

**Legal Considerations**  
**in the Investment of Assets**

**- A Practicing Attorney's Perspective -**

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**Note:** This web-based version of the seminar text does not contain four graphs that were in the original paper, but does retain the original pagination. This text also does not include the Power Point presentation given at the seminar.

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## **I. Introduction**

### **Educational In Nature**

This seminar is designed for clients, friends, and family members of the Kaufhold & Associates, P.C. law firm. It is designed to be educational in nature, and the emphasis is on legal and financial aspects of the investment of assets, with attention being given to both individual and institutional concerns.

The seminar is not designed to give out investment advice on the selection of specific assets, and is not meant to be a recommendation to buy, trade, or sell any security or any type of investment device. Financial advisors should be sought out for such selection of assets, and well as for overall financial planning at both individual and institutional levels.

### **Qualifications and Affiliations**

Kevin C. Kaufhold is licensed to practice law in the State of Illinois, is a member of the Illinois State Bar Association, local Bar Associations, and is past chair of the Labor Law Section Council for the Illinois State Bar Association.

Kaufhold has extensive experience in the representation of clients in the field of labor law, and represents or has represented several joint labor-management pension, health and welfare, and other associated trusts funds in the collection and / or representation of trust matters. Additionally, Kaufhold has widely authored and lectured on various topics of labor law.

Kaufhold is also a member of the International Foundation of Employer Benefit Plans (IFEBC), and has attended several of the Foundation's Annual Conferences.

Kaufhold graduated from Georgetown University Law Center in Washington, D.C., received his undergraduate degree from SIU-E, and an Associates of Arts Degree from Belleville Area College (now known as SWIC). Kaufhold has also recently taken graduate level courses in Economics and Finance at SIU-E, School of Business.

### **Disclosure as to Ownership of Investments and Philosophies of Investment**

Kaufhold currently holds interests in actively managed mutual funds; passively managed index mutual funds (including Vanguard Funds); several publicly traded equities; and ownership and partial ownership of several local, private businesses (including the Law Firm).

As to his own investments, Kaufhold generally follows a value style investing philosophy, and believes in the long-term investment of assets and accumulation of net worth.

## **II. On Legal Considerations**

The Origins of Common Law Obligations. The prudent man rule initially came from Harvard College vs. Amory, 26 Mass. 446 (1830). Almost all states have adopted some form of the prudent person standard. The trustee or manager of financial assets has a duty to see that the property is legally designated as trust property; that he not delegate the duty over trust property to others; that the power over trust assets be used for the benefit of the trust beneficiary; that the duty is one of undivided loyalty to the beneficiaries; and that a duty of ordinary prudence exists on investments so as to maximize the return and ensure the safety of trust assets. The trustee must resolve all conflicts between his own personal interest and that of the trust in favor of the trust. The focus of the original prudent person standard was on the appropriate investment of individual assets.

The Illinois Prudent Investor Rule. In Illinois, the common law duty regarding the investment of assets was generally incorporated into the Trust & Trustees Act, 760 ILCS 5/5. The Rule directs the trustee to invest and manage a trust in accordance with six additional guidelines. The prudent investor rule requires the exercise of reasonable care, skill and caution. 760 ILCS 5/5 (a)(1). The rule allows for the trustee to exercise “reasonable business judgment” in managing investments by clarifying that this rule is a test of conduct and not a test of performance results. 760 ILCS 5/5 (a)(2). Furthermore, the Prudent Investor Rule specifies that the trustee has a duty to diversify investments of the trust. 760 ILCS 5/5 (a)(3). There may be an exception if, under the circumstances, the trustee reasonably believes that it is in the best interests of the beneficiary and furthers the purpose of the trust to not diversify, however, it should be noted that diversification is emphasized in this rule. A trustee also has a duty to review the trust assets and make decisions about the investments in the trust based on that review. 760 ILCS 5/5 (a)(4). The trustee also has a duty to pursue an investment strategy that considers growth and stability and is impartial, focused on the purposes of the trust. 760 ILCS 5/5 (a)(5). The final component of the Prudent Investor Rule is a list of circumstances which the trustee may consider when they make investment decisions including; the general economic conditions, the potential effect of inflation, the potential tax consequences; the role of each investment, the expected total return and the costs incurred. 760 ILCS 5/5 (a)(6).

The Illinois Prudent Investor Rule is to be applied to investments, not in isolation, but in the context of a portfolio as a whole and as part of an overall investment strategy. Note the important change from common law, where the concentration was on individual assets. Furthermore, there is no distinction in this rule between a corporate executor and an individual executor. In Illinois, a corporate executor is held to no higher standard than individual executor; in either case, fiduciary must act with highest degree of fidelity, with utmost good faith, and with that degree of skill and diligence which an ordinarily prudent person would bestow on their own similar affairs Estate of Lindberg, App.1 Dist.1979, 26 Ill. Dec. 524, 69 Ill.App.3d 714, 388 N.E.2d 148. The Illinois Prudent Investor Rule is a good legislative guideline for trustees to use in protecting themselves personally and protecting the trust at the same time. It should be noted that 760 ILCS 5/5 (c) states that the courts are not restricted by this rule and they may direct or permit the trustee to

deviate from the terms of the trust or to take or refrain from taking any other action. However, trustees should be attentive to this particular instrument and use it as a guideline for their actions or inactions with respect to the trust they manage.

Foundations / Endowments. Illinois law, 760 ILCS 55/1, *et seq.*, and federal tax law, 29 USC 4944, both apply to private foundations and endowments incorporated under Illinois law. The trustee of a foundation or endowment shall not make any investment in such a manner so as to subject the trust to taxes. Monetary penalties result from the carrying out of any investment that jeopardizes the carrying out of tax-exempt purposes. Trustees shall avoid self-dealing, wasting of charitable assets, and incurring penalties. Trustees shall also adhere and conform the charitable organization to its charitable purposes, and shall not make any loans, gifts, or advances that are not allowed for a not for profit corporation. The trust must be operated in conformity with its purposes and for the best interests of the beneficiaries. All books and records shall be open for inspection at all reasonable times by the Illinois Attorney General or an authorized representative.

As to corporate investment of assets. Corporations creating employee retirement or health & wealth plans can be subject ERISA regulations (see below, for details on ERISA standards). This is especially the case for welfare benefit plans or retirement plans directly controlled or administrated by a corporation (i.e. corporate profit sharing plan; early retirement plan). A SEP or SMPL plan that is completely self-directed may also be within the general purview of ERISA, but many legal requirements of small employer, self-directed plans are specifically designed to be easily administered through a financial intermediary. Any type of employer sponsored plan that retains or vests control of plan assets with the employer will potentially impose many fiduciary requirements and obligations. These requirements include the duty of diversification, as well as the duty to act solely in the interest of the beneficiaries for the exclusive purpose of providing benefits or defraying administrative expenses.

General surplus cash accounts as well as other investment-grade assets of a corporation generally are not within the gamut of state or federal law regarding trust and retirement funds. A duty will still exist, however, by the officers and directors of the corporation to invest such assets within a professional standard of care that typically is provided by officers and directors of a corporation. Potentially, professional liability and fiduciary responsibility may attach to any error and/or omission regarding the investment of assets of a corporation. In order to satisfy this duty of care, principles of corporate finance as well as various commonly accepted standards of investments may be applicable. State corporate law generally governs privately held businesses, while publicly traded businesses are highly regulated by federal securities legislation.

As to the investment of public assets. Various state laws control the investment of municipal assets. See generally, 30 ILCS 225/1 and 65 ILCS 5/8-1. Municipal treasurers are personally liable for funds deposited. Municipal officials who do not invest idle funds are remiss in their duties and violate state law. Treasurers are authorized to enter into agreements for any definite terms with regard to the deposit, investment, and withdrawal of funds. Funds that are not immediately needed shall be invested within two working

days at prevailing rates or better. 30 ILCS 225/1. Funds must be invested in a series of investment options and vehicles that are specifically authorized by statute. 30 ILCS 235/2; 65 ILCS 5/8-1-13.

