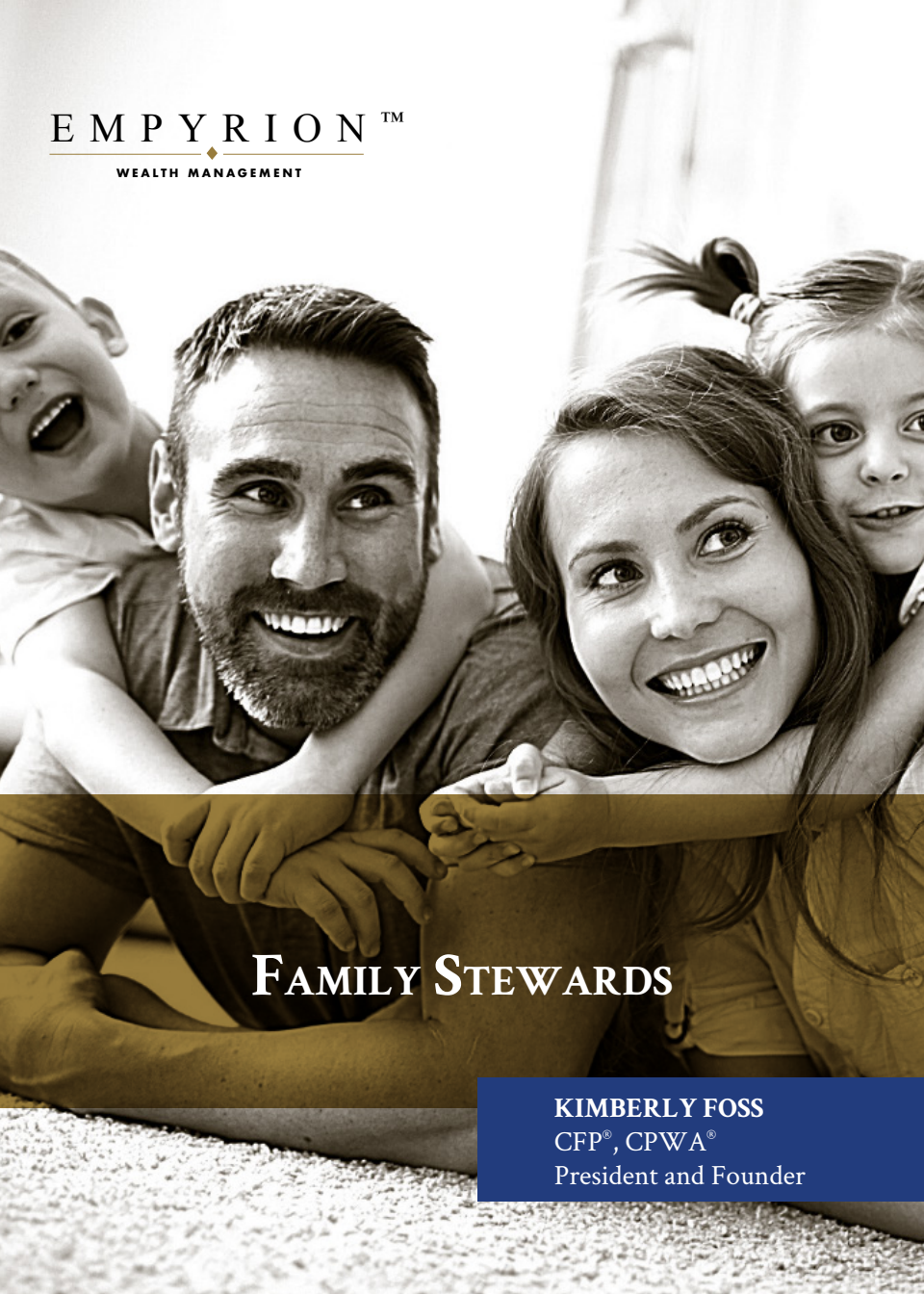
EMPYRION™

WEALTH MANAGEMENT



Family Stewards

KIMBERLY FOSS
CFP®, CPWA®
President and Founder

A Letter from Kimberly Foss

For many investors, this is both a confusing and exciting time in the investment world. Investors today are facing difficult choices in achieving their financial goals and, as well they should, are asking serious questions.

