

December 31, 2006 Review

Summary

Articles of interest remain in low supply. The article of the week documents one of my continuous themes: the Street likes to buy Ferraris with YOUR money! Happy 2007. Will this be the year the party ends?????

Credit

- "M&A activity at record \$4 trillion in '06," notes the Associated Press. "U.S. High-Grade, Junk Issuance Break Records," adds Reuters. The market of U.S. mortgage bonds passed the \$1 trillion mark in '06. DR 12/31

Commercial Real Estate

Commodities

- Gold proved just about the best place for your money in the year just passed. The price settled at \$638 per ounce on the last trading day. That is about 20% above the price a year ago. DR 12/31

Currency

Diversification

Derivatives

Housing

- Jan. 2 (Bloomberg) -- Lennar Corp., the fourth-largest U.S. homebuilder by revenue, will report a quarterly loss to write down property investments and agreed to sell a stake in a company that controls 15,000 acres of land in southern California. The loss in the three months ended Nov. 30 will be 88 cents to \$1.28 a share after a pretax charge of as much as \$500 million, the Miami-based company said today in a statement. That compares with earnings of \$3.54 a year earlier. **Chief Executive Officer Stuart Miller said that housing markets weakened in the quarter and ``we have not yet seen tangible evidence of a market recovery."** Home construction companies have been left with more land than they need and more homes than they can sell as the housing market deteriorated last year. Homebuilders including D.R. Horton Inc., the largest by revenue, have tried to lure customers with free upgrades, such as granite countertops, eroding profit margins. **Lennar said it's taking the charge to write down land it doesn't intend to purchase.** It's also writing off deposits and pre-acquisition costs for land it has under option. **Lennar to Post Quarterly Loss After Land Writedowns** [if we truly were at a bottom, one would think it unlikely that the number 4 home builder would be in the dark and dumping land.]
http://www.bloomberg.com/apps/news?pid=20601087&sid=aIC4I.sDB_aw&refer=home

- According to Fitch Ratings, the housing market is in a fairly severe, multiyear contraction — one that isn't based, as previous slowdowns have been, on rising interest rates and a sharply slowing economy. It's being driven by perceptions, the Fitch analysts said. "A negative buyer psychology seems to have become pervasive," Fitch reported this month. "The expectation or fear is that home prices have peaked and buying now would be a mistake."
- A new CRL study reveals that millions of American households will lose their homes and as much as \$164 billion due to foreclosures in the subprime mortgage market. The "Losing Ground" study is the first comprehensive, nationwide review of millions of subprime mortgages originated from 1998 through the third quarter of 2006. CRL finds that despite low interest rates and a favorable economic environment during the past several years, the subprime market has experienced high foreclosure rates, and we project that one out of five (19.4%) subprime loans issued during 2005-2006 will fail. The report discusses a number of factors that drive subprime foreclosures—these include adjustable rate mortgages with steep built-in rate and payment increases, prepayment penalties, limited income documentation, and no escrow for taxes and insurance. We also determine that these features cause a higher risk of default regardless of the borrower's credit score. Our study also finds that recent high appreciation in many areas has masked problems in the subprime market, and that the cooling housing market will cause failure rates to rise sharply in many major markets. California, Arizona, Nevada, and greater Washington DC will be especially hard hit. Also in this report, we project lifetime foreclosure rates for 2006-originated subprime loans in each MSA in the United States. **Report Reveals 2.2 Million Borrowers Face Foreclosure on Subprime Home Loans; Homeowners to lose Billions** <http://www.responsiblelending.org/>
- New home sales in November 2006 were 1,047,000, up 3.4% from October but down 15.3% from November 2005. December 27 HUD [for those who think "the bottom is in", it was unlikely that it would go down MOM linearly]

