October 2005

Summer is over, kids are back to school, co-workers are back from vacation and we are into the last 3 months of the year. I've not even begun to think about Thanksgiving and all the religious holidays over the next three months, and by our next quarterly letter, they will all have passed! The big news here this summer is that Paul (Pranav to his family) was married to Pinal on September 10th in Tampa, Florida. Mamta and Vipul attended the ceremony in Florida. Rosie and I were able to attend a small scale "replay" of their wedding here and had a wonderful time.

Recent "conventional wisdom" (sounds like military intelligence doesn't it?) has it that the summer months are weak months for the markets. It makes some sense with so many of us taking our big vacations for the year during the summer. Yet this summer, climbing the proverbial "wall of worry," the S&P 500 returned 3.61% (dividends included) which isn't a bad quarter. Happily, our Risk Adjusted Portfolios (after fees and expenses), did as well or better than the S&P 500. The entire performance report is attached, but in summary, our returns ranged from the Capital Preservation Portfolio's 3.27%, just under the market, to the Opportunity Portfolio's 7.41%, more than twice the return of the market. *Past performance is not an indicator of future results!*

Hurricanes Katrina and Rita have wreaked havoc and destruction across the Gulf region to an extent this country has never had to cope with before. Our prayers go out to those affected. Our expectation is that the region will recover, economically stronger and more prepared for future disasters than it has ever been before, but the costs will be high, and some of the individuals affected will not recover in their lifetimes. Life, liberty and the pursuit of happiness were never free, and it is not always to an enemy, that the toll must be paid.

This quarter's article will be a discussion of risk management. It is the foundation of sound investing, not to mention sound financial and business management. Appropriate risk management will do more for your long term financial well being than any other single technique. *"The essence of investment management is the management of risks, not the management of returns." -- Benjamin Graham.*

Keep spending less than you earn!

Risk Management…

(Are you or the markets a bigger risk to your portfolio?)

When it comes to financial planning it can be very interesting to discuss investment management strategies or hot securities, even tax avoidance strategies can be engaging sometimes. It is almost never interesting nor exciting to discuss risk management. Yet, there is nothing more important to a successful financial future than sound risk management. Further, while risk management is critical to the success and returns of your investments over time, the risks that we see destroying fortunes time and again, sometimes permanently, more often originate outside of our clients' portfolios than in them. It is the risks people choose to ignore or refuse to acknowledge that wipe them out.

When it comes to investing a portfolio for the long term, its assets must be available and properly deployed to take advantage of opportunities when they present themselves. You must manage your life, family, home, assets, occupation and business so that the risks these facets of your life carry with them are either controlled or financed. If your risks are not managed properly, your investment portfolios will be diminished or destroyed by withdrawals needed to recover from, or as a direct result of losses resulting from your mismanaged risks. Virtually every story you have ever heard regarding lost fortunes or devastating investment results is evidence of some form of mismanaged risk. I hope that this article will give us a start with which to "speak the same language" when it comes to discussing risk in your lives.

Risk management then, **is the foundation of sound financial planning and investing**. It is also the most difficult subject for husbands and wives, business partners, or advisors and clients to see eye to eye on. To each of us, the risks we see are plainly evident. The very idea that someone else doesn't see the same risks, the same way is hard to understand, but people don't see the same risks, and so, the language each uses to discuss risk is defined differently. The way around miscommunication is to speak of specific risks discretely and accurately and not to simply lump them all into something called risk. "I don't like to take too much risk" is a sentence just as easily and accurately uttered by an octogenarian librarian as it is by an 18 year old rock climber. You must get to the specifics, and dispassionately maintain your thoughts and evaluations to those specifics.

The following is from the introduction to "The Complete Book of Insurance" by Ben Baldwin Jr., CLU, CFP, ChFC, MSM, MSFS (yep, my Dad!) published in 1989, 1991, and 1996 and from "The Lawyers Guide to Insurance" by the same author and published by the American Bar Association in 1999. These books were written to help individuals and their advisors understand the appropriate use of insurance as a tool to manage risk. This section is intended to illustrate that it is only a small part of the equation. That there is a range of critical tools which must be properly considered and employed first. My purpose in including this is to help you to understand how we evaluate risk in the broader perspective, which will then make sense of the particular methods by which we evaluate risk in investment portfolios. The application of this process can be profitably used by every individual every day.

