue debt providing tax-free income to investors. The rate of interest an investor receives is dictated by taxability of income, credit worthiness of the issuer, period of time until maturity, and current economic conditions. A bond can be issued with a callable feature, allowing the issuer to return you principal prior to the stated maturity date. The issuer will be required to pay a premium for this feature.

Why would an investor purchase? Predictable income stream, in certain circumstances income is tax free. Lower risk profile compared to stocks. Provide stability to a larger investment portfolio.

Why would an investor avoid? Limited return. Credit risk if issuer defaults or simply goes out of business. Limited liquidity—unlike stocks, bonds typically have a sizeable spread between purchase and sale price. Interest rate risk current market value of bonds can

decline in value if interest rates rise, which could negatively impact an investor wishing to sell prior to maturity.

Mutual Funds

The ubiquitous mutual fund used to be the single most popular diversification product in all investing. The concept of a mutual fund is easy, but the devil is in the details: like how is it allocated and what are the fees?

What are they? A company that pools money from a group of investors and invests in securities such as stocks, bonds, or a combination of the two.

How are they structured? There are two general types of mutual funds on the market. Open-end funds are what you know as a mutual fund. They don't have a limit as to how many shares they can issue. When an investor purchases shares in a mutual fund, more shares are created, and when somebody sells his or her shares, those shares are taken out of circulation.

Closed-end funds look similar but they are very different. A closed-end fund functions much more like an exchange traded fund than a mutual fund. They are launched through an IPO in order to raise money and then traded in the open market just like a stock or an ETF. They only issue a set number of shares and, although their value is also based on the NAV, the actual price of the fund is affected by supply and demand, allowing it to trade at prices above or below its real value.

Why would an investor purchase? Professional management, potential diversification (a fund typically owns 50-200 securities), liquidity, and comparative low cost of entry (an inexpensive way to own a basket of securities vs. purchasing each of the underlying securities individually).

Why would an investor avoid? Potential tax-inefficiency if the fund is owned in a non-retirement account, particularly for high net worth investors in the top two tax brackets. Mutual funds must distribute income and capital gains on to investors; therefore, it is possible to have a tax liability in a calendar year *when your fund loses money.* When compared to an exchange traded fund, the on-

going management fees associated with investing in many mutual funds can be high.

Stock Mutual Funds

What are they? A mutual fund which owns a pool of individual stocks.

How are they structured? Stock funds can own U.S. or foreign companies. The objective can be very broad, such as investing in growth companies, dividend paying stocks, or small company stocks. A stock fund can track an index, or have a very specific niche in which it operates. The fund can limit purchases to a specific sector, industry, region of the world or country.

Why would an investor purchase? Investors are typically hiring a manager with an expertise in the category where the fund invests. An investor may not have the time or desire to follow a portfolio of individual stocks; therefore, they take advantage of the professional management offered by a mutual fund. Stock funds can reduce risk by offering a low-cost method of diversification in a portfolio via ownership of a basket of securities.

Why would an investor avoid? Stock funds are professionally managed; therefore, you are paying for the service. Fees can act as a drag on investment performance, with open-end mutual funds typically charging higher expenses higher than index funds. A manager will attempt to outperform a benchmark by purchasing and selling securities. Trading will generate gains, which must be distributed to the shareholder for the fund to maintain a favorable tax status. Investors in the highest tax brackets owning mutual funds in a non -retirement account face the possibility of a substantial tax drag impacting net returns. Affluent individuals in this category should monitor the turnover and the tax cost associated with an actively managed stock fund.

Bond Mutual Funds

What are they? A mutual fund that owns a pool of individual bonds.

How is it structured? A bond fund could own short, intermediate or long-term bonds. The objective can include high income, total return, or principal preservation. Bond funds can invest in junk (low quality), investment grade corporates, foreign debt, government or municipal debt.

Why would an investor purchase? Investors use bond funds as a low-risk vehicle to minimize volatility and generate income. Liquidity is typically not a problem with bond funds; but this is not always the case with individual bonds. An appropriate bond fund could reduce portfolio risk via greater diversification in a cost-effective manner.

Why would an investor avoid? Unlike an individual bond, there is no defined maturity date with a bond fund. As a result, investors have less assurance that their full principal will be returned upon liquidation. Income streams can be less predictable. While bond funds do offer professional management, there is a cost associated with hiring a fund manager.

Stocks, bonds and mutual funds are the most basic pieces. Most everyone has at least a passing understanding of how they work—but perhaps less understanding of how they work together. The following pieces are more complex. Exchange traded funds (ETFs) are important components and we take a relatively deep dive below explaining their function.

Exchange Traded Funds (ETFs)

What are they? An ETF, or exchange traded fund, is a marketable security that tracks an index, a commodity, bonds, or a basket of assets like an index fund.

