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Buffett Suggests Using Stocks to Preserve Purchasing Power

Legendary investor Warren Buffett delights in standing conventional wisdom on its head. In his latest attack on orthodoxy, he questions whether we should define investment "safety" as "low fluctuation of principal."

As usual, Buffett nails the problem quite succinctly. Rather than measuring risk by how much a potential investment might fluctuate in value, he argues that investors should concentrate on whether an investment has a "reasoned probability" that it will not cause a loss of purchasing power over time.

Buffett says stocks are the best way to preserve and increase purchasing power over time, while fixed income investments are not. "A nonfluctuating asset can be laden with risk," he writes.

Value destroyers

In an article in Fortune magazine adapted from Buffett's recent shareholder letter, he laid out the argument against bonds and for stocks. Currency-based investments (such as bank deposits, bonds and money market funds) are usually thought to be safe. "In truth they are among the most dangerous of assets," Buffett writes. "Over the past century these instruments have destroyed the purchasing power of investors in many countries, even as these holders continued to receive timely payments of interest and principal."

How does this happen? It is the twin effects of inflation (in essence, government devaluation of its currency, he says) and income taxes on interest. Buffett notes that it takes $7 today to buy the same goods and services that could be purchased for $1 in 1965.

If a currency-based investment pays an interest rate that is too low to keep up with inflation after the interest is taxed, the holder of that investment will suffer a loss of purchasing power. Sometimes interest rates will be high enough to compensate for inflation, as they were in the early 1980s, but today's rates are very low and "bonds should come with a warning label," Buffett says.

Forget about gold

He also dismisses gold as a store of value. "Gold, however, has two significant shortcomings, being neither of much use nor procreative," Buffett writes.

Gold prices go up due to fear and enthusiasm. "As 'bandwagon' investors join any party, they create their own truth – for a while." Eventually gold prices will form a bubble, and they will pop just as home prices did in 2008 and internet stocks did in 2000, according to Buffett.

Compound growth

Those who want their capital to grow should invest in productive assets like businesses, farms, or real estate. "Ideally, these assets should have the ability in inflationary times to deliver output that will retain its purchasing power value while requiring a minimum of new capital equipment," Buffett says. Consumer products companies, he says, will do just that, while others, such as regulated electric and gas utilities, won't because they have heavy capital requirements.

Productive businesses, however, are like cash cows, delivering greater quantities of "milk" over the years. "Proceeds from the sale of the milk will compound" just as the Dow Jones Industrial Average went from 66 to 11,497 during the 20th century. Buffett says stocks will be the runaway winners in the future, and "by far the safest."

Heritage Investment Group would like to thank all of our clients for their continued support. If you have any friends or family members who could benefit from our disciplined investment process, we would welcome the opportunity to speak with them. Please contact us at (954)785-5400.

Heritage Investment Group
www.heritageinvestment.com

2480 N.E. 23rd Street
Pompano Beach, FL 33062
Phone: 954.785.5400
Fax: 954.933.0966

115 South Fielding Avenue
Tampa, FL 33606
Phone: 813.258.1759
Fax: 813.254.3756

1540 International Pkwy., Ste. 2000
Lake Mary, FL 32746
Phone: 407.536.5370
Fax: 407.536.5301

Avoid Taxes by Delaying Social Security

> *"For middle-income retirees there is a bonus: a potential lower overall tax bite."*

The benefits of delaying Social Security are potentially large. Each month of delay after age 62 adds to the lifetime benefit, and a larger lifetime benefit gets a bigger boost each year from inflation adjustments. For middle-income retirees there is a bonus: a potential lower overall tax bite.

For most workers, full retirement age ranges from age 66 to 67, depending on when the worker was born. Anyone can claim a reduced benefit as early as age 62, and anyone can delay their benefit to as late as age 70.

The eight percent bump

Any worker born after 1943 who reaches full retirement age but delays taking benefits gets an eight percent increase for each year of delay until reaching age 70. So a retiree who is entitled to $2,000 a month in benefits at her full retirement age of 66 can delay until age 70 and instead get $2,640 per month, a difference of $7,680 per year. However, if that same retiree took Social Security at age 62, it would be reduced by 25 percent to $1,500 per month.

Delaying benefits may have another advantage for middle-income retirees: It will help them avoid some of the tax bump that subjects large amounts of Social Security to income taxation. Social Security benefits are tax free for a couple who has "provisional income" of less than $32,000. The trick here is the definition of income: it includes the usual taxable amounts, such as pension benefits, withdrawals from IRAs, capital gains and taxable interest, but also tax-free interest and one-half of the retiree's Social Security benefit. As soon as provisional income exceeds $32,000, then 50 percent of the Social Security benefit is taxed. Once it exceeds $44,000, then 85 percent of Social Security is taxed.

