

# THE ALTFEST ADVISORY LETTER

425 Park Avenue, 24th Floor New York, NY 10022 Phone 212 406 0850 Fax 212 406 0867 www.altfest.com

## Value Investing with Individual Stocks

BY Qi Lu, Ph.D.

It has been just over a year since we officially rolled out the Altfest individual stock initiative, in which we have placed a basket of some 40 large-cap stocks in many clients' portfolios. It seems appropriate at this time to review why we rolled out this program and how it has done.

We offered the stock initiative with a few objectives in mind, including lower fees and greater tax efficiency. The average expense ratio among large-cap mutual funds exceeds 1% per annum; clients avoid the fee on the stock-initiative securities, even though we actively manage them. As for taxes, we may from time to time make trades to lock in a taxable loss when we can find replacement stocks that are equally attractive.

Our most important objective, however, was to achieve favorable risk-adjusted returns. With that in mind, we have maintained a focus on three key variables: valuation, growth potential, and risk control.

As many of you know, at Altfest we are value investors. We look for securities that are undervalued and out of favor, meaning, for example, that they have low prices relative to earnings or book value. Buying stocks cheaply enough gives us a margin for error; generally, the price of such stocks has less room to fall and can rise on relatively little positive news. Historically, value investments have performed better than growth investments by a large margin, because growth investors (many of them momentum investors) have paid too high a price to start with.

In the case of the stock initiative, however, value considerations have, ironically, led us to embrace growth. Why? Occasionally, the valuation gap between value and growth stocks gets so narrow that we think the market is not pricing in much a premium for additional

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## Target Date Retirement Funds “The educated consumer is not their best customer”

BY ANDREW ALTFEST

Many of you are familiar with Syms, the discount department store whose commercials insist that “the educated consumer is our best customer.” By that tagline, the retailer conveys that once you learn you can get the same designer shirt at a lower price at Syms than at Nordstrom or Saks, you will be their customer.

Unfortunately with many products—especially financial ones—the opposite is often true. One such example that you might recently have seen advertised or offered as an investment option in your company's retirement plan is the “Target Date” or “Lifecycle” Mutual Fund. These mutual funds create an investment allocation between stocks and bonds based on an expected retirement date, which is why you will often see a date, such as “2015,” in their title. As the investment gets closer to the stated retirement date, the fund's asset allocation will change, typically lowering the amount of money invested in stocks and raising the bond allocation.

These funds have been heralded as a benign way to get investors to improve the investment allocation in their retirement accounts. Proponents of the funds argue that average investors do not create optimal investment allocations in their company retirement ac-

counts because they either feel too overwhelmed to make any decision—allowing their retirement savings to stay in low-yielding money market funds—or they make poor investment decisions like chasing hot mutual funds just in time for them to cool off. Target Date funds are billed as the one-stop-shop for a retirement account investment allocation.

While many people do make poor investment decisions, Target Date fund advocates are wrong to believe that they are not capable of making better ones. In our opinion, Target Date funds fall short for a number of reasons. First,

**Target Date fund advocates are wrong to believe that individual investors are not capable of making better investment decisions.**

investors' assets are not limited to their company retirement accounts. Proper investment allocation takes into account one's total portfolio—usually well beyond a single account. For example, you might put 100% of your retirement account in bond funds, and balance that with stocks outside of your retirement account. And if you believe in Total Portfolio Management as we do, your investment allocation also factors in other assets, such as your home, your future earnings power, expected inheritances, etc. When you further factor in your personal tolerance for the amount of risk you are willing to take, the equation becomes even more complex. Unfortunately for those fund companies pushing Target Date funds,

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## Altfest News

LEWIS J. ALTFEST, PH.D., CFP®, CFA, CPA

Lewis J. Altfest was named to *Barron's* list of the Top 100 Independent Advisors in the Nation for the third year in a row. He was also featured in the *New York Times* article "Ways to ease pressure of a cash crunch" (Oct, 2009) as well as the *Bottom Line Personal* article "The conservative investor" (Aug, 2009). Lew spoke twice to the American Association of Individual Investors (AAII) - once at the New York Chapter (Oct, 2009), and once at the organization's Annual Convention, in Orlando, Florida (Nov, 2009).



KAREN C. ALTFEST, PH.D., CFP®

Karen C. Altfest authored two articles for the AAII Journal: "Due Diligence: 10 Steps to Avoiding Ponzi Schemes and Financial Fraud," and "Surviving a Loss: Smart Steps for Coping with Widowhood" (Please call us if you would like a copy of either article). She also spoke at the AAII's Annual Convention, in Orlando, Florida (Nov, 2009). Karen was interviewed for the *Smart Money* article "Leveraging your cash" (Sept, 2009).



PAUL PALAZZO, CFP®, COA

Paul Palazzo was quoted in the *Wall Street Journal* article "A Time for Giving: Why now is a great opportunity to pass on some of your wealth," on April 13th. Paul also appeared in the *The Washington Times* on two occasions, discussing the General Motors bankruptcy.



