

INVESTMENT PRINCIPLES

**What You Need to Know
To Manage the Tribe's
Financial Investments**

by Gelvin Stevenson



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Introduction

This volume is one of a series of handbooks for Native American tribes that want to take control over their financial resources and to manage them well. We introduce the series first, and then this book on *Investment Principles*.

... To This Series

Something new has happened in Indian country. For the first time, a substantial number of Nations now have, or will soon have, money to invest. For many tribes, that money had been held in trust and managed by the Bureau of Indian Affairs, Division of Trust Management. Only now, after much hard work, are tribes winning the right to manage that money. In addition to the BIA Trust money, many tribes have received land claims settlements, or are earning money from tribal resources or gaming or other tribal enterprises. While the sources of this new money may vary, it needs to be managed, and managed well.

Since having money to invest is a new experience for most tribes and Native people, we often lack the experience and skills necessary to invest and manage it properly. Even people with formal education may know little about investing, and those tribal members who do understand investing may not be familiar with the world of institutional investing, which is populated by specialized laws, companies, concepts, practices and people. To manage a tribe's investment portfolio well requires knowledge not only of your tribe's needs, but also of the money management industry and its concepts and language.

This series was written to introduce tribes and tribal members to the world of institutional investing and money management. It includes three short books: *Investment Principles*, *The Investment Industry*, and *Evaluating and Monitoring Investment Advisers*.

This series is intended for tribal treasurers, controllers, investment officers, chairmen, chiefs, council members, members of finance committees, trust committees, judgment fund committees, and all other interested tribal members.

This information is meant to teach and guide, to start you off in the right direction. It is not an encyclopedia. Nor is it a bible. It is a beginning.

Your money is important enough that, in most cases, you should hire professional help. We will discuss below what kind of help you might need and where to find that help.

This handbook was funded by the Northwest Area Foundation, as part of its ongoing efforts to build the capacity of tribes and other institutions in the northwestern U.S. The Foundation seeks "to contribute to the vitality of the region by promoting economic revitalization and improving the standards of living of the most vulnerable of its citizens." The Minnesota Chippewa Tribe received and administered the grant, through its Economic Development Division. The author thanks Karl Stauber and Terry Saario of the Northwest Area Foundation for their encouragement and support and Gary Frazer and Richard Robinson of the Minnesota Chippewa Tribe for their cooperation and assistance.

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Any errors are my responsibility, and I would appreciate having them pointed out to me at 2160 Bolton St., Apt. 3B, Bronx, NY 10462, 718-863-4156.

The Foundation wants to make clear that their support of this series should not be read as an endorsement of the author in any way other than as the author of this work. In other words, the Foundation does not want to imply that it favors this author over any other professionals working in this area.

This handbook is the work of a particular person who has his own way of understanding and communicating. Like all information, it should be carefully evaluated by the reader. Part of that evaluation requires knowing something about the author.

My name is **Gelvin Stevenson**. I am Western Cherokee. I work as a Financial Consultant in New York City, have a Ph.D. degree in economics, have been a business and financial writer at *Business Week* and elsewhere, and worked as a stock broker for a brief interlude. A main interest of mine is Socially Responsible Investing. I currently serve as a Director of the First Nations Development Institute, the American Indian Community House in New York City, and the Environmental Research Foundation, and sit on the Council of the Nuyguli Keetoowah Society in New York City.

My political bias is toward the sovereignty of Native American Nations, and their well-being as they define it. I value the traditional ways, and feel that the best way to strengthen our traditions is with education and sophistication. In the area of money management, that means learning how other people and institutions manage money, and applying those insights and skills to managing our own money our own way for the goals that we define, thinking always of our children and all children to come.

... To This Volume

This handbook explains the financial principles you need to know to oversee the investment of your tribe's trust fund or other financial investments. If you learn a few fundamental concepts well, you do not have to become a financial expert to oversee your tribe's investments, just as you don't have to be an automotive engineer or even a mechanic to drive a car well. But you do have to know some things. You have to know how to start it, stop it, steer it, where the gas station is, and when to take it for a checkup or tuneup. And the more you know, the better. Because if your engine is smoking, and your mechanic says he is going to fix it by replacing your muffler, you'll want to talk with another mechanic.

I try in this book to explain the concepts you will need to know to oversee investments. First I describe the main types of securities you need to know about — stocks, bonds and others. Then we discuss returns — the various kinds, what they mean, and how to measure them, and risk — the various kinds, how it relates to return, and how to minimize and live with it. We also talk about the long run trends in the returns of various investments. Since different professional investment advisers invest according to different

“styles,” I explain what some of those styles are and what they mean, as well as various indexes that are used to compare and evaluate returns. I include a discussion of Socially Responsible Investing, so you will understand how to integrate your ethical and political beliefs into your investing. At the end, I explain additional concepts that might be useful.

Many of the concepts used in the world of finance may seem more complicated than they have to be. Indeed, some of them are. Financial professionals have taken basic natural concepts and refined and abstracted them to the point of great complexity. Nevertheless, the underlying concepts are based on natural principles of time, growth, and various types of relationships, and many financial terms and concepts originated in agrarian settings. The financial concept of yield, for example, originally meant the yield of crops. Capital is based on capita, which meant the number of something, and often referred to cattle or other livestock. Even more abstract financial concepts like options and futures were created for the agricultural markets. Options and futures allowed a buyer or seller to lock in a price today for something that would be delivered in the future. Thus the name — futures contracts, or just “futures.”

One grammatical note: Throughout, I usually use the term “investment adviser” to refer to the person or company who is investing your money. The legal term is Registered Investment Adviser. On occasion, I substitute the formal name or use the term “money manager,” which is commonly used by the industry.

1 Stocks, Bonds and Other Securities

Corporate securities refer to various legal obligations that are “secured” or guaranteed by rights or obligations. Corporate stock represents ownership rights. When you buy stock in a company, you become part owner of that company, including all its buildings, products, inventory and earnings. You own the same percent of that company that you have of its stock. As any owner, you have the right to participate in decisions the company makes, by voting for the board of directors that is supposed to represent owners’ interests. How much control you really have is discussed in the section below on *Socially Responsible Investing*. *Bonds* represent debt obligations. The company owes the bond holder a certain amount of money and interest. How and when it is payable and how it is secured is specified in the legal description of that particular bond.

There are several types of **Stocks**, or **Equities**. Common stock may or may not pay dividends. **Preferred Stock** pays preferred dividends, which are paid before dividends on common stock. If a company falls on hard times, it will reduce the dividend on the common stock before the preferred stock. And the dividends on many preferred stocks are “cumulative,” meaning that, if they can’t be paid on time, the company’s obligations accumulate, and all current and overdue preferred dividends must be paid before any common dividends are paid. Most stock can be bought from or sold to other investors through the various stock exchanges.

Bonds are legal debt obligations, like an IOU or promissory note for a corporation or government. They generally promise to pay a specified amount of interest periodically, and to repay the principal at the maturity date. Most bonds can be bought from and sold to other investors (in what is called the “secondary” market), but not as easily as stocks.

Treasury Securities are debt obligations of the U.S. government, and generally considered the safest of all investments. There are huge markets in Treasury securities, so they are very “liquid.” Which means that they can be bought and sold easily, quickly, and with a modest transaction cost. Since they are so safe and liquid, they pay lower interest rates than most other securities.