How is it structured? Unlike mutual funds, an ETF trades like a common stock on a stock exchange. ETFs experience price changes throughout the day as they are bought and sold.

Why would an investor purchase? ETFs typically have higher daily liquidity and lower fees than mutual fund shares, making them an attractive alternative for individual investors. ETFs give

the investor the opportunity to buy or sell an entire portfolio of stocks or other securities in a single security, just like buying or selling a share of a single stock.

Pros and Cons of ETFs

- **Passive diversification:** By buying a single unit of an ETF, investors can get exposure to all the securities that make up the underlying index. ETFs also reflect the performance of different sectors in the market, which can help enhance the diversification benefits of investor portfolios. However, keep in mind that diversification does not eliminate the risk of investment losses.

- **Transparency of price:** Since ETFs trade like stocks, their prices change and new prices are available to investors at all times during trading hours.

- **Tax efficiency:** When mutual funds realize a capital gain, they are obligated to distribute those gains to investors on an annual basis, which is a taxable event for non-retirement accounts. ETFs usually realize capital gains when changes are made to the benchmarks (index funds) they track. Index portfolios generally have lower turnover than actively managed funds, which makes ETFs ideal for taxable accounts. ETFs may also realize capital gains if the share price of the ETF rises. Consult a tax professional to better understand the tax implications of ETFs.

- **Potential cost advantages:** Unlike many actively managed mutual funds, there are no front-end or deferred sales charges with ETFs, which are bought and sold like stocks. On the exchange, the investor pays brokerage costs and the spread between the buying and selling price, which may be lower cost than the front-end load and transaction fees of mutual funds.

- **Protection against cash drag:** Cash drag is the return lost when an open-end fund manager must keep cash on hand or sell assets to redeem shares. ETFs don't need to hold cash in anticipation of redemptions,

which may minimize the cash drag effect. Long-term investors may be affected most by cash drag.

- **Brokerage costs:** ETFs are bought and sold through a broker which typically results in brokerage costs every time a buy or sell transaction occurs. Brokerage costs incurred may be a significant percentage of the investment for smaller transactions.

- **Variable Liquidity:** Liquidity for ETFs varies widely, depending on not just the trading volume of the fund but also the liquidity of the underlying securities it holds. Typically, the more exotic the asset class and financial instruments used, the less liquid the ETF and the higher the spread.

- **Relative newness:** Some ETFs, especially those that offer exposure to more exotic asset classes (which are riskier), are relatively new and have been around for only a few years, which may pose a few drawbacks in terms of historical data availability.

- **Limited selection:** The limited availability of ETFs in certain categories can be a disadvantage for investors. Holding an exchange-traded fund does not ensure a profitable outcome and all investing involves risk, including the loss of the entire principal. Since each ETF is different, investors should read the prospectus and consider this information carefully before investing. The prospectus can be obtained from your financial professional or the ETF provider and contains complete information, including investment objectives, risks, charges and expenses. ETF risks include, but are not limited to, market risk, market trading risk, liquidity risk, imperfect benchmark correlation, leverage, and any other risk associated with the underlying securities. There is no guarantee that any fund will achieve its investment objective. In addition to ETF expenses, brokerage costs apply. Fees are charged regardless of profitability and may result in depletion of assets. The

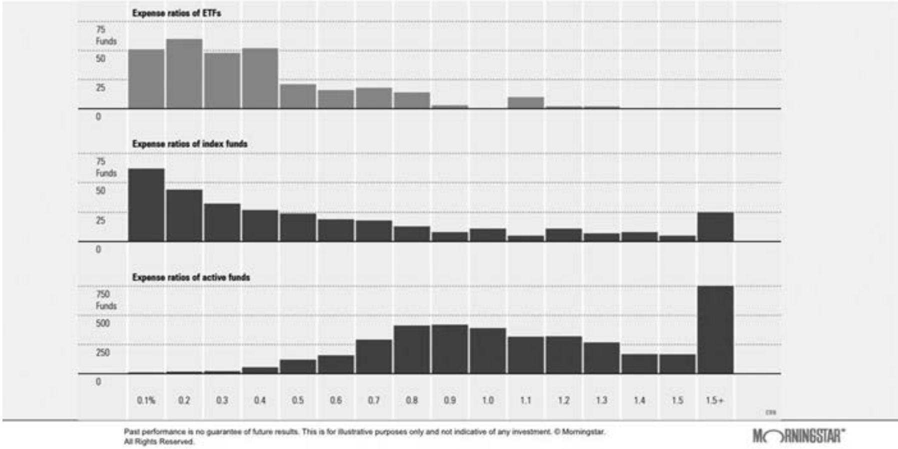
market price of ETFs traded on the secondary market is subject to the forces of supply and demand and thus independent of the NAV. This can result in the market price trading at a premium or discount to the NAV which will affect an investor's value. The market prices of ETFs can fluctuate as a result of several factors, such as security-specific factors or general investor sentiment. Therefore, investors should be aware of the prospect of market fluctuations and the impact it may have on the market price. ETF trading may be halted due to market conditions, impacting an investor's ability to sell the ETF.

