

BusinessWeek

DECEMBER 25, 2006

A PUBLICATION OF MCGRAW-HILL COMPANIES

Estate and Financial Planning...Redefined

The financial planning process is an ongoing discipline not unlike a physical fitness regime or an intellectual fitness program. We generally recognize that regular exercise, proper nutrition and intellectual stimulation add to the quality of our lives. Simply put, we feel better having adopted these ongoing disciplines. Capital Formation Group (CFG) views financial planning as an evolving and continual part of a well-balanced lifestyle.

CFG rejects the notion that there is a sharp line between financial and estate planning. Think of a spectrum moving from left to right (see figure below).

We accumulate wealth in a number of ways—in some cases by creating a business, and in others by saving and investing. At some time in our lives (represented by the perpendicular red line in the middle of the spectrum), we reach that point at which we have accumulated enough to sustain our lifestyle needs over our entire lifetimes. At this point, we are considered to be initially financially independent, as money at work replaces people at work as the source of lifestyle support. Once past the financial independence point, we begin to be concerned about preserving our wealth and directing it to be passed on to others.

CFG rejects a second notion—financial planning is static, can be dispensed with by doing it once and, above all, is an unpleasant endeavor. Even with initial financial independence achieved, we grow and our horizons tend to broaden and our lifestyles

expand. We spend more, not only due to rising costs, but also because we are doing more. The “more” is likely for ourselves (e.g., travel, exploration of interests, etc.) and for others (e.g., helping children, parents, extended family, charitable causes, etc.). Thus, it becomes important to regularly recalculate the capital dedicated to sustaining this lifestyle or Financial Independence. Moreover, the overall CFG financial and estate planning process adopted by our clients is an ongoing one, without any terminus. And, there is nothing unpleasant about adopting a process that incorporates and expresses financial purpose and deeply held personal values.

Because a properly dedicated portfolio can provide Financial Independence, we spend a great deal of time designing it and monitoring its effectiveness. The makeup of the portfolio should be customized for each client and comprised of the managers capable of delivering the highest quality return on a risk-adjusted basis. There should be no conflicts of interest as each management team is chosen for its specific asset class or strategy. The effectiveness of the portfolio is projected well into the future, longer than life expectancy, and thoroughly tested to determine its probability of accomplishing stated goals.

The comparison of portfolios ‘1’ and ‘2’ shown in Figure 1 on the following page show the difference in the likelihood of each portfolio supporting the client’s lifestyle without running out of money before

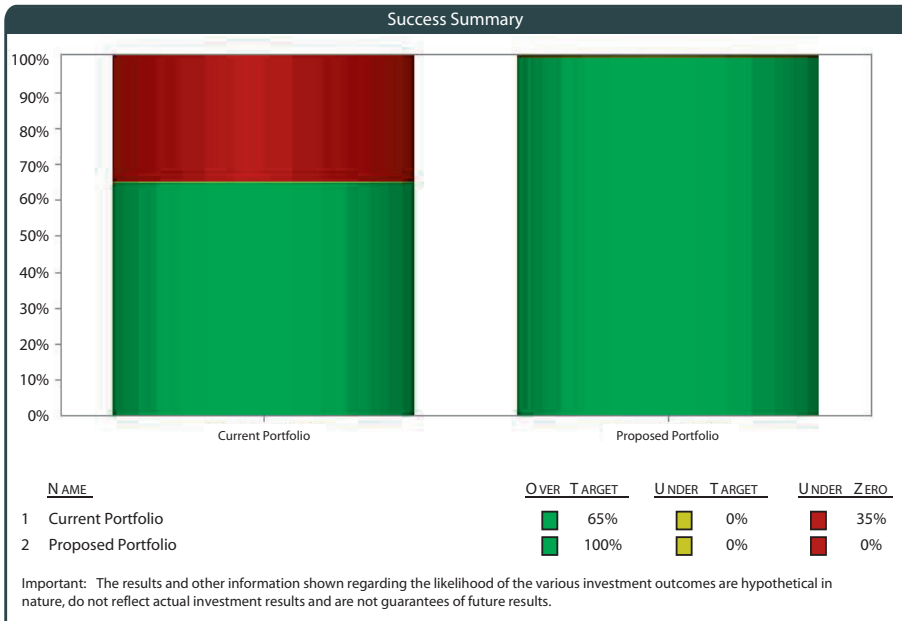
age 100. Using a large number of patterns of market behavior over the same period of time, portfolio ‘1’ is successful (i.e., does not become depleted before age 100) only 65% of the time while portfolio ‘2’ is successful 100% of the time. This analysis should be performed regularly and anytime a significant financial decision (e.g., significant purchase, gift to heirs or charity, etc.) is undertaken. It is at the core of every plan. But, the type of portfolio created can make all the difference.