Employee / Employer Pension and Health Trust Funds. Common law requirements were modified in 1974 for certain qualifying retirement and health & welfare trust funds through the enactment of the Employee Retirement Income Security Act (known as ERISA), 29 USC 1100, *et seq.* The statute differs from the common law prudent person standard in three critical respects. First, the plan fiduciary is required under ERISA to invest plan assets not in the way he or she would do so at a personal level, but as similar pension plans invest their assets; second, a fiduciary must exercise the skill of a prudent expert, and not simply as that of a prudent man would in the management of pension assets; and third, the focus is not on the performance of individual assets, but on the performance of the portfolio as a whole. See, “Asset Management”, CEBS Study Manual, IFEBP, 2003.

Under ERISA, fiduciaries are defined as a person who either: exercises any discretionary authority or control over the management of the plan; exercises any authority or control concerning the management or disposition of its assets; or has discretionary authority or responsibility in the administration of the plan. Fiduciary status depends upon a person’s function, authority and responsibility and does not merely rest on a title.

Fiduciaries must act solely in the interest of the beneficiaries for the exclusive purpose of providing benefits or defraying administrative expenses. The fiduciary must follow strictly the terms of the written plan document and administer the plan in a fair, uniform, and nondiscriminatory manner. The fiduciary cannot allow the plan to engage directly or indirectly in transactions prohibited under ERISA. A fiduciary may be held personally liable for breaches of his or her fiduciary duties.

The fiduciary must use the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. Fiduciaries must diversify investments so as to minimize the risk of large losses unless it is clearly prudent to do otherwise. 29 USC 1104. The statute has no quantitative specifications. This preserves flexibility in its implementation, but also presents interpretation problems that inevitably lead to litigation.

Parties in Interest are compelled under ERISA to not engage in prohibited transactions. Types of transaction between a plan and a party in interest includes the sale, exchange, or leasing of property; the lending of money or other extension of credit; the furnishing of goods, services, or facilities; the transfer of assets; or the acquisition of any employer security or employer real property. A party in interest is defined as a plan fiduciary; legal counsel or employee of the plan; any person providing services to the plan; an employer whose employees are covered by the plan; a direct or indirect 50% or more owner of an employer sponsor of the plan; certain relatives of the foregoing persons; employees,

officers, directors and certain shareholders of certain parties; and parties having a defined direct indirect relationship with parties in interest.

Fiduciaries are required to act in strict accordance with the plan documents in so far as the documents are consistent with ERISA. The plan fiduciaries are required to uniformly follow the express, written, terms of the plan. Decisions by the plan as to benefit claims are accorded deference unless there is a substantive issue raised on whether the plan is overly vague or ambiguous; the plan fails to expressly include a provision that the courts should defer to the administrative decisions of the plan fiduciaries; or there is an apparent conflict of interest and the fiduciary would be personally affected by the benefit decision.

Plans must have a funding policy document that addresses the level and timing of contributions necessary to fund benefit obligations throughout the life of the plan. Plan sponsors must hire enrolled actuaries to perform calculations regarding the funding policy. An investment policy statement (IPS), while not specifically required by ERISA, is routinely requested in DOL compliance audits. The IPS is narrower in scope than the funding policy in that the IPS pertains to only the governance of plan assets, and not the actuarial calculation of both the benefit and funding schemes of the plan. The IPS typically addresses the monitoring of invested assets; the evaluation and performance of investment managers; and funding and investment policies establishing formal investment policies. So long as investment decisions are in accord with the IPS and funding policy, a legally defensible position can be maintained.

Investment Policy Statements should contain several items that establishes the general; tone and policy for the investment of assets in the plan. See “Asset Management”, CEBS Study Manual, IFEBP for more details. Such items to include:

- Asset allocation targets for the plan and / or for the various asset classes of the plan.
- Policies for rebalancing the portfolio to adjust for deviations from these target allocations.
- Statement of investment objectives.
- Policies for reviewing investment objectives and liability assumptions.
- Benchmarks and / or performance expectations for the portfolio and each investment manager.
- Policies regarding proxy voting.
- Policies specifying percentages if manager trading to be directed by plan sponsors.
- Diversification requirements and restrictions, along with liquidity and quality constraints on individual assets.
- Projected cash flow of the plan over relevant time periods.

Investment Managers, Investment Advisors and Security Brokers. If a manager, advisor, or other individual assumes the role of a trustee under state laws governing trusts or foundations, or assumes a fiduciary role pursuant to ERISA, the manager’s standard of care is founded upon the applicable state or federal law. As seen in the above references, a fiduciary or trustee typically has a higher standard of care than otherwise, since a special care of trust investments is assumed in the relationship.

For professional investment advisors who do not carry a trustee or fiduciary responsibility, normal standards of professional liability will apply. The ordinary duty of care owed to a client by a professional engaged in similar services and under like circumstances is the core of professional liability. Federal law governs much of the area regarding any investment manager, advisor, or broker licensed pursuant to federal standards and licensing procedures. Binding arbitrations are commonly provided in situations involving professional investment brokers and other investment service vendors. State law governs investment advisors and others who are involved in such small monetary amounts that they are not regulated by federal law.

### **III. On Financial Considerations**

Applicable Economic and Investment Concepts. Knowledge of investment theory and practice is relevant and useful in the determination of whether a person has satisfied his or her legal standard of care regarding the investment of assets. At the institutional level, the central inquiry is: What principles of finance must be complied with and satisfied in order to not breach a fiduciary duty? At the individual level, the question becomes: what financial considerations should be employed to optimize risk and return across all investment periods?

The following economic and finance items summarize some of the commonly accepted investment principles applicable to a fiduciary, trustee, or professional investment level. The outline also contains some considerations pertinent at the individual or personal level of investment.

#### **First, Get Out of Debt.**

Pay off the credit cards and high interest rate debt. *The Only Investment Guide You'll Ever Need*, Andrew Tobias, 1998).

Manage the residential mortgage. For adjustable rate mortgages, consider moving to a fixed rate loan. *Wall Street Journal*, J. Clements, Jan.5, 2005, at D1. For 30 year loans, consider moving to a 15 year fixed rate loan. This could save a significant amount of interest. Or, simply make 13 payments in 12 months. This could reduce the total loan duration considerably. Some feel however, that an investor could be better off by investing the higher cost of mortgage payment towards a stock portfolio. See, "Long-Term Thinkers Pick 30-Year Mortgages", Jack Naudi, *St. Louis Post Dispatch*, Jan. 23, 2005, at E5. Of course, if a shorter-term refinancing can be achieved without increasing the mortgage payment (this can be done when the 30 year mortgage is at a higher rate than the 15 year loan), then there would be no extra mortgage payments to make, and a 15 year loan becomes very attractive.

Pay down / reduce other lines of credit and loans. College tuition loans, cash loans, and other lines of credit all should be kept within a reasonable percentage of adjusted gross

income. A realistic amortization schedule that is systematically maintained will lower overall debt, and will serve to gradually reorient an individual's perspective from being a consumer / debtor to that of being an investor / saver.

### **Then, Develop a Pattern of Saving and Investing.**

Investor Education. Learning anything and everything about savings and investment leads to a more informed investing public. Some good, basic books, magazines, newspapers, and seminar topics include:

- "The Only Investment Guide You'll Ever Need", Andrew Tobias (1998).
- "Winning the Loser's Game", Charles Ellis (1998).
- "The Millionaire Next Door", Thomas Stanley & William Danko (1996).
- "Common Stocks and Uncommon Profits", Philip A. Fisher (Wiley Investment Classics).
- "Where are the Customer's Yachts", Fred Schwed, Jr (Wiley Investment Classics).
- "The Intelligent Investor", Benjamin Graham (1973).
- Annual Reports of Berkshire Hathaway.
- *Better Investing*, National Association of Investment Clubs.
- *The Wall Street Journal*, Dow Jones & Co.
- Seminar papers from Conferences of the International Foundation of Employer Benefit Plans.

