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INVESTMENT PERSPECTIVES

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Investment Perspectives

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Cynthia Sharp (J.D., LL.M. (taxation)) dedicated close to 30 years building a successful law practice serving thousands of clients. At the pinnacle of her career, she sold her interest in the practice and established The Sharper Lawyer. She is also a contributor to the American Bar Association's Publications Board of Solo, Small Firm and General Practice Division's upcoming publication The Lawyer's Guide to Buying, Selling, Merging, and Closing a Law Practice. Cynthia's social media column appears on a regular basis in the GPSolo eReport. Take a look at the website and blog of The Sharper Lawyer for up to date information and commentary on relevant topics: www.thesharperlawyer.com.

From *The Lawyer's Guide to Financial Planning*, Section Two

"I think the market can be beaten, but even a broken clock is right twice a day. Best way to describe it: It's possible but not probable."

—Robert Laura¹

Investors can choose from a smorgasbord of available investment strategies when designing a financial plan and assembling a portfolio. A detailed evaluation of the innumerable options is well beyond the scope of this chapter; however, many resources are readily available for those inclined to develop expertise in this area. A good place to start is with *The Intelligent Investor*, touted by Warren E. Buffett as "by far the best book on investing ever written."² The fourth edition can be found for free online by searching for "Benjamin Graham Intelligent Investor pdf."

Cardinal principles for those seeking financial security are (1) Risk management is paramount. It must drive portfolio design; and (2) Remain disciplined with respect to investment choices. In other words, don't abandon your position prematurely. In advising individuals to think long-term and remain patient, Warren Buffett stated: "No matter how great the talent or efforts, some things just take time. You can't produce a baby in one month by getting nine women pregnant."³ The material that follows focuses on the risk-assessment process as it relates to the three primary categories of investments (stocks, bonds, and cash) and concludes with a brief discussion of several other common investment choices. Section Four of Part One is devoted to an analysis of various factors to consider before adding real estate to the portfolio.

Risk Assessment

The risk and reward trade-off in the investment world is an undeniable truth. By and large, individuals do not have direct control over risk factors; however, they can reduce or minimize exposure by participating in the risk-assessment process, which can be broken down into the following three stages:⁴

1. Understand the risk posed by certain categories of investments.

2. Determine the kind of risk you are comfortable taking
3. Evaluate specific investments.

Stage One: Understand the Risk Posed by Certain Categories of Investments

Each major investment class (stocks, bonds, and cash equivalents) has a number of risk factors, some apparent and some subtle.

The volatility of the stock market and individual stocks exposes the investor to at least short-term risk. The reward for assuming risk is the potential for a greater investment return. Indeed, investors in the stock market have historically enjoyed greater returns than those in the other two major classes. (Naturally, individual stocks vary from a risk point of view.) According to an SEC online publication for investors,

Large company stocks as a group, for example, have lost money on average about one out of every three years. And sometimes the losses have been quite dramatic. But investors that have been willing to ride out the volatile returns of stocks over long periods of time generally have been rewarded with strong positive returns.⁵

The key is to stick to the long-term plan.

Investors with shorter time horizons will not feel comfortable subjecting a large portion of their portfolio to the vagaries of the stock market and may instead invest in the relatively safe bond market. A variety of bonds are available, including municipal bonds, corporate bonds, mortgage and asset-backed securities, as well as U.S. bonds. While the bond market is not subject to swings similar to the stock market, an investment in these instruments is not without risk. In fact, some high-yield bonds (often referred to as junk bonds) may prove to be unstable. Investinginbonds.com provides significant information on the topic.

Inflation plays a major part in any risk assessment. Risk-averse individuals may invest ultraconservatively in low-risk/low-return cash equivalents, such as money market or savings accounts, certificates of deposit, and low-yield bonds, not taking into account the resulting loss of purchase power due to inflation. On the other hand, it is highly unlikely that they will suffer the huge setbacks that might be experienced by those on the other end of the risk spectrum.

To illustrate the eroding effect of inflation, CNN Money⁶ created the following scenario: Presume the historical average annual rate of inflation of 3 percent and the following annual growth rates: stocks, 9.8 percent; bonds, 5.4 percent; and cash, 3 percent. It would take the stocks seven years to double in nominal value and ten years to double taking into account inflation. Bonds would double in 12 years and in 26 years, if inflation is factored in. Cash would finally double in 23 years; however, the real value would not double even in the lives of the investor's grandchildren.

