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SPECIAL ISSUE on Wealth Management

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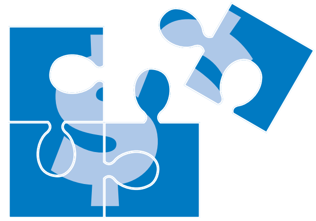
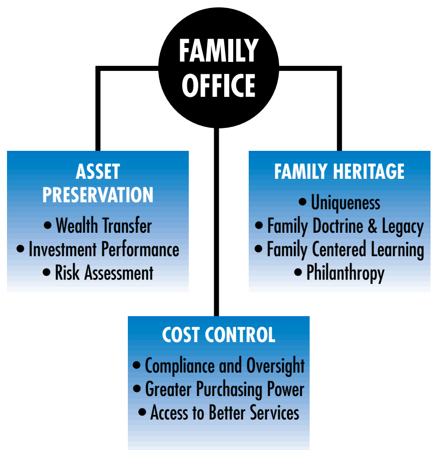
A SECOND FAMILY BUSINESS: WEALTH MANAGEMENT



Entrepreneurs who have enjoyed the challenge of building a family business often feel unprepared when, upon the sale of the business or diversification of significant business assets, they find themselves in the "wealth preservation" business. Many families have said they wouldn't consider selling their business because they wouldn't know what to do with the money if they did sell! Nevertheless, a growing number of business owners are beginning to understand that there are important advantages to sheltering some of their assets from the core business and are using a "family office" as the vehicle for coordinating all of the family's wealth management needs.



ADVANTAGES OF A DEDICATED FAMILY OFFICE

Hundreds of families who have sold operating businesses or invested substantial cash outside the business have formed family offices. Family offices had their origins among the most private family groups in Europe, where estates passed from fathers to eldest sons. Wealth was defined by vast land holdings over centuries. In the United States, the industrial revolution produced fortunes of a new order, and families like the Rockefellers, the Vanderbilts, and the Phipps evolved to diversify the wealth.

Today, the family office serves most effectively for families as a place to centralize the management of financial affairs. Where family liquidity is being managed inside the operating business, financial managers often juggle dual roles: personal investment manager and company financial manager. For both the company and the family, there is benefit in releasing company managers from overseeing personal affairs. Most families with assets of more than $50 million choose to start a dedicated wealth management office that provides professional management. Sometimes it is because the family needs unique services not offered by other alternatives, but often it is because the family wants access to a dedicated staff who will care for their needs first.

Some families discover that stronger family ties develop for future generations when there is a dedicated office, which results in a unique sense of family identity. In this environment, customized educational programs can be developed for family members who have common interests and investment goals. Family offices also offer important leadership roles for family members who may choose to serve on the Board of Directors or even work as paid employees in the family office.

WEALTH MANAGEMENT SERVICES

What are the important services that need to be performed by a family office? The services offered by a family office are always tied to the unique goals of that family group. However, Family Office Exchange's research with more than 400 families in the last seven years has identified three categories of commonly provided services: strategic, tactical, and personal. Strategic services typically require family member input while tactical and personal services are often delegated to a technician for implementation.

Strategic Services are those which contribute the most to the long-term preservation of wealth. Strategic services offered by family offices include:

▶ ***Wealth Transfer Planning*** provides the strategies and techniques needed to transfer wealth to younger generations with minimum tax consequences. This is an issue often postponed by business owners because it involves planning for future events that will be outside their control. Unfortunately, families that do not resolve their transfer plans are often left with turmoil and internal conflict when the business owner dies.

▶ ***Financial and Tax Planning*** involve the development and execution of financial plans for each family client and sets strategies for "tax intelligent" investing.

▶ ***Investment Goals, Policy, and Asset Allocation*** guide the diversification plan developed for the family assets. Institutional research shows that 75 percent to 90 percent of investment performance is determined by the asset allocation selected – not from the money managers chosen. Some families make asset allocation decisions as a family group (the top-down approach) while others allow each family member to choose a custom asset allocation profile (the bottom-up approach).

