



# The THOUGHTFUL INVESTOR

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## Emotion and the Investor

Volatility made the past year a difficult one for investors. With every fall or upward move in the market, we were treated to a host of financial experts proclaiming either ongoing doom or the resurgence of the bull market. But if there was one prevailing emotion for investors in 2007, it was fear. Fear of losing money, and fear of missing out on opportunities to rebuild portfolios that were still feeling the pain of the 2000-2002 market decline.

Behind that fear were a number of very reasonable concerns ranging from the housing market to the sub-prime lending debacle, energy prices, consumer indebtedness, inflation and more.

The problem with fear, however, and for that matter any emotion, is that it makes a lousy investor.

One of the latest studies of the mental processes of successful investors is a field called Neuroeconomics that explores the role biology plays in economic decision making, by combining insights from cognitive neuroscience, psychology and economics. Among the neuroeconomists' recent work was an interesting study in 2005 that looked at the investing success of individuals who had suffered damage to

the region of the brain that controls emotions, inhibiting their ability to experience basic feelings such as fear or anxiety. The researchers' conclusion: the individuals' lack of emotional responsiveness actually gave them an advantage when playing investment games.



*A common failing of investors, according to behavior finance theorists, is believing that one's investment success is due to wisdom rather than a rising market, but failures are not one's fault.*

A different side of the emotional spectrum comes into play when individuals invest for the pleasure of winning. When small wins no longer bring the same jolt of pleasure, the investor ups the ante, risking increasingly larger amounts to regain the pleasurable experience of winning.

Behavioral finance theorists are also quick point to emotions as the reason many investors sabotage their own financial success. Among the common mental mistakes identified by behavioral finance is

allowing emotional connections to override reason.

With that said, emotions play a very important role in life. Researchers in the study of the brain-damaged individuals found a lack of fear resulted in a much higher level of trust in the good intentions of others, often to the detriment of the individual.

## 2007 Tax Reminder

Don't forget to contribute the maximum amount to retirement plans before April 15 to reduce your taxes for 2007. In addition to employer-sponsored plans, you should fully fund individual retirement accounts such as IRAs and Roth IRAs. There are income limitations with these plans, so ask your financial adviser to make certain you qualify.

We also recommend that you fund your 2008 contribution as early in the year as possible to optimize compounding opportunities. Contributions limits for 2007 and 2008 are as follows:

Maximum Annual Contributions			
2007		2008	
Under Age 50	Over Age 50	Under Age 50	Over Age 50
<b>Individual Retirement Plans</b>			
<i>Traditional and Roth IRA</i>			
\$4,000	\$5,000	\$5,000	\$6,000
<b>Employer-Sponsored Retirement Plans</b>			
<i>401(k), Roth 401(k), 403(b), 457 and SARSEP Plans</i>			
\$15,500	\$20,500	\$15,500	\$20,500
<b>Small Business or Self-Employed Retirement Plans</b>			
<i>Solo-401k, Individual 401k, Roth 401k</i>			
100% of compensation up to \$15,500	100% of compensation up to \$20,500	100% of compensation up to \$15,500	100% of compensation up to \$20,500
<i>SIMPLE IRA or 401(k)</i>			
\$10,500	\$13,000	\$10,500	\$13,000
<b>Coverdell Education Savings Account - per beneficiary under age 18</b>			
\$2,000		\$2,000	
<b>Health Savings Account</b>			
Single	Between 55-64	Between 55-64	Between 55-64
Family	\$2,850 \$5,650	\$2,900 \$5,800	\$3,800

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# Health Insurance Options for the Retiree

When planning for retirement, it's relatively easy to quantify many of your future expenses until you get to the monster in the dark – healthcare costs. Today's retirees are living longer, healthier lives than ever in history. Cancer, stroke, heart attacks and other diseases that felled our grandparents are no longer a death sentence. But the costs of holding those killers at bay can be high.

