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THE H GROUP, INC.
The Independent Wealth Management Firm™

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THE KELEMEN-WAY FINANCIAL PERSPECTIVE

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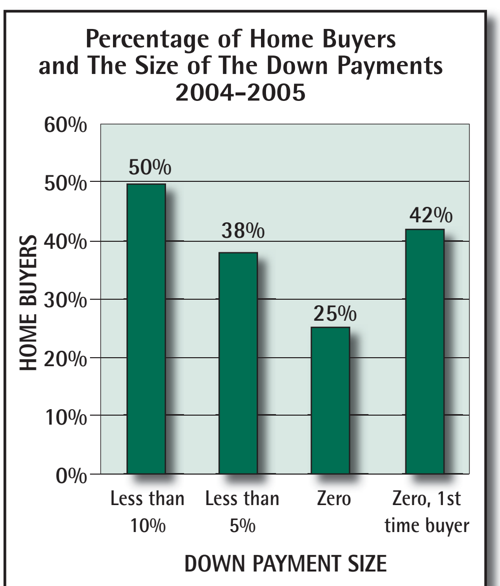
A Bubble Is A Bubble Is A Bubble...

When Ron started this practice in 1981, he had a number of clients burdened with homes, duplexes, and apartments that were "under water." If they sold them or walked away from them, the mortgage was greater than the value. They acquired these properties in the heyday real estate market of the mid 1970s and couldn't see that they were in a bubble about to pop. They thought that real estate would always go up. But it didn't, and the recession and the increase in interest rates drove the value of these properties down. They had to deplete other liquid assets to "feed" them. It wasn't pretty.

Then in the late 90's during the internet/dot.com bubble, people were constantly talking about making a quick buck in stocks. They borrowed on their homes to do so, and suffered a double whammy when the market tanked.



Source: National Association of Realtors; SMR Research

Nowadays, people are liquidating their stock portfolios or borrowing from their 401-k plans to speculate in residential real estate. And if we have learned anything from the dot.com/internet bubble it should be that when everyone is doing it, the crowd is wrong and late to the party. In fact, the smart money may be doing just the opposite. The latest *World Wealth Report* released in June by Paris-based Capgemini Group noted that the real estate allocations of wealthy individuals had declined, signaling a desire on the part of the wealthy to "harvest returns from now premium-priced holdings to other asset classes."

Bubbles can be fun while you are in one. Some bubbles survive for a relatively long time. But sooner or later, they always pop. This is true whether we are talking about children's soap bubbles, tulip bulbs in the 17th Century, the American railroad mania of the 19th Century, stock market bubbles, the dot.com bubble, and now the housing bubble.

Yes, the housing bubble. It's hard to imagine that something as sacred as our homes and recreational properties could be in a bubble. After all, the upward price of housing in most markets has lasted for years. But by many accounts, housing is in a bubble in many areas of the country. **When was the last time you were at a social gathering or professional conference and did not hear someone talking about real estate, home prices, mortgage rates, and quick profits?**

A study by The National Association of Realtors (NAR) found that 23% of all American houses bought in 2004 were for investment, not owner occupation. Another 13% were bought as second homes. Investors are prepared to buy houses they will rent out at a loss, just because they think prices will keep rising—the very definition of a financial bubble.

The June 18 issue of *The Economist* reports that the annual US rate of growth through March 2005 was 12.5%, up from 8.4% a year earlier, and up 73% since 1997. The rates are even higher in selected communities and other countries.

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The Six Habits of Good Savers

We all enter our professions with a variety of preconceived ideas about how things ought to be. Not all of them turn out to be true. In one of our earlier notions, we assumed that the more income a family made, the more they saved and the more investment assets they owned. **What we have learned instead is that good and bad saving habits transcend all income and socio-economic classes.**

Those with very comfortable six-figure incomes often live in nice houses, drive fancy cars, and take great vacations. But not all of them have enough financial assets to enable them to retire on schedule; they may have a smaller investment net worth, and are not nearly as financially comfortable as those with good saving habits who make considerably less.