▶ ***Philanthropic Goals*** identify personal and family priorities related to charitable and community endeavors. Family offices may provide support to the family's philanthropic goals by providing trustee and grant-making support and administrative services.

▶ ***Family Unity and Financial Education*** are important components of the "family glue" that hold the family together. Making financial education a priority and attending scheduled educational meetings are essential for family members to learn about issues and alternatives that will affect their wealth. Eventually, the education process can serve to involve more family in decision-making and teach them to be the next generation of leaders.

Tactical Services include day-to-day activities required for fiduciary oversight and compliance. Each of these services supports the strategic services discussed above.

One of the many advantages of the family office is the pooled purchase of services, which

(See WEALTH MANAGEMENT on page 4.)

ALTERNATIVE INVESTMENTS

Alternative investments encompass a broad spectrum of non-traditional investment strategies that include both hedge funds and private equity.

HEDGE FUNDS

Hedge funds' edge over traditional retail investments and mutual funds stems from their opportunistic nature. Hedge fund managers can use leverage, sell securities short, take large positions, invest across asset classes and security types, and generally work in areas not populated by the herd. Many managers employ strategies whose returns are largely insulated from the vagaries of market movements. Historically, returns from alternative investments have had little correlation with traditional investment strategies or markets.

The private investor must first determine the role alternative investments should play in the overall investment program.

In formulating an asset allocation strategy the private investor must first determine the role alternative investments should play in the overall investment program. Defining the investor's objectives in terms of return requirements and risk tolerance is critical. By evaluating the investor's personal situation with regard to these factors, one can customize the investment program to meet the specific needs of that investor. While some families allocate all of their "marketable securities" investments to hedge funds, it is more common for alternative investments to comprise, at a minimum, 10-20 percent of one's asset allocation.

The limited partnership structure of most hedge funds provides investment flexibility, but also poses significant challenges to the due diligence process. It is crucial for family office professionals to develop the tools necessary for evaluating funds based upon their investment strategies, personnel, and general business plans. If the family office chooses not to develop the expertise in-house, engaging an alternative investment professional should be considered the price of entry of these investments.

Sophisticated computer programs are frequently used in the manager evaluation process. Analysis of the returns provides data that are used to compare various strategies and managers based on risk/return measures. However, it is not advisable to use quantitative analysis as a crutch in place of sound qualitative analysis. The simplicity of transforming art into science provides investors with a false sense of security. Further, the utility of statistical analysis is completely dependent upon the extrapolation of trends. Relying solely on this type of analysis is not prudent. Understanding the strategy and the people employing it are of far greater value when assessing the investment risk involved.

Operating one's own investment pool of alternative managers can be problematic as most families lack sufficient resources, expertise, and/or stamina to stay the course. For many investors, once the decision to hire the managers is made, little attention is paid to ongoing due diligence. Simply tracking the manager's performance is not sufficient. The importance of maintaining regular contact with the managers, as well as their peers, competitors, service providers, brokers and other investors should not be underestimated. A commitment to information gathering will better position the family office to monitor managers' exposures, leverage, and diversification.

Unlike traditional investments, Hedge Funds require a distinct due diligence process that must be undertaken by market professionals. It is the combination of these elements that should enable families to articulate their investment directives into a successful alternative investment program. Only through keen product differentiation are families able to establish realistic investment expectations.

PRIVATE EQUITY

The importance of private equity as a source of funds for companies that either cannot or do not wish to raise capital in the public market has increased steadily in recent years. The explosive growth of the private equity market translates into increased opportunities for investors and greater access to capital for companies.

Despite its growth, private equity has received relatively little attention from press and academic circles. The availability of information regarding private equity is still limited. However, investors can benefit from arbitrage opportunities between private and public markets. Private equity has historically been a venue for higher rates of return than other asset classes.