Treasury securities can be purchased directly from the Treasury through your local Federal Reserve Bank, as described in another section. There are three types of Treasury securities: Bills, Notes, and Bonds.

Treasury Bills are short-term obligations, issued with maturities of 13 weeks, 26 weeks, and 52 weeks (or a quarter, half and full year). T-Bills (the common abbreviation for Treasury Bills) are sold at a discount and mature at face value. The difference between the purchase price and maturity value is the amount of the discount, and is considered interest. For example, you could purchase a 52 week T-Bill with a face value of \$10,000 when it is issued for, say, \$9,700, and receive \$10,000 at maturity, for a gain of \$300. That works out to an interest rate of 3.09% (\$300 divided by \$9,700).

Treasury Notes are issued with maturities of from one to 10 years. They are issued in \$1,000 denominations and pay interest semi-annually.

Treasury Bonds are the long term securities, issued with terms of more than 10 years. They are issued in \$1,000 denominations and pay interest semi-annually.

Collateralized Mortgage Obligations (CMOs) are securities that are backed by a pool of federally insured mortgages. The Government National Mortgage Association (GNMA, or "Ginnie Mae") sells interests in pools of mortgages that are guaranteed by the Federal Housing Administration (FHA) or the Veterans Administration (VA). Except for Treasury securities, these are the only securities that are backed by the "full faith and credit of the U.S. government." You can buy a Ginnie Mae certificate for a minimum of \$25,000 from a broker.

The main advantages of guaranteed mortgage securities is that they pay higher interest rates than Treasury securities, and the principal and interest payments are guaranteed. One disadvantage is that the periodic payments include both principal and interest, in contrast to a debt security where you are paid the principal all at one time. Another disadvantage is that the maturity is not fixed. When interest rates fall, people often pay off their mortgages early, and that means that holders of mortgage-backed obligations receive their principal back before they had planned. There is nothing wrong with that, except that such early payment usually occurs when interest rates have fallen, so when you invest that recently received principal, it is at a lower rate.

Other High Quality Securities. There are other securities that are very safe, even though they may not be guaranteed by the federal government. The World Bank issues bonds that many financial analysts consider safe. And financially strong corporations issue short term and long term debt that is considered safe. **Commercial paper** is a common type of short term debt issued by corporations. It is usually unsecured, and is easily transferable between investors, which makes for an active market in the security. The safety depends on the financial strength of the issuer. **Corporate bonds**, if issued by financially sound corporations, are usually safe investments, and pay higher interest rates than Treasury securities. You should check with a broker to help purchase these securities and to get the latest information on the corporations issuing the debt, and how safe they are considered at that moment. (To help you evaluate the safety of that debt, you need to know how their safety is evaluated. We discuss that later.)

2 Return

There are various ways to measure how well your investments are doing. They all mean different things and have different purposes, so it is critically important to be very careful and precise about the measures you are using and what they represent.

Profit. If you buy a security and sell it later at a higher price, you have made a profit. If you bought it for \$10,000 and sold it for \$12,000, your profit would be \$2,000 or 20% (which is \$2000 divided by \$10,000). If you only had to hold that security for a year or two to make that 20% profit, you did very well. But if you held it for 10 years, that 20% doesn't seem like a lot. To take account of that all-important time factor, we look at annual return.

Annual return is gain or loss per year. If that 20% gain took one year, then the annual return would be 20% per year. If it took two years, it would be approximately 10% per year (20% divided by 2 years. This is approximate because I'm ignoring the effects of compounding.). If that 20% occurred in 6 months, the annual return was approximately 40% (12 months divided by 6 = 2, and 2 times 20% is 40%). The process of turning a return into an annual return is called "annualizing" the return.

Real return. Another factor to correct for is **inflation**, or the general rise in prices. After all, if you are earning 10% per year, but prices are rising 20% per year, you're losing ground in terms of what you can buy with your money. On the other hand, if prices are flat, with a 0% inflation rate, then that 10% looks real good. Subtracting the rate of inflation from the stated, or **nominal** return gives you the **real rate of return**. In general, adjusting any variable for the rate of inflation gives you the "real" variable. The real return is also called the inflation-adjusted return. Unadjusted variables are called nominal values. For example, a 12% nominal annual return during a year with 4% inflation becomes an 8% real rate ($12 - 4 = 8$).

Yield is the amount of interest or dividends you receive, divided by the amount of principal you invested to generate those payments, expressed as a percentage. Bonds and

stocks both have yields. A \$20 stock paying \$1 a year in dividends has a 5% yield. A \$10,000 bond paying \$500 per year in interest also has a yield of 5%.

Capital gain is the increase in value of an investment. Stocks, bonds, real estate and other investments can all generate capital gains or losses. If you buy a bond and the value rises, you have an unrealized capital gain. When you sell it, you "realize" that gain. A **capital loss** is just the opposite — a reduction in the value of that investment.

Total return is the sum of capital gains (or losses) plus dividends or interest, expressed as a percent. For bonds, it is the interest payment plus the amount the value of the bond has risen or fallen, expressed as a percent of your purchase price of the bond. For stocks, it is dividends plus the increase or decrease in the stock price. If you invest in foreign securities, any rise or fall in the value of that country's currency should be included in the total return, because it effects the dollar value of your yield and of your asset.

Net of fees means after correcting for all fees associated with investing. Since investing usually involves fees, including commissions for buying and selling, and perhaps investment management fees, it is important to deduct all fees and transactions costs to arrive at a realistic rate of return.

Cash vs. accrual has to do with the timing of the receipt of income. If a bond pays interest semi-annually, and you buy it between those two payments periods, you'll have to pay the interest that has been earned, or accrued, but has not yet been paid. For example, if the bond pays \$50 on January 1 and \$50 July 1, and you buy it on April 1, then you'll have to pay \$25 in accrued interest. You should be sure to take account of accrued interest when you calculate the returns on an investment portfolio.

3 Time & Money: How Yields Rise With Maturities

There is a well-known relationship in the financial world that longer term investments pay higher rates than those with shorter terms. In general, the longer the term, the higher the rate. One day in late 1993, for example, 30-year Treasury securities were yielding 6.14%, 10 year were paying 5.35% and one year were yielding 3.28%.

Why?

One reason longer term investments pay higher rates is that the investor (or lender) bears greater risks when he or she ties up his or her money for a longer time. One risk is that interest rates will rise, reducing the value of the principal. (This relationship is explained later in this chapter.) Another risk is that inflation will accelerate, reducing the purchasing power of the principal and interest faster than predicted when you purchased the bond. A final risk is the general risk of not knowing what will happen tomorrow.

Another reason economists give for higher rates for longer term investments is that investors have to be compensated for giving up the use of their money for a long time. To them, money sooner is worth more than money later. They argue that people have a "time preference" for money and other things. That argument holds less weight when one is working with community money that exists to benefit people in the future. It may also hold less weight for Native Americans and others who care more about the future generations than for people with a more individualistic perspective.

