

Skinny Dipping & Investing

By Jon M. Duncan CFP®

I think it was Warren Buffet who said “When the tide goes out you find out who has been swimming naked.” Whoever said it, the quip is exceptionally appropriate in today’s volatile stock and bond markets. Many people are waking up, going to their mailbox to retrieve their brokerage account statements, and, much to their surprise and chagrin, finding that the tide has gone out and they are standing naked in the mud.

It is an unfortunate fact that many investors do not truly understand what they own. They trust their broker to do the due diligence to make certain that what they own is suitable. And, by and large, most investments do meet the standard of suitability. Suitability, however, may not always be the best standard.

About two years ago I was introduced to the mother of a client. Her husband, our client’s father, had passed away and left her with a large IRA and taxable investment portfolio. The same brokerage firm had handled the portfolio for many years, although the individual handling the account had changed several times. In reviewing the portfolio, we noticed that it was invested 100% in bonds, which didn’t seem unsuitable. On closer inspection, however, it turned out that the bonds were all non-investment grade corporate bonds; i.e., junk bonds.

When I asked the client if she knew what she owned she sheepishly admitted that she did not. She had left that decision up to her broker. When asked about the decision to load-up on junk bonds, the broker explained that the client’s objective was to generate income and that junk bonds paid the highest interest available. In other words, junk bonds were suitable in light of the client’s investment objective.

As can be clearly seen in this real life example, suitability is a necessary but not sufficient standard when it comes to recommending investments. In the final analysis, investments need to be evaluated in light of the client’s best interest. In the case of my client’s mother, junk bonds may have been suitable but it would be a difficult case to make that they were in her best interest given the cost of trading and the default risk involved.

So, how can you make sure that your investments are not only suitable but in your best interest as well? Here are some tips to keep in mind as you review your account statement:

Know what you own

You don’t have to be a financial genius to understand what you own. You do, however, need to pay attention. Review the “Investment Detail” section of your account statement. It is typically broken down by type of security: Equities (stocks), fixed income (bonds), and mutual funds. Mutual funds are probably the easiest category to understand, although there are so many different mutual funds it isn’t always easy to tell from the fund’s name what type of fund it is. Take time to browse through the prospectus for each fund when you receive it. If you own stocks of publicly traded companies, at a minimum, you should know the business the company is in and what it does. Obscure names don’t necessarily equate to bad stocks but it does make it difficult for you to assess the risk you are taking. Bonds are probably the most complicated and difficult for most people to understand. Again, look at the names of the bond issuers. If they are

corporate bonds, you should be able to recognize the issuer. S & P and Moody's typically rate both corporate and municipal bonds, so you will want to look for a rating of "A" or better (investment grade). Finally, review the maturity schedule of your bond portfolio. Do all of the bonds come due at the same time or are they "laddered" over several years? Are your bonds callable? Finally, beware of anything labeled "LLC" or "LP." These are limited liability companies or partnerships that typically invest in things you really don't want to invest in. They are not liquid investments, meaning you may not be able to get your money if and when you need it.

Ask questions

It is unfortunate that some investments are sold based on their sex appeal. New and different does not always equate to good investment results. The first question you need to ask is "Why is this investment in my best interest?" Don't allow the potential for a great return to lull you into ignoring the risk of an investment or common sense. Stellar return potential always comes at the cost of high risk. If it doesn't make sense to you or you simply don't understand an investment, don't walk for the exit, run.

Know the facts about the costs of ownership

It is not always easy to determine the costs of an investment. For example, municipal bonds are often marked-up or marked-down when sold to or purchased from the end investor. Mark-ups and markdowns don't show up on a confirmation statement; they are buried in the price of the bond. So, while it might appear that you are not paying a commission to buy or sell, you might in fact be paying dearly. With other securities it is a bit easier to determine the cost of investing. Mutual funds, for example, have expense ratios and, in some cases, up-front or deferred sales charges that must be disclosed at the time of purchase. Thinly traded or illiquid securities, like interests in limited liability companies or partnerships, typically have very wide "spreads" – the difference between what you pay to buy and the price you receive if you want to sell (if you can find a buyer). Gold and other precious metals might seem attractive but remember that you have to store them in a secure place and, in some cases, pay to have them assayed.

Simplify

Some investors can't say no to a new account. As a result, it is not unusual to find people with several accounts (remember that IRA you set up back in 1985?). It is much more difficult to understand what you own if your portfolio is spread out over a half-dozen different brokerage accounts, mutual fund accounts, and retirement plan accounts. Some people mistakenly confuse consolidation with concentration. You can consolidate accounts, making management easier, and still be diversified in what you own.

Avoiding unpleasant surprises, when it comes to investing, is a matter of knowing what you own, asking questions, understanding costs and simplifying portfolio management. A little time and effort can go a long way toward keeping you high and dry when the tide goes out.

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