Johnston Investment Counsel

Trusted Fiduciaries & Fee-Only Advisors

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Protecting Yourself from Investment Scamsters

Bernie Madoff may have gone to jail, but if you think we've seen the last of fraudulent investment schemes, you could be setting yourself up to become the next victim. Stronger regulations are in the works, but there are some basic steps you can take to help protect yourself and your family.

Know where your money is going

One of the reasons Madoff was able to avoid exposure for so long was that his firm acted as both investment advisor and custodian of his clients' assets. His clients wrote their checks directly to Madoff's firm rather than to an independent custodian. As a result, there was no outside verification of whether he was actually making the trades he claimed. Checks should generally be written directly to a custodian firm that also is involved in processing your account statements.

Know where your money's going, part 2

Don't invest purely on the basis of returns; understand what you're investing in. Because people were so anxious to invest with Madoff, he was able to deflect questions about how he achieved his results (a fairly simple process, as it turned out--he lied). Most of Madoff's investors didn't know or care what a split-strike conversion was as long as it supposedly produced the returns Madoff promised (people who did understand the strategy were the first to question whether his returns were real). You don't have to become an investment genius to have a fundamental grasp of what you're invested in, how it works, and what the potential risks and rewards are.

Web resources

The FINRA website (www.finra.org) has two interactive tools to help you spot potential investing red flags. The Scam Meter asks a series of questions about an investment to assess whether it might literally be too good to be true. The Risk Meter reviews behaviors and personality traits that make some investors more likely to be victimized.

Do your homework

A recommendation from an acquaintance may be a good starting point for research, but it shouldn't be the sole factor in your decision-making process when choosing investments or an investment professional. Being popular or well-known doesn't necessarily make someone the right person to handle your finances.

Though it might not have red-flagged Madoff, Form ADV can provide background information about a registered investment advisor. Part 1 of the form can be found at www.adviserinfo.sec.gov; Part 2 must be supplied directly by the advisor and includes information on services, fees, and investment strategies. The Financial Industry Regulatory Authority (FINRA) website's BrokerCheck allows you to confirm broker licensing and check on any history of disciplinary problems. Information about insurance professionals is available from the individual states.

Take advantage of multiple resources

Madoff used reverse psychology; the more difficult he made it for people to invest with him, the more they wanted to do so. If you question or don't understand advice from one financial professional, you should feel free to consult someone who can help you make sense of what's being proposed for your money. You might also want to consider using multiple investment managers, each of which may specialize in a specific investing style or asset class.

Finding the Right Financial Professional

At some point in our lives, many of us turn to a financial professional for help with financial matters. Charting a course with a professional to reach your financial goals can be an exciting adventure, but it shouldn't have to be a blind leap of faith. Before you commit to a long-term relationship, here are some things to think about.

Credentials and area of expertise

Take a look at the credentials of any financial professional you're considering. What degrees, licenses, certifications, and/or financial designations, if any, has he or she earned? These may depend on the professional's area of expertise.

Speaking of expertise, you should find out whether the financial professional concentrates his or her practice in a particular area, or whether he or she has a more broad-based practice. Maybe you're looking for someone with expertise in a particular area, such as business succession planning or investing in real estate and commodities. Or perhaps you want someone who will look at every aspect of your financial situation--from budgets, to saving for college and retirement, to insurance coverage, to tax planning, to estate planning. Obviously, you'll want to make sure that the person you'll be working with has experience in the financial areas for which you're seeking advice or works with other professionals who do.

A good communicator

A financial professional should take the time to fully understand your goals, and do a good job of explaining the proposed approach to meeting those goals.

Experience and reputation

While experience is important, a long track record isn't worth much if it isn't a good one. Even if you get a recommendation from family or friends, you can't be sure how thoroughly they did their research or how their circumstances might be different from yours in subtle but important ways.

