

# The THOUGHTFUL INVESTOR

Third Quarter 2005

## Opportunities for Profit in Difficult Markets

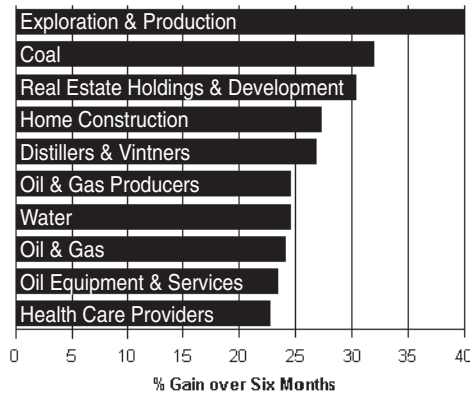
Based on broad market indices, the first half of 2005 was a tough time to be invested in equities. Despite brief rallies, the S&P 500 and Nasdaq indices ended the first six months of the year down slightly.

Behind the overall market indices were some very good gains in sectors you might not have considered. The chart to the right shows the top ten performing Dow sectors for the period. Rising energy prices propelled 40% gains in the Dow Jones Exploration and Production Index and helped the Dow Jones Coal Index gain 32% for the first half of 2005.

Sector investing clearly has the potential to enhance overall portfolio performance, but there's a catch. Hot sectors rarely stay hot over the longer term. It's quite common to see one year's top performing sector in the ranks of the worst performers the following year. In fact, the

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### Sector Performance January-June 2005



*The returns shown above are those of the Dow Jones indices and do not reflect the performance of an actual investment. Due to trading and administrative costs, a fund designed to mirror an index may not experience the same returns. Past performance cannot guarantee future results. Market volatility can significantly impact short-term performance. The possibility of loss always exists.*

## Stay Healthy, You May Be Working a Bit Longer

Doomsday scenarios abound with respect to Social Security, but the oddest thing is how very focused the arguments are on Social Security to the exclusion of other issues. Social Security is really just a small part of a coming demographic shift that will change many of our plans and hopes for the future.

At the root of the Social Security issue are demographic realities. The United States is getting older. So is the rest of the world. We are living longer, healthier lives than our grandparents and unlike

many of our ancestors, we don't expect to work until we die.

When Franklin Roosevelt established Social Security, he did more than set up a safety net for older individuals. He created a new mindset under which retirement has become a right for all, not a privilege of the wealthy. Today, most people retire not when they have accumulated sufficient assets to relax, but when they become eligible for Social Security.

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## For Graduation, Consider the Gift of Retirement



Do you have a new graduate in the family? Consider launching them in their new career or college years with a gift that will keep growing through the years, a Roth IRA.

A Roth IRA is a variation of the traditional Individual Retirement Account with some significant advantages. While contributions are not tax-deductible, distributions are tax-free for first time home-buying or after age 59½ – provided a five-year wait has occurred, or upon death or disability. The Roth IRA holder must have earned income (allowances do not count) equal to the annual contribution (up to \$4,000 in 2005) but does not need to use this income to fund the Roth plan. Gifts from others may be the source of funding.

A Roth IRA can provide a young person with years of compounding to build value and help get them started on the path to financial security. Another nice feature is that you don't need to think up a new gift next year, just provide funding for additional contributions.

# Take Advantage of Annual Free Credit Reports

This year, the Fair and Accurate Credit Transactions Act (FACT Act), takes effect, enabling consumers — by contacting a single number, Web site or address — to request their credit reports from the three credit bureaus at no charge once a year. I encourage you to order your free report as soon as possible and to make a habit of doing so every year.

A good credit report is essential for getting good financing rates, insurance (insurance companies claim that there is a direct relationship between a consumer's payment history and the number of loss claims they file) and even a good job. But according to a recent study released by the National Association of State PIRGs, almost 80% of credit reports contain either serious errors or other mistakes of some kind. These errors can result in the appearance that the consumer has "too much" credit available, is overextended or is not a responsible payer.

Knowing what is on your credit report and getting errors corrected promptly is your best defense against bad credit scoring and even identity theft. In fact, the first place identity theft typically shows up is in a credit report.

Under federal law, consumers were previously entitled to a free report only if they were denied an application for credit, insurance, or employment, and asked for the report within 60 days of receiving notice of the action. Under state laws, residents of Colorado, Georgia, Maine, Maryland, Massachusetts, New Jersey and Vermont could request their credit report at no cost once a year.

You're also entitled to a free report if you're unemployed and plan to look for a job within 60 days; if you're on welfare; or if your report is inaccurate because of fraud, including identity theft. Otherwise, a consumer reporting company may charge you up to \$9 for another copy of your report within a 12-month period.

## How to Order Your Free Report

You can order your free annual credit report online at [www.annualcreditreport.com](http://www.annualcreditreport.com), by calling 877-322-8228, or by completing the Annual Credit Report Request Form (available on-line at [www.annualcreditreport.com](http://www.annualcreditreport.com)) and mail-

ing it to: Annual Credit Report Request Service, P.O. Box 105281, Atlanta, GA 30348-5281.