While it is (at least for now) a personal decision whether or not to have health insurance, a lack of insurance can literally be the difference between life or death and the loss of financial security. If you incur medical costs that are not covered by insurance, the providers will hold you personally responsible for those costs to the extent of turning your debts over to collection agencies.

The first step to coping with the issue of health care is to understand what resources you have.

If you retire before age 65, unless you have kidney disease or are disabled (thus qualifying for early Medicare), you need to purchase private health insurance.

You may be able to do so through your former employer under the Consolidated Omnibus Budget and Reconciliation Act (COBRA) for up to 18 months after being laid off or unemployed by the company for some reason. Your other options are:

- Investigate peer group health insurance programs. Industry associations and professional organizations offer group and individual health plans. You may be able to find out about further plans through your local chamber of commerce and the National Association for the Self-Employed (<http://benefits.nase.org>).
- Work with an insurance agent to find the policy that works best for your circumstances,
- Contact your state regarding state-funded insurance programs that provide health coverage to low-income families.

## Medicare Basics

Once you make it to age 65, you qualify to apply for Medicare. In general, you are eligible for Medicare if you (or your spouse) worked for at least 10 years in Medicare-covered employment, are at least 65 years old and a citizen or permanent resident of the United States of America.

During those years of Medicare-covered employment, you paid for your

future Medicare coverage through payroll taxes of 2.9% (1.45% withheld from the worker and a matching 1.45% paid by the employer, or 2.9% if self-employed) on wages, salaries and other compensation in connection with employment.

If you do not have 40 or more quarters in which you paid Federal Insurance Contributions Act taxes, you may purchase Medicare coverage for a monthly premium.

Medicare is not an automatic enrollment. You have to apply. Like private health insurance plans, there are co-pays and deductibles. All Medicare benefits are subject to medical necessity and there are complex rules used to manage the benefit.

Medicare Part A covers hospital stays, including limited stays in a skilled nursing facility if certain criteria are met. Part B covers medical care generally provided on an outpatient basis and helps with durable medical equipment, including canes, walkers, wheelchairs, etc. Drug costs are covered only if administered in the physician's office under Part B. As of January 2006, Medicare Part D provides drug coverage.

## Advantage or "Gap" Plans

Medicare A and B plans don't pay all of your health care costs. There are costs that you must cover, like coinsurance, copayments, and deductibles – the "gaps" in Medicare coverage. "Medigap" insurance can be purchased to cover those costs as well as a "Medicare Advantage" plan to receive medical care in a format you prefer.

Medicare Advantage plans (also called Medicare Part C) give beneficiaries the option to receive Medicare benefits through private health insurance plans, sometimes with an additional monthly premium. Medicare Advantage plans are required to mirror the benefits offered by Original Medicare, or provide richer benefits than those which the individual would receive through Medicare.

Under Medicare Advantage Insurance you have five options that tend to follow traditional health insurance formats:

- Preferred Provider Organization (PPO): You choose a primary care physician who is a member of the organization and agree to use plan providers within the organization.
- Provider Sponsored Organization (PSO): A managed care plan with a network of providers.

- Private Fee for Service Plans (PFFS): This is an insurance plan, not a managed care plan. While care is still provided on a medical necessity basis, the plan determines the necessity. You see any providers you choose, as long as the provider agrees to accept the payment schedule.
- Religious Fraternal Benefit Society Plans: A managed care plan type formed by a religious or fraternal organization. Enrollment may be restricted.
- Medical Savings Accounts (MSA): A health insurance policy with a high deductible combined with a savings account. Medicare pays the insurance policy premium and deposits money into your MSA each month. You can use the money in your MSA to pay your medical costs (tax free) to your choice of providers. The providers have no limit on what they charge.

## Prescription Drug Coverage Under Part D

Anyone with Medicare Part A or B coverage is eligible for Part D, which went into effect in 2006. To receive this benefit, you must enroll in a stand-alone Prescription Drug Plan (PDP) or Medicare Advantage plan with prescription drug coverage (MA-PD). Coverage is not standardized, requiring some careful shopping before you enroll.