Some people initially were good savers. They saved for their first bicycle, struggled through college and professional training, or the start up of their business or practice. Then something happened—they started making money, and very good money at that. Like a depressed coiled spring, a whole variety of delayed needs, wants, and peer influences sprang forward and the cash was available to accommodate them. **Money became an aphrodisiac.**

Fortunately, this doesn't happen to every one. Those that have managed to become good savers differ from those who haven't mostly because of habits. Here are some of the key ones we have observed:

1. **Good savers make saving automatic.** They find a way to save before spend. This often takes the form of automatic bank drafts going into investment accounts, college savings plans, and retirement plans. If you don't see all you earn, it can't tempt you, and sooner or later, you won't miss it.
2. **Good savers treat all money equally.** "Found" money, such as inheritances, a bonus, a good month, tax refund, etc. is treated as serious money and is often considered a <u>savings</u> windfall, rather than a spending windfall.

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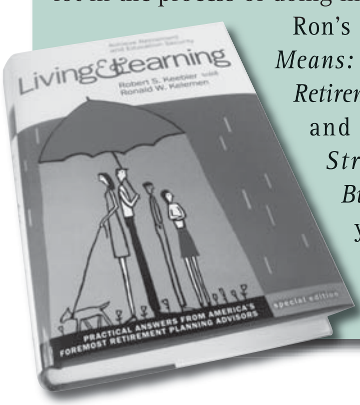
It's Finally Here!

After 18 long months, we are pleased to announce the publication of *Living and Learning: Achieve Retirement And Education Security—Practical Answers from America's Foremost Retirement Planning Advisors*. This special edition is Ron's third contributory reference book.

Edited by national IRA expert Bob Keebler, CPA, and written in question and answer format by Ron and 41 other financial advisors from across the country, this 544 page special edition reference book addresses just about every question you could have pertaining to retirement and education planning. No matter how sophisticated you are financially, you are sure to learn something new and interesting. Ron says he learned a lot in the process of doing his research.



Ron's other two books are *Ways and Means: Maximize The Value Of Your Retirement Savings*, published in 1999, and *Strictly Business: Planning Strategies for Privately Owned Businesses,* published in 2002. If you would like a copy of any of these three books, please call Lani at 503-371-3333.

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New, riskier forms of mortgage finance allow buyers to borrow more. According to the NAR, 42% of all first-time buyers and 25% of all buyers made <u>no</u> down payments on their home purchases last year! Another study by SMR Research reports that for the first half of 2005, 49.9% of homebuyers put down less than 10%, and many of them borrowed the down payment! (By contrast, you usually need a 50% down payment to leverage stocks.)

Fannie Mae and Freddie Mac—the two huge loan resellers—report that interest-only loans accounted for 35-40% of adjustable-rate loans in April. Contrast this with only 10% 18 months ago. *Business Week* magazine recently looked at specific markets for 2004. In several cities, more than 40% were interest only loans, and several more were above 30%.

These help make the payments more affordable, but they are all premised on refinancing later in a market of rising home prices. Sooner or later, homes become increasingly unaffordable to more and more buyers. It's like musical chairs—what happens when this cheerful music stops? Unlike the stock market, there is no way to quickly get out.

Fortunately real estate prices across the US are not uniform, and not all residential real estate markets are in hyperinflation mode. The Salem market isn't nearly as inflated as Portland, Bend, and other communities, but it's getting there. At some point when the prices become too high, demand will slack off and prices will flatten out or drop—especially if interest rates increase.

Real estate can provide diversification and other benefits to your investment portfolio. However, in this inflated market, **residential investment property (the kind you are not living in) should only be purchased with cash or a traditional loan with sufficient rents to cover mortgage payments and the expenses.** And make sure you have set aside adequate cash reserves for vacancies and repairs.

Your home should be the cornerstone of your financial planning—not your speculative investments. It is a hybrid item that's an asset and an expense, a beloved possession and an investment, for better or worse. But don't think that buying one on speculation or liquidating other assets and plowing the proceeds into your home is a good "investment." It may be an <u>emotional</u> investment or a <u>lifestyle improvement</u> investment, but not necessarily a financial asset for other goals. You will always need a place to live. Unless you plan to sell it later and live in a tent or a significantly cheaper home, it cannot generate a debt-free retirement income for you or put your children through college without debt. **In today's market, buy (or renovate) what you can comfortably afford without fancy loan arrangements. And remember that the increased mortgage payments may delay your retirement and other major goals.**

Are You Being Strategic and Tactical About Your Portfolio?

As we write this in mid-August, we are going through an interesting market cycle. The major market indexes are in what is called a trading range, seeming to go nowhere. For the average person using the Dow Jones average of 30 large stocks as their window on the financial markets, the market is down for the year.