More About Fees, Expense Ratios of ETFs, Index Funds, and Active Funds

ETFs normally have lower expense ratios when compared with traditional mutual funds. This happens because managers of actively-managed funds tend to charge more for their expertise in picking investments.

We will look at large-cap funds, as this is the broadest category for us to compare. Large-cap funds are funds that invest primarily in large-cap U.S. stocks. Stocks in the top 70 percent of the capitalization of the U.S. equity market are defined as large-cap. An index mutual fund is a fund that tracks a particular index and attempts to match its returns. An active fund is a fund whose manager analyzes the market and selects investments in order to maximize return. Expense ratio data is from Morningstar's open-end database. ETF and index fund expense ratios are from the domestic large-cap ETF and domestic large-cap index fund categories, respectively. All expense ratios are prospectus net expense ratios. The prospectus net expense ratio is the percentage of fund assets paid for administrative, management, 12b-1 advertising fees and other expenses. The expense ratio does not reflect the fund's brokerage costs.

Expense Ratios of Large-Caps: ETFs, Index Funds, and Active Funds
As of December 2016



See appendix for magnified chart

The image illustrates the distribution of expense ratios for large-cap ETFs, index mutual funds and actively-managed mutual funds. For actively-managed funds, it appears that expense ratios are higher on average, with many funds exceeding 1.5 percent. Expense ratios for large-cap index funds, however, vary widely from 0.1 percent to over 1.5 percent. The average active fund investing in large-cap stocks carries an expense ratio of 1.24 percent of the investor's holdings, and the average index fund, 0.72 percent.

Expense ratios for large-cap ETFs appear to be lower on average, and are typically concentrated between 0.1 percent and 1.0 percent. The average expense ratio for large-cap ETFs is 0.42 percent. The difference in costs between ETFs and traditional funds may not seem substantial, but these costs add up over time. It is important that investors evaluate their investment goals when selecting a fund.

Separately Managed Accounts

What are they? An investment strategy presented to the affluent as an alternative to mutual funds. Rather than owning a single pooled investment, the investor will actually own a large number of individual stocks.

How are they structured? A separately managed account will typically have a defined strategy, investing in a specific asset class and/or style (Large Cap growth, International stocks, Municipal Bonds, etc.). The custodian holding your assets will create a new account and provide power of attorney to the asset manager making trades on a client's behalf. A client's advisor is not making investment decisions. Trading is delegated to a large institution with a perceived expertise investing in a particular asset class or industry. Minimums range from $100,000 to $250,000 and could be higher in some cases.

Why would an investor purchase? One appeal is professional management from a firm with an expertise in a very specific style of investing. When comparing a separately managed account to a mutual fund, the former does offer the opportunity for greater tax efficiency. An investor could be purchasing someone else's tax liability if the mutual fund purchased has embedded gains. For example, if ABC growth fund has owned XYZ stock for 20 years, XYZ stock is going to have substantial gains which will be passed on to the investor that purchased the fund a few weeks ago. The separately managed account investors will have a cost basis attributable to their actual purchase date of the underlying securities.

Why would an investor avoid? Separately managed accounts are typically more expensive than mutual funds and exchange traded funds. Fees range from 1.35 percent to 2.25 percent of assets in the program. A client will commonly own 75-100 positions with very small balances in a defined strategy. While separately managed accounts may offer year-end tax harvesting, if the strategy has high turnover it may not be tax efficient. While managed accounts are often presented as a strategy for the affluent, keep in mind they are built to serve the masses, lacking customization or a willingness to work with an existing portfolio.

As we continue to review different aspects of wealth management—we continue to get more complex. If stocks, bonds and mutual funds are basic, and ETFs and SMAs are intermediate, then the following pieces would be advanced. "Alternatives" like Real Estate, Hedge Funds, Private Equity, etc.—these components do not fit into all plans because:

- They achieve different goals than the pieces above
- They can be expensive with complicated fee structures
- They may be illiquid—tough to convert to cash
- They could incur much higher risk of losing a majority, or all, of the principal invested

Even though they may be complex, it is important to understand how these function, especially if you will consider them as part of your wealth management strategy.

Before we describe specific alternatives—let's briefly review the term "alternatives" in general.

Alternative Investments

What are they? "Alternative investment" is a broad term encompassing a wide range of investment strategies that fall outside traditional asset classes. They generally include non-traded investment programs, commodities (like gold and other precious metals), currency, hedge funds, long/short, and other market-neutral strategies.

