Investment Risk and Objectives Questionnaire

Volatility Tolerances

- MARKET TIMING DOES NOT WORK
In strong stock markets like we experienced in the 1990s it is easy to forget that there have been loss years. Since 1960 a portfolio of the 500 largest corporations would have had eight loss years. If market timing worked, we would avoid such years. Unfortunately our economy is too complex to consistently forecast the market. There are investments that provide strong long-term returns and are more resilient during bear markets, but they still drop.
- THE SOLUTION IS BUYING & HOLDING A WELL-DIVERSIFIED PORTFOLIO OF STOCKS.
Diversification reduces or eliminates long-term risk and buying & holding allows one to participate in rapid, often times unexpected market surges. Despite loss years, the S&P 500 Index had an annual return of 11% from 1960 to 1995. The stock market reflects company earnings which have continued to grow despite temporary setbacks.
- NOT EVERYONE CAN TAKE VOLATILITY.
When markets drop sharply particularly for one or two years, most investors become depressed and convinced that the "good times" will never return. The greatest risk is buying high and selling low. Others may be able to take the volatility but they need income. Equities generate little income.
- HOW CAN VOLATILITY BE REDUCED?
Equity mutual funds, particularly those with moderately priced stocks, are far less volatile than individual stocks due to diversification. Yet even the most conservative equity mutual funds can drop almost as much as the general market. The only way to reduce volatility further is through cash and short to intermediate term notes or CDs.

What are your volatility tolerances in a Post World War II worse case scenario?
The answer will aid in determining your allocation to equities vs. notes or cash. Below are two possibilities, two negative years or 10 flat years. Since 1950 both have occurred. There were only two consecutive loss years, 1973 (down 14.77%) and 1974 (down 26.39%).

<u>1. Volatility Tolerances - two bad years followed by two strong years</u>
We are assuming that like 1973 and 1974 the two following years resulted in higher returns. Losses are reduced through the use of less volatile stocks.
Among the below portfolios, indicate your 1st, 2nd, and 3rd choices.

______________ A portfolio with a rate of return of -4% in year one; -4% in year two; 10% in year three; and 10% in year four. (50% cash or notes and 50% equities)

______________ A portfolio with a rate of return of -12% in year one; -12% in year two; 30% in year three; and 15% year four. (100% equities)

______________ A portfolio with a rate of return of -7% in year one; -7% in year two; 20% in year three; and 10% in year four. (20% cash or notes and 80% equities)

<u>2. Volatility Tolerances - 10 flat stock market years followed by 10 strong years</u>.
From 1965 to 1974 the annualized return on the S&P 500 Index was 2.53% or just about flat. From 1975 to 1984 the annualized return was slightly over 14%. The below example is based on those years.
Among the below portfolios, indicate your 1st, 2nd, and 3rd choices.

______________ A portfolio with a 4.7% annual rate of return for 10 years; then 10.5% annually for the following 10 years. (50% cash or notes and 50% equities)

______________ A portfolio with a 2.5% annual rate of return for 10 years; then 14% annually for the following 10 years. (100% equities)

______________ A portfolio with a 3.4% annual rate of return for 10 years; then 12.6% annually for the following 10 years. (20% in cash or notes and 80% equities)

NOTE: There is always the possibility of long-term economic stagnation such as occurred during the Great Depression. In that case equities would be high risk. Investing in the US stock market requires a strong belief that the US will always overcome its economic difficulties within at least ten years.

 Investment Risk and Objectives Questionnaire (cont)

-FULL-BLOWN RECESSION

Possible cause:

1. Excessive stimulus, via low interest rates and government spending, creates rapid economic growth.
2. Rapid economic growth increases the demand for natural resources, particularly energy.
3. Growth primarily benefits low wage nations. Excess capacity still limits U.S. growth.
4. The result is higher natural resource inflation partially offset by wage based deflation.
5. Stocks are selling at high Prices compared to Earnings based on the assumption that inflation will remain low.
6. Stocks fall as inflation pushes interest rates higher. Bonds fall faster than stocks. We only buy bonds with set maturity dates.

What would your volatility tolerances be if we entered into a full-blown recession where stock prices dropped to where they were selling at 15 times earnings (the S&P 500 is currently selling at about 27 times trailing earnings)?

Historically the stock market sells at 15 times earnings.

Among the choices below indicate your 1st, 2nd and 3rd choices.

______ A portfolio with a negative return of 50% in year one, positive returns of 10% to 30% in year two, positive returns of 10% to 30% in year three. (100% equities with 80% in the overall US market and 20% in growth or foreign funds.)

______ A portfolio with a negative return of 39% in year one, positive returns of 9% to 25% in year two, positive returns of 9% to 25% in year three. (80% equities with 60% in the overall US market and 20% in growth or foreign funds; notes yield 4% and are taxable.)

______ A portfolio with a negative return of 23% in year one, positive returns of 9% to 18% in year two, positive returns of 9% to 18% in year three. (50% equities with 40% in the overall US market and 10% in growth or foreign funds; notes yield 4% and are taxable.)

Note: the above assumes low inflation and flat interest rates. The results would be worse with rising interest rates such as occurred in the 1970s.

Shifting to 100% cash is not recommended by any "fee only" planner since it would be difficult to time reentry. Income equities and recession resistant stocks would probably perform similar to notes if next year is a down year and under perform the year after.

Your estimate of stock market growth - are you an optimistic, pessimist, or someone in the middle?

Among the choices below indicate your 1st, 2nd and 3rd choices.

______ Do you think that the S&P 500 will fall then rise with an annualized return of 1% over the next ten years?

______ Do you think that the S&P 500 will rise at an annualized rate of 10% over the next ten years?

______ Do you think that the S&P 500 will rise at an annualized rate of 4% to 6% over the next ten years?

Signature:______________________________ Date:__________

Name: ______________________________

Signature:______________________________ Date:__________

Name: ______________________________