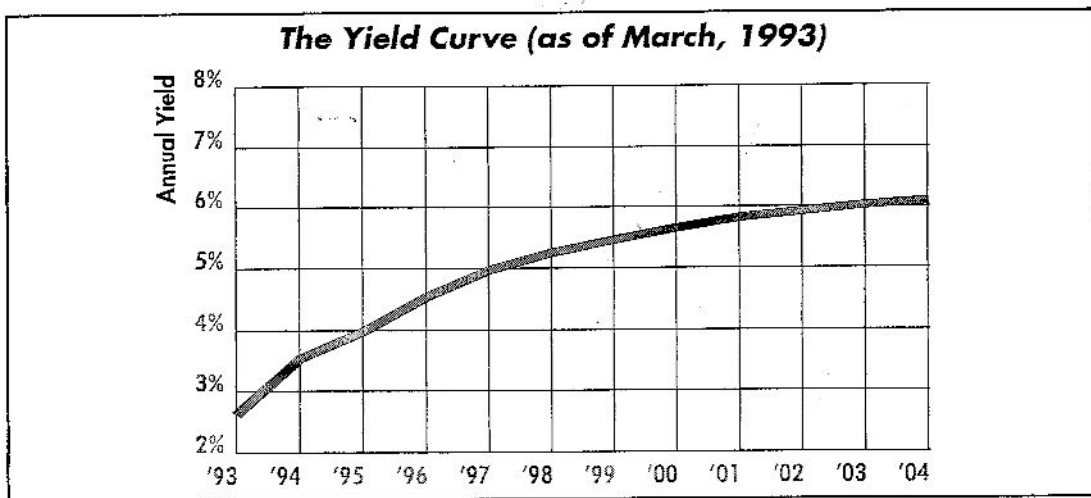
The Yield Curve

This is the graphic representation of the positive relationship between time and return. The term "yield curve" is widely used in the financial press. The following chart shows the

yield curve for U.S. Treasury securities as of March 10, 1993. The figures represented on the chart were derived from the yields on Treasury securities with various maturities as of that date.

The yield curve will change shapes as economic and financial conditions change. It almost always slopes up and to the right. But it varies from being very steep to almost flat. In very rare instances, it will slope down, but that is an unstable relationship, because investors would rush to borrow long-term at lower rates and invest short-term at higher rates. They would have to pay higher and higher long term interest rates, and that would shift the yield curve back to an upward sloping position.

The yield curve also shifts up and down as the general level of interest rates in the economy rises and falls.



Why Bond Prices Fall When Interest Rates Rise, and Vice Versa

If you own bonds or have bonds being managed by an investment adviser, you may have noticed that the values of your bonds rise when interest rates fall. That's because falling rates push bond prices up, so your fixed-income investments are producing capital gains in addition to paying interest. But when rates rise, the opposite occurs, i.e. bond prices fall. Why do bond prices and interest rates move in opposite directions?

Say you buy a \$1,000 bond that pays \$100 a year in interest. That \$100 divided by \$1,000 ($100/1,000$) gives you a yield of 10%. Now assume interest rates drop to 5%. The price of your bond has to change so that the \$100 in interest, which the bond still pays every year, provides a yield of 5%. Remember: $100/1,000$ yields 10%. What would you have to divide 100 by to get a 5% yield? The answer is \$2,000. So when rates drop from 10% to 5%, your bond rises in value to \$2,000. Interest rates fell by half and the value of your bond doubled.

We need to pause here and point out that the bond we are using in our explanation never matures. It keeps paying interest forever. Obviously, that is not realistic. Such fixed income securities, called annuities, are very rare in the U.S., although you can buy bonds like that in England, called "Gilts." More realistic are bonds that mature in anywhere from zero to 30 years. The rule for these bonds is that the longer the maturity, the more the price moves when rates change; the shorter the maturity, the less the price changes. Also, things never work this smoothly in real markets. Prices and interest rates are always in flux, so there is no static beginning point. Also, there is not one overriding interest rate that changes. There are a multitude of rates, linked together in a complex web of relationships with other rates (called the rate structure) and other financial, economic and political factors. As a result, our bond might have only risen to, say, \$1,800.

Now that we've done the arithmetic and discussed how markets function in the real world, let's return to the example and see how the relationship between bond prices and rates plays out in the financial markets. What is the mechanism? For the sake of simplicity, we'll stick with our bond with no maturity. When rates were 10%, other investors would pay \$1,000 for your bond. But now that rates are lower, those investors would pay a lot for that bond that pays \$100/year. So they start buying bonds like yours, and bid up the price. They would offer a higher and higher price until the price got to \$2,000. At that price, the yield is 5%, the same as they can get in other investments. They wouldn't pay more than \$2,000, because then they would be getting less than 5% on their investment.

If you own bonds, that's a nice story: rates drop and bond prices rise. But it won't increase your income. You're still getting \$100 a year from that bond. Of course you can cash in that bond, and get \$2,000 for it. But if you invest that \$2,000 in other bonds (of the same maturity and security), you won't get any more interest income. With yields at

5%, that \$2,000 investment will still buy only \$100 a year in interest income. (If you're borrowing instead of lending, of course, that 5% looks good.)

It is also important to realize that bond prices can drop. That's what they do when interest rates rise. Bond prices sit on one end of a teeter-totter (or see-saw, if you prefer) and bond yields sit on the other end. Rates rise and bond prices drop for a while, and then the whole thing reverses, and rates fall and bond prices rise. When you are considering hiring a fixed-income manager, ask how they get the most return when rates are falling, and how they protect your capital when rates rise. In financial markets, as in life, the only constant is change.

4 Risk

Risk, or the chance of loss on an investment, is an important element of investing. An investor's ultimate goal is to achieve high returns with low risk. But the investments that promise greater return generally involve greater risk. So you can probably get, say, 7% interest on a risk-free bond, but if you invest in a bond paying 15%, you are probably risking the loss of some or all of your invested principal. (These rates are from early 1984.)

There are several kinds of risk. Here are some of the most common.

Market risk is the risk that the market value of a security will drop. If you own bonds, their market value will drop when interest rates rise. (However, if you hold the bond until it matures, you will be repaid the full face value.) Stocks are volatile, often rising or falling in value with the overall stock market.

Principal risk is the chance that you would not receive your full principal even if you held a security until it matured.

Other kinds of risk are easy to figure out from the names. **Default risk** is realized when the debtor fails to make interest or principal payments. **Sovereign risk** is unique to investing in the debt of foreign securities. If those sovereign nations refuse to pay, you have no effective legal recourse. **Political risk** is the risk that the government of a country might seize the property of a company in which you own stock, or be replaced by a government that does not honor your investments. **Currency risk** is the chance of having the value of your investment effected by changes in the value of a country's currency. For example, if you invest in Japanese bonds and the value of the yen falls relative to the dollar, then your bonds will be worth less in dollars than they were. **Inflation risk** is the risk that prices will rise faster than you had expected, eroding the purchasing power of your investments more than you had planned for. When inflation accelerates, interest rates usually rise, too, and that lowers the value of bonds. The final risk is **Time risk** or **Risk of the unknown**. This is a catch-all category for the fact that there are a lot of things that could happen that you have not and could not have anticipated. These include war,

environmental changes, fundamental economic shifts and other unforeseen events. The only rule here is that the longer you tie up your investments for, the more likely something unforeseen will occur that might affect their value or return, for either better or worse.

Risk-free indicates situations where there is no risk at all. For example, Treasury securities are considered risk-free, because they are backed by the full faith and credit of the U.S. government. The interest paid on Treasury securities is often called a "risk-free return." The risk-free return is often used as a benchmark. To do better than the risk-free return, you have to take some chances. If you take chances with your investments and don't get any higher return than you would have by investing in Treasury securities, then you're doing something wrong.