Our goal with The Informed Investor is to help you block out the noise of the marketplace in order to systematically make smart decisions about your money. Because educated investors are the most successful investors, we have created The Informed Investor to show you, step by step, a Nobel Prize–winning approach to your investments with proven success in optimizing investment portfolios over time. We have designed it specifically not only to support you in your efforts to preserve what you have, but equally importantly, to efficiently capture the market's returns for your investments.

We believe in empowering investors to make the best decisions for themselves or, if they wish, to wisely choose a financial advisor who can implement sound investing principles on their behalf. And we believe in sharing our own knowledge of investments with all investors who want to make smart decisions about their money in order to realize everything that is important to them.

At Empyrion Wealth Management, we are pleased to present The Informed Investor to our clients and prospective clients. We sincerely believe that it will provide you with a framework for an intelligent approach to investing that will help you to achieve all your financial dreams.

Sincerely,

Kimberly Foss, CFP®, CPWA®
President and Founder
Empyrion Wealth Management, Inc.

Achieving All That Is Important to You

Money means different things to different people. All of us have different dreams. You may want to achieve financial freedom so that you never have to work again—even if you plan on working the rest of your life. You may want to make a top-level college education possible for your children or grandchildren. You may want to provide the seed capital that will give your children or grandchildren a great start in life, whether with a home or a business. You may dream of a vacation home on the beach or in the mountains. Or you may have achieved tremendous success throughout your career and believe that it's important to leave a legacy that lives on. You may want to leave something behind for your favorite charity that will enable it to continue its good work. Whatever your dreams are, they are important to you, which makes them extremely worthwhile. The resource guide you are holding in your hands will better enable you to make smart decisions about your money so that you can achieve all that's important to you. Let's get started making your financial dreams a reality.

Rising Above the Noise

Most investment professionals work very hard to make their work extremely confusing. They have a vested interest in creating investor confusion, using jargon designed to intimidate you and make it difficult for you to understand.

But investing is actually not that complicated. It can be broken down into two major sets of beliefs:

- You either believe it's possible to select superior investments, or you don't.
- You either believe in the ability to time markets, or you don't.

Let's explore which investors have which belief systems and where you should be with your own beliefs.

Quadrant one is the noise quadrant. It's composed of investors who believe in both market timing and superior investment selection. They think that they (or their favorite financial guru) can consistently uncover mispriced investments that will deliver market-beating returns. In addition, they believe it's possible to identify the mispricing of entire market segments and predict when they will turn up or down. The reality is that the vast majority of methods fail to even match the market, let alone beat it, particularly after the costs of trades are factored in.

Unfortunately, most of the public is in the noise quadrant. For one thing, the media play into this thinking as they try to sell newspapers, magazines, and television shows. For the media, it's all about getting you to return to them time and time again.

Quadrant two is the conventional wisdom quadrant. It includes most of the financial services industry. Most investment professionals have the experience to know they can't predict broad market swings with any degree of accuracy. They know that making incorrect predictions usually means losing clients. However, they believe there are thousands of market analysts and portfolio managers with MBAs and high-tech information systems who can find undervalued securities and add value for their clients. Of course, it's the American dream to believe that if you're bright enough and work hard enough, you will be successful in a competitive environment.

Unfortunately, as un-American as it seems, in an efficient capital market this methodology adds no value, on average. Study after study shows that capital markets work, and that most efforts to discover undervalues securities fail to add value over the long term.