Portfolio construction for us begins with attention to risk. Risk is largely determined by allocation of assets among asset classes. Let’s first define risk. One common measurement of risk is standard deviation. Standard deviation is the percentage above or below the average return of a given asset class. For example, if the average return of equities is 10% and the standard deviation is 15%, one could expect that in two thirds of all cases, the return would be within +25% (up) or -5% (down). In each extreme, the difference is 15% up or down from the average return. Finally, in 95% of cases, returns would be expected to be within two standard deviations.

Our definition of proper allocation is the art of diversifying funds among numerous asset classes. This does not mean having assets in different places (e.g., with multiple brokers). Many unhappy investors have learned this during market downturns where multiple brokerage statements showed virtually the same dismal results.



Figure 1



Capital Formation Group

Founded in 1985, Capital Formation Group, Inc. specializes in developing financial and estate plans that are unique to each client. Created as living documents, CFG plans grow and mature to match the changing needs of our clients. The decision to work with CFG for their financial planning needs gives our clients peace of mind knowing that they have accounted for their near term requirements and long term goals, reflecting their personal interests and aspirations.

Founded on Trust, we are dedicated to transparency and conflict free service. Our independent business model allows us to focus on, and fully align ourselves with, the interests of our clientele.

Our capabilities include: Comprehensive Financial and Estate Planning, Our Unique Wealth Design Plan, Low Risk Asset Allocation, and Family Office Services. Wellesley Hills, MA ~ 781.237.0123 ~ www.capitalformationgroup.com.

The main reason for using different asset classes is because under any given economic scenario, one class of assets may do well while another asset class may do poorly. This is called correlation, which refers to how investments vary in relationship to one another. An example of zero to negative correlation is the relationship of large cap stocks to Treasury bills. When large cap stocks go up, Treasury bills either have no change or move down in value (i.e., negative correlation).

Table 1 demonstrates the seemingly counterintuitive results obtained by high quality portfolio design as it pertains to risk. It shows the standard deviation for twenty asset classes. They range from 1.67% (cash) to 26.87% (international emerging markets). Were we to add the standard deviations up and simply divide by twenty, we would come up with an average standard deviation of 11.71% ($234.20/20 = 11.71$). Yet due to the weightings and especially the correlations, the portfolio, as a whole, has an expected standard deviation of 7.29%. This is probably a good deal less risk than one would expect.

Our responsibility, as advisors, is to step with our clients into the living, ongoing process of defining and achieving financial independence allowing them to enjoy the security and stability the process itself provides. We have described the core of this process through this brief article. Our experience with this process

tells us that our clients derive peace of mind knowing that their financial goals are being accomplished and their deeply held values are being expressed.

Table 1

<u>Asset Class/Strategy</u>	<u>Standard Deviation</u>
<u>Long Only Equity</u>	
Large Cap Value	14.14%
Large Cap Growth	16.44%
Mid Cap Value	15.52%
Mid Cap Growth	17.93%
Small Cap Value	17.81%
Small Cap Growth	21.48%
International EAFE	16.72%
Int'l Emerging Mkts	26.87%
REITS	17.30%
<u>Long Only Fixed Income</u>	
Short Gov/Corp	3.73%
Interm Gov/Corp	5.90%
Long Gov/Corp	5.64%
High Yield Bonds	10.54%
Municipal Bonds	6.80%
Int'l Bonds	13.38%
<u>Hedge Funds/Alternatives</u>	
Convertible Arb	6.73%
Fixed Income/Mortgage Arb	5.96%
Long/Short Market Neutral	3.24%
Hedge Fund of Funds	6.40%
Cash	1.67%
<u>Total Portfolio</u>	
Expected Standard Deviation	7.29%