Worth

# The Best Advisers, Best Advice

By Melissa Phipps September 2001, Worth magazine

**Presenting our 2001 list of America's elite financial advisers--and their strategies for building wealth in any kind of market**

An outstanding financial adviser's ideas on wealth creation and preservation defy easy categorization. Creativity, resourcefulness, and raw instinct manifest themselves in many forms. That doesn't mean great advisers are aggressive or prone to risk; they aren't. In fact, the advisers who earned a spot on our 2001 list of the best in their field typically recommend a balanced portfolio of growth, value, small-cap, and international stocks, combined with an appropriate allocation of bonds. What sets Worth's 250 Best Financial Advisers apart is their ability to think outside the Morningstar style box. The advisers on our list know how to manage risk, hedge against inflation and market volatility, generate income, and save on taxes (perhaps that's why the overwhelming majority outperformed the S&P 500 in 2000).

In short, these advisers know how to invest, which isn't the same thing as trading stocks. This is an important distinction since many well-respected Wall Street figures, including indexing legend John Bogle, Wharton professor Jeremy Siegel, and economist Peter Bernstein, are predicting single-digit equity returns for the next five to 10 years. If stocks are no longer enough, what's an investor to do? The best minds in the business presented the following ideas in response:

SHELTERING REITS Adviser Joe Montgomery of Williamsburg, Virginia, tells of visiting a REIT manager at a major fund family in 1999, when real estate was underperforming. "He was like the Maytag repairman. No one wanted to talk to this guy," Montgomery says. Investors may have ignored REITs when equities were flying high, but their average annual dividend yield and earnings of 7 percent have been a reliable safe haven. For the 12 months ended July 6, the Morgan Stanley REIT Index was up about 18 percent, compared with the S&P 500's 18 percent decline.

Will REITs continue to soar? If the economy skirts a prolonged recession, REIT total returns should remain in the low to mid-teens for at least the next two years, says Ritson Ferguson, chief investment officer of Clarion CRA Securities in Philadelphia, which manages multiple REIT portfolios. For now at least, REITs are a bargain, selling at a 5 percent discount to property values. And cash flows are healthy, since REITs are paying out about 67 percent of their earnings, near an all-time low. Such year-in, year-out performance isn't as important to advisers as the fact that REITs tend to perform out of step with the larger market. A recent study by research firm Ibbotson Associates (sponsored by the National Association of Real Estate Investment Trusts) found that, from 1993 to 2000, REITs had only a 0.25 correlation to stocks and an even lower correlation to bonds. To diversify and build yield into portfolios, advisers recommend that investors dedicate between 5 and 10 percent of their assets to REITs.

ALTERNATIVE FUTURES Creative advisers who serve accredited investors--those with a net worth of at least $1 million and annual income of $200,000 or more--are finding relatively cheap and transparent options for capturing returns that don't necessarily sink when the stock market takes a dive. At the top of many advisers' lists is the Mount Lucas Management Index fund, a managed futures play. Launched in 1999, the MLM fund provides exposure to 25 of the largest futures markets, such as gold, oil, Treasuries, and currencies, for a minimum investment of $25,000. Like all managed futures funds, it thrives on volatility and performs out of step with stocks, which do well when economic variables are stable. "They will not act like anything else," says adviser Bill Baldwin of Waltham, Massachusetts.

MLM offers two distinct advantages over its peers. First, it is a passively managed index fund that invests long and short according to a quantitative model, so instead of hefty 20 to 30 percent management and incentive fees (which characterize actively managed alternative funds), MLM's fees range from 1.85 to 3.65 percent. Secondly, whereas other managed futures funds are typically leveraged five to eight times, MLM invests a conservative $3 for each $1 in assets. MLM also offers a leverage-free version of its fund.

For the 12 months ended in June, MLM's leveraged offering returned 37 percent versus a 16 percent decline in the S&P 500. MLM's official track record may be short, but the managed futures index on which it is based has returned an annualized 15 percent a year since 1961, compared with the S&P 500's 11.5 percent. And though individual commodity markets can be volatile, investors get greater stability with the MLM Index fund than with the S&P 500, as measured by standard deviation. Adviser Baldwin recommends putting 5 to 7 percent of a portfolio into the leveraged version.