The highest returns came to those partnerships formed during periods when little capital was raised. This relationship is intuitively correct under the principles of supply and demand. When little capital is available, funds become more expensive. Companies are forced to give up higher ownership percentages. At the same time limited partnerships can be more selective in choosing portfolio companies, thereby making better investments.

The explosive growth of the private equity market translates into increased opportunities for investors.

Higher levels of commitments are triggered by favorable exit conditions. Hot IPO market and copious mergers/acquisitions provide high valuation and liquidity to private equity investors. The hot IPO markets of 1991-93 produced high returns on private equity investments. This, in turn, sparked a record number of commitments in 1994. This high level of commitments introduces new uncertainties to the private equity market. The U.S. private equity market has recently been deluged with investor capital; effectively there are more players with more capital chasing a fixed number of deals. As the U.S. becomes saturated with capital, investors seeking superior rates of return and the diversification benefits of private equity must look to international and emerging markets.

The supply of capital in Europe remains limited. Since European public stock markets are still underdeveloped, most companies must turn to private equity. Opportunities for high rates of return are especially abundant in formerly communist countries since the living standards and wage levels remain relatively low. This allows companies to begin operations at lower costs. Investments in these areas may be better served than investments in high-wage countries such as Germany and Switzerland. Potential rewards are, however, always associated with risks. Many governments are struggling to entice foreign investment and offer attractive incentives, but investors must be wary.

The economies of emerging markets are generating significant interest as growth rates uniformly outpace Western countries. Latin Americans and Asians are demanding more consumer goods as living standards improve. The benefits of Latin America's comprehensive economic and political reforms can now be reaped. The continent offers many of the same opportunities as Europe with continually improving fundamentals, falling inflation rates, and rising foreign investment. Infrastructures have been modernized while wages remain low. Africa is currently steering away from command economies and toward capitalism. This shift will open new doors for foreign investment. Private equity allows investors to purchase securities at low price/earnings ratios; typically 2 to 5 percent. Privately negotiated deals offer the most compelling opportunities to access the emerging parts of the world.

The same factors that influence private equity returns in the U.S., do so globally. Investors should, therefore, focus on markets with a capital deficit. Today, Europe is the obvious choice for international private equity investments. The continent lacks capital, much as the U.S. did in the 70s. The European private equity market could, therefore, parallel the development of its U.S. counterpart. With proper due diligence by industry experts, private equity investors in Europe can expect to see the spectacular returns associated with lacking capital and hot IPOs. Best of all, these returns have a low correlation to traditional assets. Private equity, namely international private equity, is an important addition to a global, diversified portfolio.

James Hedges is managing director of LJH Global Investments, Inc., an alternative investment consulting firm based in Naples, Florida, advising $1.2 billion of non-traditional investments for high net worth investors and families.

LIFE INSURANCE FOR YOUR HEDGE FUND

Hedge fund life insurance has the potential of eliminating income tax on hedge fund earnings, and with proper estate planning, even eliminating estate taxes at the death of the insured.

WHAT IS HEDGE FUND INSURANCE?

Hedge fund life insurance is life insurance with a separately invested account for that policy's cash value. With hedge fund insurance, the investor can purchase an insurance policy in which the cash value is invested in one or more hedge funds. The hedge fund's returns increase the cash value, without any reduction for income tax. The cost in some policies can average as low as 1% to 2% of cash value each year.

Assuming the insurance policy is respected for tax purposes, the growth in the fund will not be subject to current income tax, and if the policy is maintained until the death of the insured, the entire death benefit with all the earnings from the hedge fund is free of income taxes.

EXAMPLE OF BENEFITS

The hypothetical chart below compares the return on a hedge fund life insurance policy against a taxable investment at various ages. The chart assumes a 12% return per year on the hedge fund investment. The taxable account column assumes a 35% tax rate (a blended rate assuming part ordinary and short-term capital gain and part long-term capital gain).

