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Tax Law Changes You Should Know About for 2006

The good, the bad, and the ugly – updates to tax laws come in all shapes and sizes, but being aware of how these changes affect you can help you minimize their impact or maximize their benefit. Of note for 2006:

▶ The annual gift tax exclusion has been increased to \$12,000 for gifts made on or after January 1, 2006. Of note: certain education savings accounts will allow you to “pre-pay” 5 years of contributions. This means you can contribute \$60,000 to a child, grandchild, or friend’s education savings account this year and pay no gift taxes, but be aware that certain limitations apply to future contributions in these circumstances.

▶ Those of us under 50 are still limited to a \$4,000 contribution to our IRAs for 2006. Age has its privileges – if you are 50 years old or older in 2006, your maximum IRA contribution amount has increased to \$5,000 (\$4,000 regular contribution plus a \$1,000 catch-up contribution).

▶ Everyone can benefit from the increased 401(k) contribution limits for 2006. This year your maximum contribution to a 401(k), 403(b) or similar plan increases from \$14,000 to \$15,000. (If you are 50 or older, you can make an additional \$5,000 catch-up contribution in 2006.) Ask your employer if you’ll be able to contribute to a Roth 401(k) this year. As discussed in our last issue of the Educated Investor, the Roth 401(k) is a new investment vehicle that can benefit many employees who may not have been able to take advantage of a regular Roth IRA.

▶ Individuals can take a credit of up to \$500 (lifetime limit) for making energy-efficient improvements to their homes in 2006 and 2007. The credit amount for improvements is generally 10% of the cost of qualified energy efficient materials such as exterior windows and doors and insulation materials designed to reduce heat loss/gain. Material and labor expenses for certain water heaters, air conditioning systems, and furnaces are also built into this new credit. If you’ve been putting off any of these improvements, consider making them this year when you’ll receive this tax benefit.

For more information on these or other changes to the tax laws, please contact me at 401-421-4800 or email me at jdorfman@lgcd.com.

Look Both Ways Before Crossing

The goal of the financial industry is (or at least should be) to help investors accumulate and/or preserve their wealth. But how do you identify solid financial direction versus misguidance in disguise? For *all* investors, “buyer beware” is good advice. For affluent investors, the stakes — and thus disservices proffered — can be even greater.

As one’s wealth accumulates, perhaps it’s human nature to believe affluence should open up access to exclusive investment vehicles unavailable to the average investor. Yet many of these vehicles turn out to be more expensive than they are expansive for the investor’s portfolio, too often designed to ensure the seller’s profit regardless of the buyer’s gain. And if the product is well-received, its promoters often find ways to expand availability anyway, negating any exclusive appeal it may have had to begin with.

This issue of *The Educated Investor* explores a couple of approaches we’ve seen heavily marketed to unwary investors — initially to the affluent and then to a widening audience:

1. Managers of Managers: Can the Best Man Win?
2. Private Equity Markets

Worth Repeating Worth Repeating

“ The basic building blocks for investor portfolios come from well-established, enduring marketplaces, not from trendy concoctions promoted by Wall Street financial engineers. ... As a general rule of thumb, the more complexity that exists in a Wall Street creation, ” the faster and farther investors should run.

— David F. Swensen
Yale University Chief Investment Officer and
Author, *Unconventional Success*

Managers of Managers: Can the Best Man Win?

It might appear that a “manager of managers” could perform valuable services: picking the best separate account managers, watching their performance and replacing them when they underperform. Unfortunately, for an approach too often popular among individual and institutional investors alike, there’s a fly in the ointment.

Because past performance is not a reliable predictor of future results, the approach is not expected to consistently outperform the overall market. Further, for trustees, the fiduciary standards to which they are held are more likely satisfied by building a passively managed, effectively diversified portfolio with an eye toward reduced expenses.

A manager of managers, in contrast, adds a layer of expense while pursuing an active approach, seeking to select the next winning managers (who in turn add their own layer of costs as they typically attempt to time entry and exit from the market and/or pick future winning stocks or sectors).

Well-known managers of managers include Frank Russell, Callan Associates and SEI. As among the largest of such services, SEI should be a good test case if we compare its returns to those of Dimensional Fund Advisors’ (DFA’s) passive asset class funds.

