WIAD Newsletter

July 2001, Vol. 1, No. 2

Initially I intended to publish the WIAD Newsletter at the end of every quarter, however as the response to the premier issue has been sufficiently enthusiastic, I am going to try to publish issues monthly, with the idea the quarter-end issues (Mar/June/Sept/Dec) will be more comprehensive from a market and investment performance standpoint, and the between quarter-end issues will discuss investment issues from a portfolio, strategy, and estate planning standpoint.

While I am writing about the investment strategy and philosophy I am using for my portfolio, it is important to realize that different people have different risk profiles and investment goals. That being said*, the focus of this newsletter is about the general challenges facing taxable investors and the issues they should be thinking about* as it may apply to their own personal investment portfolios. The ideas in this newsletter are meant for all taxable investors regardless of portfolio size. Thanks to all who offered feedback and questions on the inaugural issue.

While I expect to continue distributing the WIAD Newsletter via email, I am keeping the WIAD Newsletter archives and links at: www.thelamgroup.com/wiad.htm

Prologue

> *"Investment management is a lot like a playing a round of golf, the player who makes the least mistakes usually wins."*

While everyone is a genius in a bull market, the simple fact is we all make mistakes, whether in our investment portfolio's, or on the golf course. Mistakes like putting inappropriate or sub-optimal assets classes in tax-deferred accounts, not having a disciplined asset allocation strategy when sectors like technology become overvalued, and/or not having an intelligent estate plan in place are common and unfortunate. Minimization of mistakes like these is a formidable goal.

From an investment portfolio standpoint, we must learn from past mistakes (our own and those of others), to think about where the next mistake can happen, and how to avoid really big mistakes.

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July Investment Results:	**July**	**YTD**
NJL Aggregate	-2.71%	-4.67%
S&P 500	-0.98%	-7.62%
Russell 3000	-1.65%	-7.66%

What I Am Thinking - Big Picture

July was a bad month across the board for the equity markets; all the Russell domestic equity indexes (small/mid/large cap as well as value/core/growth) were negative to some degree for the month of July. International and emerging equity indexes in general were down too. Second quarter earnings announcements, especially for the *TnT* (technology n' telcom) sectors were particularly disappointing. My portfolio's relative underperformance was reflective of a higher than the index exposure to the *TnT* sector as well as the short-term negative effects of the active tax-loss harvesting initiative I mentioned in the last newsletter. The majority of the proceeds of my tax loss sales are going to cash for the near-term.

As I said in the last newsletter, I expected the domestic equity markets to go sideways to negative for near to intermediate term. At this time, I have become more negative; with no good economic news on the horizon and the low probability of the Fed's interest rate cuts benefiting the economy in the 3rd quarter, I feel there are rough waters ahead. In my opinion, the institutional and retail tax-loss harvesting that will take place between October thru mid-December will be substantial, especially for the *TnT* sector, and will have a negative influence on the equity markets. I am harvesting all my tax losses/raising cash before the end of the summer and keeping some dry powder for better investment opportunities in December and January.

What I Am Researching: Lucent Bonds

"How do you lose 90%? First lose 80% then lose 50%"

One of the equity positions I sold in July (to take the tax loss) was Lucent (LU). In July, I sold all my taxable holdings at $7.50, which was down almost 90% from its high in late 1999. While we have owned Lucent for a long time (my wife worked for Bell Labs in the mid-80s), 2001 was the first year LU was at a loss versus our basis (this loss can be used to offset other gains in the portfolio or to raise the basis on other positions; more on this in the next issue). LU is one of the most widely held stocks in the nation, and at its current price it is possible many investors (both retail and institutional) are also holding LU at a loss for the first time. As a result, the amount of tax loss-related selling may accelerate as we approach year end. While it is possible that Lucent may survive in the long term, the likelihood of more bad news for Lucent and the telecom industry in general for the near-term is high.

Lucent's future as a company in uncertain and I am disappointed to have held LU stock too long. That being said, I am researching an idea that may be a more conservative way to benefit from the whole Lucent debacle. ***The idea is to buy Lucent corporate bonds****; the rationale is that eventhough Lucent is currently a poorly run, cash-strapped company, it is asset rich*. Lucent's bank lenders and bondholders are in the first position in the Company's capital structure; in a bankruptcy liquidation or corporate restructuring, they would have seniority to Lucent's common and preferred equity holders with regard to the Company's assets.

Earlier this year, Lucent's corporate bonds were downgraded to sub-investment grade status; the Company has almost $3 billion in long-term debt outstanding. These bonds are currently trading a significant discount to par as institutional investment grade bond managers had to sell LU bonds as they are no longer investment grade (rated BBB or higher). Institutional high-yield bond managers, coming off a bad year in 2000 largely due to large holdings of poor performing telecom and technology-oriented high-yield bond issues have been slow to embrace LU as new member of the high yield bond universe.

Obviously, if Lucent recovers, there is more upside in owning the common stock than the bonds. However, if Lucent goes under, the common stock holders will get nothing and the bondholders and bank lenders can reorganize and/or liquidate the Company. If the asset values (this is a BIG IF) of Lucent in liquidation are sufficient to pay the liabilities, an investment in these deeply discounted bonds may offer enough potential return to adequately compensate an investor for taking on Lucent risk. While

this may seem like a risky investment, owning Lucent bonds is certainly less risky than owning Lucent stock.