Quadrant three is the tactical asset allocation quadrant. Investors in this quadrant somehow believe that, even though individual securities are priced efficiently, they (and only they) can see broad mispricing in entire market sectors. They think they can add value by buying when a part of the market is undervalued, wait until other investors finally recognize their mistake, and selling when the market is fairly valued once again. We believe that it's inconsistent to think that individual securities are priced fairly but that the overall market, which is an aggregate of the fairly priced individual securities, is not. No prudent investors are found in this quadrant.

Quadrant four is the information quadrant. This is where most of the academic community resides, along with 40 percent of the institutional investors. Investors in this quadrant dispassionately research what works and then follow a rational course of action based on empirical evidence. Academic studies indicate that the average returns of the other three quadrants are negative, not positive. This is due to high turnover in investments, which results in additional trading costs and higher taxes. Quadrant four is where you should be and where you'll find all prudent investors.

Our goal is to help investors make smart decisions about their money so that they are firmly in place in quadrant four. To accomplish this, we help investors move from the noise quadrant to the prudent investors in the information quadrant. This is where you should be if you want to maximize the probability of achieving all your financial goals.

Five Key Concepts to Investment Success

While investing can, at times, seem overwhelming, the academic research can be broken down into what we call the Five Key Concepts to Investment Success. If you examine your own life, you'll find that it is the simpler things that consistently work. Successful investing is no different. However, it is easy for the wrong issues to draw our attention. These wrong issues can derail our journey as we attempt to achieve all that is important to us.

In this section, we'll talk about these five concepts and then explain how successful institutional investors incorporate each of these into their investment plans, no matter which direction the markets are going at the moment.

Concept One: Utilize Diversification Effectively to Reduce Risk

Most people understand the basic concepts of diversification: Don't put all your eggs in one basket. However, no matter how sophisticated you are, it's easy to get caught in a trap.

For example, many investors had a large part of their investment capital in their employers' stock during the recent downturn. Even though they understood that they were probably taking too much risk, they didn't do anything about it. They justified holding the position because of the large capital gains tax that they would have to pay if they sold, or they imagined that the stock was just about ready to take off. Often, investors are so close to a particular stock that they develop a false sense of comfort. Over the last three years many an investor has felt the pain of not being a prudent investor.

Other investors believe that they have effectively diversified because they hold a number of different stocks. They don't realize that they are in for an emotional rollercoaster ride if these investments share similar risk factors by belonging to the same industry group or asset class. "Diversification" among many high-tech companies is not diversification at all.

To help you understand the emotions of investing and why most investors systematically make the wrong decisions, let's look for a moment at what happens when you get a hot tip on a stock.

If you're like most investors, you don't buy the stock right away. You probably had the experience of losing money on an investment and did not enjoy the experience, so you're not going to race out and buy that stock based on a hot tip from a friend or business associate right away. You're going to follow it a while to see how it does. Let's assume, for this example, that it starts trending upwards.

You'll watch it a little longer to see how it does. How do you feel? You hope this might be the one investment that helps you make a lot of money. Let's say it continues its upward trend. You start feeling a new emotion as you begin to consider that this just might be the one. What is the new emotion? It's greed. You decide to buy the stock that day.

You know what happens next. Soon after you buy it, the stock starts to go down, and you feel a new combination of emotions: fear and regret. You're afraid you made a terrible mistake. You promise yourself that if the stock just goes back up to where you bought it, you will never buy like this again. You don't want to have to tell your spouse or significant other about it. You don't care about making money anymore.

Now let's say the stock continues to go down. You find yourself with a new emotion. What is it? It's panic. You sell the stock. And what happens next? New information comes out and the stock races to an all-time high.

We're all poorly wired for investing. Emotions are powerful forces that cause you to do exactly the opposite of what you should do. That is, your emotions lead you to buy high and sell low. If you do that over a long period of time, you'll cause serious damage to not just your portfolio, but more importantly, to all your financial dreams.