If the person you're considering is a Registered Investment Advisor (RIA), you can ask him or her for a copy of Form ADV, which reviews an advisor's background, services, fees, and any disciplinary actions. Similarly, the Financial Industry Regulatory Authority (FINRA) has a BrokerCheck section on its website, www.finra.org, that allows you to check an investment broker's licensing, registration, and any history of disciplinary problems.

Communication skills

A relationship with your financial professional is an ongoing one. To adapt your changing financial circumstances and preferences to the ever-changing, complex world of financial regulation and products, a financial professional must communicate with you over and over again. So you'll want to find someone who is both a good listener and responsive to your needs.

After your initial meeting, ask yourself these questions:

- Did he or she take the time to fully understand my goals, and do a good job of explaining the proposed approach to meeting those goals?
- Will we be able to meet or speak regularly about my portfolio or other issues that may arise?
- Will my e-mail and/or phone calls be promptly answered?

After you've had a few conversations, review your interactions. Is the individual you're considering a thoughtful listener who answers questions patiently and objectively? A good financial professional will put together and implement a viable plan to match your expressed financial goals.

Fair compensation

Financial advice isn't free. All financial professionals get paid and deserve to be fairly compensated. Your job is to make sure you understand how your financial professional is paid. Some are fee-only--their compensation depends entirely on the services they perform. They may be paid by the hour, by the project, or on a percentage of assets managed. But others get at least some of their income from commissions, which are based on the investments they sell. Compare the various compensation alternatives and consider the one with which you are most comfortable.

Conclusion

Before you spend time, energy, and money investing in a long-term relationship with a financial professional, make sure you feel comfortable with the person you've chosen to help you navigate the financial world. Trust your instincts, and remember, you are in control.

Homeward Bound: Investing in the American Dream

Your home is more than a shelter, it's a sanctuary from the world around you. It's also a daycare center, restaurant, laundry facility, and entertainment complex all rolled into one. And for some, it's a status symbol. But is it an investment?

Just a few years ago, with home prices steadily increasing, the answer might have seemed obvious. But recent double-digit annual declines in housing prices have--not surprisingly--led to a chorus of calls to rethink the way homeownership is viewed. Your home, you might hear, is just a place to live, not an investment. The truth is that even if your primary motivation for owning a home isn't financial, your home qualifies as an investment.

The profit motive

An investment can be defined as a purchase or an allocation of dollars with the intention of generating income or profit. Certainly, if you purchased your home with the intent of fixing it up and "flipping" it, your home would qualify as an investment under this definition. Even if your primary motivation for buying a home is the enjoyment the home provides, however, your home has characteristics that make it an investment--it generates current "income" and provides potential profit in the form of long-term appreciation.

Your home generates income

If you didn't own a home, you would be paying rent. If you own your home outright (i.e., you don't have a mortgage), the value of what you would otherwise be paying in rent might be considered a type of "income" that your home generates each and every month.

Similarly, if you have a mortgage, each payment you make is offset by the value of this generated income. For example, let's say that each month you make a mortgage payment of $2,500. If it would cost you $2,000 each month to rent a comparable home, the incremental cost of buying rather than renting is $500. In effect, you're paying $2,500 each month for your home, but receiving an immediate income benefit of $2,000 each month.

Another consideration: while rent can increase (or decrease) from year to year, most homeowners (at least those with fixed mortgages) will make the same monthly payments over the term of their mortgage. And mortgages have a finite term--you'll eventually own your home outright and will continue to benefit from the generated rental income thereafter.

Of course, equating your home to an income-producing asset is more complicated than we're describing here. A detailed analysis might account for factors like home maintenance costs and property taxes, as well as tax breaks associated with homeownership.

Potential for appreciation

When you purchase a home (and you may own several over the course of a lifetime), getting the best value for your money is usually a concern. Although you may not purchase a home with the intent of flipping it for a profit in the short term, you probably expect that your home will appreciate over the long term. The future value of your home is important, whether you hope to sell your home some day, or intend to leave your home to your children.