[www.annualcreditreport.com](http://www.annualcreditreport.com) is the only authorized source for your free annual credit report from the three nationwide consumer reporting companies, so don't fall for marketing pitches from other organizations offering to provide you with a free credit report. Those offers typically come with strings attached.

## Report Inaccuracies Promptly

If there are any inaccuracies on your report, talk with a representative of the credit bureau immediately and find out what needs to be done to correct the information. But don't stop there. If you suspect identity theft, contact the fraud

departments of the credit agencies and file a report with your local police at once. Notify any creditors you don't recognize that there is a problem with the account.

Free credit reports are now available to consumers in the western, Midwestern and southern states now and will become available for the following eastern states on Sept. 1, 2005.

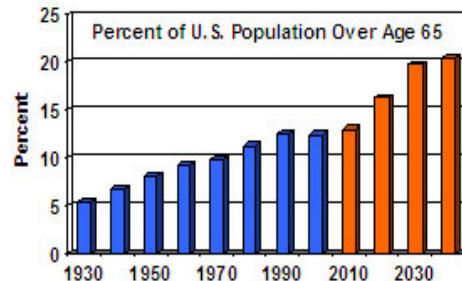
*Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Pennsylvania, Rhode Island, Vermont, Virginia, and West Virginia – the District of Columbia, Puerto Rico, and all U.S. territories residents can order their free reports beginning September 1, 2005.*

## Stay Healthy, You May Be Working a Bit Longer

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There are two facts you have to understand about Social Security.

1. There is no pool of money set aside for Social Security. Instead the Social Security surplus has been "invested" in U.S. Treasury bonds. It is part of the enormous \$7.6 trillion U.S. debt that must be repaid by U.S. taxpayers. Divided among the total U.S. population, we owe some \$26,000 per person.
2. Every penny collected by Social Security taxes is consumed by benefits to retirees or other government programs.



U.S. Census Bureau Population Estimates

Right now, there are roughly 3.3 workers for every Social Security beneficiary. If today's demographic trends continue as forecast, there will be less than 2 workers per retiree in 2040. 20% of the U.S. population will be over 65, compared to 12% today.

The ratio of workers contributing to Social Security compared to retirees will

be smaller. But the problem is bigger than that. There will be fewer workers per retiree paying state and federal income taxes; proportionally fewer workers to staff government and businesses; and so on.

Whenever there is a shortage in an open market economy, prices rise. It costs more to hire employees when businesses are competing for a smaller workforce. If businesses have to pay their employees more, prices of goods and services rise. When governments are forced to pay more to their workers, the cost of providing services rises and taxes increase.

There's a limit, however. Past history has proved you can only tax workers so much before you start destroying their incentive to work. At some point, the government will have to start cutting back on services or figure out how to be much more productive.

Where is this all going? There are dramatic changes ahead in the way we plan for our futures and in what we can expect from the government. You may need a lot more in accumulated assets to retire comfortably at 65 and stay retired than you are currently forecasting. But it's not all doom and gloom. Change doesn't have to be a negative as long as you keep your options open and don't let it sneak up and hit you over the head. The folly is in refusing to look ahead.

# The Sector Opportunity

When you combine the performance of all the different elements of the financial markets, the small caps, large caps, value stocks and growth stocks and all those investments in between, the result is an average return. Now there's nothing wrong with being average. For starters, it means you've outperformed 50% of the investment universe. Being average is even better if you've achieved a nice average performance by consistent returns year after year, rather than years of extreme highs and lows that average out to somewhere in the middle.

Over the long run, being average is the key to respectable long-term performance. But there's something in all of us that resists the idea of being average. It's probably why 80% of individuals surveyed rated themselves as above average drivers. It's also hard to accept achieving average returns when today's average is considerably lower than what investors had come to expect for an annual return on investments.

All of which is increasing investor interest in sectors. According to Morningstar, nine of the top 10 performing mutual funds each year are almost always sector funds. In 2004, the investment research firm Lipper reported the top 10 fund categories were industry and market capitalization sectors. Latin American funds led performance for the year, averaging 38% with dividends reinvested, followed by real estate funds at 32%; natural resources at 30%; emerging markets at 24% and utilities, 23%. That compared to 12% for the average general fund, again according to Lipper.

Two of those sector categories also show up in the top five when sorted for five year performance – real estate and natural resources funds, but on a five-year return basis, the performance of utilities funds fell to half that of the average general fund. And there in lies

the difficulty of sector investing. Sectors tend to move in cycles. What is in favor one month, year or five years, can fall to the worst performing category at a later stage of the cycle.

Past performance is not indicative of future returns. With sectors, even more than the overall market, market volatility substantially impacts performance.

## Targeting Sectors

A sector is a subset of the overall market that shares specific characteristics. While most sector approaches refer to industries, sector investing can also apply to (1) investment style – value versus growth, (2) company size – small cap versus large cap, etc., (3) geographic region – emerging markets versus developed nations, (4) dividend paying stocks of a larger sector, and (5) combinations of sectors such as technology in emerging countries.