DAWN BROWN, CFP®

Dawn Brown was quoted in the April 13th edition of the *Wall Street Journal*, in the article "The Right Steps: When it comes to blended families, estate planning can be a special kind of hell." She was also featured in the Summer issue of the *Hewitt Associates Newsletter* as well as the July issue of *Black Enterprise* and the August issue of *Money*. In May, Dawn spoke during the AARP's Financial Freedom Tour, at Columbia University.



## Value Investing with Individual Stocks

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growth potential. Now happens to be one of those times, in our opinion. Value stocks have performed so well relative to growth that growth stocks are trading at only 20% valuation premium, compared with 55% over the past 20 years. To use a retail analogy, if a Toyota continues to sell for \$20K while a Lexus drops its price for \$31K to \$24K, you might take a second look at the latter. So it is with us and growth.

The third key factor in our consideration is risk. By managing the weighting of individual sectors (manufacturing, technology, and so forth) and screening individual stocks, we hope to form a portfolio that is less volatile than the overall market over time. This means that we may not keep up with the market during a bull rally, but that we hope not to lose as much as the market during a bear raid. We do hope that we capture more of the market upside than the downside.

Before we could roll out the stock initiative to clients, we had to form a quantitative model to implement our objectives, and then conduct extensive tests on the model to satisfy ourselves that it worked. It does so not only in regard to large-cap stocks but also on mid- and small-caps. The reason we have focused on large-caps comes down, once again, to valuations. Over the past 20 years, small-caps on average have traded at a 22% valuation premium over large-caps, reflecting the additional growth potential enjoyed by smaller companies. Early this decade, however, small-caps were so far out of favor that they actually sold more cheaply than large-caps, leading us to give them significantly more weight in our portfolios. It worked out well, with small-caps out-performing large caps by so much that by last year the small-cap valuation premium was over 40%, close to the historical high. That alone was moving us back in the other direction. In addition, we felt that a recession like this one could help large, quality companies to gain market share and grow stronger. When the market conditions again change we will consider shifting the portfolio to wherever we see most attractive.

So, what about the results? Since we launched the portfolio late October 2008, the stock market (using S&P500 as a proxy) has fallen in six months and risen in seven. Within the Altfest large-cap portfolio, the return of an average account has been higher than that of the overall market by 0.57% per month in the six "down" months, and by 0.14% per month in the seven "up" months. With the help of lower volatility (which warrants a separate discussion) the monthly relative out-performance of the individual stock portfolio has compounded to approximately a 7% advantage over the S&P 500 since inception.

While the performance so far is satisfactory, we believe a few market factors have kept the portfolio from delivering better relative performance. During the market rally in place since March, our relative performance has been affected by an underweighting in financial stocks and other highly leveraged companies that were and in some cases still are on various lifelines. The market appetite for risky names, in our opinion, dampened the return on the quality names that our model favors. Healthy dividend distribution, something we consider the most reliable way to extract a return and a sign of good corporate governance, has not been highly appreciated by investors. In fact, dividend-paying stocks in S&P 500 as a whole trail the market by double digits year to date. Our portfolio has returned close to 3% in dividends and is poised to yield above 2.5% going forward. This above-average dividend yield, we believe, will deliver positive risk-adjusted performance in the long run, especially if market volatility turns higher after months of a rally.

We couldn't have chosen a less boring time to launch this new portfolio, and we have learned a great deal in the past year or so. We have made improvements on our research and execution, and we feel more confident going forward. We thank you all for entrusting us with your money, and we will work hard in hopes of delivering satisfactory performance for you.

## Target Date Retirement Funds: “The educated consumer is not their best customer”

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one size does not fit all.

Moreover, your goals for the assets in your company’s retirement account may differ from those you hold outside of that account. For example, you might have a greater percentage of your outside investment assets in bonds and money market funds because you have a more immediate use for those assets than you do for those in your retirement account. Tax considerations also factor into deciding whether an investment vehicle should be part of a retirement plan, and these considerations are largely ignored when one treats a retirement account as the entire portfolio instead of as just one part of it.

Second, your feelings about risk and tolerance for portfolio fluctuations should be reflected in your portfolio composition. In contrast, Target Date funds lump you together with other investors who are retiring around a certain date without regard to personal risk preference.

Third, the stock/bond allocations of Target Date funds vary between mutual fund companies. One company’s certain target date fund will typically have a greater allocation to domestic stocks, real-estate, or commodities than another’s. This tells you how investment assumptions vary between companies—a fact that should make you nervous. Unfortunately, asset allocation is not an exact science, and it certainly hasn’t been the business of mutual fund companies. Not only should you question the assumptions of mutual fund firms, but you must also understand that their assump-

tions may not correspond to the current market environment. For example, there will be times when you want more U.S. stocks than European stocks and bonds of companies with strong credit rather than weak. In fact, there is some recent evidence that external pressure to keep up with peer group performance has influenced asset allocation decisions in some of these funds, causing them to become more aggressive. And they are usually pretty plain-vanilla in what they invest in, foregoing many opportunities. Among other things, they likely cannot have a closed-end fund strategy or a merger arbitrage strategy or a bias toward private real-estate; or they are not able to invest in a fund primarily invested in debt issued by emerging countries in their own currency.