Standard deviation. The standard deviation is the most widely used measure of risk. It can be thought of as measuring the amount of volatility. If your investment has a very stable value, then it will have a very low standard deviation. If it jumps all over the place, it will have a high standard deviation. If your portfolio of stocks began with a value of \$1 million, and over a year fell to \$950,000 and rose as high as \$1.2 million, before ending the period at \$1.15 million, it would have a much lower standard deviation than a portfolio that also began at \$1 million and ended at \$1.15 million, but during that period fell as far as \$800,000 and rose as high as \$1.4 million.

In my opinion, the standard deviation is a rather lame way to measure risk. It measures volatility, and that is not the same as risk. Only if you have to sell when a security is down does volatility represent risk. The longer your time horizon, the less volatility has to do with risk. Nevertheless, the standard deviation is widely used to measure risk, so you should be familiar with it.

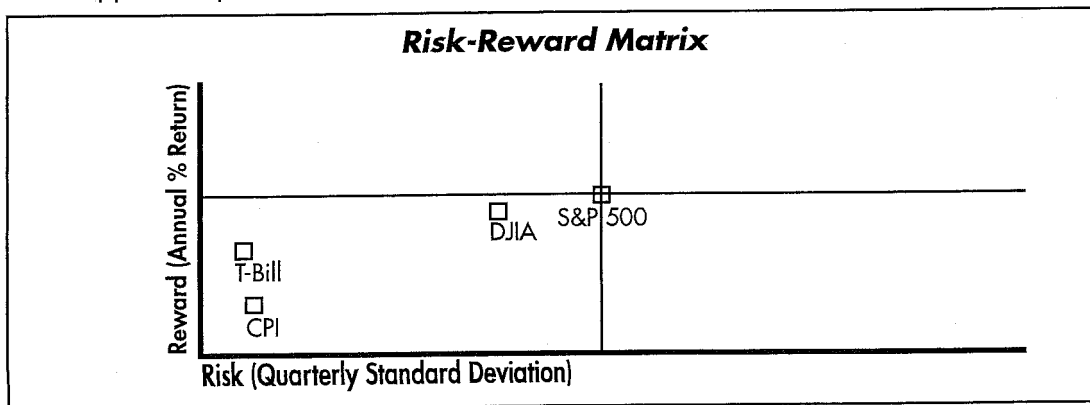
5 Risk and Returns: The Risk-Reward Relationship

The relationship between risk and reward is often presented in a well known and widely-used chart that compares the risk-reward relationships of various investment strategies. The chart shows the relationship between the risk of an investment and its rate of return (or reward). Return is on the vertical axis, expressed as an annualized rate of return, e.g. percent per year. On the horizontal axis is risk, measured as the standard deviation of the investment.

Often, a reference point is established near the middle. That point might be the performance of the S&P 500, the widely used index of 500 large stocks. Horizontal and vertical lines are drawn through that point. Then the return and standard deviation of other investments are charted.

Most investments will lie in the upper right or the lower left quadrant, indicating that higher returns are usually accompanied by higher volatility, or risk. Growth stocks would tend to be in the upper right — high risk, high return. Treasury securities would cluster in the lower left — low return, low risk.

The ideal investment, of course, would have high returns and low risk. It would be found in the upper left quadrant. These are not easy to find.

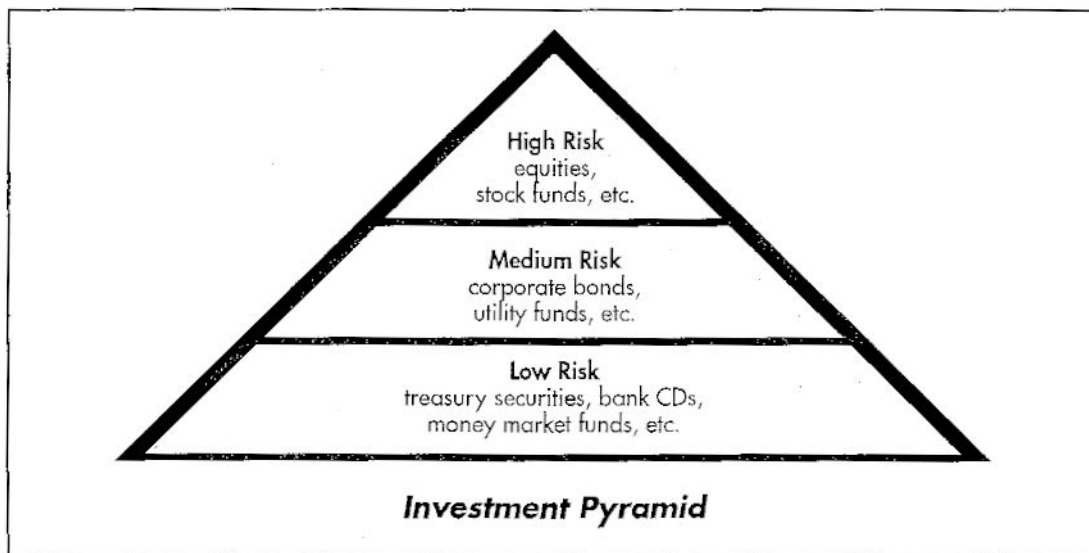


6 Managing Risk

Risk can never be avoided completely, but there are several ways it can be managed and limited. First, you should limit the amount of risky investments you make. Second, you should diversify your investments, because diversity itself reduces risk. Third, careful analysis and keen observation can help you avoid risky investments. Finally, the longer you hold your investment, the less your risk. We will discuss them in turn.

The Investment Pyramid

Most investment strategies are established according to a pyramid, where the broad base of investments is in safe, low-return securities, a middle layer is in more risky but still fairly safe securities with higher expected returns, and a small top layer is placed in high-risk investments with high expected returns.



In addition to showing a portfolio diversified among different risk classes of investments, the investment pyramid can show how taking a little more risk can increase your portfolio's overall return.

While the top part of the pyramid is the smallest, it is nevertheless very important, for it shows where you have to invest to get the highest return, and therefore where to look if you want to increase your overall return.

Consider two asset allocations. (See table.) Before the shift, you have 60% in the bottom layer, which yields 5%; 30% in the middle sector, which yields 10%; and 10% in the top, or riskiest layer, which yields 20%. Your blended or average yield would be 8%. But if you take a little more risk, by shifting 10% of your assets from the bottom to the top sector, you could raise your blended return to 9.5%. Of course there are risks and increased volatility associated with such a shift, but it might make sense if you have an appropriately long time horizon and can bear the increased risk.

	Return in that section	Assets before shift	Return with that asset allocation	Assets after shift	Return with that asset allocation
Top	20%	10%	2%	20%	4%
Middle	10%	30%	3%	30%	3%
Bottom	5%	60%	3%	50%	2.5%
Blended return			8%		9.5%

Diversification

Diversification means not putting all your eggs in one basket. The first level of diversification is asset allocation, the spreading of your investments between several types or classes of assets. For example, you might want to spread your investment between bonds, stocks, and real estate. Within those asset classes, you might want to diversify between types of bonds (e.g. risk-free Treasuries and higher-risk, higher-return corporates), types

of stocks (e.g. small growth stocks, utility stocks that pay high dividends), and types of real estate (e.g. commercial and residential). A third type of diversification requires having more than one investment adviser, and picking advisers that will invest your funds according to several different styles (e.g. value, growth, international, and small capitalization). Often, investment advisers specialize in different types of securities, so that diversifying between different types of stocks will require having more than one investment adviser.

