"THE PROBLEM"

NO ONE CAN PREDICT THE FUTURE – NO REALLY YOU CAN'T

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To begin with, on the off chance you are that special someone who can predict the future, you need to call immediately. If you're a little short on cash, you can count on me putting up all the money you'll ever need. The only requirement is that you let me know ahead of time what is going to happen in the future. I'll take care of the rest and I'm certain we will both make lots of money.

For everyone else, the most important thing to remember about the investment world is that no one can predict the future. *(Remember, Nostradamus is dead, and I believe Pat Robertson stopped making stock market forecasts after being wrong for the umpteenth time*). Let me repeat this, no one can predict the future. This means a brokerage firm, registered representative, advisor, banker, accountant, lawyer, doctor, best friend, or anyone else who might decide one day you deserve to hear their advice regarding what stocks to buy, where the market is going, or where you should put your money. This seems so obvious, but regrettably it needs repeating – no one can predict the future.

However, when dealing with the public, the investment community insists on trying to convince investors that they can do just that. In an attempt to back up this false premise they continue to shower us with sound bytes of prognostication and a bevy of reports that use techniques and strategies typically centered on some form of fundamental or technical analysis. The idea is to convince you that investing is an exact science. It's not. Consider the following

Fundamental Analysis - Fundamentally Flawed

Fundamental analysis is all about looking at the balance sheet of a company and/or studying economic indicators and then using this information to predict what stocks are going to go up or down in the future. It feeds on everyone's desire to be intelligent and to make decisions based on facts, not feelings. However, the problem with fundamental analysis is that it is flawed at its core. For example, there are three primary problems with fundamental analysis:

1) <u>There are Too Many People Looking at the Same Information</u>

Here are some facts:

1. There are a limited number of investable public companies, somewhere around 1,500 to 2,000, that would be considered as reasonable candidates for investment.

2. Each, by law, must make earnings and other financial information available to the general public on a regular basis (a regulation strictly enforced by our friends at the Securities and Exchange Commission). Stated another way, publicly traded companies must submit comprehensive balance sheet and corporate documentation to ensure that every investor has complete data to review. Failure to provide full disclosure is against the law.

While keeping these facts in mind, consider the power of the computer that can crunch numbers faster than any human. Also consider the thousands of college educated research analysts working throughout the financial industry and the hundreds of thousands of individuals working at every mutual fund, brokerage firm, bank, pension fund, profit sharing fund, professional money management organization, and investment advisory firm. What do you think the chances are that someone in this august group of professionals, with all the real and artificial brainpower in existence, is going to find the gem that has eluded everyone else?

2) <u>Market Dynamics Work Against You</u>

Taking the above one step further consider the typical sequence of events and how market dynamics can work against you.

Assume some research analyst or advisor does find something good. What happens? The usual pattern is that they either prepare an elaborate research report or begin to call their clients to share the information.

Note: Formal research reports are documents filled with an analyst's findings. This document may show information regarding the company's latest financials, current management, and products or services. It can also include assessments of the underlying industry or marketplace and usually includes some form of technical analysis regarding the stock's previous price movement, usually in the form of charts and other graphic representations. Once completed, the research report is approved and becomes the basis for all presentations to investors.

Whether a recommendation happens via a research report, or through a broker/representative/advisor calling all his clients, what follows is predicable. With all this "buy" recommendation activity the stock will go up. It's a simple matter of supply and demand. Like any barter system, more buyers than sellers increase the potential that the stock will advance.

However, sooner or later, the price will increase to a point that it no longer is attractive to new buyers and selling will begin, first from those who got in at the point of the initial recommendation and are looking to take profits, and second, from those looking to play the market on the downside who have been waiting for price to get too high so that they can "sell short".

Note: "selling short" is a term that describes a process whereby investors can play the market on the downside, i.e., at way to make money when the stock falls.

It is at this point that things can get dicey for investors who followed their advisor's advice and bought into the stock. If you weren't lucky enough to be one of the first investors in, you likely paid higher prices. And what do you think will happen if the stock begins to decline? If you believe your broker is going to call to let you know that the stock you just bought is taking a nosedive and that you should sell, perhaps you need to read a book about human nature. More than likely he'll tell you that he, the firm, or the research analyst who made the recommendation hasn't changed their mind and that the stock is still worth holding. This might be followed up with more assuring comments, such as *"Relax and hold on, after all, sooner or later quality rises to the top,"* or *"Stop worrying, you are in this for the long haul and shouldn't be trading in the short term,"* or best of all, *"Sooner or later the stock will recover."* Seldom, and I mean almost without exception, will anyone associated with the process tell you to sell or protect your position by hedging.

