Considerations Underlying the Investment Decision

In today's economic environment, there are numerous kinds and forms of financial products available to individuals. Alternative investment products range widely from simple savings accounts to stocks, bonds, mutual funds, limited partnerships and REITs —often varying substantially in nature, characteristics, utility, return, risk, liquidity, distribution alternatives, tax treatment, legal complexities, government regulation, and suitability for the individual client. Financial Service Professional's must have a sound understanding, not only of all of the available financial resources, but also of how to evaluate various investment products in terms of their ability to satisfy the specific objectives of each client.

A review of past experiences and attitudes is helpful for the identification of particular strengths and weaknesses. For example, focus on such areas as:

1. Consumption/saving ratio:  Does the individual live within his or her financial means? Do savings fluctuate widely? Has the individual increased "lifestyle" as income increases?

2. Income: Is the source of income stable? Can it be directed or controlled?

3. Family: Has the family size increased? Is it now stable?

4. Education:  What is the education level of your clients? What educational expense do they anticipate for their children?

5. Investment/financial expertise: Look for particularly rewarding past performance (or failures). If the individual can earn a substantial return on capital invested in a business, this should be reflected in the financial plan. Does the individual have insight into specific areas that can be utilized in selecting stocks or other investments? (Note: Measure this by results. Doctors, for example ' know medicine but may not understand efficient investing in pharmaceutical stocks.)

# Current Financial Position

Like any business, the family unit is a microeconomic unit that must function within the broad government, tax, and economic systems. As an economic unit, the family operates with limited resources, revenues and expenses, fixed overhead, and liabilities.

Family finances are a reflection of conscious or unconscious priorities. To establish the starting position of the financial plan, it is necessary to evaluate existing financial resources.

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One important step in the planning process is to create an inventory of assets or a "family balance sheet." A variety of "resource inventory" forms are available from broker-dealers, insurance companies and other financial institutions. These will often vary by the purposes for which they were designed. Some will not provide for the listing of personal property since most hobby items, personal use automobiles, and home furnishings are not the object of financial planning. This is because they are held primarily for enjoyment rather than financial gain.

The balance sheet is static. It only shows the assets and liabilities as they exist at that particular time. It is only a tool used to put information into usable form for its desired use. Financial planning is partly art, partly science. Rigorous standards of form and procedure would destroy the fluidity and flexibility needed to reflect different styles of planning and financial resource evaluation.

For example, if it fits the individual's planning perspective, different valuation methods may be applied to the same type of asset. Although an accountant may separately list the calculated net book value of real estate as its purchase price less depreciation (with a separate debt account listing the mortgage), if any, the financial planner need not be bound by such conventions. If it serves planning purposes, the real estate (for example, residential personal use property) can be ignored, or carried at appraised value or liquidation value.

In the final analysis, each asset must be evaluated, both in quantitative (dollar amount) and subjective terms, from the perspective of the risks covered earlier. Thus, in focusing on the death risk in the financial plan, the real estate value might best be quick sale value (low market value minus selling expenses, minus mortgage indebtedness), and a life insurance policy might be valued at full face amount. In focusing on the risk of opportunity costs, one might use the real estate's loan value (70% - 90% of assessed value minus any "points" or costs of processing) minus the existing loan balance.

Another way of looking at this is the evaluation of an asset, using an appropriate valuation amount, relative to applicable risks. In the case of the real estate the death risk is relevant as evidenced by the need to factor in a lower quick sale value. The death risk of life insurance is almost none because proceeds are paid at death based on the full face amount, not cash values or quick sale value.

Corporations depend on balance sheets to measure the financial situation at a given time. An income statement reflects the previous period's revenues and expenses. A cash flow statement reports historic sources and uses of capital through the business.

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The latter two are projected to estimate how the business is expected to operate in future periods. This is referred to as "budgeting. “Families, as microeconomic entities, operate on a cash basis (including credit). They too can benefit by analysis of prior periods' cash flow and a formal budget.