Housing Finance

Macro Economic

- Wednesday, Dec. 27, 2006 ALEXANDRIA, Va.— The American Trucking Associations' advanced seasonally adjusted for-hire Truck Tonnage Index plunged 3.6 percent in November after falling 1.9 percent in October. On a seasonally adjusted basis, the tonnage index fell to 106.8 (2000=100) from 110.8 in October, which is the lowest level since late 2003. The index decreased 8.8 percent compared with a year earlier, marking the largest year-over-year decrease since December 2000. Year-to-date, the truck tonnage index was down 2.8 percent, compared with the same period in 2005. The not seasonally adjusted index decreased 9.5 percent from October to 106.5. November 2006 marked the single worst month for for-hire truck tonnage since the last recession," said ATA Chief Economist Bob Costello. "Both the month-to-month and year-over-year decreases indicate that the economic slowdown is in full gear. The most troubling number is the 8.8 percent contraction from November 2005, despite the fact that year-over-year comparisons are difficult due to the very robust volumes during the same month last year. One month certainly doesn't make a trend, but if we continue to see year-over-year

reductions of similar magnitudes in the next couple of months, it could indicate a greater economic slowdown than economists are projecting at this point.” Trucking serves as a barometer of the U.S. economy because it represents nearly 70 percent of tonnage carried by all modes of domestic freight transportation, including manufactured and retail goods.

ATA Truck Tonnage Index Plummeted 3.6 percent in November

<http://www.truckline.com/NR/exeres/240082F3-7160-4162-92A5-C834A84E2401.htm>

- For financial markets, 2006 was more like two years than one. In the first half, U.S. stocks meandered as investors tried to anticipate the Federal Reserve's next move. But in the second half, the Fed decided to pause, oil prices fell, the economy and corporate earnings remained strong, and interest rates pulled back -- all fueling a runaway second-half rally for stocks. Here is a scorecard of major financial-market indicators. **Markets Scorecard 2006** THE WALL STREET JOURNAL ONLINE *Dec. 29, 2006*
<http://online.wsj.com/public/resources/documents/info-markets2006.html>
- WASHINGTON (MarketWatch) -- The economic outlook is more uncertain than usual. Economists, policymakers and investors are sharply divided over where the economy is heading in the next year. Will the U.S. fall into recession? Or will growth roar back, fueling inflation and forcing the Federal Reserve to kick interest rates higher? The performance of the stock market and other asset markets will depend to a large extent on the answers to those questions. **Top economists answer 10 burning questions**
<http://www.marketwatch.com/news/story/soft-landing-likely-if-housing/story.aspx?guid=%7b9339C5DC-9D4F-4A09-9241-85876B3F3644%7d&dist=&print=true&dist=printTop>

Retail

- Fitch has projected U.S. GDP growth of approximately 2.4% in 2007, as the weak housing market and high fuel prices squeeze consumer discretionary spending. Fitch projects that slower economic growth will lead to a 1.8% decline in domestic light vehicle sales from a projected 16.4 million vehicles in 2006 to 16.1 million in 2007. A portion of this decline can also be attributed to production cutbacks at the domestic manufacturers as they shrink unprofitable production geared to daily rental fleets and attempt to move away from ruinous cycles of over-production and heavy incentive programs. Weakness in the housing market will continue to take a toll on pickup volumes and pricing, which will be a harsh impediment to turnaround efforts. Full-size pickup trucks remain a critical portion of consolidated volumes (27.6% of Ford's U.S. light vehicles sales first 11 months of 2006, 22.3% of GM, 17.0% of Chrysler) and an even higher contributor to profitability. This segment has suffered a 9.2% decline in unit volumes through November 2006, but has likely not yet absorbed the full brunt of the decline in residential construction. Volumes and pricing are likely to be especially affected at Ford and Chrysler with the launch of GM's new trucks and the start-up of Toyota's new pickup plant. **Fitch: U.S. Auto Market Headed for Turbulent 2007**
http://www.fitchratings.com/corporate/events/press_releases_detail.cfm?pr_id=329132
- Dec 26 2006 Like a football team that's played a quarter or two too many, consumers are finally showing signs of folding under pressure, based on initial results of the Christmas shopping season. And with gas prices creeping back up and home prices in a slump, retailers have every reason to worry about 2007. **Retail Results Signal Tough Times Ahead**

http://www.businessweek.com/bwdaily/dnflash/content/dec2006/db20061226_522998.htm?chan=top+news_top+news+index_top+story