Note: Here's a little side note you might find interesting. At the point the market reached its all-time high in 2008, the greatest number of "buy" recommendations were released by brokerage firms. Imagine if you were unfortunate to have listened and bought stocks then, only to watch prices plummet by 50% or more and not recover for years. How do you think that might affect your average annual return?

3) <u>You may not be as High Up in the Pecking Order as you Believe</u>

You might argue the above by saying, "Yes, but I have a good relationship with my broker and he always gives me the best deals first." Well, I hope you're right because this is what you are assuming: (a) you indeed are his best client, (b) he called you first, (c) he has the ability to judge which recommendations are good, (d) he has not run out of money for the month and needs a new round of commissions to pay for rising gas prices on his new Cadillac Escalade, and (e) he is not being forced to push a less than attractive stock by his or her firm because the firm has a vested interest in recommending the company as a result of a preexisting relationship.

By the way, guess who did win, and didn't have to take any risk? That's right, the brokerage firm, broker, or advisor that made the initial recommendation. They get paid regardless of performance.

Charting - Looks Good When Everyone Believes the World is Flat

Technical analysis is usually associated with some form of charting. Charts of past performance are used in an attempt to forecast future trends. Here's the problem. Charting is based on the propensity to assume that everything of the past will continue indefinitely into the future. What isn't taken into consideration is change. The economy, new technologies, foreign conflicts, and other disasters can happen unexpectedly, and affect stocks and markets in ways that are unforeseen.

Contrarian Strategies

Contrarian investors believe that anyone who follows the crowd will lose. They abhor the crowd mentality and base all their judgments on the facts that if everyone is buying the price is too high, and if everyone is selling, prices will be bargains. In short, they believe in acting contrary to everyone else, thus the name Contrarian.

Not bad in theory, except for one thing. How do you know when the selling has stopped, and prices are at bottom, or that buyers aren't going to continue to buy when everything is at a peak? At one time, the brilliant theologians thought the Dow Jones Industrial Average, a barometer used by some to judge where the market is in relation to the past, would never break 1,000. And then it was 5,000, and finally 10,000. *(In fact breaking the 10,000 barrier on the Dow Average was such big news that even standard news programming was interrupted with the breakthrough announcement. The financial networks took it one step further. They had a box in the upper corner of the screen that showed a second by second change in the Dow as though we were looking at a countdown on NASA shuttle launch.)*

So, the question becomes, how does one know at any given point in time that the crowd has gone too far in a direction? The answer is - you don't know and can only guess.

Studying the Economy

I would love to be able to tell you that the study of economics can help find good stocks to buy, or can give an indication of when to buy. However, here again, I have a problem with the basic premise. *(I also remember the nightmare of having to study economics in school.)* As a reoccurring pattern in the investment world the study of economics still represents using facts of the past in an attempt to predict the uncertain future. If there were no wars, calamities, or changes in the economy, it might have some merit. But unfortunately, things do occasionally change, and sure enough, the economists are just as surprised as everyone else. This also says nothing about the fact that there is a wide disparity in economic theory. In other words, economists can't even agree among themselves as to what should happen. But that doesn't prevent them from sitting in their ivory towers, pontificating on the latest economic indicators, and trying to convince us mere mortals that they know how everything is going to turn out.

I always wondered why, if someone knew what is going to happen, they would be so interested in telling everyone else. It seems to me that if I could predict anything in the future

I'd tend to keep the knowledge to myself and make a guaranteed fortune. It's that old question that asks if the Tarot card reader can see so much, how come they are always living in the one room shack off the highway?

Mojo -The Dart Board VS the Top Money Managers

Studies have shown over the years that the "efficient market theory" taught in academia is valid. Translated into English, this means that stock prices are essentially random and don't have trends or patterns in their price movements. The theory also states that prices react almost instantaneously to any information. Together these theories indicate that technical and fundamental analysis is practically useless. Perhaps this is why the business professor in Minnesota who picks stocks by throwing a dart at a Wall Street Journal page has outperformed the top money managers year after year. You might also enjoy hearing about the gentleman who puts his dog's paw in ink and has the dog walk across the stock pages. Wherever the dog's toenail hits, he buys those stocks. He too has outperformed the majority of the top money managers. Then there's the guy with the monkey… anyway, you get the picture.

Conclusion

One more time - NO ONE CAN PREDICT THE FUTURE!!!