# Economizing Means Different Things To Different People

A budget may identify potential sources of funds for future investment, without jeopardizing the individual's lifestyle. It is the connecting factor between current assets (with the earnings and gains they are expected to generate) and the future objectives identified. Most people view savings as the residual balance between income and expenses. An exception might be the Christmas Club, where a target is first established and then the weekly deposit is determined.

Overemphasis on current expenses is one of the pitfalls of many families' finances. Savings, as the residual, is a misapplication of perspective but reflects the pressures placed on individuals to "buy now, pay later. "

Thus, post retirement death needs must be separated. The pre-retirement contingency is taken care of by a family needs analysis, taking into account moral obligations, debts, final expenses including taxes, accumulated savings, and a number of related factors. The derivation of such obligations is typically generated by a standard financial analysis software package.

# Projection of Financial Objectives and Planning Strategies

To adequately plan for the future, all financial obligations and cash accumulations should be mapped out year by year into the future. The budget can be very specific. It is advised however that longer term projections of either assets or budget objectives be very flexible. This reflects the constant "surprises" emerging in a dynamic or changing society. It also reflects the changing objectives of the individual and family.

It is helpful to begin by listing objectives chronologically: when they will occur and approximately how much they will cost in today's dollars. This gives the client a written blueprint that quantifies what lies a head.

Lifetime objectives can be mapped out by when they will need to be funded. Death and disability are contingencies that cannot conveniently be mapped out.

1. Cash: This pay as you go method assumes the financial objectives fit within the capability of some future budget.

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2. Credit: When it turns out that it is inconvenient, impractical, or impossible to purchase something for cash, credit is often used to obtain the goods or services desired. Proper use of credit is a major financial planning topic

3. Pre-fund: A future purchase can often be anticipated and funded in advance, either by setting aside one lump sum or by periodic payments into one or more savings vehicles. It is therefore helpful to translate the series of future quantified objectives into present value.

Inflation: To ignore inflation in the financial blueprint assumes that prices, salary, and objectives will be the same tomorrow as today. History gives reason to believe this will not be so. Thus, the plan must deal with the issue of expected price level changes.

Tax planning strategies: Since taxes reduce spendable income, the reduction in the tax burden improves one's position, assuming everything else is equal.

Hedging Strategies: Balancing risk is "hedging. " For example, if the risk of one resource as measured for inflation risk is very low, another asset might be molded into the individual's plan which offers deflation protection. This may be roughly in proportion to the possibility of conditions causing the risk to be realized, and the person's overall attitude to risk.

# Testing the Plan

Like any blueprint, it is a good approach to plan by building a model. This can be very elaborate, or it can be crude. A projection of the future expected values of the resources is very helpful. This may reflect a continuation of current levels of investment or include increases and decreases in anticipation of changing circumstances. It may separately project the value of currently held assets'. New investment and cash flow might then be added. An elaborate plan might project reinvestment of earnings at non‑constant rates. Elaborate plans may explicitly factor in acquisition, maintenance, and final distribution expenses and taxes.

If the original plan (projection of objectives and translation into marginal savings rate) explicitly includes inflation, the final asset projection should also do so. If the original plan implicitly recognized inflation the projection should do so by using inflation adjusted, real rates of return.

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The projections should be made for durations covering 12 months, to dates when children are expected to enter college (if applicable) and to retirement age (which may or may not coincide with Social Security or qualified plan benefits covering the individual). It is also helpful to list life insurance at its face amount as a separate item that has specific value no matter when death occurs.

The planner views most clients' lives as consisting of the following phases:

(1) Career entry phase: The young wage earner leaves school and enters the income earning period of life. The job must be mastered and expenses are high. Acquisition of property is a key objective. Marriage and children are huge responsibilities. If children are to go to college, a savings program conflicts with the acquisition objectives. Budgets are very tight.