- Dec 26 2006 Visa USA, the credit card company, said yesterday that it would lower its closely watched forecast for holiday spending. Based on purchases by credit and debit card holders, Visa said sales rose 6.5 percent in November and December, compared with the same period last year, down from its initial forecast of a 7.5 percent gain. The company's unexpected downward revision — and the millions of dollars in lost sales it represents — could have broad implications for the nation's merchants, who count on purchases during the holiday season for nearly half of their business. **Rush at End, but Holiday Sales Fall Short**

http://www.nytimes.com/2006/12/26/business/26retail.html?_r=1&oref=slogin&ref=business&pagewanted=print

Retirement

Risk

Savings Rate

Tech

- Total industry debt is expected to increase to record levels again in 2007, surpassing \$140 billion compared to \$100 billion of debt at the beginning of 2006. Fitch believes a majority of 2007 technology debt issuance will be driven mostly by refinancings with industry bond debt maturities of more than \$10 billion in 2007 and \$15 billion of bank credit facilities due, although LBO activity and debt-financed acquisitions are expected to contribute to record technology industry debt levels. New debt issuance is expected to remain strong for secured bank facilities and term loans, which could continue to negatively affect the ultimate recovery prospects of unsecured bondholders. **Fitch: Record Debt & Event Risk Dominate U.S. Tech Industry Outlook**
http://www.fitchratings.com/corporate/events/press_releases_detail.cfm?pr_id=326432

Wall Street

- **Your investment dollars at work!!!!** It's a brisk Wednesday morning in the windy caverns of Wall Street and Sarah Clark's toes are cold. Dressed in a purple flight attendant outfit, Ms. Clark, a 26-year-old model, is trying to entice recent bonus recipients at **Goldman Sachs** into using a charter plane service, handing out \$1,000 discount coupons to people in front of the investment bank's Broad Street headquarters. "Where am I going?" asks one man, heading toward the Goldman building. "It's your own private jet," says Ms. Clark with a smile. "You can go wherever you like." **For Wall Street's elite, the sky may well be the limit. In recent weeks, immense riches have been rained upon the top bankers and traders.** After a year of record profits, investment houses like Goldman Sachs, **Lehman Brothers** and **Morgan Stanley** are awarding bonuses as high as \$60 million. And a select group of hedge fund managers and private equity executives may be taking home even more. That is serious money. And the serious luxury goods markets are feeling the impact. **Wall St. Bonuses: So Much**

Money, Too Few Ferraris

<http://www.nytimes.com/2006/12/25/business/25bonus.html?ei=5090&en=5ced3ca840169e2d&ex=1324702800&partner=rssuserland&emc=rss&pagewanted=print>

- **Buy and hold?????** The probability that a company in an industry's top revenue quartile will not be there in five years - 30% McKinsey quarterly
http://www.mckinseyquarterly.com/article_page.aspx?ar=1734&L2=21&L3=114&srid=190&gp=0

Article of the week:

Does your financial advisor add value? A seminal study suggests **most** do not

Over the next few years, you will be hearing a great deal about a ground-breaking new study that is just now starting to receive nationwide attention.

The only notice of it that I have seen in the public media just appeared in a popular money magazine: "**A new study compares the cost and performance of more than 4,000 mutual funds--some sold by brokers, some selected by people on their own--from 1996 to 2002. The people won.**" In other words, do-it-yourselfers outperform financial advisors. Was the difference trivial? In another section, the article stated, "Estimated annual amount by which funds that people bought on their own outperformed broker-sold funds: \$8.8 billion." The number \$8.8 billion was in very large type.