To do so, we compared one-, three- and five-year live data returns for January 2001–December 2005 within the six broad asset classes of large-cap, small-cap, large-cap value, small-cap value, emerging markets and international (small-cap and large-cap). The period began in a bear market and

ended amidst a bull market. In the case of international funds, SEI had one international large-cap fund and one emerging markets fund. DFA offered funds in additional asset classes, allowing for broader, more effective diversification.

For the five-year period, SEI funds underperformed DFA across all asset classes. The underperformance ranged from 4.2 percent per annum to 15.9



percent per annum, and averaged 7.9 percent per annum. There were 48 single-year data points during which DFA funds outperformed SEI funds, and only seven single-year data points (less than 13 percent of the time) when SEI outperformed.

Also noteworthy — the SEI funds were costlier. The expense ratios of the SEI funds ranged from 0.85 percent to 1.95 percent, while the DFA funds had expense ratios ranging from 0.15 percent to 1.04 percent.

Many studies have demonstrated that individual investors and professional

money managers alike struggle to achieve market returns. Thus, we would suggest that the financial markets are functioning as expected according to the academic wisdom on the subject. Focusing on manager selection rather than asset allocation (which academic evidence has demonstrated is the overwhelmingly major return determinant) detracts from the primary objectives of portfolio construction — maintaining a globally diversified portfolio according to the investor’s unique risk tolerances as well as meeting fiduciary standards for those managing trusts.

Private Equity Markets

Its name alone may be offering a leg up for those seeking to appeal to affluent investors. After all, “private,” as well as traditional multimillion dollar minimums typically required to participate, connote a corner of the equity market unavailable to the common man.

The problem is, while it seems reasonable to assume that high-risk, illiquid investments such as private equities would be priced to deliver significantly higher expected returns than less risky, publicly traded securities, apples-to-apples comparison indicates otherwise. In addition, as their popularity has taken off, some private equity funds have begun to lower their minimums to encompass a wider, less “private” audience.

Defining Private Equities

As described within a recent *Wall Street Journal* article, “Private equity is a catchall term for money used to invest in any private company, with the potential for big returns if and when the company goes public or is bought out.”¹ They share characteris-

tics with but are not the same as hedge funds. There is typically a long lockup period, during which investors cannot access their capital, thus private equity investors forgo a great deal of liquidity. Private equity investments also are relatively non-transparent, lacking daily pricing information.

In general, the most appropriate benchmarks for private equity are considered to be small-cap value and microcap (very small-cap) stocks.



Companies seeking private equity capital tend to be small, risky endeavors whose success or failure, either way, has an increased potential to be spectacular. Private equity

investments can be further categorized into the following sectors, roughly from most to least risky (and thus from highest to lowest expected returns):

- ▶ Seed and early stage venture capital
- ▶ Later stage venture capital
- ▶ Leveraged buyouts (LBOs)
- ▶ Mezzanine financing

Show Us the Money

So, how have they performed? Several studies have assessed private equity returns compared with small-cap value and microcap benchmarks, as well as with the (large-cap) S&P 500 Index. In theory, to make the investment worthwhile, private equity returns should comfortably exceed their appropriate

benchmarks and should significantly exceed less risky, more liquid and transparent investment vehicles that capture large-cap returns. Following are annualized returns for the 20-year period ending June 30, 2005:

Fama-French Small-Cap Value	16.8 %
Private Equity	13.8 %
S&P 500 Index	12.3 %
CRSP 9-10 (microcap stocks)	12.1 %

Sources: Venture Economics/Dimensional Fund Advisors

Private equity outperformed microcap stocks and the S&P 500, but its returns were well below those of small-cap value stocks.

Additional data is available for the same period for these private equity sectors:

Early Stage/Seed Venture Capital	20.2 %
Venture Capital (overall)	16.0 %
Later Stage Venture Capital	13.8 %
LBOs	13.8 %
Mezzanine Financing	9.1 %

Source: Venture Economics

Venture capital overall nearly matched the 16.8 percent return of small-cap value stocks. Seed venture capital and early-stage funds provided the highest return. But of course they also represented the very riskiest of a risky investment.