Keep it simple. Many professionals have suggested that simplicity is itself an effective strategy for long-term investing. Numerous writers have suggested over the years to keep it simple. *Common Sense on Mutual Funds*, John C. Bogle, 1999, at 83; *What Works on Wall Street*, James P. O'Shaughnessy, at 17; *John Neff on Investing*, John Neff, at 51; *The Single Best Investment*, Lowell Miller; *Winning the Loser's Game*, Charles Ellis, at xii.

Live below your means, and save. Whatever a person's income level, even modest savings can accumulate to become significant sums. An example: after 40 years of dutifully saving \$25 a month, one person had developed a \$1 Million + portfolio. *Investing for Life*, NAIC, at 82.

Saving more, and the power of compound returns. The mere act of increasing your savings even by small amounts will do more for one's net worth than most other investment decisions can, including the adoption of an aggressive allocation strategy. In

one recent study, T. Rowe Price used a Monte Carlo simulation to show that shifting the asset allocation to a more aggressive stock position during a person's working years only marginally increase the percentage of pre-retirement income available at retirement. But modestly increasing the annual savings rate (from 15% to 20% of income) allowed for a much higher percentage of pre-retirement income during retirement. Belleville News Democrat, Dec. 19, 2004, at B5. The reason cited: compound returns will accelerate investments more than adjustments in allocations.

Invest regularly. On a related topic, methodical and regular savings will certainly accumulate over time. In one study, families with fairly low earnings patterns were found to accumulate massive amounts of savings and retirement accounts. What mattered most was the simple choice of certain families to consistently and regularly save and invest versus the choice of other families to consume and spend. "You Don't Have to be Rich to Save a Big Nest Egg", *St. Louis Post Dispatch*, Sept. 1, 2000, p.c12.

Dividends and Dividend Reinvestment. Since 1926, dividends have accounted for 42% of the S&P 500's annual return. *Better Investing*, Feb. 2005, at 23.

Dividend reinvestment and the power of compounded returns are such powerful investment tools that returns can be magnified many times over by dutiful investment of assets. The following graph provides a wonderful example: \$1,000 invested in the S&P 500 in 1926, and left there until 2004, would have grown to \$87,413, demonstrating the power of compounded returns. But with all dividends reinvested, \$1,000 would have grown to \$2,321,005 over the same period of time. *Better Investing*, Feb. 2005, at 10.

--- insert dividend reinvestment graph ----

Dollar Cost Averaging. Regular additions to capital will allow the individual to take advantage of the downs or dips of any stock, as well as getting hit with times of relatively high valuation of the same stock. You end up seeing the average of all the lows and the highs in prices. By regular investment, your average price of a stock will in all probability be lower than if you bought the same stock at any one particular time. Andy Tobias, at 133-137.

Keep Costs, Expenses, and Taxes Low. The costs of management of an asset portfolio are critical to the overall success and rate of return of that portfolio. Always remember that transaction and trading fees, administrative and management expenses, and the turnover of assets with the resultant tax impact on capital gains will all act as a drag against performance of an investment portfolio. It is therefore prudent to keep expenses to a minimum. One noted writer feels that “cost is the most important determinant of portfolio performance, not asset allocation policy, market timing, or security selection”. William Jahnke, “The Asset Allocation Hoax”, *Journal of Financial Planning*, Feb. 1997, at 109-113.

Cost, Expenses, and Taxes: A Discussion of Mutual Funds. Many mature individual and institutional portfolios contain one or more mutual funds, so the following comments are tailored to the mutuals. Actively managed mutual funds charge much higher expense fees than index funds and generate higher turnover costs. Here are some rather typical expense fees and ratios on active and index funds.

--- Expense Fees / Ratios ---

	<b>Actives</b>	<b>Indexes</b>
Load fee, Active Mutuals	up to 5.75%	0.00%
No-load fee, Mutuals	0.00%	0.00%
Expense Ratios	up to 2.00%	0.20 to 0.30%
Turnover Ratio, annual	up to 50% or more	3 to 6%

The higher expenses of the actives are the chief reason that actively managed mutual funds will underperform their benchmark indexes. In any one year, up to 70 % of all actively managed funds under-perform the Wilshire 5000 index. *Refresher for Trustees on Investment Concepts*, International Foundation of Employees Benefits Conference, Orlando, Fl, Nov. 1, 1999, chart at 70-8; *A Random Walk*, at 215. Over five-year periods, 90 % of all mutuals may end up trailing the S&P. In fact, one source indicates that only 1.20% of all actively managed funds have outperformed the S&P Index in each of the five years between 1994 to 1999! “Refresher on Investment Concepts”, IFEBP Annual Conference, Nov. 2000, Sandy Lincoln, speaker. And as of the end of 2004, only one known active mutual fund manager has outperformed the relevant benchmark index for last 14 consecutive years (Bill Miller, manager). After tax impacts are figured in, index funds may outpace 86% to 97% of all actively managed mutual funds. Bogle, at 286-287.

Pension plans also suffer from underperformance. One study showed that 87% of over 200 actively managed corporate pension plans reviewed underperformed a 60 / 40 stock to bond passive index allocation between the period of 1987 to 2003. “You Can’t Outsmart the Markets”, *St. Louis Post Dispatch*, Larry Swedroe, Jan. 23, 2005, at E6.

Coupled with an inability to outperform the indexes, active mutual funds suffer from a lack of consistency in performance. There is little or no long-term relationship between mutual performance in a past period and investment returns in a future period. Even the *Forbes* Honor Roll of Mutual Funds has under-performed the Wilshire 5000 over a 16 year test period. *A Random Walk*, at 443-444. And, a Morgan Stanley Dean Witter study in 1998 showed that repeat superior performance by the mutuals is as probable as results obtained randomly. *Common Sense on Mutual Funds*, John Bogle, at 214.

Invest in the Long-Term. A simple, long-term buy and hold type of strategy takes advantage of compounded returns, reversion to the mean tendencies of assets, and allows for the accumulation of assets in a tax-deferred status, with capital gains being paid (at the reduced, long-term tax rates) only when a sale occurs. Coupled with dollar cost averaging and dividend reinvestment, additional investments of even an incremental nature can develop into a solid, long-term asset portfolio.

Numerous financial seers believe in long-term investing. Warren Buffett has a grouping of privates and publics that he considers to be “permanent”. *The Warren Buffett Way*, at 99-158. Buffett is also fond of saying that his favorite holding period is “forever”. Peter Lynch feels that most of his investments first begin to make money in the 3<sup>rd</sup> or 4<sup>th</sup> year. *One Up on Wall Street*, at 272. Another investment professional believes that over short periods luck is probably more important than skill, with a large random element to pricing. It is only over a 3 to 5 year period that random events cancel out, leaving the net result of the investor’s intelligence. See, James H. Gipson, quoted in *The Investor’s Anthology*, at 74-75.

More formal studies also support long-term investment patterns. In a computer run of 1,200 companies over an 18 year period, the correlation of earnings to price steadily increased from a short-term 3 years of .131 to .360, up to an 18 year incidence of .688. *The Warren Buffett Portfolio*, p.74-76, and Appendix B. In another study reviewing the S&P 500 long-term performance from 1964 to 1999, two primary things became evident: First, the trend of earnings is strongly upward; Second, stock price advances over long time periods are closely aligned to earnings and dividend growth. See, *Winning the Investment Marathon*, at 10-15. A simple long-term investment strategy takes advantage of this alignment, and does so in an automatic manner.

How much to save? How much is Needed? The answer to these questions can involve very involved actuarial types of calculations. A financial advisor should definitely be sought out for answers to specific instances. But, let’s take a very simplified hypothetical example, gleaned from some very interesting, real-life numbers:

In a survey done by Putnam Investments on 2000 retired individuals (cited in *AII Journal*, Jan. 2005, at 2), the average household income of the survey was \$49,000. 11% of retirement income came from self-directed retirement accounts. 24% was from traditional pensions. 41% was provided by social security. 20% of the respondents had a systematic withdrawal plan. On average, they took out about 6.7% per year from their invested assets. 59% wished they had started saving earlier. 70% wished they had saved more, and 84% were satisfied with their new life status.