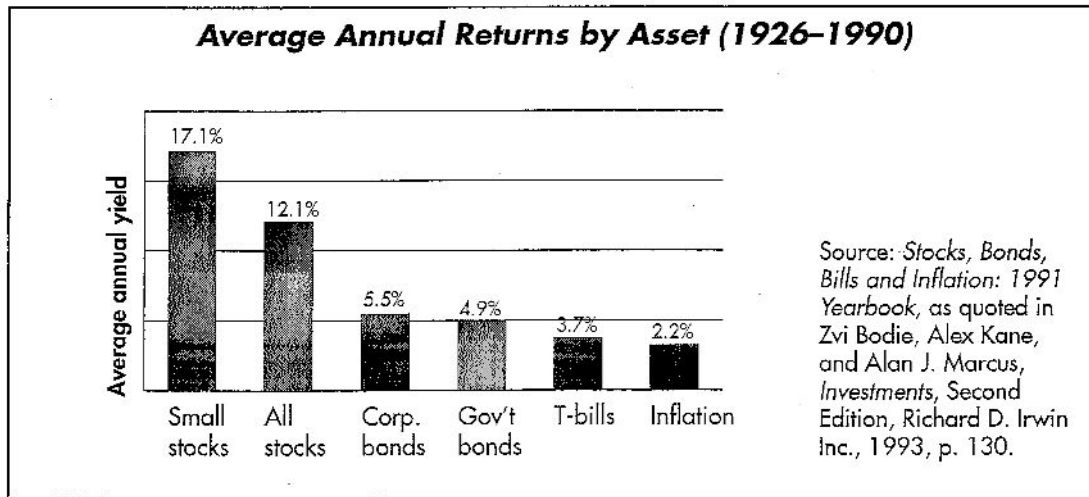
Asset allocation is the diversification of your investments among different types of investments. This is an important part of your investment strategy, and your decisions and the reasons for them should be carefully spelled out in your Investment Policy Statement, which is the document where you analyze your present and future financial needs and your investment objectives.

For now, suffice it to know that the various classes of assets have historically had different rates of return and different levels of risk. For example, one study⁴ found the following about rates of return among various asset classes:

- Stocks have doubled in value roughly every nine years since 1789.
- Bonds have beaten inflation, but with substantially lower returns than stocks.
- Cash returns closely match inflation.
- Capital gains on real estate, over the long run, have about equaled the inflation rate, after allowing for depreciation.
- Foreign stock returns have surpassed those of U.S. stocks over the past 25 years, with Asian equities returning an annualized 16% per year, vs. 10% for stocks on the New York Stock Exchange.

Diversified portfolios are the best way to reduce the risk of owning stocks, and the more you diversify, the less your risk. It should also be used for bonds, real estate and all classes of investments. If you own 30 stocks rather than, say, 4, your return will reflect the performance of a large number of securities in many companies in many industries. The gains in some will counteract the losses in others, and tending to smooth out the overall performance of your portfolio. With only a few stocks, your portfolio's performance could

⁴Roger G. Ibbotson and Gary P. Brinson, *Investment Markets*, New York: McGraw-Hill Inc., 1987, quoted in Owen, p. 50



be dominated by bad luck or bad management that hits only one company. Like any average, the larger the number of items in your calculations, the less impact any one item will have on the average. Keep in mind that you should diversify not only among stocks, but also among types of investments. You might want to divide your investments between cash, stocks, bonds, real estate and other investments. Such investment decisions should be made after performing an asset allocation study, where you plan your expenditures that will be funded from these investments, and then match your investments to those expenditure patterns.

Analysis

Doing your homework and being smart about investments can also reduce your risk. If you carefully investigate the investments you're considering before you make them, or investigate the consultants and Investment Advisers you are considering, you will make much better decisions than if you go in with your eyes closed, or immediately accept someone's sales pitch.

In the booklet on selecting consultants and money managers we will go over how to investigate them. When you are investigating stocks and bonds, here are a few of the items you should research:

debt ratios: how much debt does the company owe? Of course AT&T will have a lot more debt than Joe's Pizza — it's simply a bigger company. To know if a company has so much debt that it will weaken its financial performance, examine the debt in context. Compare the amount of debt to the company's profitability and equity. Consider the short term debt relative to short term assets, total debt as a percent of total capital (which is debt plus equity), and the "coverage ratio," which is the amount of income available to pay interest and principal compared to the amount of interest and principal due over the next year. These few lines provide only a cursory introduction to a bigger and fascinating topic. For more detail, read material on "understanding financial statements," or request material from such debt rating agencies as Standard & Poors or Moody's, discussed below.

competition can be very harmful to a company and to the performance of its stock and even its bonds. Does the company face a lot of competition in its primary markets?

stability and predictability can effect profitability and securities values. Predictability means that earnings are fairly steady over the years, preferably growing steadily. By stability is meant not steady earnings, but the stability of the corporation, of its management, of its financial structure, of its manufacturing and distribution capability, and other aspects of corporate success.

does management have a lot invested in the company? Some analysts believe that the more of their personal wealth executives and managers have tied up in the company, the harder they will try to make it a success. That way, their financial incentives are the same as other shareholders — they want the stock to rise as much as investors do.

Other things to examine in accessing corporations include product quality and brand loyalty, government regulations, environmental regulations, and the possibility of technological obsolescence. How might changes in these factors help or hurt the stock price? Think about it.

7 How Financial Safety is Rated

Two private companies, Moody's and Standard & Poor's, provide independent ratings of the "quality" of bonds or other securities. These ratings must be requested by and paid for by the party that issues the securities. Ratings are periodically reviewed and updated, and may be raised or lowered, if the company's (or town's, or state's or other issuer's) financial conditions improve or deteriorate. These ratings are concerned primarily with the issuer's ability to pay interest on its debt and to repay the principal when due. The following table shows the rankings, from highest to lowest.

Securities with ratings above Baa and BBB are considered Investment Grade. Anything below that rating — below the heavy line — runs a risk of default, and that risk increases the further down the list you go. Bonds with ratings below the line are referred to as "below investment grade," "speculative," or even as "junk bonds."

Both rating companies add refinements to these ratings. Moody's uses the number 1 to

	MOODY'S		S&P
Investment Grade	Aaa	best quality	AAA
	Aa	high quality	AA
	A	upper medium grade	A
	Baa	medium grade	BBB
<hr/>			
Below Investment Grade, Speculative or "Junk" bonds	Ba	speculative	BB
	B		B
	Caa		CCC
	Ca		CC
	C		C
	D		

further distinguish between ratings. For example, Aa1 is higher than Aa, but lower than Aaa. Similarly, S&P's uses pluses (+) and minuses (-) to indicate higher and lower. So an A+ is better than an A, but not as good as an AA.

Since issuers have to pay for the ratings, many debt securities are not rated. Just because an issue is not rated does not mean that it is of lower quality than a rated issue. It only means that you will have to find some other way of determining how safe it is.