Early stage and seed venture capital represents investments made in start-up companies and businesses through their first few rounds of funding. In recent years, funding for such ventures has declined, perhaps due to investor fears about potential losses in reaction to the 2001 tech bubble burst. A business journalist commenting on the trend observed, “Rather than laying risky wagers on unproven startups,

[private equity investors are] placing safer bets on growing mid- and late-stage companies.”²

Additional studies analyzing varying periods are consistent with the above findings. If anything, the preceding private equity returns are optimistic, for at least

two reasons. They include returns from the heady “dot.com” era, which represents



one of the greatest venture capital booms in U.S. history. In addition, the data may contain inherent upward biases. For example, the study may contain survivorship bias, in which poorly performing funds are closed and their lower numbers end up being omitted.

In general, while private equity strategies have performed well enough, we would argue that the returns have simply not been commensurate with the considerably higher risks involved. As with hedge funds, they seem to us to be products that make more sense to those who are selling them (and earning a commission) than to the investor purchasing them. The more prudent strategy is to take equity risks by increasing allocation to riskier stocks such as small-cap and value, using low-cost and tax-efficient passively managed mutual funds to do so.

¹ *Wall Street Journal*, August 2, 2005.

² *Business 2.0*, October 2005.

Rational Investing in Irrational Times: Investment Mistakes Even Smart People Make

Larry Swedroe joined us in November and hosted a lively and entertaining seminar on how to avoid the costly mistakes that even smart people make when it comes to investing. Larry is a Principal and Director of Research at Buckingham Asset Management and a member of BAM Advisor Services, LLC, a strategic alliance partner of LGC&D Wealth Management, LLC. He has authored various books on the subject of investing, including *The Only Guide to a Winning Investment Strategy You'll Ever Need*, *What Wall Street Doesn't Want You to Know*, *The Successful Investor Today*, and *Rational Investing in Irrational Times*.

Larry pointed out many of the most common investing pitfalls and discussed how we can avoid making those same mistakes. Here are a few of the "investment-don'ts" Larry touched upon, and a couple more taken from his book, *Rational Investing in Irrational Times*. Are you making any of these mistakes?



Larry E. Swedroe

▶ **Don't be overconfident in your stock-picking skills.** Some investors and money managers believe they have more or better information than others, and think they can profit from picking stocks and timing the market. Take the Mensa Investment Club – Mensa members are smart by definition. Over a 15 year period, the Mensa Investment Club had returns of 2.5% per year using active management techniques. During the same period of years, the S&P 500 enjoyed returns of almost 13% per year.

▶ **Don't confuse the familiar with the safe.** Ask an Atlanta investor what individual stock they have you're likely to get the answer – Coca-Cola. Upstate New Yorkers? Xerox and Kodak. A company you know isn't necessarily a company in which you should be investing. The Coca-Cola and Kodak examples illustrate a larger and very common mistake – failure to diversify globally. Many investors think international investments are riskier than domestic investments. Domestic stocks may be more familiar, but the reality is that by limiting your portfolio to only domestics, you are actually increasing your exposure to unrewarded risk.

▶ **Don't confuse great companies with great investments.** One of the basic concepts of investing is that reward is based on risk – the riskier the investment, the higher the potential reward. How then do we explain the common misperception that the best companies in which to invest are the big, stable Wal-Marts of the world? Too often, investors confuse large company earnings with large stockholder returns. If you limit your portfolio to growth stocks, you're limiting your potential investment returns.

▶ **Don't spend too much time managing your portfolio.** We all know someone who comes home from work, turns on the TV, and spends the next four or five hours watching CNBC, scanning the Wall Street Journal and surfing the myriad investment related sites on the web. Hopefully this isn't your typical evening. But chances are, if you're actively managing your investments, you're spending too much time on your portfolio. Indexing and passive management, while quite possibly boring, guarantee you low-cost and tax-efficient market returns. They also guarantee that you'll spend less time with CNBC and more time with your family and friends.

If you haven't already, contact us for a review of your current portfolio and we can help you ensure that you aren't inadvertently committing these or other common investing mistakes. And if you enjoyed Larry's presentation or were unable to attend, stay tuned for our 2006 series of events, as Larry will be back again!

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- ▲ Fee-only investment management
- ▲ A disciplined investment strategy
- ▲ Access to institutional no-load passive asset class funds
- ▲ Fixed income expertise

- ▲ An academic Nobel Prize-winning investment approach
- ▲ Continued access to academic research
- ▲ A tax-efficient focus, with valuable tax and estate-planning ideas
- ▲ Risk tolerance assessment
- ▲ Periodic portfolio rebalancing
- ▲ Regular communications and state-of-the-art reporting
- ▲ **MOST IMPORTANT ...**
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