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### Points of interest:

- Investors in managed portfolios pay a variety of fees and expenses in an effort to get market-beating returns.
- The cost of active investment management is growing because fewer investors are sharing in the cost.
- Smart investors have left the game and use low-cost index funds instead.

## THE PRICE OF ACTIVE INVESTING: WOULD YOU BELIEVE \$100 BILLION?

American mutual fund investors are spending a lot of money in a vain quest to beat the market, says famed finance professor Kenneth R. French of Dartmouth.

French has made public preliminary results from his detailed study of the costs investors pay to own actively-managed funds whose goals are to beat the U.S. stock market.

The estimated annual cost so far is \$100 billion, French says. And, to make it worse, the evidence suggests that the average investor falls behind the market.

The smart investors are the ones who buy simple index funds that charge modest fees to replicate the stock market's results, he adds.

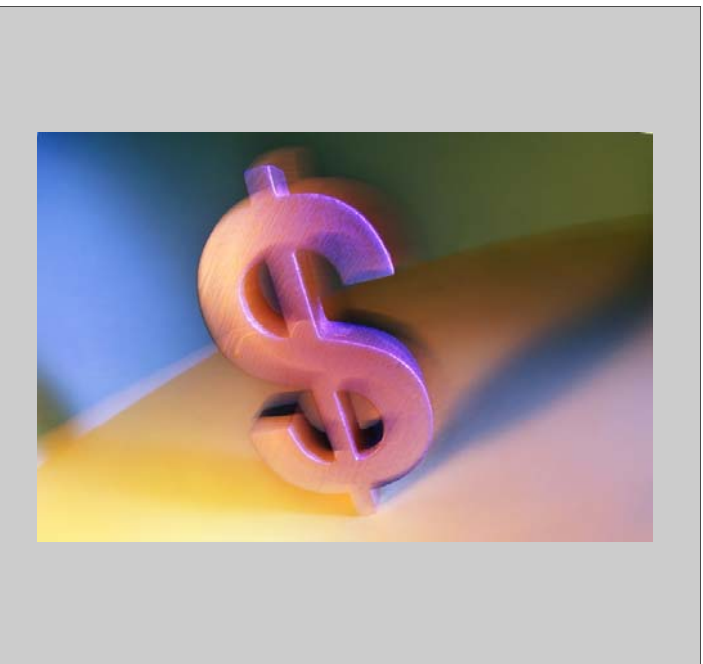
### Costs aplenty

French's study looks at funds that invest in U.S. stocks. He included open-end funds—most commonly used by individual investors—along with closed-end funds and exchange-traded funds.

He included the fees and expenses of the funds, the transaction costs for trading, and other costs.

In order to find the cost of active management, he totaled all of the costs and then subtracted the cost of investing in a passively-managed index fund. The difference was the cost investors paid in their attempts to beat the market.

The estimated annual



Mutual fund investors are paying billions of dollars each year in a fruitless quest to beat the stock market, a new study shows.

dollar cost for 2006, the last year covered by the study, was \$99.2 billion, and it is assumed that amount grew to at least \$100 billion last year.

This compares with an estimated annual cost of \$7 billion back in 1980.

### The price tag grows

It is ironic that the cost of active management keeps growing, even though market developments since the 1980s have served to reduce some of the typical costs of investing.

Today's mutual funds can take advantage of discounted commissions and smaller bid-ask spreads, while investors pay small direct

sales charges on mutual fund sales.

French contends that the costs of investing make this less than a zero-sum game. In a zero-sum game each person's losses or gains are matched by another person's losses or gains.

This, French says, would be the case in the investment markets if there were no costs. But the \$100 billion annual price tag associated with active investing means that it is really a negative-sum game. The costs reduce the pie that is divided among all of the investors who participate, he says.

*(Continued on page 2)*

## MORE INVESTORS DROP OUT OF THE GAME AND USE INDEX FUNDS

(Continued from page 1)

Adding final insult to injury, the cost of active investing is growing because many players have opted out and begun using index funds, French said.

That means the group of investors who bear the costs of active management has gotten smaller, giving each one a large share of the expenses.

French says that the portion of the stock market invested in indexed funds has grown to nearly 18% since

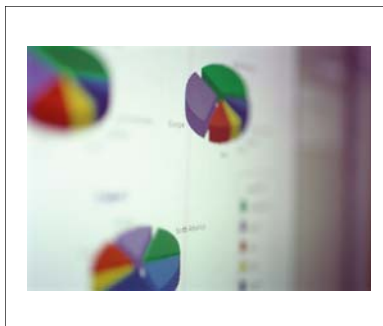
1986.

### Use index funds

There is an easy answer: use indexed funds and passively-managed asset class funds.

Investors in these funds are assured that they will earn what the market earns, minus a small cost paid to the fund.

Such a no-brainer strategy will also help the investor to beat the great mass of active investors who are constantly in search of a winning formula or a winning portfolio manager. Also, this



Winning investors stick to index funds.

strategy eliminates the pain of underperforming the market.

## U.S. BIRTH AIDED BY INFLATIONARY NOTES

The Revolutionary War not only gave birth to the United States and made George Washington a hero, it inadvertently led to a historic financial innovation that is a mainstay of today's financial markets.

Inflation-indexed government bonds, which have become the safe haven of choice during this current market cycle, were created by Massachusetts in 1780 to pay U.S. soldiers in a way that would compensate from loss of value due to inflation.

Today, 11 years after being reintroduced by the U.S. Treasury, bonds whose values are guaranteed to increase with inflation are widely held by institutional and individual investors alike.

### Principal protection

Inflation-indexed Treasuries carry a fixed interest rate but protect holders by increasing the bond's principal amount as inflation increases. Plus, there is protection against deflation because bond holders are guaranteed

to get their original principal back even if prices measured by the Consumer Price Index have dropped instead of increasing.