But as we have written in this newsletter several times before, the indexes don't tell the whole story. Some investors are making money in this market by slightly tweaking the allocation of their portfolio's asset classes. Unlike simple diversification, asset allocation uses complex mathematical models and historical data to pair up asset classes that don't move lockstep in the same direction. In other words, to match up the "zigs" with the "zags."

Traditional asset allocation (often referred to as strategic asset allocation) is generally static and long-term in nature. Once the asset allocation mix has been decided, it stays constant, except for periodic <u>and disciplined</u> rebalancing to the original model. The rebalancing forces one to sell the well-performing asset classes near the high and buy the under-performing asset classes near their lows at regular intervals.

Many investors, however, don't even rebalance, so things can get really out of whack. This was so common in 1999 and 2000 when large cap stocks greatly out performed other asset classes. Taking those profits and putting them into bonds, which were the under performing class, could have spared a lot of pain in 2000 and 2001. Likewise, rebalancing out of well-performing government bonds in 2002 and 2003 could have helped capture some of the stock and high-yield bond market rallies that started in April of 2003.

For our actively managed fee based accounts through The H Group, Inc., we also use tactical asset allocation, which goes one step further. While holding to a long-term asset allocation mix and periodically rebalancing, we over-weight or under-weight certain asset classes up to 10%, depending upon whether they are cheaper or more expensive relative to other asset classes. The trick is in measuring cheap vs. expensive. Stocks, bonds, and real estate securities all have different measures of valuation, so in the interest of space, I'll just focus on stocks.

We like to use the Price/Earnings-to-Growth Ratio (PEG), which combines a great deal of information in a concise number. It is a ratio that tells us how another ratio—the Price/Earnings or PE—compares to the expected growth rate of a company. The earnings and the PE ratios of various types of stocks are available from a variety of sources, such as Morningstar. Using the PEG ratio, it is best to compare a security or asset class both <u>historically</u> against itself and <u>relatively</u> compared to other asset classes.

As this goes to press, the PEG ratios indicate that generally speaking, large companies are now fairly valued compared to their historical ratios. Meanwhile, mid and small cap stocks are overvalued on an historical and relative basis, especially compared to large caps. This makes sense because the big run-up in the stock market the past few years has been in the small and mid cap stocks.

We also apply style analysis, which refines things even more. Style refers to stocks with different characteristics within the same broad asset class. Generally this refers to <u>value</u> and <u>growth</u>. Stocks that trade at a discount to the asset class average are deemed to be "value" stocks, and those that trade at a premium tend to be considered "growth" stocks. Over the past several years, the value style of investments has outperformed the growth style across most asset classes. Value has become relatively expensive and growth stocks are somewhat undervalued, especially in mid and small-sized company stocks.

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THE KELEMEN-WAY ADVANTAGE

Ron Kelemen and Mary Way are independent Certified Financial Planner™ certificants and jointly serve their clients as a team with over 33 years of combined experience. Their fee-based practice focuses on wealth planning and management for professionals, business owners, and retirees. Together, they have developed <u>The Planning Vision Process</u>® and several other unique processes. They are both advisory associates of The H Group, Inc., one of the largest independent fee-based registered investment advisory firms in the Northwest with 18 professionals and over $500 million under active management. They are also registered with Financial Network Investment Corporation, (unaffiliated with the H Group, Inc.) a national broker-dealer with offices throughout the United States, Member SIPC.

About Ron Kelemen, CFP®

In practice since 1981, **Ron Kelemen, CFP®** is a contributing author of the 1999 definitive book on retirement planning: *Ways and Means: Practical Answers from America's Foremost Financial Advisors and Retirement Planning Attorneys.* His other contributory book, *Strictly Business—Planning Strategies for Privately Owned Businesses,* was published in 2002. His latest one, Living and Learning—Achieve Retirement and Education Security was just published by Quantum Press in July. He is President of the Willamette Valley Estate Planning Council, active in mentoring and in several local charities, and is frequently quoted in the national press.

About Mary Way, CFP®, CPA

Mary Way, CFP®, CPA is a professional team member on Ron's team for 11 years. She is also a non-practicing CPA with 16 years experience in banking, business, and finance. She is active in Salem Rotary, the Financial Planning Section of the Oregon Society of CPAs, The Oregon Financial Planning Association, and The Willamette Valley Estate Planning Council.