Using the above survey as a rough guideline:

Retirement income goal .....	\$50,000
SSA retirement payments .....	\$20,000
	-----
Income needed from pensions, cash and retirement savings .....	\$30,000

A 5 to 7.5% withdrawal rate would be in the range of the above survey's 6.7% rate and may also be close to a typical rate of return that could be generated from a mature and diversified asset portfolio. Such an annualized withdrawal rate would necessitate \$450,000 to \$600,000 in savings in order to produce an annualized income of \$30,000 per year. Lower reserve amounts would be possible, but would then increase the probability of a person outliving his or her investments, assuming the individual would desire to maintain a \$30,000 annualized withdrawal.

If a traditional pension plan is available, then a smaller reserve would be needed. Generally following the above example of 11% of household income coming from self-directed accounts, a 5 to 7.5% withdrawal rate would require reserve of roughly \$150,000 to \$200,000 in order to be sustainable. Of course, if inflation is to be accounted for (a highly recommended approach), or if a person wants greater investment income than in the above example, the required reserve account for retirement would have to be much larger.

For an example of a more sophisticated analysis of retirement savings requirements over short withdrawal periods, see "Retirement Withdrawals: What Rate is Safe When Time is Short and Uncertain?", Phillip L. Cooley, *AII Journal*, Jan. 2005, at 4.

Tax Issues. Low turnover of assets is a great and easy way in which to manage and contain the capital gains taxation of assets. Selling capital assets with losses to offset capital gains of other assets is another way to lower taxes. Buying tax-exempt bonds is a tried and true approach. There are numerous other tax issues involved in financial planning, many of which may be inter-generational in nature. Advice from financial advisors, accountants, and estate lawyers versed in the nuances and complexities of taxation of assets and income is highly recommended.

Insurance Issues. No investment plan is complete without considerations of insurance coverage. Term life, whole life, disability, AD&D, homeowners, automobile, health, and umbrella policies should all be evaluated for coverage and effectiveness. Sufficient coverage is necessary at all times to protect capital assets and net worth patterns. Advice from an insurance agent is highly recommended.

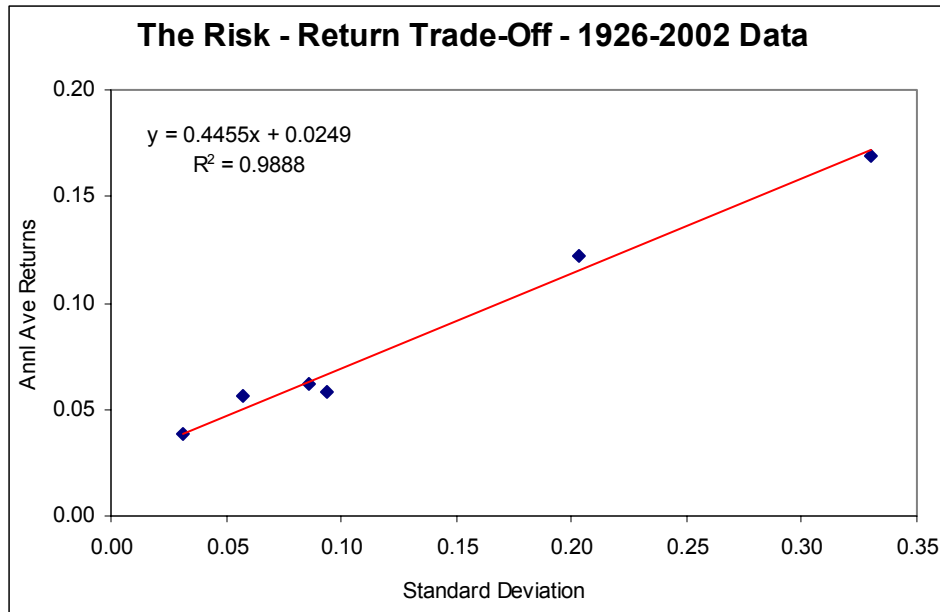
Investment Policies and Practices. Charles Ellis, in *Winning the Loser's Game*, strongly recommends the development of stated, written investment policies and plans that guide the investor towards a methodical and consistent investment of assets. The above concepts can be incorporated into an investment policy. Such an investment plan is mandatory for ERISA types of investment trust funds, but is also a standard practice in the investment community for larger portfolios. Thus, structured investment policies and plans have a definite place at both the institutional and individual levels.

## **IV. Risk and Return Concepts**

### **Always be Aware of Risk and Return.**

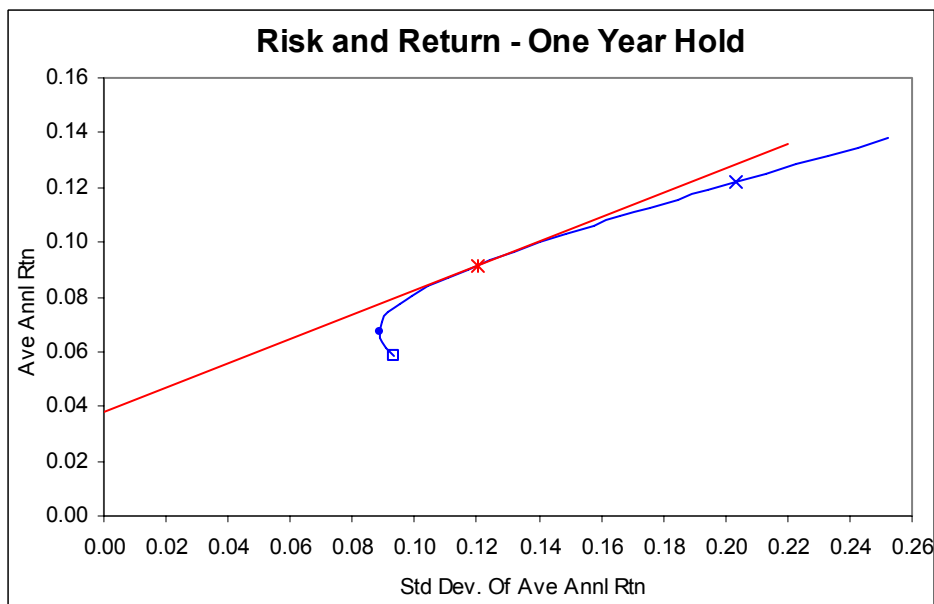
On Definitions. Many forms of risk exist: currency risk; liquidity risk; international and political risk; and the risk of default are just a few of the risks involved in the investment process. But, risk is typically defined in the economic literature as the standard deviation of expected pricing returns, while return is seen as the annualized rate of return of an asset's pricing. The literature suggests that most if not all of these other types of risks are ultimately priced into assets through the open markets. Indeed, much of the variation in the pricing of assets at any one point in time can come from market adjustments in asset pricing to these various risks via news announcements. For a more extensive discussion of risk and return, see *Investment Analysis and Portfolio Management*, Reilly & Brown, 6<sup>th</sup> ed., 2000.

The Risk – Return Trade-off. Standard economic theory indicates that a trade-off exists between risk and return. In order to increase the rate of return on investments, there must be a corresponding increase in basic risk levels. This is demonstrated in the following graph (generated by Kevin Kaufhold, using Ibbotson data, 1926-2002).



Balancing of Risk and Return through Optimization. Risk can never be eliminated entirely, only managed, reduced and “optimized”. Return cannot accelerate indefinitely, and is limited to gains flowing from economic productivity. The following graph shows the means variance optimization process for a one-year holding period, and is derived from econometric equations of the Markowitz Portfolio Theory and the Capital Asset Pricing Model. Ibbotson data between 1926 and 2002 was again used.