(2) Career maturity phase: The above phase doesn't abruptly end at the day of the last child's graduation (if any). Instead it evolves into the midlife cycle. The wage earner(s) now has (have) become firmly established in a career (or separate careers). Equity in real property, either inherited or accumulated, is now well under way. Two wage earner couples with no children almost may start out in this phase. Budgets now have more room for saving and investing.

(3) Retirement phase: As people approach retirement age, job responsibilities are handled with well refined skills. They have attained the right to longer and longer vacations. Others seek to delay retirement. They work the same (or longer) hours. Eventually, whether by mandatory means or by voluntary choice, people will retire.  During this phase, which lasts until death, income tends to become fixed. Expenses have likely dropped because the mortgage is now paid off. Taxes are lower. Government and employer provided benefits begin. Hobbies or "second careers" are pursued to relieve boredom and make the balance of life meaningful.

The planner uses the projections to double check the adequacy of funds at major objective points in the life cycle unique to that client. Any inadequacy indicates a need for refinement of the plan. An excess provides a cushion against failure to realize performance levels assumed. The more aggressive the assumptions, the more buffer there should be.

The projection may, with the family budget, be used for contingency planning. Each contingency is tested, to see how death, disability, loss of job, divorce or marriage, additional children, dependent relatives, or a host of other events might affect the plan. The plan may absorb some of these, but a sequence of these events can quickly render objectives unobtainable.

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# Risk

"Coping" is the psychological term applied to dealing with mental risks, stress, anxieties, and panic. Financial risk is interwoven with psychological risk. Risk of death can be measured statistically and is referred to as mortality or morbidity. This cannot, however, be used on an individual basis to measure one's own risk (or probability") of dying.

Risk is not the equivalent of stress. The latter is the emotional and physiological reaction to risk or perceived danger. Unless the individual actually sees or believes the risk is present, stress is impossible. Thus, by pointing out potential risks, the financial planner initially may cause the client to feel stress.

Once risk is identified, it is easier to deal with. Psychologists generally agree that stress may be caused not by actual risks, but by fear that the individual has not taken the time to identify, measure, and deal with it. There are several basic methods for handling risk:

1. Accept it. If the potential reward justifies the assumption of risk, the investment may make excellent financial sense.

2. Minimize the risk. This can be done, as in insurance, by actuarially spreading risk over a large number of individuals. Hedging is also a strategy to offset or minimize potential damage caused by risk.

3. Avoidance. For the same reason some people don't play cards for money, others avoid various risks by choice. It is, however, impossible to simultaneously avoid all forms of risk.

As related to specific assets, "risk" is a general term. Various types of risk, even when objectively measured, may exist for a single asset. It is helpful to itemize some of these forms of risk, because to a large degree these are criteria by which the resources will be evaluated.

Security of Principal

This is the risk that an asset will later turn out to be worth less than its initial value or cost (ignoring for this discussion technical refinements of "basis" and adjustments). For example, if an asset is purchased for $X and the objective falls due in "n" years, a risk of loss of principal exists. If the asset turns out to be worth less than $X at the time it is needed, "loss" results.

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Market Value, or Investment Risk

This is the risk that the asset will rise and fall in the interim between its purchase date and the time it is needed. For example, if the asset purchased for $X falls 30% in market value in " 1/2n" years, there is a potential loss. (Note: As long as this asset is expected to be worth $X when needed at the end of the original "n" years, actual when needed at the end of the original "n" years, actual loss, for tax purposes, has not been realized, and may never occur.) Investment risk, like other forms of risk, may vary dramatically between specific items of property, even within the same classification. The "beta" factor was developed to measure relative price volatility of shares of common stock. For example, telephone utility stocks normally fluctuate over a very narrow range compared with share prices of a technology company or cyclical manufacturing company. The averages measure broader movements of share prices in total.