Any investment portfolio should be designed to hedge against inflation. Classic strategies include investing in real estate, stocks, commodities, and gold. Some have opted to purchase Treasury inflation-protected securities (TIPS) from the U.S. Treasury. A comprehensive discussion of this topic is beyond the scope of this book. It should be noted that opinions vary widely with respect to the most effective strategies, as illustrated by a recent article authored by Wharton finance professor Jeremy J. Siegel.⁷ He

points out that while gold does well in an inflationary economy, it performs poorly over the long term. Over the past 200 years, the return on gold has been a mere 0.7 percentage point per year more than inflation.

A number of other factors potentially in play, such as currency, liquidity, and sociopolitical risk, are beyond the scope of this book and most likely are beyond the control of most investors.

Stage Two: Determine the Kind of Risk You Are Comfortable Taking

Risk tolerance can be measured by answering a series of questions posed in one of the numerous assessments available online. The assessment developed by CalcXML (<http://www.calcxml.com/do/inv08>) categorizes possible risk profiles as very defensive, defensive, conservative, moderate, moderately aggressive, aggressive, and very aggressive. The major factors in determining risk tolerance include age, goals and timelines for meeting them, financial responsibilities, and other financial resources.

Because an investor's level of risk tolerance most likely shifts over time, it should be formally assessed on a periodic basis. An impending retirement is one of the major catalysts in a shift to a more conservative portfolio. On the other hand, an individual receiving a large inheritance may become less risk averse and more willing to take enhanced risk with a portion of the total portfolio that he or she could live without. An investor's level of risk tolerance is uniquely subjective and depends on the circumstances at hand.

Stage Three: Evaluate Specific Investments

A number of tools are available to evaluate (and ultimately reevaluate) the strength of a particular company or bond issuer. Unless an investor is able to devote significant hours to this endeavor, it is probably wise to rely on financial professionals for this information.

Risk-Minimization Techniques

Some investors gamble with the hope of achieving an ultrahigh return. However, those seeking financial security are most likely inclined to invest with a view to minimizing risk. Two classic strategies—asset allocation and diversification—are outlined below.

Asset Allocation

An investor must consider a number of factors before deciding on the appropriate allocation of investment funds among the broad asset classes that include stocks, bonds, and cash equivalents, and their subcategories. The primary considerations are age, current financial position, amount to be saved each year, length of time the money will be invested, and risk-tolerance level. Software is widely available to assist investors with staying on track from an allocation standpoint. Of course, financial advisors can assist in this regard.

Those with longer investment horizons may opt for stocks even though the investment carries varying degrees of risk. Because the stock market generally has the strongest long-term return, the gamble may be justified since time remains to recoup unanticipated market losses. Investments that will be tapped in the near future should be more conservatively invested, which means an emphasis on bonds and cash equivalents. For example, a person planning to save enough to have a down payment on a home in two years would not want to enter into a risky investment. On the other hand, a 30-year-old putting away money for an anticipated retirement date 35 years hence will probably have a higher risk tolerance.

ASSET ALLOCATION ILLUSTRATIONS

George is 35 years old, has a net worth of \$50,000, and plans to save at the rate of \$12,000 per year. He self-classifies his risk tolerance as 5 (balanced). The suggested asset allocation is: 75 percent stock, 10 percent bonds, and 15 percent cash equivalents. At age 70, with a net worth of \$2 million, he plans to save no more and wishes to withdraw 4 percent per year. The suggested asset allocation at that point is: 44 percent stock, 40 percent bonds, and 16 percent cash equivalents.

Lynn is 60 years old, has a net worth of \$1 million and plans to save at the rate of \$40,000 per year. She self-classifies her risk tolerance as 8 (aggressive). The suggested asset allocation is: 60 percent stock, 24 percent bonds, and 16 percent cash equivalents. At age 80, with a net worth is 2.5 million, she plans to save no more and wishes to withdraw 4 percent per year. The suggested asset allocation at that point is: 35 percent stock, 48 percent bonds, and 17 percent cash equivalents.

Diversification

“It is the part of a wise man to keep himself today for tomorrow, and not venture all his eggs in one basket.”

—Sancho Panza, *Don Quixote* (Part I, Book III, Chapter 9) by Miguel de Cervantes

A diversified portfolio represents different categories of investments as well as diverse subclasses within a particular category. Investment options other than the three major categories should be evaluated. Real estate investment considerations are discussed in Part One, Section Four. Diversification may reduce risk since classes of assets normally do not simultaneously react to economic conditions in the same manner. A decline in stock values may be occurring while bond values are on the rise. The same holds true within an asset class. For example, an investor may hold both domestic and international stocks or may hold both corporate bonds and municipal bonds.

Most busy lawyers do not have time to conduct sufficient background research and the task is best left to financial professionals. Many choose to participate in pooled investments, such as mutual funds, exchange traded funds, and lifecycle funds, since the manager is responsible for all diversification and asset allocation decisions.