The intersection of the capital market line (in red) and the Markowitz efficient frontier (in blue) is the optimized point between risk and return, and is represented as a red diamond. With Ibbotson’s historical data sample, and assuming an historical average of 4% risk free rate of return, the optimized level of stocks to bonds with a one-year hold was 52% stocks, 48% bonds (the red dot on the curve). The box on the curve is 100% bonds; The blue dot on the curve is the minimum level of risk; and the x on the curve represents 100% stocks.



While the above graph is based on complex equations and investment theories, the principle behind the graph is straight-forward: risk and return can be managed and optimized simply through an appropriate mixture of various asset classes. That is a key investment concept for any trust fund manager to understand and utilize, and is also very useful at the individual level.

### **On the Diversification of Assets.**

Reduction of Risk through Diversification. Fluctuations in the rate of return can be reduced by holding a broad grouping of investments within each asset class. For example, the following graph (taken from *Investment Analysis & Portfolio Management*, at 293), demonstrates that as the number of stocks held in an equity portfolio increases, the risk that the rate of return will deviate from expected levels of return substantially decreases.

---- insert diversification graph here ----

How many equities are needed for sufficient diversification in an equity portfolio? Many years ago, Benjamin Graham suggested 10 to 30 companies that are large, prominent, and with a long record of dividend payment. *Intelligent Investor*, at 54. Burton Malkiel, in a popular treatise, felt that a 20 stock portfolio was appropriate. *A Random Walk Down Wall Street*, 6<sup>th</sup> ed., at 240. Recent studies have indicated that more equities may now be needed for complete diversification, due in large part to greater individual stock volatility from 1986 forward. Even these treatises however, recommend only 50 to 75 stocks as being needed for diversification purposes (Studies are summarized in “How Many Stocks Should You Hold?”, James Picerno, *Personal Finance*, March 2002, 86-88). Of course, a broadly diversified asset index fund would be the simplest approach to complete diversification, avoiding the necessity of actively monitoring specific assets in a portfolio while ensuring market risk levels.

Reduction of Risk through International Diversification. Risk can also be reduced by adding international investments into an investment portfolio, as the following graph demonstrates. From, *Investment Analysis and Portfolio Management*, at 78.

---- insert international diversification graph here ----

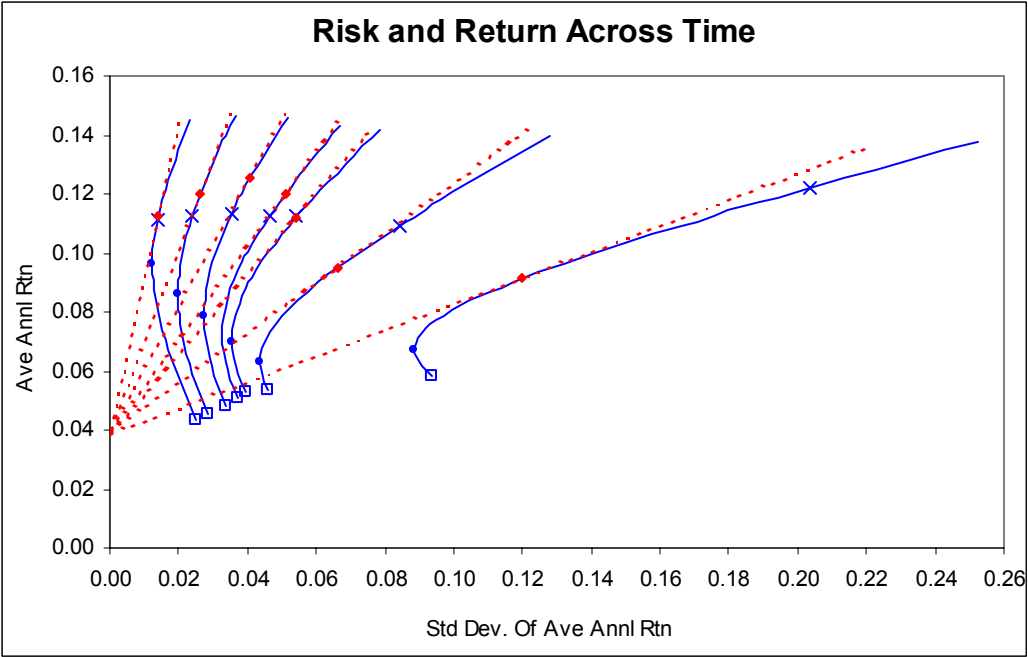
But how much international diversity is needed? This is really an asset allocation question, but is appropriate for discussion here, as well. The following graph is contained in *Stocks for the Long Run*, Jeremy Siegel, at 133. It demonstrates that merely adding international investments into a portfolio can reduce volatility pricing risk significantly. For the sample data analyzed, a 60% / 40% mix of domestic and international assets generated an “optimized” rate of return and risk, at around 13.7% annualized return, and 15.7% standard deviation.

---- insert domestic / international equity optimized frontier ----

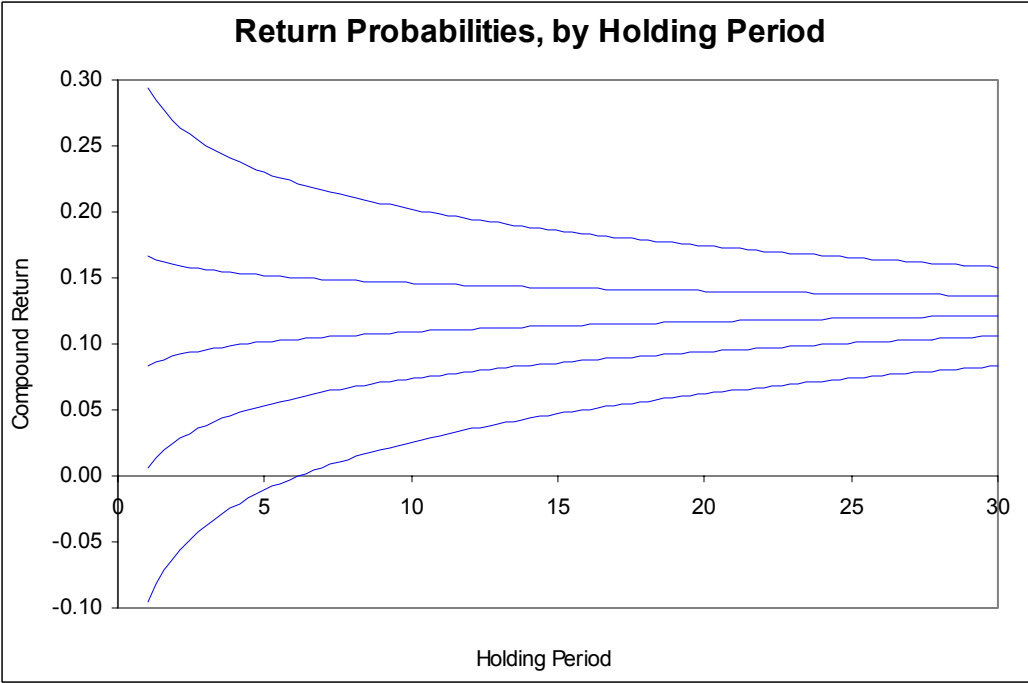
### **On the Changing Nature of Risk and Return.**

On the Reduction of Risk through Time. Traditionally, economic theory has assumed that the intended period of investment is unitary in nature, with all investors having the same “timeless” holding period. Once that assumption is relaxed however, economic textbooks indicate that the definition of risk and return must change in accordance with the longer investment time horizons. See, *Investment Analysis and Portfolio Management*, supra, at 287. This is due to the traditional measure of risk (standard deviation of expected returns) becoming meaningless in long-term time frames, as shown in the following graph. Through reversion to the mean tendencies inherent in almost all assets classes, the volatility of the expected rate of return is greatly reduced in long-term time periods to almost insignificant levels.