Age	Single Premium	End of Year Cash Value	Death Benefit (including cash value)	Taxable Account (at 35% rate)
50	$ 5,000,000	$ 5,398,996	$ 17,782,027	$ 5,390,000
53		6,561,573	17,782,027	6,263,632
60		13,594,803	18,217,036	10,596,382
70		39,928,676	46,317,264	22,456,663
80		117,942,390	123,839,720	47,591,877
90		343,582,426	360,761,548	100,860,340

The chart shows that the death benefit in the hypothetical case greatly exceeds the taxable account value at all ages. Obviously, the after-tax benefit of the insurance policy would be substantially higher if the average returns on the hedge fund investment exceeded 12%, and would be lower if the average returns were less than 12%. The tax benefit would be even higher if the investor's tax rate were more than 35%. Marginal tax rates for many hedge fund investors are between 40% and 50%.

ASSET PROTECTION

An additional benefit of the insurance policy is that insurance is generally a good form of asset protection. The funds in the separate account of the insurance company are generally not exposed to creditor's claims against the insurer. Also, the separate account is generally protected from the claims of creditors of the policy owner.

ESTATE PLANNING

Hedge fund life insurance useful in estate planning because it combines the estate and gift tax planning benefits of hedge fund returns with life insurance. Life insurance is frequently purchased by an irrevocable trust, either existing or created in connection with the purchase of the life insurance. Properly structured, the death benefit, including all the income tax free earnings on the cash value invested in hedge funds, can escape estate taxes on the death of the insured and spouse and possibly the generation-skipping tax on the death of the policy holder's children. Since each of these federal taxes can be as high as 55%, the tax savings could be substantial.

Proper estate planning may minimize the gift tax incurred in setting up such a trust. If such an irrevocable trust with sufficient assets to purchase the hedge fund life insurance does not already exist, gift tax obligations may have to be incurred to receive the estate and generation-skipping tax advantages. To the extent gift tax must be paid, it is important to remember that any gift tax paid before the tax free build up is much less than the gift or estate tax after the build up, and that gift tax is generally one-third less expensive than estate tax.

HEDGE FUND INSURANCE IS NOT FOR EVERYONE

Since insurance companies often require $20 million to open a separate account and $1 million in premiums for each policy, this strategy is generally appropriate only for very wealthy individuals or families. Hedge fund life insurance is best for someone who expects not to withdraw the cash value from the insurance prior to the policy holder's death or at least is planning not to need it for a long time. Although the cash value of such policies can be withdrawn at any time, the earnings on the cash withdrawal are taxed as ordinary income at the time of the withdrawal. Additionally they also may be subject to a 10% excise tax. If the policy is held long enough, the tax benefit of the deferral of income tax, even if subject to an excise tax, is likely to make the purchase of the life insurance policy (or of a similar, variable annuity policy) beneficial. But the benefit is certainly not nearly as great as the complete exemption from income tax.

Generally, only investors who really want to invest in hedge funds would purchase hedge fund life insurance. Because the costs of maintaining the policy and the at-risk life insurance, the return on the cash value invested in the hedge fund should average at least 5% for the after-tax return to be better than a direct investment in the hedge fund. If the cost of the at-risk life insurance is not considered a cost, because the insured needs this insurance coverage anyway for personal or estate planning reasons, even returns on the hedge fund investment of less than 3% may result in a better after-tax return than a direct investment in the hedge fund.

INVESTOR CONTROL

The investor control issue is one of the trickiest issues related to this type of policy since if the policyholder has too much investor control; the IRS might claim that the investor should be taxed on the earnings currently.

Although the lack of investor control may be a problem, the degree of control permitted varies from policy to policy. The tax-free build up, the income tax free death benefit, and the estate tax-free payment at death make hedge fund life insurance very attractive to certain wealthy investors, especially those with life insurance needs.

BENEFITS FOR HEDGE FUND MANAGERS

Hedge fund life insurance provides potential benefits for hedge funds and their managers. Funds placed in the insurance policy are likely to grow faster, since income tax does not have to be paid, and are less likely to be withdrawn or switched to another hedge fund or other investments. Some hedge fund insurance policies provide a way for managers to allow up to one hundred additional investors to invest in the fund as a group.