Personal Risk Management

Personal risk management means dealing with uncertainty. This uncertainty exists because we constantly are exposed to the possibility of loss, injury, disadvantage or destruction. To win the battle of living in an uncertain world is to experience *no loss.* We cannot assure you that you will experience no loss if insurance is the only tool you use in dealing with risk.

Take a look at the risk management diagram that follows. It traces the personal risk management decision making process from left to right and begins with the risk identification phase of a personal risk management program.

<table>
<tr><th colspan="4">Personal Risk Management Diagram</th></tr>
<tr><th>Step 1</th><th>Step 2</th><th>Step 3</th><th>Step 4</th></tr>
<tr><td>IDENTIFY RISKS!</td><td>One of these two STRATEGIES Will be employed.</td><td>Apply the appropriate TREATMENT based upon severity & frequency</td><td>Risk Management TOOLS and techniques</td></tr>
<tr><td rowspan="5">Dispassionately and objectively identify all the risks you and your trusted advisors can imagine. Do not dismiss any simply because they may be unlikely. The frequency will help determine the treatment in Step 3.</td><td rowspan="2">CONTROL</td><td>AVOID
High Frequency, High Severity Risks</td><td>Don’t do
Don’t own
Don’t say
Don’t expose
Don’t associate
Don’t go</td></tr>
<tr><td>REDUCE
All Risks</td><td>Rules
Safety procedures
Pooling
Segregate
Diversify</td></tr>
<tr><td rowspan="3">FINANCE</td><td>TRANSFER
Low Frequency, High Severity Risks</td><td rowspan="2">Rent
Insure
Government
Credit
Hold Harmless Agreements
Laws</td></tr>
<tr><td>SHARE
Low Frequency High Severity Risks</td></tr>
<tr><td>RETAIN
High Frequency Low Severity Risks</td><td>Absorb (pay)
Deductibles
Coinsurance
Self-Insurance
Ignore</td></tr>
</table>

What we do to earn a living and what we do for fun and recreation determines many of the risks to which we are exposed daily. Family relationships and responsibilities produce additional risks. What we own and what we owe, sources of support, and spending habits all reveal additional risks. The policy inventory forms in the following chapters help identify risks and that you may have overlooked or that are not adequately provided for under existing policies. Keep in mind that if a risk in the lives of others would

jeopardize your economic security, you want to assist them in making sure their insurances are in good order.

Risk Treatment

As you identify each risk, you will have to determine how to treat it. Basically you have two choices. You can seek to "control" the uncertainty, or to "finance" it. First we will discuss "control."

Risk Control

Your mother's advice on how to handle risk (and you still hear it today no matter what your age) was "Be careful." Her method of handling risks was to reduce them by practicing caution. She encouraged safety procedures which we all observe to one degree or another.

However, the reduction and caution strategy are not sufficient for certain risks. Some risks are of such high severity and, under certain circumstances, of such high frequency that the best strategy is to avoid them entirely. For example, if your client owns a three-wheel, all-terrain vehicle that thirteen-year-olds drive recklessly at high speed over unfamiliar territory, the consequences of that action are so severe and will happen with such high frequency, that the primary recommendation to your client would be to sell the vehicle. Should he/she reject that advice, the next suggestion would be to institute mother's method of handling this exposure to risk—control it. Fix the all-terrain vehicle so it cannot go too fast; make sure the vehicle is driven only over familiar territory and make sure that proper safety equipment is used at all times the vehicle is in operation. You might also trade it in for the four-wheeled variety as another way of controlling your exposure to risk. To handle those high severity, high frequency risks, remember the "don'ts." *Don't* own, *don't* do, *don't* say, *don't* expose yourself to that particular risk. Once these control strategies have been implemented to the maximum degree possible, you will have avoided the risks that can be avoided, and reduced to the greatest extent possible, those risks that cannot be avoided.

Risk Financing

The next strategies dealing with risk are financing strategies. We need others to assist us in financing risks that happen infrequently and are so severe that they threaten our economic security.