Those are fighting words. But more and worse is to come from the popular media. This monumental study will surely be misinterpreted by some in the media. Clients could be outraged. A few may vote with their feet.

The questions we must ponder is, "*How do we defend ourselves? How do we establish our economic value?*" The vast majority of all financial advisors have long assumed they helped their clients achieve financial goals. **At least when it comes to mutual fund investing (the most common service financial advisors offer), this study implies that financial advisors add no value.**

Within weeks, the popular media will be writing articles stating that financial advisors harm clients. Jonathan Clements, one of the most popular columnists in *The Wall Street Journal*, has long contended that most people would be better off by avoiding financial advisors and just putting their money in the bank. He may now have rigorous scientific proof to back up his arguments--and many other journalists and thought-shapers are sure to join the chorus.

The Study

"Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry" is written by Daniel Bergstresser of Harvard Business School, John Chalmers of the University of Oregon, and Peter Tufano of Harvard Business School. While I earned my Ph.D. at the University of Oregon, I have no connection with Chalmers or the other authors.

It is likely that this landmark work will soon become known as the "BCT Study" just as we all refer to the seminal work on asset allocation as the BHB study after the initials of its authors.

The BCT study is an exhaustive analysis of the cost and performance of more than 4,000 mutual funds sold by financial advisors and selected by investors on their own over the years 1996 to 2002. The amount of data analyzed is staggering. The study has been going on for years and various working drafts of the research findings are available on the

Internet. The latest is dated Jan. 16, 2006.

The findings of the BCT study will create a firestorm of controversy. Let's prepare ourselves now.

The Findings

First of all, I must explain the usage of the word "broker" in the title of this study. It does not just apply to Series 7 licensed reps who work on commissions and loads. It truly applies to almost all financial advisors who sell mutual funds.

The authors use the term "direct channel" to refer to what we might call "the public" or "do-it-yourselfers." This includes investors who buy mutual funds directly, on their own, or through no-load fund supermarkets.

All other mutual funds that are sold through banks, advice givers, RIAs, IARs, broker-dealers, mutual fund wrap accounts, wire houses and captive agents are included in the author's "broker channel." Unless you work for a fund supermarket on a salary, you are referred to as a "broker" in this study.

In short, the authors' findings probably apply to the vast majority of all financial advisors, whether they are RIAs, IARs or registered representatives.

This is the first study ever to scientifically quantify the benefits that investors may enjoy if they work with financial advisors. The authors asked these essential questions:

1. Do advisors give clients access to funds that are harder to find and evaluate? The answer is yes, but as you will see, as a whole, *advisor-selected funds underperform funds that investors select on their own.*
2. Do advisors help clients find funds that are lower cost (excluding distribution costs)? After analyzing several trillion dollars worth of transactions, the answer is no.
3. Do advisors give clients access to funds with better performance? The answer is a resounding no. I know this is shocking--and it may not apply to you. But the scientific evidence shows that many of the other advisors in America not only underperform indexes--they underperform what most people do on their own if they don't have an advisor.
4. Do advisors provide superior asset allocation? After years of research covering trillions of dollars of asset allocations, the finding is that advisors do not provide superior asset allocation. Even without this study, one only had to look at how advisors overemphasized technology funds in the late 1990s and how many advisors are overemphasizing energy, gold, and foreign funds today.
5. Do advisors help correct bad investor behavior such as chasing fads and chasing performance? The sobering answer is no. In fact, the evidence shows that advisors even contribute to such behavior. Again, look at all the money advisors are pouring into energy, gold, and foreign funds.