Hedge fund managers may also be interested in investing in the hedge fund life insurance themselves. However, there are some limitations on hedge fund managers investing in a policy for which that manager will control the investment of the cash values.

Although hedge fund life insurance is not for everyone, in the right circumstances, it can provide very significant benefits to policyholder investors and hedge fund managers.

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Article adapted from Lookout Mountain Hedge Fund Review *with permission.*

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WEALTH MANAGEMENT (Continued from page 1.)

provides family members with increased buying power. A family office facilitates the combined purchasing of financial services from bankers, money managers, accountants, consultants, and financial and estate planners. Pooled purchase of services can also result in broader investment opportunities for family members.

The majority of day-to-day activities in the family office are accounting and financial functions. The typical family office coordinates financial records and shareholder information for each family member. The family office also monitors the family's investment portfolio by using a variety of tools, including portfolio modeling, time-weighted/dollar-weighted returns, risk/volatility measurements, and benchmarking to measure investment performance. Trust accounting and income tax compliance – typical functions of the family office – often offset a large portion of the cost of the family office via savings on external fees. Depending on the needs of the family, other services could involve offshore trusts and family investment partnerships.

Personal Services vary by office but can include bill paying, payroll, accounting for domestic employees, and property management. Personal services are usually optional for family members and are billed on an hourly basis.

The founding family determines the family office's role in the wealth preservation process. Its success is dependent upon the clarity of the family mission, consensus on its purpose, and the expertise of the professional staff selected to lead the office. In nearly every instance, the benefits provided by the office far outweigh the costs – whether it is educating the younger generation, setting the investment policy, or coordinating financial decisions that some family members view as burdens.

Sara Hamilton is founder and president of Family Office Exchange in Chicago, which runs an industry association for family offices and advises families on wealth management issues.

SPECIAL EDITION

We interrupt our regular format of *ReLATIVELY Speaking* to introduce our first ever, "Special Edition." Publications, like businesses, must from time to time experiment with new ideas or in our case, a new concept. All of the dedicated warriors that help produce *ReLATIVELY Speaking* believe in the adage, "If it ain't broke, break it." Hopefully during the afterglow of this issue, your feedback will help guide future "Special Editions."

Since the birth of *ReLATIVELY Speaking* in 1995, we have received numerous calls and letters from readers wanting our thoughts or information relating to the topic of wealth: how to keep it, how to manage it, how to pass it on, how to choose between philanthropy choices, how to select investment managers, how to minimize the tax bite, etc. In our work as consultants to family businesses, we routinely help guide clients in all of these areas to professionals that match their specific needs.

For this issue we set out to interview dozens of professionals that have successfully built their businesses from helping others manage their wealth. From these interviews, we selected recognized professionals to write about a wide range of wealth issues. Many thanks to all the contributing authors as well as The Northern Trust Company, Dallas, Texas and Gerber/Taylor Associates, Memphis, Tennessee.

Look for us to return to our regular format with the August issue. In the meantime, please write, call, or email us with your comments, protest or praise. We look forward to continuing a tradition of meeting your family business needs.

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A WALL STREET LEGEND

Charles E. Merrill was born in 1885 in a small hamlet outside Jacksonville, Florida. As a young man, while Henry Ford was making the Model T automobile as a consumer product for the masses, Merrill was becoming convinced that stocks and bonds could be marketed as consumer products as well.

Merrill won his first big account in 1912, working for Burr & Company when he helped Kresge sell $2 million in preferred stock. It was in doing so that he discovered a new retailing phenomenon in the process. Chain stores were just beginning to proliferate. He recognized that this new retailing idea would change the way Americans would shop.