In most cases, when we seek to finance our exposure to risk we do so with the assistance of insurance companies, we find that most companies will accept the obligation to "share" our exposure to risk rather than accepting 100% of the responsibility for the loss if it should occur. The reason for this is that if we have arranged for the financing of a risk by paying a small amount (accepting a small personal loss in the way of a premium payment), so that an insurance company or governmental agency picks up 100% of the loss if some contingency occurs, we might become less careful than we should be. The Federal Deposit Insurance for banks and savings and loans is a good example of this. As a result of the fact that depositors theoretically cannot lose, they do not think about the economic strength of the organization to which they send their deposits. They merely concern themselves with the amount of interest they earn. Managers of these organizations pay a higher rate of interest to those depositors if they routinely make high interest rate loans to less creditworthy borrowers. When bank and savings & loan managers are in a situation where they feel they cannot lose, nothing holds them back. They are not careful and losses are inevitable. We as taxpayers have had to pay for cleaning up the savings and loan mess. It has happened and it can happen again.

Sharing risks, on the other hand, seems to make everyone involved more careful. You will find insurance companies, the government and the government agencies much more willing to pick up the major economic loss of risks that you and I are exposed to if we will share with them in those losses via deductibles and co-insurances, e.g., after we pay the first $250, they will pay 80% of the loss if we will pay 20%.

There are certain risks that we just have to live with. They happen with such high frequency and/or cause losses of such low severity that they cannot be shared economically with others. You can provide financing for them through your personal budget and manage them by being as careful as possible. Many people have difficulty recognizing these risks and they try to insure them. As a result, they pay premiums for unneeded insurances that have little prospect of paying meaningful benefits. They have, in effect, taken a potential opportunity for loss and turned it into a certain loss by paying a premium to the insurance company for unneeded insurance.

This book, then, is just as much about when *not* to insure as it is about when and how to insure.

What Is Insurance?

> *"A device for the elimination of an economic risk, to all members of a large group by employing a system of equitable contributions out of which losses are paid."*

Webster's Third International Dictionary

> *A plan by which large numbers of people associate themselves and transfer risks that attach to individuals to the shoulders of all."*

General Insurance, David L. Bizkelhaupt, 1979, page 28.

These two definitions reveal two fundamental characteristics of insurance. First, it is a method of shifting risk from one individual to a group. As people join this group in ever increasing numbers in order to avoid a particular type of risk to which all are exposed, the risk for the group becomes more and more certain. To you, the loss *might* occur whereas to the total group, the loss *will* occur, at some statistical rate. The accuracy with which this rate of occurrence can be predicted determines how much each member of the group must pay in order to provide funds to cover the losses experienced by that small statistical portion of the total group. The second fundamental characteristic is that insurance is an arrangement for paying for inevitable losses and thus is a risk financing method.

From, The Complete Book of Insurance", 1989, 1991, and 1996 and from "The Lawyers Guide to

Insurance", 1999 by Ben Baldwin Jr., CLU, CFP, ChFC, MSM, MSFS

Risk management is more important in the long run than are the returns you might achieve on your investments. To some this may sound absurd, but consider this; risk management is involved in virtually every single decision you make every day. The career you choose, the relationships you choose, the recreational activities you choose, the route you choose to take to work, the vehicle you choose to drive, the type of house you choose to own, where you choose to own it, whether you choose to insure what you own, and how you choose to insure, the things you choose to eat and drink, the advisors you choose to work with, or not, how you work with them, to save and pay cash for things or to borrow and pay over time, to save for retirement or college at all. These are all risk management decisions, and as can be seen by the hurricanes Katrina and Rita, poor risk management can wipe out a lifetime of work in an instant. Few if any of the huge number of individuals who failed to maintain their Federal Flood Insurance will be able to rely on their investments or 401(k) plans to rebuild their lives, without mortgaging their entire future.

We are here to help you with your portfolios and planning. Let's stay on the same page by discussing your risks accurately and coping with them directly. We have (painfully) implemented a new database and financial planning system in our office which helps us to document your objectives and the steps needed to accomplish them. Please call us, make an appointment to review your financial plans, and the risks that may hinder your ability to achieve them.

"The essence of investment management is the management of risks, not the management of returns."

- -Benjamin Graham