It is important to note that the authors are not anti-advisor. Remarkably, they had the cooperation and support of some of the largest and most respected industry groups and research organizations in America in working on this study. Further, the authors go out of their way to point out that financial advisors may offer significant "intangible benefits." Unfortunately, these researchers found that the clients of advisors buy funds that have substantially higher fees and lower risk-adjusted returns than funds that investors buy on their own. The implications of these findings are staggering. The BCT study may even affect public policy toward advisors in the future.

What Will Compliance Departments Do?

None of us is perfect. So advisors underperform what investors can do on their own--so what? Underperformance is bad enough, but the BCT study finds that investors pay billions of dollars a year for this underperformance.

Reading this study, one wonders how compliance departments will react. The methodology of the study is rigorous and sound. The massive amounts of data involved have been analyzed for years from many different angles. Researchers from major universities around the country have contributed guidance and expertise to the authors. Morningstar and Financial Research Corporation contributed data (although the findings of the study and the conclusions drawn can only be attributed to the authors.) In addition, staff members of the Investment Company Institute and representatives of various mutual fund companies assisted the authors. This is not a biased study.

There are no studies of which I am aware that can contradict the findings of the BCT study. An implication of these findings is that investors suffer a loss of billions of dollars a year in lower performance and in fees if they hire financial advisors to select mutual funds.

A few advisors who have read the BCT study have asked, "Will compliance departments require advisors to disclose that that advisor-provided advice may hurt them?"

That is very unlikely. You don't have to worry about compliance departments raising their standards because of the BCT study.

It is a virtual certainty that financial advisors all over the country, even those who have only been in the business for a week, will still be able to tell prospects, "I can pick the best mutual funds in America for you." Even advisors who have lost their clients millions or tens of dollars will still be able to make this claim because no compliance department forbids or even regulates this statement.

This does not mean, however, that the BCT study will not have a huge impact on practice building. You had best be prepared for clients asking you questions about this study.

Many prospects will probably almost always believe advisors who say they can pick the hottest mutual funds. However, a few years after prospects become clients, questions arise. "Why am I not making very much money?" "Why am I losing money?"

In the past, pat answers worked: "We're in for the long term." "It's not timing the market, it is time in the market." "Be patient. We'll make money over the next five or 10 years."

However, there is a good chance that these well-worn answers will no longer suffice once the findings of the BCT study become known. I've shared this study with a few million-dollar producers and they are already preparing their responses.

I am myself preparing speeches to help advisors deal with the BCT study, and I'm working with advisors around the country on their responses. However, in addition to knowing what to say, *advisors must also change their behavior.*

It is the unprepared advisors who will be caught flat-footed and who will suffer the greatest loss of clients as the BCT study hits the nightly news. Unfortunately, the clients you are most likely to lose are your better-educated and highest-net-worth clients.

The BCT study also found that the clients of advisors are less educated and have lower net worth than do-it-yourselfers. The findings of the BCT study are likely to increase the exodus of bright high-income clients who may decide it is better to simply buy low-cost index funds on their own. Let's work together to stem that tide.

The Good News

I am a perpetual optimist. In my speeches and in my work with top advisors, I always like to stimulate deeper thinking, provide solutions, and to leave advisors feeling good about the future.

Don't be depressed about the BCT study. Ultimately, it will strengthen our profession and improve the results we deliver to clients. For much too long, some advisors have been engaging in investment practices that provide minimal or non-existent benefit to clients. For example, the BCT study found that the raw returns of equally weighted mutual funds (net of all expenses) for 1996 to 2002 were 6.626% for the investors working on their own and were 2.924% for funds provided by advisors.

In other words, *the public working on its own did more than 100% better than financial advisors when it came to selecting equity mutual funds*. After factoring in inflation and taxes, clients of financial advisors lost money and lost purchasing power. This must change.

