Financial Advisors
Independent Objective Advice


# New England Capital Times

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***Special Interest Articles:***


- A Risky Conversation (front page)
- Index Funds vs. Active (Managed) Funds (front page)
- NECFA News (page 4)


## A Risky Conversation

*By Christopher W. Beale, CFP®*

I had a conversation with a client less than a month ago about risk. I thought I knew what he was talking about, but I asked him to more fully explain what he was afraid of and what risk was keeping him up at night. I discovered the risk he was worried about was very catastrophic in nature. He felt the global financial system would collapse for any number of devastating reasons.

This got me thinking about risk; the types of risks, potential severity of various risks and how we manage risk. Wall Street Journal columnist, Jason Zweig wrote an article about two months ago describing "shallow risk" and "deep risk".*

Shallow risk is the risk I assumed my client was worried about. This risk can be defined as a temporary drop in an asset's market price. While this "dip" can be deep, quite disruptive, and unsettling, they are not unusual. In fact, what is unusual is that the stock market (as measured by the Standard & Poor's 500 index) has gone 728 calendar days (10/03/2011 through 9/30/2013) without a 10% or greater drop. This is the 5th longest stretch without a double digit pullback in the last 50 years.

I'm not terribly worried about this risk for a couple of reasons. First, I'm not worried about if it will happen, because in my opinion it will happen. I believe the market will eventually (I don't know when) pull back and drop in price by 10% and at some time it will drop by 20% or more again. The second reason not to be too worried about market corrections and even bear markets is that most of our model portfolios are prepared to deal with this risk. Clients taking distributions from their retirement accounts often have 2-4 years of distributions in fixed amounts or money markets with another 3-5 years in other fixed income vehicles. This means we may have 5-9 years of distributions without disrupting our stock or equity holdings during a prolonged down market.

*(Continued on Page 2)*

## Index Funds versus Active (Managed) Funds

*By Christopher M. Lee, CFP®*

After being in this business for over 20 years now, there are certain questions that pop up from time to time, one of them being "Which should I own, Index Funds or Managed Funds?" First, let me explain what each are.

**Index (Passive) Funds**

Index funds are mutual funds that are intended to track the returns of a market index. An index is a group of securities that represents a particular segment of the market (stock market, bond market, etc.). Among the most well-known companies that develop market indexes are Standard & Poor's and Dow Jones.

Some index funds will hold all of the securities in the same proportion as its respective index. Other index funds try to replicate the index by holding a statistical sampling of securities in an index. Index funds are considered to be passively managed because the portfolio manager of each index fund is replicating the index, rather than trading securities based on his or her view of the potential

*(Continued on Page 3)*

## A Risky Conversation

*(Continued from Page 1)*

We are more conservative with college funds as children get into high school. Clients who are in the accumulation phase of their lives should be thrilled to buy at lower prices during market declines. To be unaware of market events that have historically repeated themselves is naïve at best. Being unprepared for their occurrence is worse.

In Zweig's article he describes four "deep risks which can cause irretrievable real loss of capital." The four deep risks he listed are: devastation, confiscation, deflation and inflation.

Devastation could come from an Armageddon type war or asteroids colliding with the earth. This was the risk that was bothering my client. The odds against these occurrences are great but the consequences would be horrific. Because of the very low probability and near complete devastation, I don't spend too much time on speculating on or planning for this risk.

Confiscation typically refers to a government taking private property or assets. This seizure can be done partially or completely. Partial confiscation is typically done through a surge in taxation but could take the form similar to what the Cyprus government did to bank depositors last year. Total confiscation typically could happen during a regime change with "nationalization" of businesses and institutions.

Deflation is the persistent drop in asset values. Deflation slows economic activity because consumers won't buy an asset today, believing it will be cheaper to buy the asset in the future. Sellers or manufacturers of goods and services are forced to lower prices thereby reinforcing consumer beliefs of lower future prices. This becomes a vicious circle which is difficult to break.

Inflation, while a lower risk today, is in my opinion the greatest deep risk threat. For example, between 1940 and 1979 France, Italy and Japan, along with other countries, lost 80% of purchasing power to inflation. Even with a modest inflation rate of 3.5%, goods and services which cost $100.00 today will cost over $280.00 during a typical 30 year retirement. I think of this deep risk as financial high blood pressure. We typically don't feel any problems daily, but it is a risk we must manage for long term financial health. We do this by investing in asset classes, such as equities and natural resources that have historically kept pace with or exceeded the long term inflation rate.

Financial crises are an inherent part of our modern, developed and interconnected/interdependent financial system. We may not be able to avoid them completely. Before you jump into survivalist mode, remember (if you're as old as me) we have been warned (or maybe terrorized) by the media of devastating global famines, expanding deserts, imminent plagues, water wars, depletion of oil and other fossil fuels, mineral shortages, thinning ozone, nuclear winters, fiscal cliff, mad cow epidemics, Y2K computer bugs, government shut downs, killer bees and falling sperm counts. We have survived them all. Not only did we survive them all but we, as a species have thrived and grown. Certainly more needs to be done. We do have very real problems that need to be solved. The answer is not to duck and cover. The answer lies in human beings inherent ability to help each other solve our problems.