Concept Two: Dissimilar Price Movement Diversification Enhances Returns

If you have two investment portfolios with the same average or arithmetic return, the portfolio with less volatility will have a greater compound rate of return. For example, let's assume you are considering two mutual funds. Each of them has had an average arithmetic rate of return of eight percent over 5 years. How could you determine which fund is better? You would probably expect to have the same ending wealth value.

However, this is only true if the two funds have the same degree of volatility. If one fund is more volatile than the other, the compound returns and ending values will be different.

Two equal investments can have the same arithmetic rate of return but have very different ending values because of volatility. You want to design your portfolio so that it has as little volatility as necessary to achieve your goals.

Think about two portfolios with the same average results. As a prudent investor, you want the smoother ride of Portfolio A not only because it helps you ride out the emotional curve, but more importantly, because you will create the wealth you need to reach your financial goals.

Concept Three: Employ Asset-Class Investing

Many investors feel that they could have executed better than they did during the last few years. Unfortunately, most investors are using the wrong tools and put themselves at a significant disadvantage to institutional investors. The average investor who uses actively managed mutual funds is trying to fix a sink with a screwdriver when they really need a pipe wrench. You need the right tools.

Almost all investors would benefit by using institutional asset classes. An asset class is a group of investments whose risk factor and expected return are similar. Originally, institutional asset class funds were not available to the great majority of investors. Often the minimum investment for these mutual funds was in the millions of dollars, effectively keeping them beyond the reach of all but the wealthiest investors. This was their goal because these funds were for institutional accounts such as large pension plans.

These are four major attributes of institutional asset class funds that attract institutional investors:

1. Lower operating expenses;
2. Lower turnover, resulting in lower costs;
3. Lower turnover, resulting in lower taxes;
4. Consistently maintained market segments.

We'll look at each one in turn.

Lower Operating Expenses

All mutual funds and separately managed accounts have expenses that include management fees, administrative charges, and custody fees. These are expressed as a percentage of assets. According to Morningstar, the average annual expense ratio for all retail equity mutual funds is 1.54 percent. In comparison, the same ratio for institutional asset-class funds is typically only about one-third that of all retail equity mutual funds. All other factors being equal, lower costs lead to higher rates of return.

Lower Turnover, Resulting in Lower Cost

Most investment managers do a lot of trading, thinking that this adds value. The average retail mutual fund has a ratio of 83 percent. That means that, on average, 83 percent of the securities in the portfolio are traded over a 12-month period. This represents $83,000 of traded securities for every $100,000 invested.

Higher turnover is costly to shareholders because each time a trade is made, there are transaction costs including commissions, spreads, and market impact costs. These hidden costs may amount to more than a fund's total operating expenses if the fund trades heavily or if it invests in small company stocks for which trading costs are very high.

Institutional asset-class funds have significantly lower turnover because their institutional investors want them to deliver a specific asset class return with as low a cost as possible.

Lower Turnover, Resulting in Lower Taxes

If a mutual fund sells a security for a gain, it must make a capital gains distribution to shareholders, because mutual funds are required to distribute 98 percent of taxable income each year, including realized gains, to stay tax-exempt at the corporate level. They distribute all their income annually, because no mutual fund manager wants to have his or her performance reduced by paying corporate income taxes.

In one study, Stanford University economists John B. Shoven and Joel M. Dickson found that taxable distributions have a negative effect on the rate of returns of many well-known equity mutual funds. They found that a high–tax bracket investor who reinvested the after-tax distribution ended up with an accumulated wealth per dollar invested of only 45 percent of the fund's published performance. An investor in the middle tax brackets realized just 55 percent of the published performance.

Because institutional asset-class funds have lower turnover, they generate significantly lower taxes.

Consistently Maintained Market Segments

Most investment advisors agree that the greatest determining factor of performance is asset allocation: how your money is divided among different asset categories. However, you can only accomplish effective asset allocation if the investments in your portfolio maintain consistent asset allocation. That means your funds need to stay within their target asset classes.