How are they structured? They can be liquid in a mutual fund; or non-traded structures, private equity, hedge funds, real estate investment trusts, commodities, as well as real assets such as precious metals, rare coins, wine and art.

Why would an investor purchase? Alternatives usually represent investments that have a low correlation to the S&P 500. The lack of correlation between the two helps dampen portfolio volatility. Because of this lack of correlation, many large institutional funds like pensions and private endowments, allocate a healthy portion

(typically in the 10-20 percent range) of their portfolios to alternatives. Inclusion of non-correlated assets should decrease volatility and increase overall diversification. These tools are further used to customize investment portfolios to meet the objectives of the individual.

Why would an investor avoid? It may be difficult with some alternative investments to determine the current market value of the investment. They may also be relatively illiquid. In some instances, these investments may have limited historical risk and return data, and the cost of purchase and sale may be high.

We could literally write a book on alternative investments alone—but to keep this Lesson manageable, we cover the most common alternatives: commodities, real estate, hedge funds, private equity, structured products and annuities.

Commodities

You would have to have been living under a rock for the last 10-20 years to have not seen or heard at least one commercial or radio advertisement advocating a commodity. Often that commodity is gold. Gold has such staunch advocates that it has spawned the term "Gold Bug"—for someone who attempts to hedge their portfolio against weakness in the U.S. Dollar, inflation and deflation by relying on gold. On the other side, gold has detractors who speak and write almost exclusively on dispelling myths and discussing why the Gold Bugs are wrong.

The truth is—there can be a justification for utilizing gold (or other commodities) in your portfolio. However, you should understand the how and the why.

What are they? Metals (Gold, Silver, Copper), grains and other food, or financial instruments such as foreign currencies.

How are they structured? Typically, commodities are owned *via* futures contracts, which is an agreement to buy a certain quantity of a commodity at a point in the future. Futures contracts are typically traded on the floor of an exchange. Today, commodities can be purchased via an ETF or mutual fund specializing in a specific commodity or basket of commodities.

Why would an investor purchase? Commodities are often viewed as a hedge against inflation, and they are purchased by certain investors who may be concerned about the strength of the U.S. dollar. Correlation to traditional stocks and bonds is typically low, therefore an allocation to commodities has the potential to lower overall portfolio volatility.

Why would an investor avoid? While a small allocation to commodities may reduce volatility in a portfolio, commodities themselves tend to be one of the most volatile asset classes an investor could access. The SEC does not regulate commodity futures, therefore investing in the asset class is typically not suitable for the average investor. An investment in commodities can generate a K1, therefore taxation can be very complex.

Real Estate

For many people, the majority of their net worth is tied up in their home and business property—more than in any other investment. Compared to stocks, bonds and most other investment vehicles, real estate is a highly tangible asset—and an emotional one. We raise our children there; our vacations often revolve around it and it's our piece of a beach or mountain—a place we love. Nothing in a financial portfolio provides quite the same warm feelings, memories and experiences wrapped up in real estate.

There can also be a financial benefit to owning real estate such as tax, income and diversification. It is important to understand the role that real estate plays in your overall wealth management plan. Like any other asset, it comes with advantages and disadvantages. It can be an important part of your overall portfolio and wealth management plan.

Using real estate, fortunes can be won… and lost during market downturns. Often this is because of leverage—as most real estate is bought with mortgages, the leverage factor can work to build fortunes quickly, but also to decimate them quickly as well. In our practice, we have seen more clients get in financial trouble with leveraged real estate than any other investment.

Real estate is often touted as a hedge against the securities market—but 2008 demonstrated this is not always the case—as the real estate market crashed along with the securities markets… and, in many places around the U.S., took longer to rebound. Because of this, along with illiquidity and mortgage interest payments coming due, we saw many otherwise financially secure families suffer greatly.

What is it? Real estate is property comprised of land and the buildings on it as well as the natural resources of the land.

How is it structured? Real estate can be grouped into three broad categories based on its use: residential, commercial and industrial. Examples of residential real estate include undeveloped land, houses, condominiums and townhomes; examples of commercial real estate are office buildings, warehouses and retail store buildings; and examples of industrial real estate are factories, mines and farms.

Why would an investor purchase? The price of real estate historically has increased in value over longer periods; say at least 10-year time periods. Therefore, purchasing real estate can be one of the great long-term investments a person can make. Benefits include the ability to use leverage to take advantage of low interest rate environments, the ability to create predictable income streams with rental properties, the ability to take advantage of tax benefits like depreciation, and the potential increase the value of the real estate itself.

Why would an investor avoid? Depending on the expense and value of real estate holdings, a portfolio can become over-weighted by real estate, creating possible exposure to a sharp decline in the real estate market. You may also have the issue of a lack of liquidity and cash flow in retirement based on the size and type of the real estate in your portfolio.