But what concerns me the most about Target Date funds is their underlying holdings. More often than not they invest in mutual funds within the same fund family. So while you might decide one mutual fund company in your company retirement plan is the best option for your large U.S. growth stock allocation, but another is better for your large U.S. value stock allocation, you will most often be offered a portfolio consisting of all of their company’s funds. And this is where we arrive at the true advantage of these funds for the fund companies, not you the investor. By offering these products they hope you will place all of your retirement investments in them—for now and for many years to come—even after you reach retirement and technically can move your assets

away from your employer and expand your investment options, because Target Date funds keep going—past their stated retirement dates.

Granted, for the average person having a Target Date fund in his or her retirement account could be better than the alternative, assuming the average person makes poor investment decisions. But educated investors will likely decide to put their dollars elsewhere.

### Altfest Blog Launches: *Retiring Well in NYC*

As you may know, we recently revamped our website, giving it a modern look that maintains the warmth we strive to exhibit every day in our interaction with clients. In order to bring added value to the site, this November we launched our own opinion blog, which focuses on how individuals can retire well in the New York City area.

We invite you to take a look at our blog postings, located at [www.altfest.com/blog](http://www.altfest.com/blog). Altfest professionals as well as a guest blogger will be submitting posts each week, so check back often and read about our latest opinions on the personal financial topics and investment strategies we feel will be important to you.

### Continued Thanks for Your Referrals

The Altfest team would like to thank all of you who continue to refer your friends, colleagues, and family members to us. The majority of our new clients come through referrals.

Referrals are given when clients feel they receive real value from their wealth management team and want to share that benefit with their loved ones.

We at Altfest Personal Wealth Management are committed to providing special attention to each person introduced to us, especially since they come from you, our respected clients and colleagues.

## Annual Event Provides Analysis of Market Events

BY JONATHAN BERNSTEIN, CFP®

On June 9th, 2009 Altfest Personal Wealth Management hosted its 26th Anniversary Annual Event at the Cornell Club. More than 150 client and colleagues joined us for the event. After a delightful (and filling) cocktail reception, Karen Altfest welcomed everyone and introduced the first ever recipients

of the Dr. Lewis J. Altfest Certified Financial Planner Endowed Scholarship Fund at Pace University. Awarded each year to two students pursuing careers in financial planning, the 2009 undergraduate recipient is Nina Hrushko and the Graduate recipient is Matthew Yanocone.

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## Annual Event Provides Analysis of Market Events

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Andrew Altfest continued the evening's program with a description of recent exciting changes at Altfest, including a virtual walkthrough of the new Altfest website, which you can view at [www.altfest.com](http://www.altfest.com).

Lew Altfest highlighted some of the changes made to portfolios over the last year, such as its purchases of quality, discounted bonds and equities in emerging Asia. Next, Lew introduced the featured speaker of the evening, Michael Aronstein, manager of the Marketfield mutual fund and Chief Investment Strategist of Oscar Gruss.

Marketfield is a fund that has recently been added to many Altfest client portfolios, so the evening was in fact a sneak preview of Mr. Aronstein's investment style and thinking. Mr. Aronstein gave his perspective on the major reasons for the credit crisis of 2008. He explained

that for several years before the collapse of Lehman Brothers in September of 2008, there were unusually high levels of borrowing by banks and much of the



Lewis Altfest (l) speaks with Michael Aronstein (c) and Qi Lu (r)

borrowing was not coming from quality sources like the Federal Reserve (as it had in the past), but instead from poorer quality, less stable sources. When Lehman Brothers failed, a worldwide panic set in questioning the stability

of these loans, and lenders demanded their money back. The rapid spread of information worldwide sped up this cycle, effectively sending down the prices of many financial assets all at once, as borrowers were forced to raise money. Only when governments stepped in and began providing liquidity and lending did the cycle stop. Mr. Aronstein felt that the cycle had indeed been reversed and that a recovery was in the making.

Mr. Aronstein then engaged in a lively set of questions from Lew and the audience and explained how he was able to predict the credit crisis: "It's my profession - I've been doing it for 32 years - that's all I do - I sit around and think about the global macro economy all day, pretty much every day." You can watch a video of Mr. Aronstein's remarks on [www.altfest.com](http://www.altfest.com) in the "Event Videos and Podcasts" section.

# Altfest

personal wealth management™

425 Park Avenue, 24th Floor  
New York, NY 10022

212 406 0850 Phone  
212 406 0867 Fax

[www.altfest.com](http://www.altfest.com)

Altfest Personal Wealth Management is a family owned fee-only financial planning and investment management firm celebrating its twenty-sixth year of helping our clients achieve their financial goals. The Altfest Advisory Letter is produced in-house as a client service, to share our thinking on relevant topics.

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