Unfortunately, most retail funds effectively force you to relinquish your control of your asset allocation. On the other hand, because of their investment mandates, institutional asset-class funds must stay fully invested in the specific asset class they represent.

Fortunately, these institutional asset-class funds are now available to investors through fee-based financial advisors. You can gain the same advantages that previously only large institutional investors received.

Concept 4: Global Diversification Reduces Risk

We've all read about the concept of the "global village"—that we're getting closer and closer together. Technology is creating a new paradigm in which businesses around the world are tied together, just as markets are now tied together. But why should you include international investments as an asset class in your portfolio?

The answer is that American equity markets and international markets do not move together. Individual stocks of companies around the world with similar risk have the same expected rate of return. However, they don't get there in the same manner or at the same time. There are tremendous dissimilar price movements between international and US asset classes.

Concept 5: Design Portfolios That Are Efficient

How do you decide which investments to use and in what combinations? Since 1972, major institutions have been using a money management concept known as modern portfolio theory. It was developed at the University of Chicago by Harry Markowitz and Merton Miller and later expanded by Stanford professor William Sharpe. Markowitz, Miller, and Sharpe subsequently won the Nobel Prize for Economics for their contribution to investment methodology.

The process of developing a strategic portfolio using modern portfolio theory is mathematical in nature and can appear daunting. It's important to remember that math is nothing more than an expression of logic, so as you examine the process, you can readily see the commo- sense approach that it takes—counterintuitive to conventional and over-commercialized investment thinking.

Markowitz has stated that, for every level of risk, there is some optimum combination of attributes that will give you the highest rate of return. Combinations of investments exhibiting the optimal risk/reward tradeoff form the "efficient frontier" line. The efficient frontier is determined by calculating the expected rate of return, standard deviation, and correlation coefficient for each institutional asset-class fund. Using this information, we can then identify the portfolio with the highest expected return for each incremental level of risk.

By plotting each investment combination or portfolio representing a given level of risk and expected return, we are able to describe mathematically a series of points or "efficient portfolios." The line between these points forms efficient frontier. Portfolios such as the S&P 500, which is often used as a proxy for the stock market, fall below the line when several asset classes are compared. Investors can have the same rates of return with an asset-class portfolio with much less risk, or they can achieve higher rates of return for the same level of risk.

Rational and prudent investors will restrict their choice of portfolios to those that appear on the efficient frontier and to the specific portfolios that represent their own risk tolerance level. You want to ensure that, for whatever risk level you choose, you have the highest possible return on the efficient frontier so that you can maximize the probability of achieving your financial goals.

Your Next Steps

Given today's market volatility, one of the most important things you can do as an investor is to ensure that your investment plan is current. Your plan should examine where you are now and where you need to go to realize your financial goals. You should also identify the gaps you need to fill.

It's important to recognize that it's very difficult to be good at all things. Because most of us are not emotionally wired to effectively develop and maintain our investment plan, it may be advantageous to work with a qualified financial advisor. One major survey of affluent investors found out that 90.2 percent of them want to work with financial advisors. The key is to find an advisor who will implement the five key concepts we've discussed here.

If you do choose to work with a financial advisor to update and Implement your investment plan, you should be aware that not all advisors will approach your investments the same way. There are two types of advisors: those who are transactional and those who are consultative.

The difference? Transactional advisors are primarily focused on recommending a variety of investment products to their clients. Consultative advisors, on the other hand, are primarily concerned with talking with their clients in order to develop an approach that will help them meet the client's investment needs.

Because consultative advisors are committed to uncovering your true financial needs and goals and crafting a long-range investment plan that will meet those needs and goals over time, we recommend that you choose the consultative approach.

And what should you expect from a consultative advisor? The most successful consultative advisors use a systematic process, usually spread over a series of meetings, to design an investment plan that maximizes the probability of achieving your financial goals. These meetings typically involve the following:

- A discovery meeting. The advisor will determine your current financial situation, where you want to go, and the obstacles you face in achieving what is important to you.