Use IRA earlier

A retiree who takes larger distributions from retirement savings early in retirement while delaying taking Social Security potentially could save money on taxes. Once the retiree collects Social Security, the benefit may be big enough that smaller withdrawals will need to be taken from tax-deferred accounts. That would allow the retiree to reduce or avoid altogether any taxes on the Social Security benefits. A lesser-earning spouse whose benefit is determined by the level of the higher earning spouse also comes out ahead if the spouse delays benefits.

As with any financial strategy, your optimal Social Security strategy will depend to a great extent on your own personal circumstances. Delaying Social Security could be beneficial to you, but you should review these ideas with your tax advisor and your financial advisor before making any decisions.

Bards of the Bar

As a topic of conversation, investing is like sports: Everyone has an opinion. And the strongest opinions often come from those who spend more time in front of the TV than out on the field.

Professionals, meanwhile, are wary of anything labeled a sure thing. Indeed, it is one of life's ironies that the people who know the least about a subject sound the most sure of themselves. In investing, these are the folks who occupy bar stools, telling anyone who will listen that they have found the path to certain wealth. These pub philosophers tend either to be permanent bulls or permanent bears about the market. They have their standard story, and they adapt the facts to fit. Some of them even end up writing newspaper columns and hosting television shows.

By contrast, some of the world's most respected and seasoned investors strike a humbler tone, having learned from personal experience about the unpredictability of markets. Instead of trying to predict future returns, they focus on things within their control. Take, for instance, the frequently heard line that smart investors should seek to time their entry points into the markets and wait for the volatility to clear. We are hearing a lot of that this year as the European crisis is dominating market attention.

Writing about this in 1979 before one of the biggest bull markets in history, Warren Buffett said, "Before reaching for that crutch (market timing), face up to two unpleasant facts: The future is never clear [and] you pay a very high price for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values."

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Another line from the pub philosophers is that the job of an investment expert is to spot the best market-beating returns and harvest them before someone else finds out. Asked about this in 2007, two years before his death, legendary investment consultant and historian Peter Bernstein said it was better to focus on risk than return. "The central role of risk, if anything, has grown rather than diminished," he said. "We really can't manage returns because we don't know what they're going to be. The only way we can play the game is to decide what kinds of risk we're going to take."

A third perennial pub conversation is the role of stock picking in investment success. The line here is that the key to wealth building lies in painstakingly analyzing individual stocks and buying them based on a forecast or even a hunch about their prospects.

Prompted by a newspaper reporter for his opinion on that piece of conventional wisdom, Charles Ellis, long-time Wall Street observer and the founder of Greenwich Associates, said the truth was actually quite the opposite. "The best way to achieve long-term success is not in stock picking and not in market timing and not even in changing portfolio strategy," Ellis said. "Sure, these approaches all have their current heroes and war stories, but few hero investors last for long and not all the war stories are entirely true. The great pathway to long-term success comes via sound, sustained investment policy, setting the right asset mix and holding onto it."

While that is probably not the kind of message you are likely to hear from the instant experts who occupy your local bar, it is a more durable and a more useful one.

This article was adapted, with permission, from Parker, Jim, "Bards of the Bar" November 30, 2011.

Why Do Mutual Fund Investors Keep Chasing Active Funds?

Objective mutual fund performance studies have shown time and again that passive, indexed mutual funds beat their more expensive actively-managed cousins. If that is true, why do investors still overwhelmingly buy active funds rather than passive funds?

> *"Investors might overestimate their ability to identify outperforming funds."*

Only about 10 percent of the assets invested in mutual funds has gone into passive, indexed funds, says the industry's trade group, the Investment Company Institute. The vast majority of individual investors' money has gone into funds that actively pick and choose which investments to buy based on the fund manager's outlook for the economy, the markets, and individual industries and companies.

Literate but overconfident

German university professors Sebastian Müller and Martin Weber studied 3,000 mutual fund investors to see if there was any relation between the investors' financial literacy and their purchases of passive versus active mutual funds. "Given the limited value that these funds seem to offer to their shareholders and the size of the fees they charge, current academic wisdom suggests implementing a simple passive investment strategy based on well-diversified, low-cost fund alternatives."

They expected that investors who had lower financial literacy would be influenced by salespeople and advertising to buy active funds. They were surprised to find, however, that although financially literate investors were more aware that passive indexed funds were a better deal, the majority continued to plunk their money into active funds.

"One possible explanation for this result lies in the overconfidence phenomenon," Müller and Weber write. "Investors might overestimate their ability to identify outperforming funds."

They said they found a positive relation between the investors' belief in their own ability to identify superior investments and the likelihood that they would buy actively-managed funds. But since active funds do not tend to perform any better than passive funds, these sophisticated investors in essence outsmarted themselves by being overconfident.

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