Investment Opportunities to Review

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Many physicians and other professionals want to know more about the wide variety of investment opportunities that are available. These physicians and other professionals should know enough so that they can work intelligently with a professional investment adviser. To learn the basics about some of the various investment opportunities, these physicians should review a brief description of some of the most common investment vehicles.

It is best for physicians to leave portfolio monitoring to an investment professional and use this professional as an adviser. Physicians also should be aware of the factors that can affect the performance of an investment vehicle. (See "Managing an Investment Portfolio," *Practice Options*, June, for a description of the role of the investment adviser and a discussion about the factors that affect performance.)

Investment Opportunities
One popular investment vehicle is convertibles. Convertible bonds are hybrid securities with the characteristics of both bonds and stocks. A convertible bond has a fixed coupon and a maturity date and can be exchanged for a predetermined number of shares of common stock. A convertible preferred stock has a fixed dividend, no maturity date, and can be converted into a predetermined number of shares of common stock.

The unique risk and reward characteristics of convertibles make them excellent investment vehicles. They offer investors the limited downside risk of fixed income securities and the upside potential of common stocks.

Another popular vehicle is annuities. An annuity is a contract between an individual and an insurance company that allows the individual to accumulate tax-deferred earnings. When an individual purchases an annuity, he or she pays a fixed amount of money, which the insurer invests in an equity sub-account, or fixed income account, according to the individual's financial objectives. On a specified date, the individual may withdraw part or all of the accumulated cash value or annuitize the annuity contract. If the individual annuitizes the contract, the insurance company distributes a specific amount each month for the life of the individual or perhaps for a spouse's lifetime. The individual chooses the time and method of payment most appropriate for one's income needs and tax situation. Annuities are generally designed as long-term investment vehicles designed for retirement purposes.

Many professionals rely on life insurance as an investment strategy. Permanent life insurance, whether whole life, variable life, universal life, or variable universal life, provides an investment feature called the cash value in addition to the death benefit. As the individual pays premiums, the policy's cash value accumulates on a tax-deferred basis. The individual may borrow against the cash value at relatively low interest rates, with possible tax-advantaged treatment although such treatment may reduce the policy's death benefit.

Of course, liquid and marketable securities also are popular mostly because high levels of liquidity and marketability are desirable characteristics in investments. Professionals should avoid investing in assets that are illiquid or unmarketable.

Liquidity refers to the ability to quickly convert assets to cash. A money market deposit account has high liquidity, since the holder can usually write checks against the funds. Other liquid assets include savings accounts, checking accounts, and Treasury bills. Liquidity also refers to the ability to convert assets to cash without substantially affecting the price. A high level of liquidity indicates a good market for an investment.

Marketability refers to how quickly and easily you can access a market of potential buyers and sellers. An actively traded stock with a large number of outstanding shares is highly marketable. Shares in a small, closely held, or less well known company are less marketable because there are fewer potential buyers or sellers.

Physicians should be cautious, however; although liquidity and marketability are desirable characteristics, their presence does not indicate an asset that will necessarily provide a favorable return.

Stock Strategies

When owning stocks, it is important, of course, to understand the various strategies one can use to get the most return from the stock market. These strategies include market timing, buy and hold, growth investing, value investing, contrarian investing, and indexing.

Market timing involves making decisions about when to buy or sell securities using economic factors, such as strength of the economy and direction of interest rates, or technical indications, such as the direction of stock prices and volume of trading. Investors may implement market-timing decisions by switching from stocks to bonds to cash and then back again, as the market outlook changes. The market timer is relying on his or her ability to determine when significant high and low points are achieved in a certain investment or category as the main factor when deciding to buy or sell.

Use caution when employing this strategy, however, because it is generally considered a fool's game due to the statistical improbability that an investor can consistently time correctly when to be in or out of the market.

Buy and hold is a well proven investment strategy in which an investor purchases assets and holds them over an extended period of time. If one adheres to the buy and hold strategy, the investor is trying to ride through the ups and downs of the market to achieve potentially higher returns than one could get if buying and selling securities.

Some advantages of the buy and hold strategy include no hassle involved in timing the market, generally lower transaction costs and expenses, and long-term capital gains taxes may be favorable. Two of the disadvantages of the buy and hold strategy are that actual results may differ from those forecast, and it is psychologically difficult for some investors to have the requisite patience to make buy and hold worthwhile.

Growth investing is a strategy that involves selecting securities in growth companies, meaning those firms that have experienced significant gains and are expected to continue to do so. In other words, a growth company is a successful one, showing improvement each quarter and each year.

Growth investors believe that improvements will continue and result in rising stock prices. Growth stock is generally sold at a premium, but growth investors are willing to buy high to sell higher. The challenge of growth investing is knowing when a growth company has matured or is about to experience a permanent decline. This strategy is generally most successful during a bull market.

Value investing is picking stocks in companies that are undervalued and poised for a turnaround. In other words, value investors look for a bargain so they can buy low and sell high. The key to value investing is in knowing what a particular stock is really worth.