8 Market Timing

One way money managers try to achieve higher returns for your portfolio than the overall market is to time the market. That means, for example, selling securities when they think the market is about to decline, and holding the money in cash or cash equivalents (such as Treasury bills or commercial paper or other short term debt securities) until, they hope, the market drops. Then they are able to buy the securities back at cheaper prices. That way they outperform the market because their securities prices rise when the market averages go up, but don't decline in value when the market averages drop.

That sounds fine in theory, but there is one problem with the strategy: it doesn't always work. One reason is transactions costs. Every time you buy and sell, you pay commissions. Also, there is the cost of mistakes. Being wrong costs you money, either when you buy and the market declines, or when you sell and the market rises.

One of the most dramatic reasons that timing the market gets you in trouble is that a surprisingly large part of the "action" occurs in brief spurts, and often when the consensus view would have a manager out of the market. If you had owned a broadly diversified portfolio from 1982 through 1990 (i.e. the S&P 500), your compound annual return would have been 18% per year. But if you had been out of the market for only 10 days, but the 10 days when the market made its biggest moves, your return would have dropped to 12%! If you had missed the 20 biggest days, your return would have been only 8%. And missing the 30 biggest days would have dropped your annual compound return to only 5%.⁵ So one can see how difficult it can be to time the market.

Nevertheless, if you do time the market correctly, and have all your assets in cash (money market funds) when the market drops 500 points in a day or several hundred points over several weeks, then you can improve your investment returns substantially. So be cautionary but be alert to opportunity.

⁵ Cambridge Associates, quoted in Ellis, Charles D., *Investment Policy: How to Win the Loser's Game*, Business One Irwin, 1993, p. 14]

9

Investment Styles: Active vs. Passive; Value vs. Growth vs. Balanced vs. Rotational vs. ...

Investment Advisers tend to specialize in various investment “styles.” You should specify in your Investment Policy Statement, the document that matches your financial needs with your investment objectives, those investment styles you think will best meet your investment objectives. When you select an Investment Adviser or mutual fund, you should pick one that specializes in those styles. Here are some common styles:

Active vs. Passive. Active investing is the process of you or your Investment Adviser purchasing a portfolio of stocks or bonds and “actively” buying and selling the securities. Passive investing, by contrast, is the purchase and holding of an index fund or a large number and wide range of stocks that represent all or part of “the market.”

The idea behind passive investing is that you will be satisfied if you earn the same rate of return as the overall stock or bond market. (Remember, the long run annual average return for stocks has been about 9%, and was 18% through most of the 1980s.) Passive investing can be achieved by buying into an index mutual fund, which buys stock in all the companies represented by the index, or in a smaller number of companies that reflect the index. (See the section below on Indexes.)

Balanced investing usually refers to the inclusion of both stocks and bonds in one portfolio, but can mean the incorporation of several different investing styles within one portfolio. An investor can balance his or her portfolio through asset allocation (e.g. between stocks, bonds and cash), and hiring different Investment Advisers for each class of investments, or by hiring an Investment Adviser that will manage a balanced portfolio, and specifying how it should be balanced (e.g. 60% stocks and 40% bonds).

Growth investing emphasizes the stock of companies with rapidly growing earnings and the promise of continuing growth. Growth stocks are generally in smaller companies that do not pay dividends.

Value investing emphasizes stocks in companies that may not grow very fast, but have some unrecognized financial or other value. That usually means some combination of little debt, a lot of cash, stable earnings, predictable earnings growth, dividends, and a low stock price relative to all those variables.

Rotational investing moves investments from one sector to another as the economy and market conditions change. For example, a rotational investor may emphasize cyclical companies — those whose fortunes rise and fall with the economy — at the beginning of an economic recovery, and then move or rotate into countercyclical stocks — those whose fortunes move opposite to the economy — when he or she thinks the economy is about to slow down. They might also rotate among industry groups, for example going from oils to drugs to airlines depending on various factors.

10 Indexes

Generally speaking, indexes are ways of putting one value on a basket of goods. In other words, indices are one number representing the a large number of component pieces. They are useful in allowing you to compare how well your portfolio of stocks is doing against other, very broad groups of stocks. For example, you may think you're doing well if your portfolio is up 20%, but if the indexes you have chosen as your benchmarks are up by 50%, something is wrong. Indexes give you good, objective criteria to compare your performance to.

These are some important indexes:

Dow Jones Industrials is widely reported, but not very useful for investment purposes, because it contains only 30 of the largest industrial companies (and a few service companies now).

S&P 500 is probably the most widely watched and used index, containing the 500 largest publicly traded companies in the U.S. It is the standard against which most equity investing is measured. Many investors place their capital in index funds that mirror the performance of the S&P 500.

Wilshire 5,000 is a broader index, and its 5,000 companies include practically every publicly traded company in the U.S., including those found in the S&P 500. In recent years, as small companies have done better than large companies, the Wilshire 5,000 has slightly outperformed the S&P 500. Increasingly, it is being used by institutional investors as the index to invest in and to match performance against.

Domini 400 is the only index of socially screened stocks. It begins with the S&P 500 companies, takes out companies with bad records in South Africa, pollution, employment practices, nuclear weapons manufacture, and other areas, and adds in companies with particularly good social and community practices. Throughout much of 1993 and early 1994, it outperformed the S&P 500.

11 Socially Responsible Investing

Introduction

Socially Responsible Investing (SRI) is the application of your ethical, social, political and environmental beliefs in making your investment decisions. A more comprehensive and formal definition is that SRI is: "the process of allocating scarce financial resources among competing available opportunities with the object of maximizing the financial and social well-being of the investor, the organization in which the investment is being made and society at large."⁶

SRI is a relatively recent movement and is not universally embraced on Wall Street, where many conservative investors argue that SRI will lower your investment returns. Most histories of SRI point out that it has been around for decades and even centuries. They note investments by London bankers in the 1800s in housing for the poor, and recall that at least since the late 1800s, Quakers have avoided such "sin stocks" as tobacco, alcohol and gambling companies. And studies have shown time and again that investing "responsibly" does not have to lower your return.

While the SRI advocates may be right, the approach they take is defensive and backwards. It assumes that investing WITHOUT considering the social consequences is the norm, and that SRI is the exception. That way of thinking accompanied the Industrial Revolution and the rise of capitalism and colonialism. In a long view of history, this modern economic era has been with us for only a relatively brief period of time. Much more common in human existence is a more agrarian and more communal way of living, where there was very little pure finance, and all actions and behavior had many types of consequences. So it is more accurate to see SRI as a return to a world view where morality is part of everyday life, and is reflected in all one does. Moreover, SRI is consistent with more Native ways of thinking, which are circular, intuitive and natural, as opposed to the

⁶ *Social Investment Services: A Guide to Forum Members*, Social Investment Forum, January 1, 1993.

abstract, linear, rational and reductionist ways of thinking that Europeans spread around the world.

SRI as we know it accelerated rapidly during the Vietnam War and Civil Rights movement, as investors avoided companies that were manufacturing weapons and profiting from the war, and as the role of corporations in propping up the apartheid regime in South Africa became widely recognized. Later, this new generation of activist shareholders — including individuals, churches and public pension funds — broadened their reach to other issues, including the environment, employment discrimination, tobacco products and marketing, and a host of other areas. Today, over \$620 billion is invested according to one or more social screens.