Lucent Corporate Bonds

Price Yield (as of 7/24)

Amount Issued/Maturity on 7/24/01 52 Week Range to Maturity Current

$ 750MM 7.25% of ’06 $81.5 $68 - $103 3/8 12.3% 8.9%

$ 500MM 5.50% of ’08 $71.0 $62 - $88 7/8 11.5% 7.7%

$ 300MM 6.50% of ’28 $62.0 $57 - $85 10.9% 10.5%

$1,360MM 6.45% of ’29 $62.0 $55 - $87.5 10.8% 10.4%

If Lucent flourishes, the bonds purchased at a deep discount mature at par: the bondholder receives a nice double-digit total return (interest payment & appreciation to par). Also, the bonds may get upgraded to investment grade again, bringing back the investment grade buyers.

If Lucent goes under and the bank lenders and the bondholders take control of the Company, it all comes down to is: does the company have sufficient assets that could be liquidated to pay off the Company’s liabilities? According to Lucent’s 6/30/01 financial statements, Lucent had approximately $40 billion in assets and $20 billion in liabilities. Obviously, with Lucent’s recent track record with respect to financial reporting and asset valuation, these numbers need to be looked at in greater depth. My initial impression is that in the liquidation scenario the bonds are only worth $0.65 to $0.70 on the dollar. Obviously, more analysis needs to be done, but at this point, the bonds aren’t cheap enough to buy. Yet.

This is what I am researching. Lucent has more rough times ahead and there may be better opportunities to buy the bonds in the future. In the meantime, I am crunching the numbers and as I develop a more informed opinion or a long position in these bonds I will report back in future newsletter.

Note: The Lucent bond idea is highly speculative and is contrary to the passive investor, disciplined asset allocation strategy, tax-efficient philosophy I generally endorse. It is, however, fun to think about.

What I Am Hearing

There was a lot of feedback and questions about the issues raised in the last newsletter regarding the types of investments that should be put in tax-deferred accounts.

One reader wrote, “you should always put the investments with the greatest potential for high returns in your tax-deferred account.”

In my opinion this is a poor strategy. Often the investments with the greatest potential for high returns are more risky and also have higher potential for losses. As we know from the last newsletter, tax-deferred accounts have no capacity to utilize capital losses, and investment gains are eventually taxed at income rates that are higher than the long-term capital gains rate. Ironically, the day after I sent the first newsletter, The New York Times (7/9/01) carried a front page story on exactly the same topic. Whether you read the NYT or the WIAD newsletter, what you put in your tax-deferred account requires broader, more portfolio-oriented thinking.

Here’s an analogy my golf friends may enjoy: The Rules of Golf limit a player to carrying only 14 clubs for a given round of golf. If we think of the golf bag as a portfolio of clubs a golfer needs to play a round of golf, a prudent player would carry a putter, some wedges, some irons, some woods and a driver to comprise a bag of 14 clubs. This portfolio of different clubs can be used to address varying course conditions and the different places on the course a player might find him or herself on a given round. If

we take the “put all your investments with the highest potential return in your tax deferred account” ideology to our golf bag analogy, we might end up with a golf bag with 14 drivers in it. Most golfers would agree this “all driver” portfolio of clubs would result in a high/poor golf score. A good golfer knows what club to use based not only on the distance to the hole, but also taking into consideration shot trajectory, course conditions, and individual ability/competency.

For an investment portfolio, a prudent manager should first decide on what types of asset classes he or she wants/needs to hold in aggregate (based on risk profile, return characteristics and time-horizon/holding period), then decide the percentage allocation of those assets that should be held, and only then deciding where and what type of account (taxable vs. tax-deferred) those assets should best be held in.

As we said in the last newsletter, for taxable investors, a good guideline is to keep your higher volatility/growth-oriented positions in your taxable account (pay tax at the capital gains rate and take capital losses to manage your taxes) and allocate your lower volatility, income-producing assets in your tax deferred account (defer paying *income* taxes until retirement and a lower income tax rate, and have a lower risk of unusable capital losses). In a well diversified investment portfolio, it is important to have both types of assets; the art is knowing where to put them.

For tax-deferred accounts, hitting investment home runs is not all there is to winning the game.

Tax Deferred Accounts (how much is too much?)

Another issue/question that came up as a result of tax deferred vs taxable discussion in the first newsletter was, “should you always put as much of your assets in tax-deferred accounts as you can?”

The short answer is no. The long answer is yes, to a point, then no. We will discuss this subject in greater depth in the next issue of the WIAD newsletter.

What I Am Recommending

Rich Dad, Poor Dad by Robert Kiyosaki

This book is recommended reading by the private client group at J.P. Morgan & Co. for their high net-worth clients. While I originally thought this book was going to be pop-culture drivel, I was pleasantly surprised. Once you get past the “rich/poor dad” marketing hook, there is a lot of substance in what Mr. Kiyosaki has to say. I believe his message is multi-generational, however, those of us in our late 30s to early 50s should benefit the most.

I bought the book in CD format so I could “read” it while carpooling the kids. With young children in the house it is impossible to get any serious book reading done. The CD version is abridged so the actual book may have more to offer, however, the abridged version does get Mr. Kiyosaki’s point across.

Summary

As I’ve said earlier, everyone is a genius in a bull market. While that may be true, is it during bear markets that the importance of intelligent investment decisions and a well-conceived strategy cannot be over-emphasized. It is these often difficult decisions and the disciplined implementation of these strategies that allow long-term taxable investors to benefit when the good markets return. We will discuss these decisions and strategies in future issues.

Please keep the feedback and suggestions coming.

Nelson J. Lam
The Lam Group
August 10, 2001

Next Month:

- The importance of tax loss harvesting
- Is it possible to have too much money in tax-deferred accounts?

PS: For those who weren't familiar with the term ***negative split*** from the last newsletter, a negative spilt is a track & field and competitive swimming term for when an athlete completes the second half of a race/event faster than the first half.

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