The following graph is based on MPT and CAPM equations using the same Ibbotson data as before, but now includes longer holding periods of (left to right) 30 years; 25 years; 20 years; 15 years; 10 years; 5 years; and 1 year. The red diamonds are optimized levels of risk and return for each holding period. A very similar graph is found at *Stocks for the Long Run*, 2<sup>nd</sup> ed., 1998, Jeremy Siegel, at 36.

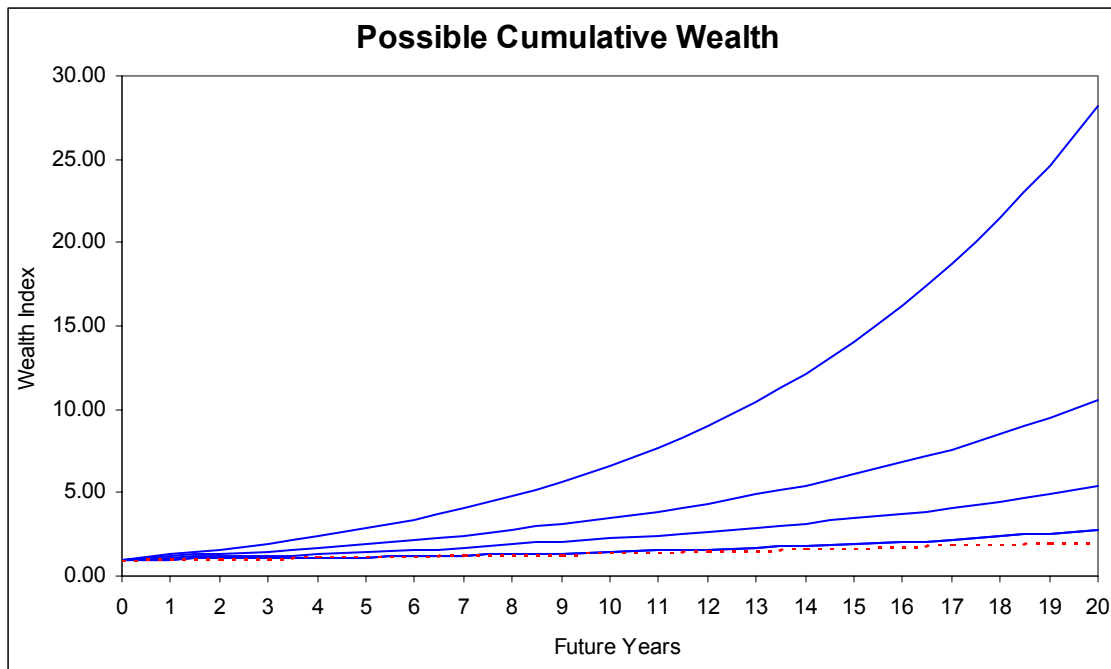


On the Reduction of Risk over Time for all Asset Classes. Longer holding periods not only greatly reduce the risk levels of an optimized asset portfolio, a long-term investment pattern also reduces volatility risk of all asset classes. This is again due to reversion to the mean tendencies of investment assets. The graph uses Ibbotson data and probability equations.



The above graph clearly demonstrates that volatility risk, shown here as the range of probable returns at any one point in time, decreases as a function of the holding period, so much so that one writer has noted: “The holding period becomes a crucial issue in portfolio theory when data reveal the mean reversion of the stock returns”. See, *Stocks for the Long Run*, at 37.

On Other Forms of Risk Increasing across Time. In the longer holding periods, pricing volatility types of risk are greatly reduced, but another type of risk, that of shortfall risk, markedly increases. This is demonstrated in the following graph showing an ever-increasing range of terminal net worth. See, Research Notes on Risk, Return, and Time, 2004, Kevin C. Kaufhold. The range or variability away from expected net worth thus becomes a key concern of long-term investing. The following graph portrays the increasing divergence in probable wealth as a function of time, using the returns of the 95%, 75%, 50%, 25%, and 5% confidence intervals of optimized return probabilities.



One writer has commented that the real risk of a portfolio is insufficient cash being available to cover necessary expenses. The term “portfolio risk” by itself may be meaningless, since future and present cash needs at the individual investor level must be factored into the process. See, Robert H. Jeffrey, excerpted in *The Investor’s Anthology*, at 143-148. Thus, in the longer time horizons, the variability of net worth and the distinct probability of under-funding of investment goals becomes the relevant risk at both institutional and individual levels. Return in the longer holding periods moves toward the rate of overall increase to net worth and away from the rate of return of specific assets. The risk of under-funding is a clear danger for pension trusts and may lead to fiduciary

breaches, if not anticipated and dealt with in advance. At the individual level, the risk of a shortfall in assets needed for retirement is of utmost concern.

The possibility of under-funding of cash needs is commonly analyzed through Asset / Liability modeling, while the balancing of market pricing risks with shortfall risks can be accomplished through Utility Analysis, with the focus being on the maximization of investor marginal utility.

Very-Long Term Risk and Return. For holding periods spanning decades, risk definitions relevant in short-term and even longer-term time frames gives way to practical problems associated with intergenerational transfers. This is especially the case from a practicing attorney's perspective, where client experience has repeatedly shown disputes between relatives, heirs, and legatees; problems with the continuation of private family businesses upon the death of the primary manager / owner; concerns over estate and gift taxes; and differences of opinion among the heirs concerning continued direction and focus of surviving family wealth.

A primary risk in very-long time frames is one of excessive diminution of net worth upon transfer to heirs. While a short-term investor may be very happy with a 10% rate of return per year on his or her investments, a very-long term investor may be ecstatic to see a sizable portion of his or her net worth (say 75%+) ultimately and successfully transferred to net of kin. Estate planning becomes critical if taxes are to be avoided, capital assets are to be preserved, and a family unit along with its businesses are to be kept intact post-transfer of assets.

Institutional investors, such as trust funds and charitable foundations, essentially operate within the context of an "indefinite" holding period, or a series of successively longer holding periods. While institutionals do not have the concern of intergenerational transfers going awry, they do have very-long term risks, nonetheless: the likelihood of under-funding of liabilities is always a danger; policy drift of the institutional is possible and even likely given enough time; director control of the fund may become contentious over longer-time frames; and eventual misdirection of assets by directors far removed in time and perspective from the original trust of fund sponsors is a possibility. Continued monitoring of practical and policy issues is therefore paramount for an institutional to survive in perpetuity.

While many economic and finance models are appropriate business vehicles to utilize in short to long-term time frames, models that incorporate both economic and sociological concepts may be more useful for investors operating within an intergenerational construct. Complex Adaptive Behavior may more fully describe the motivations and desires of investors with very long time horizons. See, *The Warren Buffett Portfolio*, Robert G. Hagstrom, 1999, at 161-185.

Summary of Risk and Return Considerations Across Holding Periods. The following table summarizes the changing nature of risk and return across intended investment time horizons. Please note that an investor can be simultaneously operating in more than one

time frame, and thus, may be forced to consider and deal with varying types of risk and return for assets held in different time frames.

	ST	LT	VLT
<b>Risk</b>	Std Dev	Shortfall Risk Underperf. Risk	Intergen. Risk Policy Drift, etc
<b>Return</b>	Pricing Return	Rtn to Net Worth	Intergen. Transfers
<b>Bus Model</b>	CAPM / MPT MVO	Asset / Liability Low P/V Indicators Utility Analysis	Complex Behavior Estate Planning

## V. On the Allocation of Assets

Allocation versus specific stock selection. Determining the percentage of asset allocation that fits an investor's own risk pattern is by far the most important investment decision that anyone can make. Everything else may be secondary. Only 10% of a return of an investment may be due to individualized security selection decisions, with some studies showing that asset allocation accounts for 91.5% to 93.6% of a portfolio's return. *Common Sense*, at 67. Standard academic texts also note similar findings: 85 to 95% of overall investment returns arise from asset allocation decisions. *Investment Analysis and Portfolio Management*, at 54. Another source indicates that from 1970 to 1995, buying a broad based measure of stocks on the peak day of each year would have generated 8.5% annualized returns. Buying on the lowest point of any one year in the same time period would have generated a 10.1% return rate. There is therefore not much difference between great timing and the world's lousiest stock picking. *Learn to Earn*, Peter Lynch, at 200.