The real estate pendulum swings back and forth between being in vogue and passé. Usually it depends on where the securities markets are. Real estate can be a useful and valuable asset—it can also be a major headache. Rather that owning actual real estate, many investors utilize Real Estate Investment Trusts (REITs).

Accredited Investor

It is important to note that an investor must be '*accredited*' before ascertaining a possible investment in many REITs, hedge funds and/or private equity strategies. Accreditation standards for individuals: $1 million net worth, $200,000 of individual income, or $300,000 for joint income for two documented years (and assumption that this income level will continue for some time). In addition, entities such as banks, partnerships, corporations, nonprofits and trusts may be accredited investors:

- An entity, with total assets more than $5 million, not formed to specifically purchase the subject securities, whose purchase is directed by a sophisticated person; or
- Any entity in which all the equity owners are accredited investors.

The accreditation standard in of itself eliminates a clear majority of the investing population.

Real Estate Investment Trusts (REITS)

What are they? A trust that owns a pool of income producing real estate assets. REITs may invest in office buildings, shopping centers, storage facilities, apartments, hotels, mortgages, or loans.

How are they structured? A REIT buys properties and operates the properties as part of a larger investment portfolio. Typically, REITs will distribute income to investors, and trade on an exchange. REITs can also be purchased in a non-traded format. If this is the case investors should expect to receive a premium for tying up their funds.

Why would an investor purchase? Investors have the opportunity to diversify the risk of owning real estate, by holding multiple properties in various regions in the U.S. and potentially internationally. Income streams can be attractive, while capital appreciation may be a secondary objective. A pooled real estate investment does not require the investor to accept the responsibilities of management

and maintenance that may be required with a direct investment in real estate. REITs may also offer an added layer of diversification in a larger investment portfolio.

Why would an investor avoid? If an investor purchases a non -traded REIT, they are unlikely to have liquidity, meaning the investment cannot be sold. If economic conditions deteriorate, a lack of liquidity can be detrimental. Transaction costs, financing, and operating costs can be substantial with real estate investment trusts. Non-traded REITs purchased through a broker can charge as much as 10 percent of the investment up front. Tax rules can be complex, as distributions could be treated as ordinary income, a return of capital, or a combination of the two.

Hedge Funds

The term "hedge funds" is ubiquitous, but many people do not understand what a hedge fund actually is. Let's look past famous hedge fund managers, and acquaintances dropping the term in dinner conversations, and learn the details about how they work and why they may be useful.

What are they? The concept has some similarities to a mutual fund. Hedge funds pool money from individual investors to purchase assets. Strategies can vary drastically; some may have the objective of reduced volatility with a return stream which is not correlated to traditional financial markets. Many hedge funds strive to achieve maximum return, investing in niche markets, or using leverage to enhance upside. Hedge funds have high minimum investment requirements, are not liquid, and face fewer regulatory requirements.

How are they structured? As previously mentioned, the structure of hedge funds varies widely. Many hedge funds hold investments that are illiquid and difficult to value. Valuation of the fund typically comes from an independent source, and is provided on a quarterly basis, as opposed to a publicly traded security offering daily valuation. Given the lack of liquidity and risks associated with hedge funds, they typically require investors to meet minimum income and net worth requirements.

Why would an investor purchase? A broad answer is difficult due to the wide range of potential objectives for the funds. The answer generally falls into one of three categories: 1) Greater upside (albeit with greater risk); 2) Access to niche investments not available through traditional methods; 3) Opportunity to achieve returns which may not correlate with traditional stocks or bonds. An appeal does exist to gain access to certain managers with a lengthy track record of success. These individuals may no longer run traditional mutual funds, therefore the only way to access their expertise is *via* the hedge fund channel.

Why would an investor might avoid? Lack of liquidity or transparency, limited regulation and risk are several reasons why hedge funds are not appropriate for most investors. While each of the previously mentioned characteristics are reasons why many high net worth investors avoid hedge funds, none are the number one reason many pass on the opportunity. Hedge funds are famous for their high fee structure. Management fees range from 1-2 percent of assets, in addition to a performance fee of 20 percent of the fund's profit. *Example: (this is for illustrative purposes, we acknowledge the math is not quite this simple) a $10,000 investment obtains a gross return of 20 percent and is now worth $12,000. A 2 percent fee is $240, 20 percent incentive on $2,000 gain is $400. $640 in fees paid on $12,000 is 5.34 percent.*

Since the start of 2005 through 2015, the HFRX Global Hedge Fund Index and HFRX Equity Hedge Index (two investable indices widely used as benchmarks in the hedge fund industry) have posted negative returns (-1 percent and -6.4 percent respectively). Over that same time period, the Barclays Aggregate Bond Index was up 62.1 percent and the S&P 500 up 97.6 percent. The argument for hedge funds is not typically just about returns, but lower volatility, low correlation and absolute return when equities go down. The difficulty is that the managers who achieve those goals are few and far between.