We must manage risk not avoid it. Risk and risk taking are part of life. As Facebook CEO, Mark Zuckerberg said "The biggest risk is not taking any risk…In a world that is changing really quickly; the only strategy that is guaranteed to fail is not taking risk."

* Wall Street Journal, July 27-28 2013

"My biggest motivation? Just to keep challenging myself. I see life almost like one long university education that I never had-every day I'm learning something new."

*-Sir Richard Branson, British business magnate; founder and chairman of Virgin Group of more than 400 companies*

"The chains of habit are too weak to be felt until they are too strong to be broken."

*- Samuel Johnson, English writer*

## Index Funds versus Active (Managed) Funds

*Continued from Page 1)*

risk/reward characteristics of various securities. Conversely, an actively-managed fund has a portfolio manager who is buying and selling securities based on an opinion about which securities will accomplish the fund's objectives.

Indexes come in many varieties. Some indexes may include nearly all of the stocks in the U.S. (such as the Wilshire 5000 Index) or other countries (such as the MSCI Brazil Index). In recent years, more obscure indexes have been created to allow investors the opportunity to take advantage of markets that are more specialized. Investors who want to invest in commodities, foreign currencies, or socially-responsible companies can now look to index funds.

Index funds have expense structures that are similar to other mutual funds. Generally, the total costs of owning an index fund are less than an actively-managed fund. However, those total costs depend largely on the fund company offering the funds and the index which the fund tracks. In other words, you can't safely say that all index funds are cheaper than all actively-managed funds. Since there is usually not a lot of portfolio turnover in the index funds, they can also be tax efficient.

**Active (Managed) Funds**

The portfolio manager of an actively-managed fund tries to beat the market by picking and choosing investments. The manager performs an in-depth analysis of many investments in an attempt to outperform the market index -- like the S&P 500.

The potential to outperform the market is one advantage that actively-managed funds have over index funds, and this notion of outperformance is attractive to investors. After all, why settle for an index fund when you know you will only receive the market return, less a nominal fee, to the fund's manager?

Another issue, which is not reflected in fund return numbers, is that the portfolio manager of an actively managed fund usually buys and sells investments more frequently than an index fund. This buying and selling of stocks by the active manager -- known as turnover -- results in taxable capital gains to the fund shareholders, *provided the fund is owned in a non-retirement account*.

There are also ongoing management expenses associated with active (managed) funds which may be higher versus the costs of its passively managed cousin. The key is finding the right actively-managed fund!

**Which type of fund should I own?**

The good news is, if you are a client of New England Capital Financial Advisors, LLC you don't have to worry. One of our firm's core beliefs is proper asset allocation. We start the asset allocation process by first deciding which asset classes to put in the portfolios and how much to weight them. Once we have that process done, we then select the underlying securities. When selecting securities for your portfolios, we have an in depth screening process that we go through. That process includes: manager tenure, manager philosophy and strategy, fund expenses, risk (beta and standard deviation), performance, performance versus its peers (including peer rank and Alpha), and tax liability to name a few. We screen both active and passive managers during our process. There are times when a passive manager approach makes sense and vice versa. We may have one or the other, or even both in a portfolio at any given time.

We appreciate the confidence that you have in us and our firm to make these decisions for you as you are attaining (or have reached) your life goals. We know that this is your hard earned money and that is something that we do not take lightly.

"Happiness is not something ready made. It comes from your own actions"

*-Dalai Lama,*
*Tibetan spiritual leader*

"There is no man living who isn't capable of doing more than he thinks he can do."

*-Henry Ford,*
*American industrialist, the founder of the Ford Motor Company*

# NECFA News!

- We are in the process of transitioning all of our mailings/reporting to our *Client Access* on our website www.newenglandcapital.com. Effective **December 31st 2013 we will no longer be mailing (via USPS) out our "quarterly summaries"**. Unless you have specifically asked us, they will now only be available through our secure website. If you are not already on our *Client Access*, please contact Michelle to get registered.

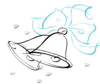
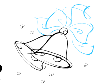
- We also found a great article on navigating the new health care law. Here's the link to the article http://www.newenglandcapital.com/files/How%20to%20Navigate%20the%20New%20Health%20Insurance%20Environment.pdf

## We are celebrating some milestones!

*Christopher Beale & Christopher Lee*

Celebrating 30 years & 20 years in the financial service business
Chris Beale started in the business on Oct 23rd 1983
Chris Lee started in the business on Jan 2nd 1993

## Congratulations to the Bride & Groom!

 *Christopher Lee & Leandra Reale* 

The two were married in a beautiful ceremony on September 28th 2013
We wish them many years of happiness together!

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