AN AMERICAN PROFILE

With his early success and a burning desire to be his own boss, Merrill in partnership with Edmund Lynch, opened his own brokerage house in 1914 at 7 Wall Street. While most Wall Street executives disdained chain stores as a passing fad, Merrill recognized them as the future of American shopping. In the decades that followed World War I, Merrill amassed a fortune specializing in the public sales of grocery stores, department chain stores, and other retailers.

In the late 1920s, the clouds of impending disaster were beginning to loom large on the financial horizon, and Merrill sensed it. He advised all his clients to *"take advantage of the present high prices and put your own financial house in order."* Although his dire predictions alienated him from much of the financial community, his prophecies were vindicated in October of 1929. While the crash bankrupted many brokerage firms, Merrill-Lynch remained solvent.

It took years for the country's economy to recover following the Depression, but Merrill was still preaching the gospel of marketing stocks and bonds to the average American. As Merrill put it: *"We must bring Wall Street to Main Street, and we must use the efficient, mass merchandising methods of the chain store to do it."*

Merrill believed that the key was public trust and education. He began to build his business on the conviction that educated consumers would be more willing to invest. He plowed substantial amounts of money into advertising and easy-to-read information pamphlets, and it paid off handsomely.

In the 1950s the growth of the stock market encouraged small investors to invest as an act of patriotism. Soon the public was buying stock on installment, and they were doing so through the dozens of small branch offices Merrill had placed throughout America. The New York Stock Exchange census estimated that over half a million people were becoming new stockholders each year.

As more and more Americans began to move their assets out of low-interest savings accounts and into the stock and bond markets, the number of individual shareholders grew to 8.6 million by 1956. Merrill died that year in his eighties, a Wall Street legend.

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NON-TRADITIONAL INVESTING CAN ENHANCE RETURNS

The art of investing involves devising forecasts of future conditions which may influence the success or failure of investments. Many investment managers claim the ability to predict such future conditions, but individual investors have to decide that for themselves.

It is far less difficult for investors to analyze the past than to foretell the future. A great deal of historical information is available from many sources in all industries and most companies. From these sources of information, investors can learn a great deal. On the other hand, there is only a very small collection of relevant information about the future.

Just finding relevant and valuable data for predictive purposes is a formidable challenge. Let me show you what I mean: Assume that you wanted to identify the best performing stock in the S&P 500 over the past forty years. From today's vantage point, investors have a number of advantages. First, we know that the stock is probably one of the larger stocks in the S&P Index. Knowing that, we can immediately narrow the search to less than one hundred issues. Next, we can review the successful technological innovations of the past four decades and the industries that suffered from excessive competition, overzealous regulation, or poor capital structure. Knowing these facts considerably narrows the possible candidates. You will discover that there are still 40 or 50 possible candidates.

Some will be surprised to learn that the best performing stock of the past four decades was Philip Morris. When you consider the industry as a whole, most investors might believe that Philip Morris operates in a declining market. While this may be true in the domestic market, the international market is a different story. Who could have predicted the international growth of the Marlboro brand forty or even ten years ago? Philip Morris has faced the threat of potentially devastating litigation for well over a decade. And for this reason, most analysts would not recommend such a company as a good investment.

Philip Morris owes much of its success to its acquisition strategy. Most acquisitions tend to be failures. In fact, the Philip Morris acquisitions strategy was an effort to diversify away from its dependence on tobacco and into the food industry. Since acquisitions outside the core industry expertise of a company usually fail, Philip Morris should logically be a poor choice.

My point is this. If it is so difficult to analyze the past; it must be even more difficult to identify the best performing stocks of the future. This is the great paradox of traditional investing. Investors are forced to rely on factors that are difficult to quantify or describe.

Non-traditional investing uses tangible or quantifiable factors in the investment decision process. For instance, it is extremely difficult to anticipate the future growth rate of any business enterprise. However, if the investment were made in the form of a high-yield bond or a high-yield convertible security, it is a different story. As long as the company generates sufficient cash to service its debt, the investor will receive a defined rate of return at worst. Moreover, if the security contains an equity conver-

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PAYING ESTATE TAXES DOESN'T HAVE TO BE A BURDEN TO HEIRS

Are you planning to leave behind a business, stocks, real estate, or other investments for your family? If you are not careful, you may leave them with the heavy burden of coming up with cash to pay estate taxes.