## Medicaid is a State Sponsored Program to Help Low Income Families

Medicaid comes into play for individuals and families with low incomes and resources. Medicaid is a state-administered program. Each state sets its own guidelines subject to federal rules. Certain services must be covered by the states in order to receive federal funds. Additional services are optional. It is possible to be dual-qualified for both Medicare and Medicaid.

## Long-Term Care is a Separate Consideration

Medicare does not pay for custodial, non-skilled, or long-term care activities, including services such as personal hygiene, cooking, cleaning, etc. While Medicaid does cover long-term care, you must be essentially destitute to qualify, a circumstance preferably avoided.

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## Appealing Property Taxes

One of the first rules of accumulating wealth is to not pay any more in taxes than you are legally obligated to do. Which brings up the issue of property taxes.

Falling real estate values in many areas of the U.S. could mean your property tax assessment is too high. Because lower valuations will mean a big hit for county revenues, you may also find your county assessor's office slower at lowering appraised values than it has been at raising them over the past few years.

Appealing a tax assessment starts with the question of whether or not your home has been valued fairly and if it is classified properly. A residential property is going to be taxed at a lower rate than a commercial property. Agricultural properties are lower yet. The best place to start is typically by looking at the sales prices of comparable properties at the time your assessment was made and double checking how those properties are classified. For a list of sales in your area over the past two years, visit the office or website of your local county property appraiser or tax assessor. If you have recently received your 2008 appraised value, the county will often include a list of comparable properties it considered in determining your valuation.

When comparing values, look at the size of the homes, lot size and the average assessed value per square foot. You also need to consider type of construction and amenities. If your property's value seems out of line, there's a chance you can lower your property tax bill by appealing the assessment. But make certain you follow the proper procedures to avoid wasting time.

To appeal your assessment, contact your county assessor's office for information on the appeal process and the proper forms. Ask questions when you call, but don't get defensive. Sometimes a friendly conversation can resolve the problem quickly without going through the formal appeal process.

If there are particular circumstances that make the county's valuation too high, you may want to consider hiring an appraiser to provide a professional assessment of your property's value. Because many counties now use computerized programs to arrive at assessed values, it can be difficult to dispute a valuation when special factors come into play without a professional's opinion.

## Emotion and the Investor

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The challenge for investors is to remove emotion from the investment process as much as possible. That starts with recognizing that we are vulnerable to emotions and that those emotions can make us act counter to what is good for us. The next step is to set up rules that help remove emotion as much as possible from the decision process.

In our management of client assets, we do this through quantitative decision models that depend on mathematics and trend analysis rather than subjective judgments. We let the market tell us what is happening rather than trying to impose an emotional decision that may not necessarily be based on facts.

For investors who are able to do the same with their portfolios, this is a good way to go. But not everyone operates along those lines. That's when using a good investment adviser is invaluable.

An investment manager typically has several advantages over the individual when it comes to managing assets. Expertise and time are two key advantages. A good manager has spent years studying financial markets, developing investment approaches and backtesting them prior to investing to understand the strengths and vulnerabilities of the approaches. The individual also invests on a full-time basis. In today's fast moving markets, this can be a distinct advantage.

A professional manager should also have the benefit of emotional distance—it's not his money. While that sounds a bit callous, it helps the manager put losses and gains in perspective. Yes, the manager wants the client to do well, but setbacks and gains tend to stay in perspective of long-term goals. By keeping emotion at a minimum in the investing decision, the manager is in a better position to make good buy and sell decisions.

Naturally, there is the potential for any manager to lose money as well as achieve gains in your portfolio, and past performance is not a guarantee of future results. You also need to understand how the manager is compensated and review appropriate disclosure documents. But if you are not currently using a professional financial advisor, or would like more of your assets professionally managed, please call.