"THE SOLUTION"
HEDGING BY COMBINING INVESTMENT VEHICLES

The solution to not being able to predict the future, while still developing a solid investment strategy, is quite simple in some regards but complex in other ways. The simple answer is to hedge by combining investment vehicles in combinations so as to keep most profit potential intact while mitigating risk. The difficult part is that in order to understand the mechanics of hedging and using complex investment vehicles you must first have knowledge.

Unfortunately, most busy individuals don't have time to gain the proper education and, therefore, tend to rely on others to manage or advise them on what to do with their money. This can lead to a myriad of problems, including

Some Advisors Lack Knowledge

Many providing advice or direction may not be up to date on all the sophisticated strategies or latest investment vehicles that are available. Without a strong financial background, these advisors simply fall into a pattern of recommending something that most people can understand – buy a stock, buy and bond, keep money in a money market account and do so under the umbrella of asset allocation model that seems logical and is easy to sell.

> *Note: Most asset allocation models are centered on keeping a certain amount of your assets in something "safe" that produces income, another amount in something that provides growth, and another amount in cash or other investments geared toward achieving a particular goal. In and of themselves asset allocation models are fine. They only become a problem when the advisor employs investments that can't be hedged or protected (such as mutual funds) or have little flexibility to be altered without incurring large commissions or fees. While the use of asset allocation models may appear to be safe and logical, typically they are not. In declining markets, you can lose money in stocks and mutual funds, and in periods of low interest rates you can lose money when interest rates move higher. In short, tying to diversify can backfire, especially when positions are not protected.*
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> *Unfortunately, the asset allocation charts and other dramatic representations appear to be based on science which helps sell the concepts to the uninitiated.*

Many Advisors Resist Selling Complex Concepts

Seldom will advisors make an attempt to explain anything complex. For one, they aren't paid to educate. Secondly, they don't have the time and/or the inclination to spend hours talking about something that will tend to confuse the investor, who may then reject the strategy in favor of something more easily understood. That is why many advisors find a niche area that makes their advice more attractive to investors. For example, in today's markets it centers on convincing investors to invest in hot or popular companies involved in "green" energy, bio-tech, or socially responsible areas. In the past it was oil and gas companies, computer technology, and even gaming stocks. The problem is that even with these types of recommendations, which may or may not be valid, there is little time spent on focusing on what one can do in case a particular stock or industry declines.

<u>The Complexity of Competition in the Marketplace Influences Advisor Recommendations</u>

Hedging requires that the investor be willing to give up some profit potential in an up market. This also means that the advisor's performance may be less favorable in up markets in relation to competition that does not hedge. However, when markets fall, the advisor who does hedge tends to do far better. So the choices are, hedge and protect the downside but give up some profit potential, or don't hedge and make more in up markets but lose money when markets decline. Most choose not to hedge and take the chance that they can explain away a decline by saying *"Well, everyone lost money, it's the risk of making investments."* This deniability factor, in which the advisor is not held to any performance standard, states that what happens isn't the advisor's fault, it's just the nature of investing. Few will tell you that the declines could have been largely prevented.

<u>Investors Seldom Understand the Dynamics of Fees and Commissions</u>

Hedging, if done properly, does not generate the same high commissions and/or fees as many other investments, mainly because it discourages short term trading. If a position protects principal in a declining market but offers reasonable upside in the up market, there is less need to trade in and out of a security. Most legitimate hedging is based on long term positions using vehicles that have lower overall commission structures. They are not based on buying mutual funds that can't be protected, or stocks that use up a lot of capital.

Additionally, if an advisor or professional money manager is to make a living he or she must charge the client money. This creates an inherent conflict of interest and can be a problem. Does the advisor have your best interest at heart, or does he or she put their self interests first? While I believe most professionals want their clients to make money, there will always be the temptation to choose those investment vehicles that generate the biggest fees over those that don't, especially when the clients do not know the difference.

It is also important to recognize that fees can be hidden in prices, commissions can be concealed in net asset values, and worst of all, promoters can show no commissions, yet still receive large percentage kickbacks from the source – that are eventually paid by the investor when the security is sold.

In simple terms, brokers, advisors, money managers and others don't work for free. They charge you fees and commissions from <u>your</u> money. And if their performance is less than stellar, you still get charged. While this is pretty straight forward stuff, be aware that mutual funds typically have the highest fees and/or commission structures, followed by stocks, special investment packages such as limited partnerships and hedge funds. Options, if handled incorrectly, can also generate large commissions.

AREAS OF FOCUS

If one is serious about learning how to hedge there are a number of investment vehicles that can be studied. Below is a sampling of some of the areas that can be used to produce solid results on a reduced risk basis.