- An investment plan meeting. The advisor, using the information gathered at your first meeting, will present to you a complete diagnostic of where you are now and specific recommendations for how you can bridge the identified gaps in order to achieve your goals.

- A mutual commitment meeting. At this meeting, assuming that the advisor can truly add value, both you and the advisor will decide to work together. You will now officially become a client.

- Follow-up meetings. These meetings are typically held quarterly (but could be more or less often, depending on your specific needs) when the advisor reports to you the progress you're making towards achieving your goals.

You should always expect outstanding service from any financial advisor you choose. Your phone calls should be returned on the same day, you should receive quick and complete responses to all your questions, you should be able to meet with your advisor as often as you wish, and your advisor should always take your unique needs and preferences into account. In short, you should expect to be treated like what you are—a very important client.

If you are currently working with a financial advisor and you are unsure if he or she is using a consultative approach or the proven methodologies we've discussed here, you should have another advisor complete a diagnostic of your situation so that you can have a second opinion.

This is an exciting and challenging time to be an investor. There are many more things going on around the world that will make the next few years extremely rewarding, as long as you design your investment plan to be successful.

You owe it to your family and yourself to make sure that your investment plan is designed to not only deal with the changes you've experienced during the last few years of market volatility, but more importantly, to also take advantage of the opportunities to maximize the probability that you will achieve all your financial goals.

We wish you nothing but success in achieving all that's important to you.

About the Author

I was born and raised in Auburn, California, a town founded in 1849 during the gold rush. One of Auburn's original settlers was my great-great-grandfather, Daniel Austin Rice, the first Wells Fargo agent in the greater Sacramento Valley. A career in finance always seemed to be written in the stars for me.

But it was a dream that was hard to come by. I grew up the youngest of six children from humble means. We didn't have much, but one of the things my parents gave me in abundance was the ability to dream.

In order to achieve my dreams, I learned how to believe in myself. That belief landed me a job at Merrill Lynch post-college, where I was the youngest female account executive at the time. It drove me to leave the commission-driven environment of a stock brokerage firm to establish Empyrion Wealth Management. And it led me to write my book, "Wealthy by Design: A 5-Step Plan for Financial Security," which made it to #7 on The New York Times Bestsellers List.

It all comes down to the power of choice — and my life's work is to give that power to my clients, which include affluent family stewards, women in transition, and thriving retirees. As a fiduciary, I strongly believe in putting people over profit and service above self. My sole priority is to provide my clients with the independent advice, tools, and analysis they need to make the best financial decisions for themselves and their families. Backed by a research-driven, disciplined, and diversified investment philosophy, I'm committed to guiding my clients to new levels of financial abundance and security, so they can soar farther in life than they ever dreamed possible.

In addition to my work as a financial advisor, I'm also proud to be one of the industry's leading personal financial experts and thought leaders. I frequently share my expertise on the markets, financial planning, and investing with some of the nation's most reputable media outlets, including The Today Show, Good Morning America, CNBC, Forbes, The Wall Street Journal, Fox News, Fox Business, MSN Money, Investor's Business Daily, and U.S. News & World Report.

About Empyrion Wealth Management

Empyrion Wealth Management was founded on the principle that an effective investment portfolio should directly reflect the investor's primary economic objectives. We strive to maximize the probability of achieving all that's important to our clients. We are a fee-based company, specializing in long-term investment strategy and dynamic portfolio design.

Empyrion Wealth Management provides financial and investment counseling to a limited number of high-net-worth individuals, closely held corporations, trusts, and pensions. We only take new clients when we have determined that we can add substantial value to those clients' financial situations. Our services include thorough historical performance analysis, complete portfolio and investment policy development, diversified asset allocation, and comprehensive performance measurement and monitoring. In every aspect of our work, we make an uncompromising commitment to provide world-class client service and to meet every client's highly individualized wealth management needs.

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By Kimberly Foss, CFP®, CPWA®