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## Health Insurance Options

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Will you need long-term care? Only time can answer that question, but you can get an idea of its probability by considering the health of parents and other family members. Depending upon your financial condition, it may be prudent to purchase long-term care insurance now, while you know you have the resources, rather than leave it to chance.

### Travel Medical Insurance is Essential Outside the U.S.

Medicare Parts A and B do not cover individuals while they're traveling outside the United States. You need to have special travel medical insurance before you leave the U.S.

### The Future of Medicare

Just like Social Security, Medicare faces funding issues. In its 2006 annual report to Congress, the Medicare Board of Trustees

reported that the program's hospital insurance trust fund could run out of money by 2018. The problem is that, much like Social Security, there is no set aside cache of money to pay current expenses. Expenses are met through current tax payments. With the ratio of workers paying Medicare taxes to retirees drawing benefits shrinking at the same time the cost of health care services per person is increasing, funding issues are inevitable. Because of the uncertainty of Medicare's long-term future and the potential for "rationing" of health care to control costs, it can be very prudent to set aside funds that may be needed for private health insurance during retirement.

*This is a very simplistic overview of Medicare. Please consult with your financial health care advisor prior to making any health care insurance decisions.*

# Lessons from the Sub-Prime Crisis

The sub-prime lending crisis currently impacting the financial markets is also a primer in investment basics that we as individuals would do well to remember.

- 1) Markets are not efficient.
- 2) The pursuit of excessive returns involves higher levels of risk.
- 3) Supply and demand are the ultimate determinants of value.
- 4) History has lessons that matter today.

## Markets are not efficient.

The efficient market theory maintains that market participants have rational expectations; that on average, the population is correct (even if no one person is) and whenever new relevant information appears, investors update their expectations appropriately. The problem is that at market extremes irrational behavior is often the norm. Late stages of a bull market are driven by buyers who take little notice of underlying value. As the market collapses, investors sell positions regardless of the value that their investments represent.

## The pursuit of excessive returns involves higher levels of risk.

Risk is the potential that an investment will lose money. Everyone who purchased a home with adjustable rate mortgages,

zero-down mortgages, interest only balloon mortgages, inaccurate financial data, etc. took on the risks that housing prices would not continue double-digit gains and interest rates could increase. Every investor that purchased mortgage-backed securities based on these mortgages assumed the same risks. Many investors compounded that risk by using leverage to further enhance their returns.

Bubbles collapse. They always have and always will because the market cannot sustain excessive returns indefinitely. The fact that the Federal Reserve is in the process of bailing out these investors through lower interest rates raises the concern that investors will not learn from the experience. But then again, they don't appear to have learned from prior bubbles, either.

## Supply and demand are the ultimate determinants of value.

Many of the mortgage-backed securities that are now trading at a fraction of their prior value still have real value. A majority may eventually be paid in full. But demand disappeared at the same time supply increased as many investors were forced to sell their positions. As a result prices have tumbled creating a new opportunity for those with the cash and wherewithal to accurately evaluate these investments. But the players with cash are not the ones who take excessive risk.

## History has lessons that matter today.

Included in every investment prospectus, ad and performance report are a variation of the words, "Past performance is not indicative of future returns." While there is plenty of truth to that statement, the past still provides us with clues to the future because what has not changed is human nature. There's an entire field of study called behavioral finance that looks at how people react to different situations in the financial markets. Behavioral finance and other fields of research have proved that patterns repeat.

We would all do well to remember the lessons of history in our own investments. Nothing goes straight up forever; there are always corrections along the way. Any asset which gets priced in a free market tends to be impacted by variations in other assets in that market. Every investment has the potential for loss as well as gain.

As an investment advisor, one of my hardest jobs is often explaining why investing in the top performing mutual fund, the hot sector, or latest greatest investment may be okay for a portion of the portfolio but not to the extent that a loss will jeopardize the individual's financial future. The relationship of risk and return is not just a theory.

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