Private Equity

What is it? Private equity funds are typically structured as pools of capital that invest primarily in private companies. The intention of

the strategy is to create value in these private enterprises by cutting costs, improving logistics/synergies, and selling non-performing assets (making the company more 'lean' in the attempt to generate additional cash flow). Through a private equity fund, a number of investors combine their capital, enabling the managers of the fund to actively make investments in various companies on the investor's behalf. This asset class can contain both equity and debt securities in operating companies that typically are not publicly traded. Most private equity deals come in the form of a "*private equity fund*" as most institutions/individuals lack the necessary resources to identify and monitor privately held businesses.

How is it structured? Many private equity funds are structured as limited partnerships (LPs) or limited liability companies (LLCs) which are in turn are managed by an LP general partner or LLC manager. This general partner/manager will identify and perform extensive due diligence on potential companies, all with the discretion to make investments for the fund. Private equity funds usually have a main investment theme or strategy that focuses on businesses in certain industries, geographic location, and varying valuations/size. Most private equity investments are illiquid and can be difficult to value (mainly because the underlying companies being purchased are not public and therefore do not have readily available financials). The fee structure is very like that of a hedge fund, meaning 2 percent ongoing annual management fee as well as a 20 percent fee for gross profits upon the sale of the company.

Why would an investor purchase? An investor would typically purchase a stake in PE firm/strategy for many of the same reasons when considering a hedge fund:

- Greater upside returns (albeit with greater risk due to illiquidity/leverage)
- Access to niche investments (private businesses) not available through traditional methods
- Opportunity to achieve returns which may not correlate with traditional stocks/bonds

Why would an investor avoid? Much like any investment, there are many potential risks to investing in private equity. Some of those risks include considerable capital commitments, lack of liquidity, lack of transparency, high ongoing management/incentive fees, use of leverage, potential conflicts of interest, minimal control over investments, dependence on key management, lack of regulation (albeit improving), tax considerations, and wide-ranging performance amongst all PE funds.

Our take is that the illiquidity profile of these deals is the most burdensome hurdle to overcome (especially in a world where you can invest in most areas of the globe through a daily liquid/traded fund). A typical PE fund can take anywhere from 4-8 years before its eventual 'exit' (liquidity event). A client investing in a PE fund needs to understand that his/her money can be locked up for a period of eight years while receiving little to no income distributions (PE structure lacks income/yield component).

Another challenge for investors to overcome is lack of full transparency. This has slightly improved since the financial crisis of 2008-2009 with the passing of the "Dodd Frank" regulations. Title IV of "Dodd-Frank" requires all PE firms with more than $150 million in assets to register with the SEC (this began in 2012).

Lastly, investors may look to avoid PE funds largely due to the performance divergence between the top and bottom quartile managers. According to Preqin, a firm that indexes PE returns, an individual with a top quartile PE fund manager would have earned more than 2.6x that of an investor with a second quartile manager, and lost money investing with a bottom (fourth) quartile manager. An investor with $10,000 invested in PE funds, would have accumulated an extra $56,180 (per every $10,000 invested) by investing in the top vs. second quartile managers (From Sept 2000-2014).

Structured Products

What are they? Structured products, as described by the Financial Industry Regulatory Authority (FINRA), are securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency. They are a hybrid between two asset classes typically issued in the form of

a corporate bond or a certificate of deposit but, instead of having a pre-determined rate of interest, the return is linked to the performance of an underlying asset class.

How is it structured? As this definition suggests, there are multiple types of structured products. These variations include certain products offering full protection of the principal invested while others may offer limited or no protection of principal. Most structured products offer the potential to pay an interest or coupon rate above the prevailing market rate and are used as tools by high net worth investors for portfolio diversification. Structured product sales began in the 1980s. These investment vehicles arose from the needs of companies seeking options for debt issuance. Here, companies can transfer risk, for a fee. Structured products provide investors with highly targeted investments that are tied to a specific risk profile, return requirements and market expectations.

How Structured Products Work Similar to a zero-coupon bond, often, no interest payments are made during the life of the security. In most cases, the investor bypasses traditional payments in exchange for participation in the underlying asset class of that particular issue. Any payments earned by the investor, such as through market performance or the return of principal, are determined by the specific terms of each individual deal and are made on the set maturity date. Moreover, many structured products are designed by combining two components, a zero-coupon bond, providing for the principal return, and a call option on the underlying asset, allowing investors to participate in the potential appreciation of the referenced asset.

