Steven G. Blum and Associates LLC

Serving individuals and families by guiding them through every aspect of their financial lives.

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Dear Clients and Friends,

As always, our goal is to make this both useful and pleasurable for you to read. Your feedback is actively solicited; let us know what will make this newsletter better for you.

IS IT POSSIBLE? THE EMPEROR HAS NO CLOTHES?

We have been conditioned to believe (through relentless advertising campaigns) that the key to investing is choosing the right stocks. We need to study individual companies to decide which stocks will perform best. And it makes intuitive sense to us: to learn which stock or bond will do better, we must read and study, or pay someone else to do it for us.

Our only problem is that this method doesn't work. Economic studies have shown clearly that such research does not make it any more likely that an investor will choose better performing stocks. Truth is, it probably can't be done.

How can this be? Let's look at one of my favorite examples to try to explain the concept. Which is a better company, Kmart or Wal-Mart? The answer is clear with little research needed: Wal-Mart is the most financially successful retailer in history with Kmart having recently emerged from bankruptcy. So, which one's stock will perform better next year? It will help us to realize that the stock market has already assigned prices to the two stocks that take into account the relative values of the two companies. The market price recently valued Wal-Mart as being 300 times more valuable than Kmart. Which company's stock will perform better in the coming year, therefore, will be determined by some surprise – either positive or negative – that will occur sometime in the future. By definition, a surprise event sometime in the future tends to be unpredictable. Thus the answer to our question is that, notwithstanding lots of research, nobody knows which stock will perform better next year.

"That can't be right", many people say. Some stock pickers (or mutual find managers, or stock brokers), do pick stocks and beat the averages. Some people really do seem to be quite good at it. Here's where the science comes in: after we remove probability, randomness, and plain old luck, most of the Wall Street "superstars" are shown to be just average folks. In any given year, of course, some pickers will do better than average (and some will do worse) …but this is more a demonstration of mathematical probability (chance) than of any unique talent. After all, everybody wins a coin flip about half the time- and in any large group there are one or two people who get "heads" many times in a row- no talent in that.

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The idea that markets price stocks correctly and thus make individual "stock picking" almost useless is called the "random walk" theory. Almost all real economists believe some version of it. If you want to learn more about it an excellent book is *A Random Walk Down Wall Street* by Princeton Professor Burton G. Malkiel. If you'd rather not do more reading, though, that's ok: the principle can be put to work for your benefit without understanding it further.

It stands to reason that if researching and picking individual stocks is without value, then paying someone (either directly or indirectly) to do it is really folly. And some Wall Street firms charge big money to pick stocks for you – per trade commissions, brokerage "spreads", 5% sales charges and annual operating expenses are just the half of it. Yet they are charging big fees for a service that economic science suggests is of no value. You can achieve significant increases in your investment returns just by avoiding these types of "services".

If stock picking has no value why would a rational investor seek any professional guidance at all? The answer lies in a series of other services that can add real value to your bottom line: diversification, asset allocation, investment, tax planning and coordination of investment risk with other risks in your life. There are plenty of valuable services that financial professionals can perform for you – but picking individual stocks or mutual funds is probably not one of them. So be careful in choosing your Professional Advisors: A company that pushes an expensive service that has little or no value can hardly be trusted to put your interests first when offering other, more worthwhile, financial services.

One more benefit of avoiding such companies – you won't have to turn your head away in embarrassment when you see that their man or woman, talking about which stocks to buy or sell, is standing there utterly naked

ASK MARY

by Mary Q. Bonfini, CPA

What are the tax consequences for a donor and recipient in the case of gifts of cash or other property?

Under current tax law, a donor can make gifts of cash or property in the amount of $11,000 (for 2004) to an unlimited number of recipients during a calendar year completely tax free. Couples can combine their annual exclusions, meaning they can give away $22,000 per calendar year per recipient. Should a gift be given in excess of the applicable exclusions, the donor would be required to file a gift tax return but still would not have to pay a gift tax until the cumulative lifetime taxable gifts exceed the applicable exclusion amount ($1,000,000 as of 2004). (It should be noted that gifts such as gifts between spouses, charitable gifts and direct payment of medical and tuition are excluded from the gift tax requirements.)

For the recipient, gifts you receive in the form of cash or property are not taxable unless that gift produces income. Thus, any cash gifts you receive are not taxable. If you receive gifts of appreciated property and choose to sell it, your basis (or cost for tax purposes), for calculating capital gains tax is the same basis that the donor originally had. If the donor was required to pay gift tax, the recipient's basis is increased by the amount of gift tax paid related to that gift.

If you receive property as an inheritance, you get what is called a "stepped-up basis" for tax purposes. What this means is that your basis is established at the fair market value of the property on the date of death of your relative.