You don't have to lose clients because of the BCT study. Many of the income planners I am coaching have done very well for themselves and their clients by offering combinations of tax-free bond funds, covered call stock funds and other investments. For example, MuniHoldings CA Insured MUC, a closed-end bond fund that has historically produced about 6% per year tax-free over long periods of time, outperforms the vast majority of all mutual funds on an after-tax basis--yet very few advisors know about it. Another investment class that is relatively unknown to most advisors is covered call funds. Funds such as Madison Strategic Sector Premium Fund MSP, pays nearly 10% per year, invests in high-quality stocks, and can make money from call-writing even if the market is flat.

How many advisors make money from equities in a flat market? Very few. However, funds like MUC and MSP help clients prosper even when the stock market is flat or slightly declining. In addition, MSP sells at a discount to net asset value.

MSP and MUC are not perfect--no investment is. Yet when you can earn about 10% per year (taxable) as MSP is doing or 6% per year after-tax as MUC is doing, you do have an advantage over the 2.924% taxable return that so many advisors are delivering.

The implications of the BCT study go far beyond security selection. This paradigm-challenging study points out the need for many advisors to change their behavior. We have long known about the dangers of chasing investment fads, but it turns out that many advisors may be just as guilty as the public.

We must have the courage to occasionally buy companies or sectors when they are out of favor. How many of us have the courage now to buy Intel, the world's largest semi-conductor company, now that it has the lowest price/earnings multiple in its history and is about to release a whole new generation of products? Or Microsoft, which has a similar story?

In future articles, we will take a closer look at the BCT study and how both you and your clients can actually prosper from its startling findings--if you are prepared.

Our world is about to change. Millions of clients and prospects will never see us in the same light again. With the right knowledge, you stand to be a beneficiary rather than a victim of this massive sea change in the perception of financial advisors.

Don't just be a trusted advisor--be a trusted advisor who adds economic value.

Get practice-building tips and information from our team of experts delivered to your e-mailbox every Thursday. Sign up for our free Practice Builder e-newsletter.

Dr. Donald Moine, trained as a research scientist, has specialized for the past 24 years in persuasion training, marketing, practice building, behavioral finance, and the development of low-risk, high reward investment strategies. His websites are www.DrMoine.com and <http://CertifiedIncomePlanners.blogspot.com/>. Based in Palos Verdes, Calif., Dr. Moine is a consultant and coach to financial advisors, insurance professionals, information-marketers, accountants, estate planning attorneys, investment bankers, pension managers, and *Fortune 500* companies around the world. To learn more, write to DrMoine@aol.com and request a copy of "Helping Financial Advisors Rapidly Build Highly Profitable Practices" and/or "How to Build Your Practice as a Certified Income Planner." Dr. Moine is the author of 10 books. **The views expressed in this article are the author's. They do not necessarily reflect the views of Morningstar. Feedback about this article may be sent to advisorquest@morningstar.com.** <http://trendfollowing.com/whitepaper/The%20Study%20of%20the%20Decade.pdf>

the referenced paper can be found in its entirety at this link:

Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry

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AFA 2006 Boston Meetings, Forthcoming

Abstract:

Many investors purchase mutual funds through intermediated channels, engaging and paying brokers or financial advisors for fund selection and advice. This paper attempts to quantify the benefits that investors enjoy in exchange for the higher costs they pay in order to purchase funds through the broker channel. We focus on five measurable potential benefits to consumers of brokered fund distribution: (a) Assistance selecting funds that are harder to find or harder to evaluate; (b) Access to funds with lower costs excluding distribution costs; (c) Access to funds with better performance; (d) Superior asset allocation, and (e) Attenuation of behavioral investor biases. **Exploring these dimensions, we do**

not find that brokers deliver substantial tangible benefits. In short, while brokerage customers are directed toward funds that are harder to find and evaluate, brokerage customers pay substantially higher fees and buy funds that have lower risk-adjusted returns than directly-placed funds. Further, brokered funds exhibit no better skill at aggregate-level asset allocation than funds sold through the direct channel. This analysis implies that any benefits that exist must be found along less tangible dimensions.

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=616981#PaperDownload