Investors don't always agree about what constitutes a good company. Indeed, corporations are complex organizations, often with both good and bad characteristics. For example, the same company whose mining operations are disrupting ancient Hopi and Navajo water tables might give money for Indian scholarships. And the same company that is clear-cutting forests in one area may hire a lot of Indian employees. Everyone must make these decisions themselves, and that process can be a highly informative way to learn about issues and the corporate world.

Investor-activists also started using their financial resources in more direct ways, by making "alternative investments." These are typically loans for low-income housing, credit unions or loan funds serving poor people, minority-owned banks, or cooperative businesses.

Types of SRI

There are several types of Socially Responsible Investing.

- screened portfolios
- investing in "good" companies
- proxy resolutions
- alternative investing

Screened portfolios. This refers to avoidance investing, where investors avoid investments in companies that are engaged in behavior they disapprove of. The most common screen applied, until recently, was against companies that were involved in South Africa. Other screens include nuclear power; weapons manufacturers; polluters; companies involved in tobacco, alcohol or gambling; companies that discriminate against minorities, women, or anyone else; and gun manufacturers. A total of over \$40 billion is invested according to social screens by institutional investors in the U.S. At least one Native Nation — the Oneida Tribe of Wisconsin — has sold its stock in three companies that have polluted reservation land, and instructed its Investment Advisers to avoid buying stock in those companies. If done carefully, investing with screened portfolios will not hurt an investor's financial performance, and might even help it.

Investing in good companies. The mirror image of avoiding bad companies is actively seeking good companies. These may be companies with stellar environmental records; with such progressive programs for employees as on-site child and elder care, and generous parental leave; with programs that support their communities; and that manufacture particularly good or useful products.

Proxy resolutions. Anyone who owns stock in a company can file proxy resolutions, as long as they abide by certain laws. The resolution calls on the company to do certain things and is included in the proxy statement sent to all shareholders and voted on at the annual meeting, or by proxy. By law, resolutions have to pertain to policy issues like doing business in South Africa or selling dangerous products, and not to "ordinary business" like hiring or firing a particular person. Corporations tend to dislike proxy resolutions, because they create issues not of their making, recommend actions opposed by management, and are costly. According to one estimate, the cost to AT&T of each proxy in the proxy statement is \$50,000 in legal fees, printing, mailing, processing and other costs. Often, corporations will try to exclude social action proxy resolutions from the proxy statement, but they must receive permission to do so from the Securities and Exchange Commission.

Historically, most proxy issues have been filed to get companies to stop doing business in South Africa. Now, such issues as environmental stewardship, employment discrimination, marketing techniques for tobacco and alcohol products, and corporate governance, especially executive compensation, are receiving more attention.

For the 1992 annual meeting season (the date of annual meetings depends on the corporations' fiscal years, but most occur in the spring), churches alone filed 230 resolutions at 155 corporations. For the 1993 season, churches filed 220 resolutions at 150 corporations. In addition, individuals and public pension funds often file proxy resolutions.

1992 was the year that the first proxy resolutions on an explicitly Native American issue was introduced. Several Catholic orders submitted proxies to American Express, owner of Shearson Lehman Brothers, and to Merrill Lynch, to have them report on their reasons for underwriting (helping to sell) bonds for Hydro-Quebec, the giant Canadian utility trying to build James Bay II, a huge series of dams and waterways that would flood 10,000 Cree Indians and Inuit people out of their ancestral homes and destroy their way of life. The resolutions were withdrawn when the companies agreed to disclose some of the information requested.

Alternative Investing. A rapidly growing part of SRI is "alternative investing," or investing directly in organizations that help poor people or strengthen community development efforts. There are several types of alternative investing:

- investments in alternative financial institutions: low income credit unions, loan funds, micro-enterprise loan funds, community development banks and minority owned banks;
- investments in low-income housing or similar facilities;
- investments in cooperative businesses or businesses in low-income neighborhoods; and
- investments in new companies making socially beneficial products.

Alternative financial institutions have grown substantially in recent years, and are now receiving attention and perhaps support from the Clinton Administration. They have proven to be highly effective at making capital available to poor people and to organizations that could not get capital from other sources. There are several credit unions on Indian reservations that accept deposits from off the reservation, and use the money to lend to their on-reservation members or to invest at higher rates and use the "spread" between the interest they pay and the interest they receive to cover their costs. Deposits in credit unions are insured up to \$100,000. They often pay less than an investor could get in a bank. The national organization is the National Federation of Community Development Credit Unions.

Loan funds are less formal and are not regulated, as are credit unions and banks. They can exist anywhere and make large loans to housing organizations, for example, or small loans to craftspeople. There are several micro-enterprise loan funds on Indian reservations, and several more are being established. The national organization is the National Association of Community Development Loan Funds. Usually, loans to a loan fund are not insured or guaranteed by any other organization. Their safety depends on how the loans and the organization are structured and how well the borrower does.

A very few banks concentrate on community development lending, including housing development, local real estate and neighborhood businesses. Deposits in these banks are insured just like any other deposits in federally insured banks. Also, there are several banks owned by tribes or Native American individuals.

For a list of institutions involved in alternative investing, begin with the *Social Investment Services: A Guide to Forum Members*, Social Investment Forum. To order a copy, write the Social Investment Forum at Post Office Box 57216, Washington, D.C. 20037, or call 202-833-5522. For alternatives in Indian Country, call First Nations Development Institute at 703-371-5615.

Does SRI Lower Your Investment Returns?

There is no evidence that a program of SRI necessarily lowers your investment returns. Of course cynics have long argued that SRI would lower your investment returns because it would limit the universe of stocks your investment advisers could invest in, and in fact this happened during the 1980s in some instances. For example, divesting South African stocks lowered returns slightly for some pension funds. But the reason was that the companies engaged in South Africa tended to be large, international oil and pharmaceutical companies, and the stocks of those companies were rising during that period, whether or not they were engaged in South Africa. In the late 1980s and early 1990s, socially screened portfolios have often outperformed unscreened portfolios, and the main reason is that socially screened portfolios have a larger percent of small companies in them, and small companies have been outperforming large ones in recent years.

Alternative investing can pay lower returns than other fixed income investments. Indeed, the organizations that accept alternative investments are non-profits which pass on lower interest rates to the people they are trying to help, or benefit directly from the lower rates. However, there are a fair number of alternative investments that pay market returns and are very safe, as well.

Does SRI Change Anything?

There are several aspects of SRI that try to create change in corporate behavior, help certain nonprofit organizations in their missions, or make the investor's investments align more closely with his or her ethical principles. Has SRI actually succeeded in creating all those types of change? The record is mixed.

Divesting stock in bad companies has impacts only when combined with a larger campaign. The campaign to convince U.S. corporations to stop doing business in South Africa, for example, was successful. The number of U.S. companies in that country dropped from nearly 170 in 1986 to about 105 in 1991. Much of this success was due not just to the fact of the securities being sold, but to the bad publicity and lobbying that accompanied the divestment, as well as the loss of sales from company boycotts.

Proxy resolutions definitely get corporations' attention. If the resolutions are legal, they must be included in the proxy resolution that is sent to every shareholder, and then brought up and voted on during the shareholder's annual general meeting. As mentioned above, the very act of printing one proxy resolution reportedly costs American Telephone and Telegraph \$50,000. Of course that is largely because AT&T has a huge number of shareholders — more shareholders than any other company in the U.S. The strategy of filing proxy resolutions is becoming increasingly popular. In 1988, 150 proxies were filed at 120 companies. In 1992, nearly 330 proxies were filed at over 270 companies — more than a doubling in proxies and companies over that six year period.