Other Investment Options

Dividend Reinvestment Plans

Dividend reinvestment plans, commonly referred to as DRIPs, allow existing shareholders to purchase shares (or fractional shares) of stock directly from a company by reinvesting cash dividends on the dividend payment date. Conducting an online search of dividend reinvestment plans will yield a number of instantly available resources. Dripdatabase.com lists over 1,600 companies that offer DRIPs. Although Firstshare.com lists only a handful, none of them charge commissions or fees.

A careful reading of the prospectus will ensure that the investor is familiar with the features of the plan. Companies often provide a link to the document or refer people to the entity relied on for shareholder services (such as BNY Mellon). The prospectus will reveal interesting tidbits such as whether optional cash purchases of stock are permitted by shareholders or whether a discount is extended for purchases made with reinvested dividends or cash. While anyone can invest in DRIPs, they are particularly well

suited to those who have little to invest since the minimum purchase threshold is as low as \$50. The reinvestment of the dividends becomes a “forced” savings and takes advantage of dollar cost averaging. Another advantage is that transaction fees are nonexistent or nominal, meaning that there are no commissions.⁸

Annuities

An annuity, sometimes incorporated into an investor’s retirement strategy, is an insurance product that pays out income in accordance with the terms of the contract. The main distinction between the two basic categories of annuities (deferred and immediate) is the timing of the income stream. Money invested in a deferred annuity accumulates over a period of time until the investor begins taking withdrawals, while an immediate annuity begins payout status shortly after the initial investment is made. Typically, annuities are either fixed, variable, or indexed. An in-depth description of the myriad of available options (including choices regarding payout and death benefits) is beyond the scope of this section. A financial advisor should be consulted for complete and current information, as new products are routinely introduced into the market.

The major advantage of an annuity is the ability to invest large sums of money (above and beyond the IRA/qualified plan limits), which then grows on a tax-deferred basis. However, this advantage often comes with huge and hidden costs, including steep commissions, hefty surrender charges, and rather high management fees for variable annuities. It should be noted that a taxpayer is not entitled to a deduction when investing in an annuity product. Upon distribution, the portion allocated to earnings is taxed as ordinary income while the portion allocated to principal is not subject to taxation. Details regarding the tax treatment of annuity distributions can be found in IRS Publication 939, General Rule for Pensions and Annuities.⁹ A question often asked is whether an annuity should be purchased with funds inside an IRA or other qualified plan. In most circumstances, there is no advantage to investing capital already growing tax deferred within an IRA into an annuity. Because another layer of tax deferral is unnecessary, the high fees associated with annuities are also unnecessary and the investor is usually well advised to invest funds held within an IRA into low-fee investments.

Another hot issue is whether the investment of a lump sum into an immediate annuity is useful for Medicaid-qualification purposes. The technique is viable for married couples in some states that treat the transaction as a transformation of countable assets into a noncountable income stream so long as the annuity contract satisfies certain statutory requirements. Of course, the income stream must be for the benefit of the community spouse. Other states disallow the technique, characterizing the transaction as a prohibited transfer. An attorney focusing on elder law must be consulted before trying this or any other Medicaid-planning strategy. By the way, purchase of an immediate annuity would do little to benefit a single person in a nursing home since he or she would be required to turn over the annuity income to the facility.

Many of my clients and friends who integrated annuities as part of a balanced financial plan have experienced favorable long-term growth. Others have been burned. Volumes have been written on this complex topic and investors are advised to carefully analyze options as well as claims made by the person selling the annuity.

Alternative Investments

Various opportunities exist for investors willing to speculate with their investment dollars in return for a potentially high financial return. Because this class of investments is high risk, usually involves complicated strategies, and requires specialized knowledge, this author has steered clear. However, others have done well investing in financial assets such as hedge funds, financial derivatives, and commodities or in tangible assets such as precious metals or collectibles. Many others have lost their proverbial shirts after venturing into this territory reserved for gamblers.

Investing in an Outside Business (Other Than the Practice)

Lawyers (as well as certain other professionals) may have unique access to business opportunities through their clients. For example, in the course of reviewing a deal, a lawyer may decide to become an investor in a project. Another common situation presents itself when a client does not have the wherewithal to pay cash fees and transfers a piece of the action to the attorney. Lawyers also sometimes assume a board position while continuing representation. A few words of caution are in order. First, the professional liability policy in force may exclude acts of an attorney in any of these contexts. Second, state conflict rules should be consulted. Model Rule of Professional Conduct 1.8 covers conflict issues.¹⁰ Finally, participation in outside business activities can divert a legal professional from his or her primary mission, which should be providing stellar representation to clients. However, it can be done with the right team in place.

Endnotes

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