This was the same problem Massachusetts solved with its indexed bonds.



Revolutionary war soldiers who were tired, broke, and dispirited in 1780 kept fighting after being given inflation-indexed notes as pay.

Inflation was running rampant during the war, as prices of goods soared and the exchange value of paper currencies declined sharply. Soldiers were refusing to accept pay other than in coin, and morale was so low that there were two army mutinies

in 1780 and 1781.

Massachusetts tried fixing prices but that measure only served to shut down markets in commodities because traders would not sell at anything other than current prices.

### Payable in beef, corn

The commonwealth then decided to issue "Soldier's Depreciation Notes" that were tied to one of the first consumer price indexes. Four commodities were picked as the index components: beef, sheep's wool, corn, and shoe leather.

The Notes worked: over the next six years, they kept up with the prices of basic commodities before being redeemed in 1786. And, of course, the soldiers kept fighting until the British surrendered at Yorktown.

Unfortunately, the Massachusetts innovation was well ahead of its time. Inflation indexed securities would not come back to the market until 1945, when Finland was first to start issuing them.

*"Four commodities were picked as the index components: beef, sheep's wool, corn, and shoe leather."*

## THE PROS CAN'T PREDICT MARKETS, AND YOU PROBABLY CAN'T EITHER

The next time you make a prediction about the stock market or the economy, write it down. Check back a year or two later and see how it worked out: on average, you are bound to be disappointed.

Studies of the forecasting success of the best and brightest on Wall Street and among economists have found that even the pros have a dismal record in forecasting. If they can't do it, why do we think we can?

For instance, the Federal Reserve Bank of Philadelphia has for years tracked the forecasts of inflation by professional economists.

### Past is prologue

They consistently find that economists are pretty good at telling us what has recently happened, but are not good at predicting the future. Their predictions of inflation rates generally appear to be merely a function of recent inflation rates.

Other studies show that the average bond trader incorrectly forecasts the direction

of yield changes and that stock analysts cannot forecast the trend in operating earnings.

One of the psychological factors involved in bad predictions is overconfidence. Studies have shown that we are not "well-calibrated" when making estimates.

Too often, we make an estimate based on a range and the actual answer lies far outside our range.

### Test yourself

Try it yourself. Answer the following questions with a range (like 50 on the low end and 100 on the high). You should have confidence that 98% of the time the correct answer will fall within your range.

- What is the length of the Nile River?
- How many books are in the Old Testament?



Studies have shown that stock analysts' predictions are not very accurate.

- What is the diameter of the moon in miles?
- How deep is the ocean in feet?

Here are the answers: the Nile is 4,187 miles long, there are 39 books, the moon's diameter is 2,167 miles, and the deepest known part of the ocean is 36,198 feet down.

Don't feel bad if you didn't get them all right: on a longer test, most professional forecasters failed.

*"Economists are pretty good at telling us what has recently happened, but are not good at predicting the future."*

## LEAN SAVINGS, DELAY RETIREMENT, & MORE\*

Despite trying to do better, the average American may not be saving enough for retirement and emergencies, a new national survey found.

The non-profit American Savings Education Council says 53% of American households save at least 5% of their income, while just 28% save the 10% minimum that is usually recommended by experts.

Higher income families with \$75,000 or more did better at saving 5% of income than did those who earn

\$35,000 or less: the difference was 81% to 34%.

Less than half of those surveyed said they had a plan that mandated enough savings to meet goals.

### Phased retirement

Baby Boomers will have to consider working past 65 or phasing in retirement by working part time, says The Center for Retirement Research at Boston College.

Rising health care costs have put 35% of those born between 1948 and 1954 and 44% of those born between

1955 and 1964 "at risk of being unable to maintain their standard of living in retirement," the Center said.

### Capital gains break

Lower-income taxpayers whose top federal tax rates are 10% or 15% get a big break on taxation of capital gains and qualified dividends starting this year.

The capital gains tax rate will be 0% for single taxpayers with taxable income of less than \$32,550 and married taxpayers with taxable income of less than \$65,100.



\* Please consult your tax advisor for more detailed information.

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## YOU ALREADY KNOW THIS: THE RICH DO KEEP GETTING RICHER

As the gap between the super-rich and the rest of us continues to grow, the United States boasts a record number of millionaires, according to recent surveys.

One estimate by TNS, a global market research firm in New York, estimates that the population of millionaire households increased by 5% in 2006 to 9.3 million. Other estimates say there are 7.5 million to 8 million millionaires.

But that isn't the real story: it is the growth of wealth held by the nation's billionaires that staggers the imagination.

*The Wall Street Journal* recently asked the Internal Revenue Service for information on the 400 richest U.S. taxpayers. It found those taxpayers reported a total of \$85.6 billion in income for one year in 2005. The aver-



The richest Americans make hundreds of millions of dollars each year.

age annual income reported was \$214 million.

The share of U.S. income controlled by those 400 taxpayers more than doubled over 10 years, the IRS reported.

In 2005 they controlled an astonishing 1.15% of all U.S. income, compared to 0.49% a decade earlier.

*The Journal* reported that after adjusting for inflation the minimum amount of income to make the top 400 taxpayers had tripled since 1992.

The IRS figures also probably underestimated the actual income of these taxpayers. It consists of adjusted gross income, which does not include tax-exempt interest from municipal bonds and also excludes income spent on various deductions such as moving expenses, alimony, and health insurance.

Where do the rich get most of their income? Capital gains on the sale of successful investments accounted for \$50 billion of the total, for an average of \$125 million per taxpayer.

Meanwhile, the median after tax income of all taxpayers in 2005 was \$55,900.

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