Corporations often try to negotiate with the shareholders submitting the resolution, in the hope that they will voluntarily withdraw it. If the company can convince the shareholder that it is trying to remedy the situation, or pledges to do so in the future, the shareholder

might withdraw the resolution. This often serves the shareholder well, because no social resolution has ever won a majority of the votes. So negotiation and compromise are often the best outcomes one can hope for.

All in all, it is best to think of proxy resolutions as one of several forms of pressure that can be applied to corporations to convince them to change their behavior. They work best when other methods are also being pursued.

Purchasing stock in good companies is supposed to make the shareholder happy about owning a piece of a company doing something good. But it is not likely that a purchase of stock by a small number of investors will do much concrete good for the company. And since buying stock on a stock exchange is merely purchasing stock that someone else already owns, the money does not go to the company. Nor will the purchase raise the price of the stock, unless it is a very small company.

What does help in an immediate way is to invest directly in a company. Usually this is done before a company "goes public" by selling stock to the public. Such early stage investments are called venture capital, or private placements. They are risky, but can pay off handsomely if the company does well. Organizations that do this from a SRI perspective are listed in the Forum's **Guide**. Occasionally, a public company will sell stock in private placements, sometimes slightly below the market price of the stock.

Alternative investments can have very significant impacts on the organizations that receive them. They can make the difference between an organization being able to build a low-income housing complex or not. They can provide the capital for a loan fund or a credit union to make more loans to its low-income members who can't get loans from banks. These have the most direct and immediate impact on organizations and on their clients.

12 Resources

In addition to the **Social Investment Forum**, the industry group for investors, service providers, and others interested in SRI, there are several other useful resource organizations and sources of information. For starters, there are regional SRI groups in several major cities around the country. There are also newsletters and research organizations. Effectively all of these are listed in the Social Investment Forum's **Guide**. The Forum is located at PO Box 57216, Washington, D.C. 20037, telephone 202-833-5522.

The **Interfaith Center for Corporate Responsibility (ICCR)** is a coalition of religious investors using proxy resolutions to pressure corporations to change their behavior, and engaging in Alternative Investing. Many members of ICCR have invested in credit unions, banks and loan funds in Indian Country. Address: Room 560, 475 Riverside Drive, New York, NY 10115, telephone 212-870-2316.

For information about tribal investing and alternative investments in Indian Country, write or call **First Nations Development Institute** at The Stores Building, 11917 Main Street, Fredericksburg, VA 22408, 703-371-5615.

For basic information about financial concepts, you might check with local business colleges and universities.

13 Additional Concepts

Basis points: In everyday life, the difference between 8.10% and 8.11% is not very great. But with large sums of money, that one-hundredth of a percent becomes significant. So investors have given it a name: a basis point. It is one hundredth of a percent. You can also think of it as one percent of one percent. It is used often in quoting bond prices.

Compounding: This is commonly known as earning interest on interest. If you invest \$100 at 5% interest, you earn \$5 and you've got \$105 at the end of a year. In the second year, you earn 5% of \$105, or \$5.25, and end the year with \$110.25. That extra 25 cents comes from compounding. It means that even if you don't invest any more money, and even if interest rates don't rise, your account and your interest earnings will continue to grow by larger and larger amounts every year.

Coupon: This is the amount of interest an owner of a bond receives. The coupon divided by the current market value is the yield. The term coupon refers to small coupons that were once attached to bonds. At stated times, those coupons were clipped off the bonds and redeemed for the interest. Now, few bonds have actual coupons, but the term is still used for the amount of interest paid.

Rule of 72: This shows the relationship between interest rates and the number of years it takes to double your money. Dividing the interest rate into 72 will give you the number of years it will take to double your money. For example, an 8% return will double your money in 9 years. If you get 10%, you'll lower your doubling time to 7.2 years. [It is important to note that this rule assumes compounding.] It also works the other way: dividing the number of years in which you want to double your money into 72 gives you the interest rate you need. So if you want to double your money in 5 years, you have to earn 14.4% ($72/5 = 14.4$).

Appendix: Investment Management for Smaller Amounts

Many tribes and Indian organizations do not have millions and millions of dollars to invest. Even if you have a small investment account, you can still use the principles and techniques described in this book to plan, select and monitor your investments, just as the largest pension funds do. These basic steps still apply.

1. Plan how and when you will use the money or the returns it generates
2. Develop your Investment Policy Statement
3. Select your investments
4. Monitor your investments

There are, however, several important differences. They have to do with whether to use mutual funds or investment advisers, the greater importance of diversification and risk reduction, and whether and how to use consultants.

Mutual funds or investment advisers? Small portfolios may not be able to access professional investment advisers. Many investment advisers require a minimum portfolio of \$1 million or even \$5 million to manage. Since you may want to diversify your investments among several managers, it will be even harder to meet their minimums. And be careful with investment advisers who will manage smaller portfolios, because the fees on small portfolios are so low that those portfolios may not get the attention that they should.

Mutual funds are a good alternative for small portfolios (and also useful for larger portfolios). Mutual funds, as discussed in the section on mutual funds in *The Investment Industry*, also charge fees, but these fees are usually less for relatively small amounts of money than fees charged by investment advisers. Index mutual funds have lower management fees than most advisers. And sales fees for mutual funds can be avoided by investing in no-load funds.

More diversification and less risk. Diversification and risk-minimization are important no matter how much money is involved, but they require slightly different approaches when smaller amounts of money are involved.

If you invest directly in individual securities, stocks or bonds, it is more difficult to achieve sufficient diversification with capital less than, say, \$1 million. You need at least 20 securities and 30 is better to be well diversified, and you need to make sure that they don't all move in the same direction at the same time. In that case, they wouldn't be diversified. It's easier to diversify a small amount of money by investing in several mutual funds, because they already have a great deal of diversification built into them.

Also, with less money to invest, it becomes more important to minimize risk, even if that may require giving up some chances for higher returns. The reason is simple and psychological. Any decline in your asset value will hurt more if you have \$10,000 than if you have \$50 million. A 10% decline leaves only \$9,000 in one case, and \$45 million in the other, but the folks with \$9,000 left will often feel worse. Most tribes or organizations will feel any loss more keenly when they have less money, and so they need to create a mechanism to reduce or otherwise handle risk and volatility.

Consultants. Consultants can be very important and useful in helping institutional investors develop and implement investment strategies, but they can be expensive for an investor with small amounts of money. A consultant fee of \$5,000 is a small percentage of a portfolio of \$1 million (0.5%), but a substantially larger percentage of a portfolio of \$200,000 (2.5%). Still, a consultant can be well worth it if you get from the consultant an effective asset allocation and investment strategy. Moreover, it is just a one-time fee, not one you have to pay every year. And 2.5% is about the same size as a sales commission on stocks.

A mutual fund family or a stock broker might be able to do some of your consulting work for you, although you'll have to be careful of potential conflicts of interest. A consultant can tailor an investment program directly to your needs and tribal structure. One way to keep the fee low is to do as much as possible of the consulting work in-house, with your own staff. Explain to the consultant how you want to proceed, and ask what work you can do yourselves. With a good computer, good data, and good advice, you should be able to do a great deal of the work yourself.

Finally, remember that a good consultant, like a good doctor, might be worth a little more.

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