STRUCTURED PRODUCTS – MARKET LINKED CD's AND MARKET LINKED NOTES

Structured Products are at the apex of financial inventiveness. They have become an important tool in the investment world for both institutional and private clients.

Structured products are designed to facilitate highly customized risk-return objectives. In simple terms, most structured products use a strategy where the money manager purchases regular bonds or discounted bonds (sometimes referred to as "Zeros") that mature at a predetermined date. The money manager then uses the difference between what is paid for the bond and the amount given by the investor to invest in a series of derivatives based on some kind of market component. *(These components can be based on virtually anything including individual stocks, indices, commodities, gold, currencies, foreign companies, and even limited partnerships.)* Since the difference in the cost of the bonds and the amount received from the investor can be significant, and the cost of the derivatives may be only a small percentage of the underlying security (usually an Index), the combined package can offer a number of benefits. For example, a typical Structured Product might offer investors a 100% return of principal in "x" number of years and some percentage of stock market participation that can range from 50% to in excess of 120k% of the upside performance of a security.

Mostly geared toward non-tax paying clients (pension, profit sharing, IRA's, etc.), Structured Products can be manufactured for taxable situations by using high grade or insured zero-coupon municipal bonds.

No matter how they are structured they provide reasonable performance with absolute safety. While the benefits offered can be substantial, the worst-case scenario is based on the premise that the investor receives a full return of principal regardless of market movement.

Structured Products may also contain other derivative type transactions such as swaps, forwards and futures, as well as embedded features such as leveraged upside participation or downside buffers.

PROTECTIVE PUTS

A protective put strategy uses a "put" option to buy protection against a price decrease in an underlying security or index. A put option allows the holder to sell a specified number of shares at or before a certain date for a fixed price, known as the strike price. The investor is able to decide how much protection he or she wants by naming the strike price. This strategy limits the downside risk of the stock or index, while still allowing the investor to participate in any appreciation. Protective puts are often preferred by those who remain bullish on the stock, but want protection against a price decline.

PURCHASED CALLS AS A SUBSTITUION

An investor who buys a call instead of purchasing the underlying stock or index considers the lower dollar cost of purchasing a call contract versus an equivalent amount of the stock or index. While purchasing calls can be risky if mishandled, it is nevertheless, a valid strategy when coupled with a money management strategy.

For example, one strategy might be to hold 85% of investable funds in a guaranteed or very safe investment (government bonds, high grade corporate bonds, insured municipal bonds, or money market funds) using the remaining 15% to purchase call options in whatever security or underlying asset is attractive. The concept is that the portfolio is 85% isolated against risk, while the remaining 15% which is at risk is put into an investment that has the same effect of having 100% or more of the investable dollars in the stock or underlying security – in other words one receives full upside potential with limited downside risk.

Of course, purchasing options is not for everyone. Options have time limits that usually only go out 3 years. This means that the strategy of buy and hold may not work as well. However, options can be purchased off-market that extend the time period for more than 7 years, and options can always be reinstituted at the end of a time period.

Finally, call options can be hedged as well (protected against a major decline) through the use of sophisticated spread positions too numerous to mention here.

CONCULSION

This article describes a problem that has been going on for a number of years. It is the “dummying down” of the investment process in which investors are being sold, and not educated. Further, those doing the selling have become less and less professional, even though they have fancy titles and/or have maintained a solid track record in all but the most extreme of times. This would be fine if anyone could predict when an economic downturn will end or to what extent it will recover. However, as we mentioned previously, no one can predict the future. At best you can only use the investment vehicles available (provided you are aware they exist) in a combination to take as much of the risk out of the investment as possible. Then when your advisors says that he outperformed the market and only lost 20%, you won’t nod your head in agreement as though he did something important. Losses do not have to happen. Structured Products can offer complete protection without diminishing upside. Protective Puts can provide substantial protection in down markets (up to 100% or more) with only a small percentage of give-up on the upside. Finally, a money management program using call options can be instituted with a minimum amount of in and out activity in which a portfolio has the ability to increase at a rapid rate.

The choice is yours, you can learn some basic information and improve your chances of making consistent profits or you can buy into the babble of the industry in which the nice gentleman with the big title and made-up track record tells you he knows what is going to happen and that he can pick winners. You can listen to your common sense or you can get sucked up into the hype of the TV business showman in which you are made to look like a fool for not knowing all you should. Like you've probably done numerous times in your past you can learn something new, or you can take the easy way out and hope you find the right guy who really is interested in you first. I strongly recommend the former.