Historical Rates of Return. In order to allocate appropriately, once should keep in mind the long-run return rates. The following are annualized averages between 1926 to 1998. *The Only Investment Guide You'll Ever Need*, at 119.

Inflation -----	3.1%
T Bills -----	3.8%
Corporate Bonds -----	5.7%
Blue Chip stocks -----	11.1%
Small cap stocks -----	12.7%

One should always be aware of the corresponding risks, with pricing volatility looming large in short to near-term time frames, and shortfall risk and the probability of underfunding of investment objectives becoming paramount by the long-term.

Cultural Differences. Cultural perspectives have historically affected the allocation decision. In Germany, only 11% of portfolios are in equities. In Japan, 24% are in equities. In the US, 45% of all assets are in stocks. In the UK, 72% are in stocks. Average age in each country is a factor, as well. In Germany and Japan, the population is much older on the average, resulting in a lower percentage of equities. Germany also has a large retirement option, so there is less need to have privately owned equities at the individual level. *Investment Analysis and Portfolio Management*, at 58-60. In Japan, sophisticated forms of insurance and annuities are immensely popular, and effectively operate as substitutes for equities.

Age Considerations. Some investors will become more intolerant of risk as they age and move towards retirement, scaling back on equity percentages of a portfolio. This is a common approach to allocation, but others believe an age relationship to allocation decisions is too conservative, especially since many people are now living so long that they are outlasting their safe, secure, and low yielding nest eggs. Charles Ellis even notes that individuals should extend their own time horizons to include their children's time frames, and thus age should not overly affect investment styles. *Winning the Loser's Game*, at 111. Further, since bonds are currently as volatile or even more volatile than equities in the longer time frames, a switch away from equities may actually increase risk in long-term hold situations. *Stocks for the Long Run*, at 32.

Other Asset Classes. Some arguments have been made in favor of "alternative" asset classes. Real estate generally has a low correlation with the broad movements of the public equity markets, especially in response to inflation. If inflation increases, stock markets will often go down, while real estate may hold value or actually increase in value. *Investment Valuation*, at 466-469. In normal situations where there is no speculative component to real estate land prices, total returns on non-commercial real estate may move largely in accord with inflationary pressures. *Value Investing in Real Estate*, Gary W. Eldred, John Wiley & Sons, 2002. Liquidity risk exists with most real estate activities, however, which may serve to reduce the overall attractiveness of this investment class.

Private business formation is another traditional part of the investing experience for investors with a long-term focus. Many millionaires are heavily invested in private businesses, and only secondarily involved in the public equity process. One survey showed that millionaires hold 20% of their wealth in publicly traded securities and 21% in private business ownership. *The Millionaire Next Door*, at 11. These types of investors may feel that they can achieve greater free cash flows and investment value from their private businesses than from the dividend yield and pricing returns of the public markets. Private businesses introduce liquidity risk and involve a high degree of active management, so private firms should not be developed solely as a way to increase the basic choice of asset classes.

Still other alternative assets exist. Art and antiques, futures and other derivatives can all be made part of the asset allocation process. One source indicates that alternative investments are certainly consistent with the capital market line's risk-return trade-off. *Investment Analysis and Portfolio Management*, at 100. Residential real estate is somewhat below the risk and return level of US common stocks, while commercial real estate has higher risk and return characteristics than both US and International equities. Collectables, artwork, futures and other derivative instruments tend to have still higher risk and return levels.

Thus, the asset allocation model for some long-term investors involve a mix of cash, bonds, public equities, real estate ventures, private businesses, and possibly alternative asset classes, as well. All of these choices may be considered to be appropriate with long run investors, especially those that are already involved in real estate and business ventures.

Risk Tolerances and Holding Periods. One noted Economist has proposed allocation percentages sorted by the various holding periods and risk tolerances, and not merely by age. Jeremy Siegel's research suggests that model portfolio mixes can be optimized for the risk and return trade-offs consistent with the time horizon of the investor. Based upon historical data, Siegel has come up with the following table for the optimized percentage of stocks to hold, with risk tolerance and holding periods factored in.

---Equity Percentages---

<b>Risk Tolerance</b>	<b>1 Year</b>	<b>5 Year</b>	<b>10 Year</b>	<b>30 Year</b>
Ultra conservative	7	25	41	71
Conservative	25	42	61	90
Moderate	50	63	86	100+
Risk Taking	75	77	100+	100+

The above equity allocation percentages may appear high to many investors, but are consistent with mean variance optimization efforts done on Ibbotson data. See, Research Notes on Risk, Return, and Time, Kevin Kaufhold, 2004. More conservative equity allocations reflecting lower risk tolerances can always be obtained simply by adding the risk free rate of return into the allocation mix. Please note that a more complete holding period allocation model is discussed in the practical section on allocation, below.

Asset-Liability Modeling and Holding Periods. Professionals with completely opposing views have written favorably on the general concept of asset liability modeling. See, Burton Malkiel, *A Random Walk Down Wall Street*, at 400-405; David Dreman in *Contrarian Investment Strategies*, at 298-299. With this type of allocation, assets of a portfolio are matched with probable liabilities, in each respective time frame. Risk is typically defined as the mismatch between assets and liabilities. When assets line up with liabilities, there is little or no risk to the model. But when assets don't match up to anticipated liabilities on an actuarial basis and in each time frame, risk is incurred. A

customized index, unique for each investor or fund, is then developed. This generates a dynamic model of asset allocation, and not merely a static one. A nice overview can be found in talks given at International Foundation seminars. Recommended readings include *Asset/Liability Modeling*, Orlando, Fla, Nov. 2, 1999, Ron Ryan, of Ryan Labs, speaker; and *Asset Allocation*, Nov. 2, 1999, Jim Krebec, speaker. Asset Liability Modeling is an important tool for institutionals, but can be also adapted to individual portfolios.

Three Factor Modeling: Style, Size, Country. Much of the current interest in the allocation of assets by style and size stems from a famous 1992 study done by French and Fama showing that a value style, small business size, and country of business statistically explains superior performance. In following studies, a large value strategy was found to outperform both the S&P 500 Index and a large growth grouping of stocks, while small value holdings generated superior returns over small growth stocks. Most importantly, the superiority of the value style occurred with no increase in the standard deviation of variance. *Investment Gurus*, Peter Tanous, at 270. In many studies, small caps have generally outrun large companies. In one study, a mix of styles, sizes, and country passive funds outperformed the S&P 500 by over 5%, and with less standard deviation risk. *Investment Gurus*, at 392-402.

While much research has shown that style and size of investment matters, others studies show that value and growth styles produce almost identical results over very long time frames. When one goes back over 60 years, growth and value have generated virtually identical rates of return. *Common Sense*, John Bogle, at 231. And, high-grade stocks versus low-priced stocks have also had very similar returns, too. *Id.*, at 232-233. Growth and value styles have very deep swings over very long time frames, and may be linked to both the ups and downs of business cycles and to generational and demographic changes in investing patterns.

As to size, data mining and survivorship bias issues may be involved. The small cap effect has been known and debated over far before the 1992 French and Fama study. A concern expressed even before the 1992 study was that small cap out-performance may be nothing more than a low PE effect going on, masked as a size correlation.

Macro versus Stock Specific Analysis. Many value investors will use fundamental analysis to intensively analyze individual equities and capital assets. The focus is on the selection of individual assets, based on quality, growth, and value characteristics. This is traditionally known as “stock specific” research (sometimes referred to as “bottoms-up” investing). It is intuitively appealing to anyone looking for high quality and reasonably priced equities, bonds, and other capital assets.