In addition to expecting your home to appreciate in value over the long term, if you have a mortgage, you probably anticipate building wealth through equity as you pay down the mortgage. With each mortgage payment you make, more and more money (equity) is potentially available to you to use toward future goals or to serve as a financial safety net in retirement.

That's not to say that a home is necessarily the most *efficient* way to accumulate wealth. Depending on where you live, and how long you intend to reside in your home, you might come out ahead financially by renting and investing the dollars you save by doing so. The point is, that as bleak as the current housing market is, over the long term, you probably view your home as a relatively safe vehicle for wealth accumulation. As with any investment, that expectation may or may not be reflected in actual performance over time.

The bottom line

Your home is likely your single largest investment asset, playing a critical role in the overall accumulation of wealth during your lifetime. But, as is the case with all investments, whether owning a home is the most efficient allocation of your dollars depends in part on your expectations and tolerance for risk.

Since 1987, when the Case-Shiller index of 10 major cities begins, it's risen from an index value of 63 to 151. Annual return: Just 4.1% per year. During that period, according to the Bureau of Labor Statistics, consumer prices rose by 3% a year. Net result: Home prices produced a real return of just 1.15% a year over inflation over that time.

Brett Arends, **Is Your Home a Good Investment?** ***WSJ, May 27, 2009.***

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LIFE THE WAY YOU PLANNED IT.

Ask the Experts

Can I change investments in my 529 plan account?

The short answer is yes. During the stock market declines of 2008-2009, many 529 plan participants made investment changes in their accounts. But the rules for doing so depend on whether the change is for *future* contributions or *existing* contributions.

Future contributions. Typically, most 529 plans allow you to change your investment allocations for your future contributions at any time. Some plans let you do this online in a matter of minutes, while other plans require you to mail in a form with your new investment preferences. (Note that this seemingly inconsequential difference may be an important one if you want to act quickly.)

Existing contributions. The rules are more restrictive when it comes to changing investment allocations for your existing contributions. Generally, under federal law, 529 plans are permitted (but not required) to allow you to change the investment allocations for your existing contributions once per calendar year. But for 2009 only, 529 plans may allow you to do so twice per year. (No word yet on whether the IRS will extend this "twice-per-year" rule to 2010 and beyond, though the 529 industry is sure to lobby for it.)

If you've already made two investment changes this year but want to make another, there is a workaround: most 529 plans allow you to change your investment allocations for your existing contributions whenever you change the beneficiary of the account.

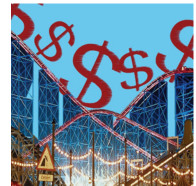
But if you don't want to change the beneficiary of your account and you're still unhappy with your investment allocations, you have one more option: you can jump ship to a different 529 plan. Under federal law, you can roll over your existing 529 plan account to a new 529 plan (college savings plan or prepaid tuition plan) once every 12 months without any federal tax penalty and without having to change the beneficiary.

I am a conservative investor. Is a 529 plan a good way to save for college?

It can be. The investment options for 529 college savings plans have broadened dramatically since their inception in 1996. And with the market turmoil of the past year, many states have expanded the conservative investment options in their 529 college savings plans as more families look to protect their college savings from financial risk.

For example, Colorado is offering a stable value fund in its 529 plan paying 3.35% interest through the end of 2009, and a few other states are offering principal-plus-interest options that guarantee a minimum rate of interest while protecting your principal. And as 529 account holders funnel more money into conservative investment options, the list of states offering such options in their 529 college savings plans is likely to grow.

You might be asking why you should bother with a 529 plan when you could earn a comparable rate of interest on your own. Well, even if you could earn a similar rate outside of a 529 plan, you would generally have to pay income taxes on the earned interest at ordinary income tax rates. By contrast, any interest and capital gains earned in a 529 plan account are completely free of federal (and typically state) income tax, provided the withdrawal is used for the beneficiary's qualified education expenses. However, any withdrawal not used for such expenses is subject to income tax and a penalty.



***Note:** Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.*