PORTFOLIO GREASE Tax-sheltered investments may be held in low esteem by investors who got burned by questionable real estate deals in the mid-1980s, but several advisers say the time is right for considering tax-advantaged direct investments in oil and natural gas leases.

Here's how they work: For a minimum of $25,000, accredited investors can purchase a 15- to 30-year "working interest" in natural gas and oil drilling wells, which earns an immediate tax deduction of as much as 99 percent of the investment (the government's largesse is designed to encourage domestic energy production). Investors also receive a yearly income stream that generally declines over the life of the investment, although a guaranteed minimum is usually negotiated for the first few years of the deal. One working interest purchased in 1996 yielded 41.91 percent in 1997, 40.62 percent in 1998, 29.11 percent in 1999, and 24.9 percent in 2000.

The risk, of course, is that investors will recoup less than they ponied up. But thanks to soaring energy use--especially demand for natural gas, the bulk of which must be produced domestically--some advisers think investors can expect to earn a respectable return on their outlay. There are no guarantees: An investment is typically spread across eight drills, but it takes only one dry well to hurt returns. "No one should try this without a substantial asset base," says Timothy Chase, an adviser in Towson, Maryland, who studied one driller for years before signing up clients. If you're bullish on energy, can take full advantage of the tax break, and can afford such an illiquid investment, consider investing no more than 5 percent of your portfolio.

CASH BOOST Most advisers aren't comfortable trying to structure clients' investments around interest rate predictions. But the Federal Reserve's six interest rate cuts this year have knocked down money market yields to a recent average of 3.4 percent, about even with the recent rate of inflation (3.6 percent in May). In real terms, therefore, money fund holders are barely breaking even. For investors who can't tolerate paltry returns on their cash, some advisers say ultra-short-term corporate bond funds, which yielded an average 5.82 percent for the year ended July 12, can be used as an alternative. Debt instruments held in ultra-short bond funds such as Strong Advantage and Schwab YieldPlus Select have an average maturity of eight months, compared with 90 days for money funds, making them more vulnerable to interest rate swings (thus the higher yield). In a rising interest rate environment, therefore, money markets are the safer bet for preserving capital.

INFLATION TIPS Until recently, investors had little protection from the natural tendency of prices to climb over time, a phenomenon that can eradicate otherwise solid yields on corporate bonds. But now inflation doesn't have to be the scourge of your entire fixed-income portfolio. Treasury Inflation Protected Securities, or TIPS, provide a useful insurance policy for fixed income. Investors can buy TIPS directly from the U.S. Treasury or invest via bond mutual funds such as PIMCO Real Return or Vanguard Inflation-Protected Securities.
TIPS provide a real rate of return currently averaging 3.5 percent, plus a variable rate based on the consumer price index, recently at 3.6 percent. Total yield, therefore, is currently above 7 percent, versus about 4.8 percent for intermediate-term Treasuries. "They are as close to a perfect investment as you can get," says Harold Evensky, an adviser in Coral Gables, Florida.

There are important tax consequences, however. TIPS holders must pay ordinary income tax on the semiannual distributions as well as on the inflation adjustments, even though they don't receive that principal until the bond is redeemed. That's why many advisers prefer to hold TIPS in a tax-deferred retirement account.

TAX HARVEST As disappointing as the stock market has been lately, a lot of investors, fearing the tax consequences of a sale, are sitting on highly appreciated, low-cost-basis stock positions. Exchange traded funds, which combine mutual fundlike exposure with stock-like ease of trading, can help smooth the task of diversifying.