Some of the advantages of value investing include:

- Value stocks are less vulnerable to market downturns
- Most value stocks offer high dividend yields
- Value investing is considered a relatively conservative style of investing, so even risk-averse investors may participate comfortably

There are disadvantages to value investing as well. A value investor must know, for example, whether stocks are bargains or just poor investments. Recognizing bargains takes research into company financial data, the ability to correctly interpret such data, and detailed knowledge of the company’s business and market environment. Value investing is said to represent a contrarian style of investing because it focuses on the assets of a company more than its earnings or growth rate.

Contrarian investing involves doing the opposite of what most investors are doing at a particular time. As the name implies, contrarians buy stock that is out of favor and sell stock that is popular. Here’s their reasoning: If most people who say the market is going up are fully invested and have no additional purchasing power, then the market is at its peak. When most people predict decline, they have already sold out, so the market can only go up. Thus, contrarians buy securities that nobody else wants at the moment, betting that the current market trend is about to be reversed.

Indexing is a passive investing style that involves designing an investment portfolio to match a broad-based index, such as Standard & Poor’s 500, so as to match its performance. Index investors believe that trying to beat the index is not worth the risk. In addition to the S&P 500, the other main categories to index are the Dow Jones 30 Industrials, the Russell 2000 Index, and the NASDAQ 100.

The advantages of index investing include no need to select stocks or time the market, increased diversification, and generally lower implementation costs. The disadvantages of index investing are that getting good results requires an efficient market. In addition, indices are unmanaged and you cannot invest directly in an index.

Strategies for Bonds

Once a physician knows the strategies to use for stocks, he or she would be wise to learn the strategies for investing in bonds. These include laddering, rebalancing one's portfolio, and rebalancing versus redesigning.

Laddering. A laddered bond portfolio is one in which an investor staggers the maturity dates. Doing so diversifies the portfolio over time, reducing one's exposure to interest rate risk and increasing the likelihood that the investor will receive a higher than average interest rate. An investor can use a laddered portfolio for U.S. government, municipal, or corporate bonds.

Rebalancing. Some time after an investor has designed a portfolio and allocates assets accordingly, he or she will probably notice that the original allocations have changed. Investment gains and losses, and influxes or unexpected outlays of cash may alter the percentage holdings in each investment category. To maintain your asset class weightings, one may need to employ a rebalancing strategy.

Rebalancing versus redesigning. Rebalancing is not redesigning. Redesigning is a more drastic measure that involves dismantling one's old portfolio and starting fresh with a new portfolio that contains different investment categories. The investor may want to consider redesigning the portfolio when facing major life changes, such as retirement, or when investment goals or needs change.

Rebalancing simply involves restoring the original asset allocation by shifting funds among investment categories to regain the ratios one decided to use when designing the portfolio.

Many investment advisers recommend using shifts of 5% or more as a trigger for rebalancing. Others recommend rebalancing every year. Tax time or year-end are natural times to consider rebalancing.

Investors should be cautious, however, and consider the transaction costs or tax consequences that might result from rebalancing. Selling shares of a mutual fund, for example, might trigger redemption fees.

To rebalance a portfolio, one could sell investments, but this strategy should be considered only if it is advantageous to do so. One should sell only if the investment has performed poorly or well below expectations, or if the investment has performed well and exceeded expectations, and doing so is beneficial from a tax standpoint. In addition, the timing of a sale may depend on factors unique to a particular investment.

An investor may want to sell for a variety of other reasons, such as to generate cash flow, or to purchase a superior investment. But a wise investor will understand the importance of properly timing the sale of an investment and any capital gains tax consequences.

Advice on Taking Income

An investor may take income from a portfolio that generates dividends and interest, and there are hundreds of books about the income tax consequences of doing so. Briefly, then, is a discussion on the topic.

Consider that stock and stock mutual funds may pay dividends. Qualifying dividends are currently taxed at the tax rates that apply to long-term capital gains. Only dividends that domestic corporations and qualified foreign corporations pay to individual shareholders qualify for this tax treatment. Certain dividends, such as those that credit unions and mutual insurance companies pay are taxed as ordinary income at ordinary tax rates.

For tax years beginning on or after Jan. 1, 2003, and before Jan. 1, 2011, qualifying dividends paid to individual shareholders from domestic corporations and qualified foreign corporations are taxed at capital gain rates. For tax years beginning before Jan. 1, 2003, however, dividends were taxed at ordinary income tax rates. This rate generally resulted in significantly more tax due. Without further legislative action, dividends will again be taxed as ordinary income beginning in 2011.

Strategies for Hedging and Options

As an aggressive investor, an individual can face a great risk from changes in the market's direction, including the loss of principal. Hedging is a strategy that helps individuals to offset this risk. The objective is to protect against loss from future price changes.

Options are a widely used hedging technique. An option gives the individual the right to buy or sell a specified number of shares for a set price within a predetermined time, usually several months. Options are traded as a put, which is a contract to sell shares, or as a call, which is a contract to buy shares. Options are traded on a number of exchanges. The Chicago Board of Options Exchange is the oldest and largest.

Investors considering options should consult with a tax advisor. Supporting documentation will be supplied upon request. Be sure to read the Option Clearing Corp.'s Option Disclosure Document (ODD) carefully before investing. It can be accessed at http://www.theocc.com/publications/risks/riskchap1.jsp. A copy can also be obtained by writing to Stifel Nicolaus, One Financial Plaza, 501 North Broadway, St. Louis, MO 63102, or calling (314) 342-2000.

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