Team Update

So much for a light workload this summer! It's been really busy around here, or maybe it seems that way as we try to cover for one another's vacations.

Lani Moore hosted a weeklong family reunion at her home. Unfortunately the weather and some bad colds affected travel plans to nearby attractions. She and husband Jim have just completed a 50' long water feature in their yard.

Debbie Renggli and husband Bob celebrated their 25th wedding anniversary in Paris. It was all they had dreamed of and more. She also had a "vacation" of weeklong chores around the house in Salem. Sadly, her beloved 99-year old grandmother passed away in July.

Alex Sheppard successfully challenged and passed the first three CFP® exams and is now working on the Taxation unit. He has augmented the practice with new technical skills and is working hard to get to know as many clients as possible. He also managed to squeeze in a long weekend to New York, spend time with his family at Black Butte, and participate in weekly Ultimate Frisbee matches. He and Ron were among the 20,000 bike riders at the 10th annual Portland Bridge Pedal. (What a zoo!)

Mary Way and husband Steve took an intensive one-week sailing class on a 42-foot Hunter in The San Juan Islands in rough water. They passed the exam and are now licensed to charter a sailboat any where in the world without a professional skipper. Mary earned the nickname "Thirty Degree Heel Mary" for her nerve in maneuvering in 25-knot winds. In August she and Steve rented a motor home and explored NE Oregon for a week.

Ron and daughter Skyler explored miles of dirt roads in the Malheur Wildlife and Hart Mountain Antelope Refuges in SE Oregon. Later he backpacked in the Maroon-Snowmass Wilderness in Colorado with his brother and nephew, followed by a family reunion campout. He's logged over 1300 bicycle miles training for Cycle Oregon in September. **Ron and Kathy** have been fixing up their home for sale next summer. They plan to move into The Meridian, a five-story condominium under construction just two blocks from the office. (Only 26 more lawn mowings to go!)

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So, if you wish to be tactical about the asset allocation of your equities, you would now slightly overweight large companies with a bias toward the growth style, and underweight small and mid cap companies, especially those with a value style. (Of course, this could change by the time this article gets published and you get around to reading it!)

Like any investing system, tactical asset allocation and style analysis aren't foolproof. You could be early or late in your weighting decisions, or an asset class can continue to stay over-valued or under-valued longer than expected. And much depends upon your main or strategic asset allocation to begin with. However, in the stock and bond markets we find ourselves in these days, tactical asset allocation is a more disciplined and conservative way to stay in the market without placing high stakes timing bets on whether to get in or out of the market altogether.

THE H GROUP, INC.
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The Kelemen-Way Financial Perspective

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3. **Good savers don't budget.** Yes, you read it right. Budgets are hard to do, especially when your income varies. They are negative in nature, saying, "You can't have this or do that." And when you're told you can't have or do something, you want it more. Good savers set goals and priorities, which is psychologically positive. **In the absence of a goal, it is too easy to spend money and enjoy the instant gratification. A goal on the other hand, makes it easier to evaluate the immediate spending opportunity in view of other priorities.**
4. **Good savers know the time value of money.** They know what a dollar grows to at a certain interest rate over time. This arms them with the knowledge of what the true opportunity cost of a pending purchase or activity costs their long-term goals. In other words, *"Is X spent on Y really worth not having part of my child's college costs covered? Or is it worth delaying retirement by an extra few months?"*
5. **Good savers don't view savings as a loss, but as spending power in the future.** We frequently see this conflict with couples, where one spouse wants to spend more and the other wants to put it into the retirement plan. This ties in very closely with habits #3 and #4 above. The way to deal with this is to mutually agree upon goals and learn what is required to meet those goals. In some instances we have determined that the couple was actually <u>over</u>-saving, and so more money could be spent on lifestyle now. If you have this conflict, perhaps we can help you resolve it.
6. **Good savers invest and use credit wisely.** They put their money to work instead of hiding it under the mattress. They have a <u>purpose</u> for their money and invest accordingly. They use their credit card for convenience only and pay it off each month. Saving money isn't always easy. Having a good income really helps, but it can be even easier if you adopt these key habits. In light of today's headlines about pensions, Social Security, and the world-wide pressures for lower prices (therefore costs and wages) it is helpful to remember this: **All that will be there for you in the future is what you send ahead today.**