To create a loss for tax purposes, investors could simply sell an underperforming asset such as a technology mutual fund. But losing the exposure creates the risk of missing out on a short-term tech rally. The IRS is no help: To write off the loss, the wash-sale rule requires a 30-day wait before an investor may buy back a "substantially identical" security. But the rule does not prevent an investor from using an ETF with similar exposure, such as the Nasdaq 100 QQQ, as a 30-day placeholder before swooping back into the fund.
ETFs can also be used to make entire portfolios more tax efficient. Adviser Jay Shein of Lighthouse Point, Florida, uses sector ETFs to build his own version of an S&P 500 index fund. He buys an ETF for each sector--one tech, one utility, one financial, and so on--and harvests losses in each. If the utility sector stumbles, for instance, Shein will sell the Utilities Select Sector SPDR, buy the iShares Dow Jones U.S. Utilities Sector Index (which offers similar exposure), and capture the write-off. Shein uses this approach as a substitute for investing in large-cap value and growth mutual funds; however, he prefers to use actively managed funds for his clients' small-cap and foreign stock allocations.

LEARNING CURVE Advisers say one of the most welcome changes in the new tax law centers on 529 Plans, which allow parents to save up to $250,000 for a child's education expenses in a tax-deferred investment account run by individual states. Beginning next year, earnings that are currently subject to federal taxes at the beneficiary's rate will become tax-free.

Today 45 states offer 529 Plans, and more big-league investment firms such as TIAA-CREF, Vanguard Group, and Fidelity Investments are running the funds. Some states now offer managed plans whose costs are as little as 0.31 percent annually. Although the plans still don't provide much choice in asset allocation, most now offer an all-equity, an all-fixed income, or a market-index allocation. Advisers say the best choice is usually the "life plan," an age-based portfolio that starts with an aggressive equity allocation that gradually shifts into fixed income as the child nears college age.

ADDED BONUS As compensation packages grow increasingly complex, financial advisers are learning to help their clients to better navigate the territory. Planner David Bugen of Chatham, New Jersey, helps many pharmaceutical executives, whose compensation tends to include healthy doses of stock options. To evaluate job offers, Bugen uses the Black-Scholes options-pricing model to compare the values of stock options and pension investments. He also helps clients evaluate employment packages against their overall financial plan. Armed with Bugen's analysis, one client obtained a higher signing bonus. Another, who was evaluating competing offers, was able to pick the one that would allow him to retire two years sooner.

Two extra years. It's the sort of dividend that doesn't show up on a financial statement, but it's the kind we've come to associate with our top advisers.

## Hawaii (Only Advisor in Hawaii)

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|---|---|
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| Avg. Client Net Worth | $1.5 million |
| Specialty | Retirement Planning<br>Tax-efficient Investing<br>Small Business Planning |

### THE TOP TWO-FIFTY: How This List Was Created

Zeroing in on the nation's best financial advisers is a rigorous process. We cull nominees from a vast pool of new recommendations and past members of our list. We then ask the candidates to complete an extensive questionnaire detailing their credentials, professional distinctions, and compensation structures. The advisers under scrutiny must also submit a financial plan and a letter of recommendation from a client or a professional peer outside their firm. We review all this from the client's perspective: We scour each submission for clarity, completeness, and attention to individual needs. We also query nominees for their best ideas and recommendations, and we expect carefully reasoned and thoughtful responses.

Next we check nominees' backgrounds. Registered investment advisers must send us their Form ADVs, which describe the firms' services and fee structures and the advisers' qualifications (this is a great resource that all advisers should be willing to share with their clients). We verify credentials and make inquiries with industry associations, local courts, and the Lexis legal database.
Eighty-four percent of the advisers on our list are fee-only planners: They earn a percentage of assets under management or negotiate fixed fees. The rest are commission-based planners who clearly outline their fee schedules to clients (something every above-board adviser should be willing to do).

We find it gratifying that a large proportion of the advisers who appear this year have also made past Worth lists. Failure to return, however, is no slight: Our top 250 is a highly elite group. We also know that many great advisers out there have yet to come to our attention. Readers in search of a financial adviser would do well to contact any member of our list as a starting point. All are able to take on new clients. But the needs of individuals and families seeking financial advice vary widely, and so do adviser specialties. We counsel patience in seeking the right match. It's well worth the effort. -M.P.