There have been periods when prices in general were relatively stable. Those wishing to minimize investment risk enjoy such periods. Others, however, find these periods unexciting. The lack of large price fluctuations reduces the speculative opportunities available. Economic, political, and social changes influence market prices in an uneven fashion. When major changes take place in these systems, financial resources may seek a new level, then establish a new equilibrium.

Yield Risk

Just as it is possible for an asset to decline in value, the same can happen to a series of income payments derived from that asset. This may be viewed in two very different perspectives, depending on one's objectives.

If the primary objective is a fixed dollar level of return, the risk is measured by the probability that the payments will be less than expected. This risk becomes greater as the future time span increases. For example, an individual may purchase an annuity to satisfy a compensation agreement. A curtailment or reduction in the benefits may subject the purchaser to liability for this shortage.

Alternatively, a fund manager might want to maintain a stable percentage yield. For example, a pension fund that permits participants to make voluntary contributions may want to offer a separate account that yields a consistent percentage based on the value of the contributions plus reinvested interest or dividends. Because yield is a function of both income and the value of the underlying asset, a change in either will disturb the yield percentage. An increase in a corporation's dividend will increase the rate of yield.

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A decrease in the price of the common stock will increase the percentage yield on the same dollar amount of dividends.

Many corporations pay out a fairly constant percentage of net income to common stock shareholders in the form of declared dividends. Either the "regular" dividend amount is adjusted, or a special irregular dividend is declared. Thus, the risk of loss of yield may be iewed as a derivative of the risk that the corporation's earnings will decline. This, in turn, is derived from the net sum of revenues and expenses (including income taxes payable) of the corporation. Economic and tax conditions are therefore important inputs into the evaluation of "yield risk." Even where a bond has a fixed coupon rate, the issuer must either have revenues or the ability to tax citizens to pay the bond holder.

Liquidity Risk

Reflected in the individual's strategies should be an estimate of the period over which the asset will be held. "Traders" may buy into a position for quick (short term = less than 12 months) gain, or close out a position on price drawback to or below "support levels." In this case, the market for the asset must be almost immediately accessible. New York Stock Exchange volume leaders are popular for trading.

Most individuals lack the time and skill to "play the stock market" in a speculative manner. Trading is also an expensive proposition, in terms of commissions and taxes paid, as well as record keeping.

Even long term investments (reflecting distant future objectives) are usually bought to sell, unless the objective is to transfer the actual property at death to heirs or to charity. The expression "for every buyer there must be a seller" expresses a fundamental principle of any transaction. The reverse is also true. When the asset is put up for sale, the buyer must not only be located but also must be willing and have the resources to consummate the exchange to the satisfaction of the seller.

Supply is a function of the potential seller's utility in continuing to hold an asset. Demand is a function of how much utility the potential buyer can derive from acquiring the asset. These utilities are price sensitive. The lower the price the less the seller wants to sell the asset, but the more eager the buyer is to acquire it. If the buyer has no use for the asset, the price would have to be zero (or less if the "seller" had to pay "buyer" to take the worthless possession away). Liquidity risk is the possibility that a seller will not find a ready, willing, and able buyer for an asset at an acceptable price.

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"Physical" Risk of Loss

Property and casualty insurance can insure physical assets against loss by fire, flood, theft, accident, and violent acts of nature. Intangible property is exposed to risk of loss in some or all of these ways and perhaps in ways less obvious to the owner. If currency is destroyed, in general the Treasury Department will not print replacement bills for the owner (unless the majority of serial numbers on each bill can be physically identified). Securities deposited in a bank vault (safe deposit box) are not exempted from risk of loss, although the amount of risk is normally quite low. Securities left on deposit at a stock brokerage house may be unrecoverable in the event that the broker becomes bankrupt.

The Securities and Exchange Commission (SEC) and other government agencies attempt to minimize this risk to the investing public; however, even if the property is ultimately recovered, there can be a lot of time and expense involved. Registered securities can generally be replaced if destroyed or stolen. Duplicate life insurance policies can be obtained by proper completion of a lost policy affidavit.