Conversely, many theoreticians advocate a macro-level, three-step approach to asset selection and allocation (occasionally stated as “top-down”). National economies and capital markets are analyzed first, followed by sector and industry trends. Lastly, analysis of specific companies and assets are reviewed. The reason for this multi-step analysis is that most changes in a firm’s earnings and rates of return in stock pricing can be

attributed to changes in earnings and rates of pricing return at the aggregate, national level and a firm's industry level. *Investment Analysis and Portfolio Management*, at 414. Additionally, studies have shown that a relationship exists between stock prices and business cycles. Such cycles can be more clearly identified with a three-step approach than a review of only specific companies. The current popularity with sector and industry funds may stem from the top-down approach.

A criticism of the top-down method is that it leads to sector rotation, high turnover, and is essentially an effort at market timing. Some of the research supporting a three-step method even includes the term "market-timing" in the titles of the articles. *Id.*, at 442, n.5.

## **VI. Practical Considerations for Asset Allocation**

The Simplest Approach. For those investors who want immediate allocation and diversification but do not have the inclination or interest to delve deeply into matters of finance, lifestyle funds or balanced funds are available from both active and index fund families. These funds will typically maintain a fixed asset allocation between domestic and international equities, bonds, and cash, based upon your overall investment objectives (i.e., income versus growth). The investor simply makes a selection of one fully diversified mutual fund, and the managers of the fund then stay within that lifestyle choice for the selection of investments. Owning one single balanced fund is a recommendation of John Bogle in *Common Sense On Mutual Funds*, at 86-87.

To factor in intended holding periods, a number of active and index fund families have developed target retirement funds. These mutual funds will automatically decrease equity allocation percentages as one approaches a desired retirement age, while still maintaining full diversification in bonds, equities, and international arenas.

A Simple and General Approach, Recently Recommended. S&P has recently recommended (as of end of 2004) a portfolio of 45% US stocks, 15% foreign stocks, 25% bonds, and 15% cash. See, *The Outlook*, Dec. 15, 2004, at 13. The model portfolio can be adjusted from there for holding period considerations, income objectives, and risk tolerances (see below). The recommended allocations are:

<b>US Stocks</b>		
Large-Cap Blend	37%	
Mid-Cap Blend	4%	
Small-Cap Blend	4%	
...Subtotal...		<b>45%</b>
<b>Foreign Stocks</b>		
International EAFE	9%	
Pacific	4%	
Emerging Markets	2%	
...Subtotal...		<b>15%</b>
<b>Bonds</b>		
US Debt	15%	
US ST Debt	10%	
...Subtotal...		<b>25%</b>
<b>Cash</b>		
...Subtotal...		<b>15%</b>

A Holding Period Approach. Allocations can be developed on the basis of holding periods without undue complexity. A very simple portfolio with broad diversification and appropriate allocation can be achieved through the use of only a few mutual funds. A diversified domestic equity fund (tracking the Wilshire 5000), a total international equity fund (itself composed of three targeted international areas of Europe, Pacific, and emerging countries), and a total bond fund (tracking the Lehman bond aggregate) is all that is needed to produce the necessary allocation and diversification for an asset portfolio. Money market and inflation-protected bonds may be added to the mix as a short-term time horizon is approached.

The percentages in the following table loosely follow the target retirement fund allocations of Vanguard. Please note that risk tolerances will affect the allocations, with individuals having higher risk tolerances / preferences for growth possibly preferring somewhat greater international allocations and somewhat lower bond percentages than the percentages listed below.

**---Holding Period---**

	<b>Ret/1 Yr</b>	<b>2 Yrs</b>	<b>10 Yrs</b>	<b>20 Yrs</b>	<b>30 Yrs</b>	<b>40 Yrs</b>
Domestic Equity	20%	35%	40%	48%	64%	72%
Intl Equity	--	--	10%	12%	16%	18%
Total Bond	50%	50%	50%	40%	20%	10%
TIPS Fund	25%	15%	--	--	--	--
Money Market	5%	--	--	--	--	--

Two Investment Objective / Risk Tolerance Models. Portfolios with certain investment objectives or risk tolerances can also be easily designed. The asset class weighting is from a Merrill Lynch recommendation, contained at *Investment Analysis & Portfolio Management*, at 45.

	<b>Income Conserv.</b>	<b>Mod. Risk</b>	<b>Growth Conserv.</b>	<b>Aggr. Risk</b>	<b>Balanced Benchmark</b>
Stocks	30%	50%	60%	60%	50%
Bonds	60%	40%	30%	40%	45%
Cash	10%	10%	10%	--	5%

Another somewhat more involved investor objective model with additional features for size, type of bond, and type of cash investment is contained below. The international component can be further delineated with investments from European, Asian, and emerging countries, if an investor so desires. The percentages are roughly based upon an International Foundation seminar, *Refresher for Trustees on Investment Concepts*, Orlando, Fl, Nov. 1, 1999, Eugene Burroughs, speaker.

	<b>Income</b>	<b>Equity Inc.</b>	<b>Growth</b>	<b>Aggr. Growth</b>
Inc. Equity	10%	10%	10%	--
Lrg Dom.	10%	10%	10%	15%
Med Dom.	--	10%	15%	15%
Sml Dom.	--	10%	20%	20%
International	--	10%	20%	35%
Govt Bond	20%	10%	5%	--
Corp Bond	20%	10%	5%	5%
CD	15%	10%	5%	5%
T-Bill	15%	10%	5%	--
MM	10%	10%	5%	5%

A More Complex Approach. A greater variety of investments can be developed than with the above methods. Allocation decisions can take on aspects of asset liability modeling or other sophisticated models, such as means variance optimization techniques and integrated asset allocation methods. The following are some of the details that can be added to develop more comprehensive and professional asset allocation models.

- Develop investment plans and policies that expressly provides for risk tolerance levels, investment and lifestyle objectives, and intended holding periods.
- Consider national and international economies, including aggregate growth rates, money supplies, interest rates, etc.
- Review sector and industry level economics to ascertain productivity and earnings growth rates, and overall attractiveness of investment.
- Develop expected rates of return and risk levels for each asset class and holding.
- Identify asset classes, specific assets, sectors, and industries for inclusion.
- At all times, seek to keep portfolio expenses costs and expenses low.
- Identify assets and liabilities in each respective time frame.
- Optimize among asset classes and adjust for risk tolerances and intended holding period.

- Possibly, utilize derivatives where appropriate to further reduce various forms of risk (i.e., currency risk; political risk; develop a market neutral position, etc).
- Develop wealth and / or utility indexes that maximize marginal investor utility, and further adjust optimized allocations for utility.
- Obtain feedback and then regularly maintain and adjust the allocation strategy.
- Develop greater detail and variety for each asset class, after considering risk tolerance, investment objectives, and intended holding period. The following table itemizes the various types of investments that should be considered within each asset class.

<b>Equities ----</b>	<b>Bonds / Debt ----</b>	<b>Derivatives ----</b>	<b>Alternatives ----</b>
Individual vs. Mutual	ST, NT, LT	Options	Annuities
Active vs. Passive	Muni Bonds	Futures	Residential RE
Growth vs. Value	Government	Commodities	Comm. RE
Small, Medium, Large	Tax-Exempt	Fin. Engineering	Private Bus
Income vs. Growth	Government		Precious Min
Domestic	Corporate		Art/Antiques
Europe/Pacific/Emerging	International		Collectables
Sector/Industry	TIPS		
Tax-Managed	Money Market		
	Warrants		

## **VII. Conclusion**

The legal and financial considerations of the investment of assets can be simply and eloquently summarized by two quotes, the first pertaining to the law, while the second applies to investments.

- “Fiduciaries must act solely in the interest of the plan’s participants and beneficiaries for the exclusive purpose of providing plan benefits .....”.
  - Employee Retirement Income Security Act of 1974 (ERISA)
- “Investment is most intelligent when it is most businesslike”.
  - Benjamin Graham

## **VIII. Questions / Notes**

**Version 2005:Legal1.**