Do as I do, not as I say

By David Mayes

NO, I have not gotten so fed up with the financial world that I have started writing about parenting. However, there is a very good investment strategy out there which needs to be looked at in detail if you really want to use it properly. It is called "follow the smart money", and while it initially may seem very contradictory to my usual approach of going against the crowd, you will hopefully see by the end of the article that it is just another way of doing exactly that. Part of the strategy involves paying attention to what management of a given company are doing, but today I am focusing on following what the investment banks are doing in their own accounts (as much as is possible).

You may not know about the history of Wall Street, but there has been a repeating cycle which has gone on for quite some time and was well documented long before I ever arrived on the planet. There is a big conflict of interest between a bank and its customers if it is simultaneously issuing advice on a given stock issue while trading it within its own account for a profit. It's kind of like paying the guy across the poker table a fee to help you play when he has a stake in the very same pot. In practice this is how it worked – banks issued sell recommendations on companies they wanted to increase their position in without driving up the price on themselves. Once the position was established, the research department would issue a buy recommendation to offload the shares onto their clients and drive up the price. Inventories depleted now and the stock price high, they could create a panic, issue a sell recommendation, and replenish their inventories from the public who was now willing to supply those same shares at fire sale prices.

This practice eventually caused enough outrage to become outlawed, and now the investment banks are by law required to maintain a firewall between their research and trading desks, meaning it is forbidden by law for them to have any communication whatsoever. If you actually believe that this is what happens in reality, and of course I have absolutely zero proof that it doesn't, then you are far less jaded than I am. What the law has done, in effect, has given the banks an alibi to continue on with the same practices. They can now buy in their own accounts while simultaneously recommending clients to do the opposite since those two functions are prevented by law from communicating. Of course two independent business units can come to opposite conclusions. Yeah, right.

This actually creates a very good opportunity for you to invest like they do, going against the crowd, who likely is following their research. Of course there may be instances where their trades are on the same side as their advice, so I am not advocating buying on every sell signal and vice versa. What you can do, is look at the SEC filings to see what they are actually doing with their own holdings. It might shock you to see that some banks have increased their gold or mining stock exposure by over 100% since their research departments have come out with sell recommendations.

This strategy is not fool proof by any means. The markets are highly competitive and the banks are in fact competing against each other, and very often get it wrong themselves. Thus I do believe the playing field is more level now than it ever has been, but humans are very clever in finding ways around rules. I would do your own homework first, and simply look at what the smart money is doing to confirm your own idea. Or you could look at the filings to see what they are doing first and then try to do your own research and discover the logic behind their actions. In any event, I think you are much better served by studying what Wall Street is actually doing than by what it is advising you to do.

Wall Street Photo: Urban

David Mayes MBA lives in Phuket and provides wealth management services to expatriates around the globe, focusing on UK pension transfers. Faramond UK is regulated by the FCA and provides advice on taxation and pensions. He can be reached at david.m@faramond.com or 085-335-8573.

Don't let your retirement get derailed

IF YOU have diligently saved and invested throughout your whole working life to build a good sized nest egg to help see you through retirement, you might be wondering what are the chances something could go wrong. Unfortunately, the chances are pretty good.

Ameriprise Financial recently surveyed 1,000 employed and retired Americans between the ages of 50 and 70 and found that 9 out of 10 respondents had experienced at least one retirement "derailer". The average respondent experienced four, costing them a total of US$117,000 in lost retirement savings. And while respondents mentioned a number of derailers, there are some particluar retirement derailers that I feel are more dangerous than others, especially for someone already retired.

Boomerang children or grandchildren

The financial crisis, lackluster job market and rising cost of living has sent many children or grandchildren home. While at the same time, the high cost of education, especially in the US, means that many young people are weighed down by student loan debt. However, you need to remember that while your children or grandchildren are young enough to still have time on their side to help make it through any financial difficulty, you don't – meaning you should probably never co-sign a mortgage or a student loan for another family member. Moreover and if a child or grandchild truly needs to return home, think carefully about how their return might impact your finances (e.g. higher utility bills) and suggest an arrangement that would be a win-win for everyone (e.g. they help with utility bills and chores around the house to make your life easier).

Pension income falls

If you think your pension is completely safe, think again – the private sector is increasingly dumping defined pension plans, while even the public sector is struggling to fund the pensions of public sector workers. For these reasons, you need to plan on having income from more than one source in case the unthinkable happens with your pension.

Asset value declines and low interest rates

Asset value declines can come in the form of your portfolio dropping in a market correction or crash or the value of your home falling. To make matters worse, periods where asset values decline often coincide or are followed by periods of low interest rates, as governments attempt to restart their economies by holding down rates – meaning your retirement income takes a hit. Fortunately, proper diversification can help lessen the impact from this double whammy and keep you on track.

Miscalculated withdrawal rates

If you are already retired, perhaps you have been advised that a 4% withdrawal rate is safe (while the 3% to 3.5% level is "absolutely safe"). This means if you have a $1 million investment portfolio, you can safely withdrawal $30,000 to $40,000 a year. However, financial advisers are increasingly questioning such withdrawal assumptions in the wake of the dot com bust, the financial crisis, historically-low yields or interest rates, higher life expectancies and uncertainty over retirement entitlement programs or future tax rates. In other words, a 3% to 4% withdrawal rate is just a general rule of thumb and your withdrawal rate could be higher or need to be lower.

The best way to avoid retirement derailers?

The easiest way to be prepared for derailers while in retirement is to do the following before you retire: spend less, save more, work longer.

In reality, one or more of the above and rather simplistic suggestions may not be available to you – especially now that you are already retired.

With that said, there was a silver lining from the results of the Ameriprise Financial survey in that that 74% of respondents who had a financial adviser also had a written financial plan to act as a road map for the future – meaning they felt more confident about their retirement. Do you have a written financial plan for retirement?

Don Freeman is president of Freeman Capital Management, a Registered Investment Advisor with the US Securities Exchange Commission (SEC), based in Phuket, Thailand. He has over 15 years experience and provides personal financial planning and wealth management to expatriates. Specializing in UK and US pension transfers. Call 089-970-5795 or email: freemancapital@gmail.com.

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