Charles Dow deserves the credit for first formalizing sector investments when he began to publish averages of American stocks in the 1880s. The Dow Jones Industrial, Utilities, Transportation and Composite Indices are still used today. At one point, Fidelity Investments defined much of the sector investing world with 41 different sector funds under seven broad industry groups – Cyclical Industries, Health Care, Consumer Industries, Natural Resources, Utilities Growth, Financial Services and Technology.

With the evolution of no-load funds and low-cost mutual fund trading, sector investing was no longer limited to the offerings of one fund company or another. Now investors could diversify between fund families with different sector expertise and investing approaches.

Two recent developments, Exchange Traded Funds (ETFs) and stock baskets, are making it possible to target even more narrowly specific sub-segments of industries via diversified portfolios of

stocks. Like mutual funds, ETFs represent a collection of underlying securities or stocks, but can be traded on the market similar to an individual stock. Most ETFs replicate an index for the broad market or industry sectors.

The challenge today is not finding a sector fund in which to actively invest, but choosing which sector or set of sectors offer greater potential at one point in time and then continually monitoring the universe of sector investments for performance shifts.

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volatility of sectors makes it essential to use an active investment approach.

*Active management can't assure you success in sector investing, but it does acknowledge the risk of a narrowly focused investment approach and provides rules for moving out of a sector when the trend turns against you. By using diversified funds, sector investing also controls the risk of the poor performance of a single company unduly impacting the returns of the fund.*

While sector funds have been around for decades, trading restrictions have limited the participation of many investors. But that has changed dramatically in the last five years. Traditional mutual funds designed for frequent trading and Exchange Traded Funds (ETFs), designed to follow the performance of sector indices, have proliferated.

More investment options don't mean profiting from sector investing has become easier. The volatility of sector performance makes it essential to have a sound investment approach that is implemented on a daily basis. While sector investing can provide additional "umph" to your investment returns, it should be used in moderation. As with all investment approaches, it is essential that one position not have the ability to damage your portfolio to such an extent that recovery is doubtful.

For more information on how we incorporate the potential of rising sectors in your portfolio, please contact us today.



# Remind Recipients to Cash In Mature Savings Bonds

If you've made a habit of giving U.S. Savings bonds as gifts for new grandchildren, graduations, and other special occasions, you might want to remind the recipients to cash them in when they reach maturity. Literally billions of dollars in mature savings bonds are sitting in safe deposit boxes and file drawers forgotten by their owners.

Savings bonds stop earning interest at their final maturity and should be redeemed no later than the year in which they reach final maturity. Interest earnings are reportable for federal income taxes in that year.

Series EE Bonds absolutely should be cashed before or at their final maturity dates. Under IRS regulations, tax is due on the interest in the year the bond is cashed or it reaches final maturity. If you hold the bond beyond 12/31 of the final-maturity year, when you finally get around to cashing it, you will not only owe the tax on the earnings, but interest and penalties.

Until September 2004, holders of Series EE bonds who wished to defer tax on the interest paid by those bonds at maturity could cash in their EE bonds to purchase Series HH Savings bonds (prior to 1980, H Bonds). Series HH Bonds pay interest every six months, in the form of a check from the Treasury. When the HH bond matures, the holder receives

the principal, and a form 1099-INT for the deferred EE interest. However, Series HH bonds are no longer sold.

Paper savings bonds can be redeemed at any financial institutions that is authorized as a paying agent by the Treasury Department, which includes virtually all of the major banks, credit unions and savings associations.

Typically, any amount of I Bonds and Series EE Savings Bonds can be redeemed at an institution where you have had an account in good standing. You may also ask the institution to certify your signature and either forward your savings bonds to a Federal Reserve Bank or give you the address so that you may mail them yourself. The Federal Reserve Bank will mail you a check for the redemption value of the savings bonds.

Series I Bonds are sold at face value and earn interest for up to 30 years,

although they can be redeemed anytime after 12 months. Series EE Bonds are sold at half their face value (for example \$25 for a \$50 bond) and also earn interest for 30 years. While Series EE bonds can also be redeemed any time after 12 months, their value will be the purchase price plus accumulated interest, which could be more or less than the face value of the bond. The face value of an EE Bond will be realized in a maximum of 17 years.

Interest is exempt from state and local income taxes. Federal income taxes are deferred until the bonds reach final maturity, or are redeemed, whichever is first. Using Savings Bonds to pay for qualified higher education expenses may allow qualified bondholders to exclude earnings from federal income taxes as well.

SAVINGS BONDS NO LONGER EARNING INTEREST	
SERIES	ISSUE DATE
E	May 1941 through February 1965 and December 1965 through February 1975
H	June 1952 through February 1975
HH	January 1980 through February 1985
Savings Notes	May 1967 through October 1970
A, B, C, D, F, G, J, K	All issues