Estate planning can usually mitigate estate taxes when the first spouse dies, but after the surviving spouse's death, estate taxes can cost the heirs more than 55 percent of the estate's value.

One way to alleviate the difficulty of paying these taxes is through a life insurance policy commonly referred to as "second-to-die" or survivorship insurance. This type of policy insures both the husband and wife, but pays off only at the death of the surviving spouse. Because the mortality risk is spread over two lives, the cost may be substantially lower than the cost of providing the same coverage for one.

After deciding to purchase "second-to-die" insurance, the next step is to create an irrevocable life insurance trust so that the trust is the applicant, the owner, and the beneficiary of the policy. Holding the policy in a trust allows for greater flexibility in determining how the insurance proceeds are used. The trust could include provisions that direct the insurance proceeds for the payment of estate taxes and other estate obligations. This may be accomplished by giving the trustee discretion to purchase estate assets or to lend money to the estate. Generally, the trustee pays the insurance premiums through the annual contributions made to the trust by the insured. The trust can be structured so that the gift taxes on these contributions are minimized.

This strategy is beneficial if a large part of the decedent's estate is made up of real estate, stock in a family business, or other assets that the family wants to retain. The insurance proceeds can be channeled to the estate from the trust in exchange for the assets of the estate. This not only solves the potential liquidity problems caused by the estate tax, but it also allows the insurance proceeds to avoid estate tax. And since life insurance proceeds are excluded from income tax, this is an added benefit.

Although these benefits are important, holding insurance in trust has its drawbacks. First, the insured must give up ownership of the policy. And second, the insurance can neither be payable to the insured nor for the benefit of the estate. The insured loses some control of the policy, including the right to change the designation of the beneficiary. In light of the possible change in parents' attitudes towards their children, this aspect should be carefully weighed.

As with any investment, the potential benefits must be compared with the projected costs and possible alternatives. In situations where proceeds are needed at the death of the first spouse, purchasing separate policies may be advisable. Whether or not you should create a life insurance trust is a question that should only be answered on a case-by-case basis.

(Continued from page 5.)

sion feature or warrant attachment, there is the potential for a supplementary return over and above the base case. However, the equity return will never detract from the base or defined return.

Security returns are somewhat indeterminable in non-traditional investing. There is, however, at least some definable return expectation. The logic of such investing is that by removing some of the uncertainty from security returns, the risk is lowered. Security returns are enhanced by lowering the risk. Unfortunately, these security returns are "mean geometric." In other words, risk or volatility always works against the investor. Here's a hypothetical example:

Assume that you are comparing the performance of two portfolios over two years. Let's also assume that each portfolio suffers a loss in the second year equal to half the return in the first year. That means that if "Portfolio A" attains returns of 100 percent in the first year and a negative 50 percent in the second, the cumulative return of "Portfolio A" is zero.

Now, let's also assume that "Portfolio B" is less volatile than "Portfolio A" and that its returns for the first and second years are 15 percent and negative 7.5 percent, respectively. In this case, the result is that the cumulative return of "Portfolio B" is a positive 6.375 percent. Thus, the less volatile "Portfolio B" performance is superior to the more volatile "Portfolio A." Moreover, such differences in returns often are more pronounced as the time period expands. It is interesting to note that if the two portfolio examples above had the same returns for eight more years, "Portfolio A" would have a cumulative ten-year return of zero while the ten-year cumulative return of "Portfolio B" would be over 36 percent. This is known as the "Volatility Paradox," or Siegel's Paradox.

Non-traditional investors are highly sensitive to risk. But sometimes in their effort to lower or at least control risk, they may actually enhance returns. This partially explains the excellent returns non-traditional investing has been able to provide investors over the years.

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