Tax Risk

Ultimate enjoyment of any resource is reduced by the amount paid in tax. At the time of purchase, an investment's current tax status is usually known. Tax laws are changed to reflect current fiscal policies and governmental objectives at federal, state, and local levels. Taxes can be divided into primary groupings: those applied to income, death taxes, transfer or transaction taxes, and those imposed as a result of possession, ownership or occupancy of the asset or property. The possibility that either the tax laws or the nature of the property or personal conditions change in such a way that more taxes are paid than anticipated is tax risk.

Death Risk

Few individuals die precisely when expected. No matter when death occurs, most people consider it premature. It is human nature to want to survive and to lay plans for the future, whether at age 25, 45, or 85.

Death terminates one's ability to pursue strategies. As previously mentioned, most debts come due when the executor settles the estate. This can trigger estate taxes, settlement expenses, liquidity problems, and forced sale of property. When a wage earner dies, the income generally stops immediately. Pension plans rights may be forfeited at death, or discounted to present values. Family medical and dental coverage

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for dependents may cease. The contingency of death should be built into any financial plan.

Disability Risk

Death involves immediate termination of income and some measurable final expense. Disability also may completely terminate income but in addition exposes the individual (or family members) to a future of continued medical, living, and investment expenses.

Political Risk

The tax risk example also illustrates how politics is interwoven into financial planning. For example, for many years, stock market averages tended to move in two and four year patterns with national political elections. These averages tended to be stronger (an upward bias) in anticipation of the presidential elections and early in a new president's term.

Foreign investments are particularly subject to political risk. Defense contractors, utilities, transportation companies and other corporations selling to, buying from, or regulated by various governments may have no choice but to accept these higher political risks. Expropriation of private property is one severe example of this type of risk.

Risk of Loss to Creditors

Creditors have different rights in different states. In general they can foreclose on property subject to a mortgage (after due process). Personal property necessary to one's family and life sustenance, and property held in joint name, may escape the creditors' grasp. Depending upon applicable state law and specific facts, pension and profit sharing benefits are generally free from attachment by creditors.

Purchasing Power Risk

Future enjoyment of an asset depends not only on the price realized, net of expenses and applicable taxes, but also on prices of alternate goods and services. Loss of purchasing power attributable to rising prices is inflation risk.

Alternatively, if prices decline, there is a deflation risk. When prices of goods and services decline, as they did during the 1930s, not all assets decline in value uniformly. The possibility that assets will decline at the same or greater rate than the goods and services is called the "deflation risk.

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Opportunity Risk

Economic models define a financial plan in terms of limited, finite resources. When a strategy calls for investment in one specific asset, the same money is no longer available for purchase of another asset or for consumption. The difference between what one could have earned in an optimal investment portfolio and what was actually earned is the "opportunity cost" of holding the resource. This "cost" is a risk related to error in judgment, but also to conscious choice in a strategy designed to minimize risk. Regardless of the base used, holding any asset involves opportunity cost. This may be in terms of current consumption or passing up alternative investments.

Interest Rate Risk

Interest rates serve many purposes in financial planning. Because they serve so well to measure opportunity cost, they in turn become a risk in themselves.

Commodity holdings, if in equilibrium at a given price, will tend to fall as interest rates rise. This is because the opportunity cost of holding a non‑income‑producing asset rises. A certain percentage of those holding the commodity (or other assets) will sell and reinvest the proceeds in the higher total return alternative investments. Total return is subjective, based on judgments of the future and one's own situation.

Misinformation Risk

Forecasts of future events and conditions are difficult even with accurate, concise, detailed financial data. It is impossible to ingest all, or even a major portion, of available information that may affect one's resources. The Federal Register is published every workday with new regulatory developments; pending, proposed, and final.