Why would an investor purchase? Structured products are designed to provide increased control over risk and returns through leverage, principal protection, enhanced returns, risk management and customized access to asset classes or investment types. Their payments are typically linked to the performance of underlying market indices or securities, rather than fixed coupons, and they are customizable for specific investment objectives. Investors in structured products are typically seeking to maximize returns on an investment strategy, manage risk exposure to capital classes, hedge market risk, or customize solutions for complex investment objec-

Types of Structured Strategies

- **Enhanced Yield Notes**—Designed to provide enhanced yield relative to comparable fixed income securities with the same credit rating and maturity. In this category, digital notes, auto-callable notes and callable yield notes are some of the offerings.
- **Growth-Oriented Notes**—Designed to provide levered upside participation in the gains of the underlying asset; the maximum return may be capped or uncapped. In this category, accelerated return notes and market plus notes are some of the offerings.
- **Market-Linked Securities**—Designed to provide investors a return of their full initial investment if held to maturity. In this category, market-linked notes and market-linked certificates of deposit are some of the offerings.
- **Access Notes**—Designed to provide investors exposure to an underlying asset class or index that may be difficult to access through traditional investment vehicles.

tives. While structured products may potentially outperform typical fixed interest rate bonds, it is important to remember that they are subject to risks, including, among others, the credit risk of their issuer and potential underperformance in certain circumstances.

Why would an investor avoid?

- **Credit Risk:** Structured products are unsecured debt obligations of the issuer. As a result, they are subject to the risk of default by the issuer. The creditworthiness of the issuer will affect its ability to pay interest and repay principal. The financial condition and credit rating of the issuer are, therefore, important considerations. The credit rating, if any, pertains to the issuer and is not indicative of the market risk of the structured product or underlying asset. If a structured issue provides principal protection or a minimum return, any such guarantee rests on the credit quality of the

issuer. Those issued by banks in the forms of CDs may also provide FDIC insurance with standard coverage limitations.

- **Liquidity Risk:** Structured products are generally not listed on an exchange or may be thinly traded. As a result, there may be a limited secondary market for these products, making it difficult for investors to sell them prior to maturity. Investors who need to sell structured products prior to maturity are likely to receive less than the amount they invested. Therefore, structured products with longer maturities are subject to greater liquidity risk. The price that someone is willing to pay for structured products in a secondary sale will be influenced by market forces and other factors that are hard to predict. Sometimes, a broker-dealer affiliate of the issuer may make a market for the resale of structured products prior to maturity; but the price it is willing to pay will be adversely affected by the commissions paid by the issuer on the initial sale of the structured products and the issuer's hedging costs. Some structured products have lock-up periods prohibiting their sale during such periods. Persons who invest in structured products should have the financial means to hold them until maturity.

- **Pricing Risk:** Structured products are difficult to price since their value is tied to an underlying asset or basket of assets and there typically is no established trading market for structured products from which to determine a price.

- **Income Risk:** Structured products may not pay interest (or may not pay interest in regular amounts or at regular intervals), so they are not appropriate for investors looking for current income. Because the return paid on structured products at maturity is tied to the performance of a basket of assets and will be variable, it is possible that the return may be zero or significantly less than what investors could have earned on an ordinary, interest-bearing debt security. The return on structured

products, if any, is subject to market and other risks related to the underlying assets.

- **Complexity and Derivatives Risk:** Structured products typically use leverage, options, futures, swaps and other derivatives, which involve special risks and additional complexity.
- **Pay-Out Structure Risk:** Some structured products impose limits, caps and barriers that affect their return potential. With barriers, a structured product may not offer any return if a barrier is broken or breached during the term of the structured product. Conversely, some structured products may not offer any return unless certain thresholds are achieved. Some structured products impose maximum return limits so even if the underlying assets generate a return greater than the stated limit or cap investors do not realize that excess return. Structured products also have participation rates that describe an investor's share in the return of the underlying assets. Participation rates below 100 percent mean that the investor will realize a return that is less than the return on the underlying assets.

Options

What are they? A contract giving the owner the right to buy or sell an asset at a specific price, at or prior to a specific future date. An option is a derivative, meaning the value is determined by an underlying asset. Examples of these assets are stocks, bonds, exchange traded funds, commodities, currencies, or stock indices.

How are they structured? Options have a variety of designs; explaining every type is beyond the scope of this Lesson. In the interest of simplicity, the focus will be limited to the most common form of options, the stock option. The security trades on an exchange, and each option trade represents a zero-sum game between the buyer and seller. A single contract represents 100 shares of a stock. Understanding the terminology within an option quote via an actual example may be an easier way to learn.