Perhaps worse than dealing with incomplete information, is the possibility of dealing with wrong information. This can result from consulting outdated material, misinterpretation, or plain error from the source. In some cases this may even be fraudulent or deliberate misrepresentation.

The SEC and FTC (Federal Trade Commission) attempt to prevent fraudulent claims and misrepresentations. In many cases class action suits have been brought by shareholders against management for alleged misrepresentation and fraud. Registered financial advisers must disclose any conflicts of interest. For example, the editors of a stock advisory newsletter must disclose ownership positions in featured stocks. Corporate annual reports are a combination of marketing plus accounting and financial

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information (much of which is contained in footnotes). Prospectuses are generally so lengthy and tedious that only the most diligent investor or analyst actually reads them.

People involved in their primary occupation can't possibly do the amount of research necessary to even moderately reduce the risk of misinformation. Instead they must use good judgment in selecting reputable annuity cash values into a variable annuity. Though her dealers, brokers, insurance professionals, an accountant, advice increases exposure to investment risk (for one) it and an attorney. The financial planner's role is varied, but also decreases exposure to the risk of loss in purchasing is primarily to aid the client as a team leader.

Mismanagement Risk

Most people must rely on others for guidance in financial matters if the individual, for example, is a participant in a qualified retirement plan, the ultimate financial benefits the participant will receive depend at least partially on the skill and integrity of the plan fiduciaries, just as mutual fund share value depends on the expertise and administrative performance of its management.

The days of "rugged individualism" are gone for all but a very few. Just as the individual depends on government for defense, utilities for heat, and agribusiness for food, one's financial resources are largely entrusted to other individuals or institutions.

A fee basis financial planner may be the only person capable of rendering totally objective planning in order to stay on top of the administration of that plan. Other individuals, perhaps due to the fairly high expense of fees, select a salesperson who qualifies, by reason of additional training, as a "financial planner."

Regardless of selection procedure or method by which the financial planner is compensated, actual results will differ. Performance and style should vary to reflect the personal objectives of the client.

# Assumption Of Risk

Risk is unavoidable. By doing nothing, one has unconsciously chosen a strategy. Because, by doing nothing opportunity cost risk is elevated. Additionally, by spending one is exposed to the risks of disability, death, or excess longevity. Risks are not necessarily cumulative. By exposing an individual to one risk by choosing a strategy that is compatible with stated objectives, another type of risk exposure may actually be reduced.

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In a positive vein, the other side of risk is reward. A decline in market prices is a risk in holding shares of common stock. However, to a person holding a short position this same change represents an opportunity for gain. In general, for each type of risk there is a similar type of reward opportunity, but conditional on opposite strategy or circumstances.

How much risk, and the types of risk an individual assumes, depends on a number of factors. The objectives may be very aggressive or rather modest. To build a million dollar estate and retire by age 55 is a good objective, but is not easily obtained. To have any chance of success, the strategies would bypass lower yielding Treasury bonds for highly leveraged speculative stocks, options, or joint ventures. The higher the potential reward, usually the higher the risk (within the same category).

Another factor is temperament or psychological adaptability to risk. Some individuals cannot live with risk. These individuals seek to minimize risk at all costs. In general these people define risk in only one of the 16 forms covered (see Table B which follows the text of this unit). "Risk" to the untrained simply means the possibility that loss may result from a decline in the market value of the asset. The "risk avoider" fails to realize that by such strategies, other risks may be increasing. This individual has either not been informed of these risks (and opportunities), has blocked them out mentally to avoid stress, or has assigned these very low priorities in his or her financial plan.

Weighting of risk: After outlining objectives the client identifies, it may be helpful to survey the attitudes the client holds toward each type of risk. This should reflect the forecast made of future events and conditions. It is suggested that three or four primary risks be identified which are probably critical. This, as will be covered, avoids wasted recommendations which pose unacceptable risk to the client. A more elaborate refinement might prioritize these from most to least critical, thus retaining all measures of risk for analysis.