An investor deciding to buy an XYZ January 50 Call $1.85 suggests the following:

- XYZ is the name of the underlying stock
- January is the month which the option expires
- $50 represents the strike price for the option, the price at which the buyer of the option contract may buy the underlying stock
- Call identifies the type of option contract. In the example above the buyer of the call maintains the right to purchase 100 shares of XYZ stock at $50. If the stock runs to $60 or even $100, the investor would maintain the right to buy the stock at $50. The inverse strategy is to buy a put option, which is the right to sell a stock at a pre-determined strike price. An investor purchasing a put would anticipate the underlying stock declining in value.
- $1.85 is the price you pay per share for one contract, also commonly referred to as the option premium. A single option contract typically represents 100 shares, consequently the investor would pay $185 for this particular option.

Why would an investor purchase? Tremendous upside and leverage are the most common reasons.

Why would an investor avoid? Two big reasons:

1. **Risk**—Investors must understand the potential loss associated with options trading. Selling *put* options (selling a *put* option means you are granting the opposite party the right to sell a stock at a defined price. The seller of the put option has an obligation to buy the stock from the contra party. A stock price is not capped, consequently an investor's potential loss is unlimited) is arguably the most aggressive investment strategy one could pursue, considering the potential loss is *unlimited*. Purchasing a *call*, is an

option trade occurring with greater frequency. A *call* option expires worthless if the stock does not exceed the strike price. If the option does expire, the investor loses his or her entire investment.

2. **Finite Time-Period Equates to Speculation**—Investors recognize stocks tend to increase in value over time. Unfortunately, the appreciation is not linear, in many cases equites flatline for months or years (for example: investors referred to the period from 2000-2009 as the lost decade. The S&P 500 experienced two major corrections, equity investors with unfortunate timing experienced negligible returns during this timeframe). Equity returns tend to be concentrated over short periods of time. Unlike stocks, options are finite investments with a specific expiration date. An options trader is speculating they will be able to identify the proper time frame when a stock or stock index appreciates. The trader is attempting to successfully execute marketing timing. He or she must identify the correct time to purchase the option and recognize the appropriate time to close the trade.

Annuities

What are they? A contract between you and an insurance company, backed by the full faith and creditworthiness of that insurer. The insurance company will agree to make payments to you at some point in the future via a lump sum or as a series of payments over an agreed upon period time.

How are they structured? Annuities are typically structured to credit your account in one of three ways: 1) A fixed annuity designed to credit a minimum amount of interest annually 2) Variable annuity providing the investor with an option to invest in mutual funds. The payout is directly related to the success of the selected investments. 3) An Indexed annuity offered a form of crediting tied to an index such as the S&P 500.

Why would an investor purchase? In the accumulation phase: Tax

deferred growth, no annual contribution limit. Some states provide unlimited asset protection as part of their state exemption statutes. Distribution phase: Offers the ability to create an income stream for life or a defined period. Reliable income stream designed to complement a pension, social security, or an investment portfolio.

Why would an investor avoid? Cost. An investor could be subject to an up-front commission of 5-10 percent of the initial investment. Annuities often have a surrender charge, meaning you must pay a fee to exit the policy if you attempt to do so within the first several years of the contract. Surrender periods commonly run from 7-10 years, with the surrender charge typically declining by 1 percent for every year you are in the contract. Annual fees are typically higher in annuity compared to a traditional investment account. Insurance charges, fund management fees, and insurance riders can increase the annual fee to 3-4 percent of assets.

Conclusion

The preceding information is provided to give you a quick summary of components and tools utilized in wealth management. How the tools are used depends on your goals, your appetite for risk and your timeline. Further, how you employ these tools will likely change depending on whether you are just starting out with your planning—or are getting close to retirement.

Knowing what the tools are is one thing—understanding how they work is another. To help illustrate, we use the next Lesson to provide a history of the markets. Having a passing knowledge of how the markets have worked historically will help you understand how investing fits into your overall wealth management.

The following Lesson illustrates some of the most prevalent trends of the last 100 years—but it is important to keep in mind, as all disclaimers and disclosures note: past performance does not promise specific future results.

You will see that, historically, the markets have been unpredictable yet have trended upwards. We will show you how allocating the tools in the previous Lessons can help mitigate the consequences of market unpredictability and work to build your wealth.

WEALTH MANAGEMENT
MADE SIMPLE

A recent American Psychological Association survey found that money is the leading cause of stress among Americans. Why are we all so stressed out about money? Because most of us are afraid that we will run out. No matter how much you have—it is a basic fear that you may lose it. We wrote this book to be a resource that provides answers for the most common questions that we have heard from working with over 1,000 clients at our firm. These are the questions you must ask yourself and your advisors—to ensure you are on the right path.

This book makes no guarantees. We do not have a secret strategy or magic algorithm; we do not offer get-rich-quick lessons or an easy path to financial freedom. If you pick only one piece of advice to take with you from reading this book, it is, *do not trust anyone who offers easy, get-rich-quick ideas.* What we offer is a time-tested approach that will help you reach your goals and enable you to retire on your terms.

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